FINANCIAL ANALYSIS AND REPORTING

Semester – IV

18BAU403A **4H – 3C**

Instruction Hours / week: L: 4 T: 0 P : 0 **Marks: Internal: 40 External: 60 Total: 100**

End Semester Exam: 3 Hours

COURSE OBJECTIVES:

To make the students

1. To Understand the Concept of Financial reporting standards, difference between IFRS and IAS and the users of the financial statements for the decision making.
2. To understand and apply tools and techniques to analyse the financial statement analysis.
3. To critically evaluate the results of the tools applied, interpret the result.
4. To communicate orally and in written form the financial statement analysis, and results interpretation of the results.
5. To utilize the knowledge of financial statement analysis for lifelong practice.

COURSE OUTCOMES:

Learners should be able to

1. Comprehendthe Concept of Financial reporting standards, difference between IFRS and IAS and the users of the financial statements for the decision making.
2. Understand and apply tools and techniques to analyse the financial statement analysis.
3. Critically evaluate the results of the tools applied, interpret the result.
4. Communicate orally and in written form the financial statement analysis, and results interpretation of the results.

UNIT I : FINANCIAL REPORTING

Accounting Standards, Accounting Standards Interpretations and Guidance Notes on various accounting aspects issued by the ICAI and their applications.

Overview of International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS)- Interpretations by International Financial Reporting Interpretation Committee (IFRIC), Significant difference vis-a-vis IAS and IFRS.

Corporate Financial Reporting – Issues and problems with special reference to published financial statements

UNIT II FINANCIAL STATEMENTS - AN INTRODUCTION

Traditional Assumptions of the Accounting Model :Business Entity -Going Concern or Continuity - Time Period - Monetary Unit - Historical Cost - Conservatism - Realization - Matching - Consistency - Full Disclosure - Materiality - Industry Practices - Transaction Approach - Cash Basis - Accrual Basis

The Financial Statements :Balance Sheet (Statement of Financial Position) - Statement of Stockholders' Equity (Reconciliation of Stockholders' Equity Accounts) - Income Statement (Statement of Earnings) - Statement of Cash Flows (Statement of Inflows and Outflows of Cash)

Auditor's Opinion :Auditor's Report on the Firm's Internal Controls - Report of Management on Internal Control over Financial Reporting

Basic Elements of the Balance Sheet :Assets - Liabilities - Stockholders' Equity - Quasi-Reorganization - Accumulated Other Comprehensive Income - Equity-Oriented Deferred Compensation - Employee Stock Ownership Plans (ESOPs) - Treasury Stock - Stockholders' Equity in Unincorporated Firms
Basic Elements of the Income Statement :Net Sales (Revenues) • Cost of Goods Sold (Cost of Sales) • Other Operating Revenue • Operating Expenses • Other Income or Expense

UNIT III FINANCIAL ANALYSIS – 1
Common-Size Analysis (Vertical and Horizontal), Year-to-Year Change Analysis

Ratio Analysis - Liquidity of Short-Term Assets
Current Assets, Current Liabilities, and the Operating Cycle
Cash - Marketable Securities - Receivables - Inventories - Prepayments - Other Current Assets - Current Liabilities
Current Assets Compared with Current Liabilities
Working Capital - Current Ratio - Acid-Test Ratio (Quick Ratio) -Cash Ratio
Income Statement Consideration when Determining Long-Term
Debt-Paying Ability- Times Interest Earned
Balance Sheet Consideration when Determining Long-Term
Debt-Paying Ability
Debt Ratio - Debt/Equity Ratio

UNIT IV FINANCIAL ANALYSIS - 2

Profitability Measures
Net Profit Margin - Total Asset Turnover - Return on Assets - DuPont Return on Assets - Interpretation Through DuPont Analysis - Variation in Computation of DuPont Ratios Considering Only Operating Accounts - Operating Income Margin - Operating Asset Turnover - Return on Operating Assets - Sales to Fixed Assets - Return on Investment (ROI) - Return on Total Equity - Return on Common Equity - The Relationship Between Profitability Ratios - Gross Profit Margin
For the Investors
Earnings per Common Share, Price/Earnings Ratio, Dividend Payout, Dividend Yield
Book Value per Share

Basic Elements of the Statement of Cash Flows
Financial Ratios and the Statement of Cash Flows
Operating Cash Flow/Current Maturities of Long-Term Debt and Current Notes - Payable - Operating Cash Flow/Total Debt - Operating Cash Flow per Share - Operating Cash Flow/Cash Dividends

UNIT V *THE USERS OF FINANCIAL STATEMENTS*
*Financial Ratios as Perceived by Commercial Loan Departments :*Most Significant Ratios and Their Primary Measure • Ratios Appearing Most Frequently in Loan Agreements.
*Financial Ratios as Perceived by Corporate Controllers :*Most Significant Ratios and Their Primary Measure • Key Financial Ratios Included as Corporate Objectives

Financial Ratios as Perceived by Certified Public Accountants
Financial Ratios as Perceived by Chartered Financial Analysts
Financial Ratios Used in Annual Reports

Note: Distribution of marks - 40% theory and 60% problems

SUGGESTED READINGS:

1. Subramanyam, K. R. and John, J.W.(2014), "Financial Statement Analysis", 10th Edition, Tata McGraw Hill, New Delhi.
2. Stephen H. Penman(2014) "Financial Statement Analysis and Security Valuation", 4th Edition, Tata McGraw Hill, New Delhi.
3. M.S Narasimhan (2016), Financial Statement Analysis, 1st Edition, Cengage Learning India Private Limited, New Delhi.
4. Charles H. Gibson (2013), Financial Statement Analysis, 13th edition, Cengage Learning India Private Limited, New Delhi.
5. Lawrence Revsine , Daniel Collins , Bruce Johnson , Fred Mittelstaedt , Leonard Soffer (2015), Financial Reporting and Analysis, 6th Edition, McGraw-Hill Education, New Delhi.
6. Deepa Agarwal (2017), Financial Reporting and Auditors Responsibility, 2nd edition, Bloomsbury Professional India, New Delhi.
7. Deepa Agarwal (2018), The Law & Practice of Financial Reporting and Auditor's Responsibilities under Companies Act, 2013,1st edition, Bloomsbury Professional India, New Delhi.

KARPAGAM ACADEMY OF HIGHER EDUCATION
(Deemed to be University)
(Established under section 3 of UGC Act 1956)
Coimbatore-641021
Department of Management (UG)

Name : Dr. M.Usha **Department : Management**
Course Code : 18BAU403A **Semester: IV** **Year : 2018-21 Batch**
Course : Financial Analysis and Reporting LESSON PLAN

UNIT I			
SI.No	**Lecture Hours**	**Contents**	**References**
1	1	Financial Reporting: Basis of financial reporting Meaning and Introduction of financial Reporting, Objectives of financial reporting Elements and Nature of Reporting	T: Pg.No.: 2-7
2	1	Accounting Standards Interpretations and Guidance Notes on various aspect issued by the ICAI and their applications	R1: Pg.No.: 13-14
3	1	Financial Statement: Meaning Difference between Financial reporting and Statement	R1: Pg.No.: 15-17
4	1	Overview of International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS)	R1: Pg.No.: 17-19
5	1	Interpretations by International Financial Reporting Interpretation Committee (IFRIC)	R2: Pg.No.: 21-23
6	1	Significant difference between IAS and IFRS Main users of financial reporting – Investors, Employee, Lenders, Management, Competitors and Government Agencies	T: Pg.No.: 11-15
7	1	Corporate Financial Reporting Issues and problems with special reference to published financial statements	R2: Pg.No.: 45-46 W1
8	1	Recapitulation and discussion of important questions	
Total number of hours planned for Unit I			**8**

UNIT II			
SI.No	**Lecture Hours**	**Contents**	**References**
1	1	Financial Statement: Meaning Objectives of financial statements Structure of financial statements	T : Pg.No.: 1-3
2	1	Traditional Assumptions of the Accounting Model : Business Entity, Going Concern or Continuity, Time Period, Monetary Unit, Historical Cost	R 2: Pg.No.: 1 – 4
3	1	Traditional Assumptions of the Accounting Model : Conservatism: Realization, Matching, Consistency, Full Disclosure, Materiality, Industry Practices, Transaction Approach, Cash Basis , Accrual Basis	T: Pg.No.: 4-5
4	1	The Financial Statements :Balance Sheet (Statement of Financial Position) Statement of Stockholder's Equity (Reconciliation of Stockholder's Equity Accounts) Income Statement (Statement of Earnings) - Statement of Cash Flows (Statement of Inflows and Outflows of Cash)	T: Pg.No.: 5-7
5	1	Auditors Report on the firm's internal controls Report of Management on Internal control over financial reporting	W2
6	1	Basic Elements of the Balance Sheet : Assets, Liabilities, Stockholders' Equity, Quasi, Reorganization, Accumulated other comprehensive income, Equity Oriented Deferred Compensation, Employee Stock Ownership Plans (ESOPs), Treasury Stock, Stockholders Equity in Unincorporated firms	R 2: Pg.No.: 7 - 10
7	1	Basic Elements of the Income Statement : Net Sales (Revenues), Cost of Goods Sold, Operating Revenues and Expenses	T: Pg.No.:8-15
8	1	Recapitulation and discussion of important questions	
Total number of hours planned for Unit II			**8**

UNIT III			
SI.No	**Lecture Hours**	**Contents**	**References**
1	1	Financial Analysis: Common-Size Analysis (Vertical and Horizontal), Year-to-Year Change	R1: Pg.No.: 204-210
2	1	Ratio Analysis: Meaning and importance of ratio analysis, Advantages and limitations of ratio analysis	R1: Pg.No.: 211-213
3	1	Liquidity ratio analysis: Current Assets, Current Liabilities, and the Operating Cycle Cash, Marketable Securities, Receivables, Inventories, Prepayments, Other Current Assets, Current Liabilities	R1: Pg.No.: 214-215 W2
4	1	Current Assets Compared with Current Liabilities, Working Capital, Current Ratio, Acid-Test Ratio (Quick Ratio), Cash Ratio	R1: Pg.No.: 215-216
5	1	Income Statement Consideration when Determining Long-Term, Debt-Paying Ability-Times Interest Earned\	R1: Pg.No.: 216-217
6	1	Balance Sheet Consideration when Determining Long-Term, Debt-Paying Ability	T: Pg.No.: 146-147
7	1	Debt Ratio - Debt/Equity Ratio Activity/Turnover ratio analysis Profitability ratio analysis Financial statement variation by type of industry	T: Pg.No.: 150-155 W3
8	1	Recapitulation and discussion of important questions	
Total number of hours planned for Unit III			**8**

UNIT IV			
SI.No	**Lecture Hours**	**Contents**	**References**
1	1	Financial Analysis : Profitability Measures Net Profit Margin, Total Asset Turnover, Return on Assets, DuPont Return on Assets, Interpretation Through DuPont Analysis	R2: Pg.No.: 188-190
2	1	Variation in Computation of DuPont Ratios Considering Only Operating Accounts , Operating Income Margin, Operating Asset Turnover, Return on Operating Assets, Sales to Fixed Assets	R2: Pg.No.: 191-193
3	1	Return on Investment (ROI) , Return on Total Equity, Return on Common Equity, The Relationship Between Profitability Ratios, Gross Profit Margin For the Investors	R2: Pg.No.: 194-195
4	1	Earnings per Common Share, Price/Earnings Ratio, Dividend Pay-out, Dividend Yield Book Value per Share	R2: Pg.No.: 195-196
5	1	Basic Elements of the Statement of Cash Flows Financial Ratios and the Statement of Cash Flows	T: Pg.No.: 183-185
6	1	Operating Cash Flow/Current Maturities of Long-Term Debt and Current Notes , Payable	T: Pg.No.: 185-189 W4
7	1	Operating Cash Flow/Total Debt, Operating Cash Flow per Share, Operating Cash Flow/Cash Dividends, Financial ratios used in Annual reports, International Financial Reporting Standards (IFRS) basic framework	R1: Pg.No.: 451-452
8	1	Recapitulation and discussion of important questions	
Total number of hours planned for Unit IV			**8**

UNIT V			
SI.No	**Lecture Hours**	**Contents**	**References**
1	1	The users of Financial Statements: Internal Users and External Users: Owners and investors, management, suppliers, lenders, employees, customers, the government, and the general public.	R4: Pg.No.: 195-200
2	1	Four main financial statements: Balance sheets, Income statements, Cash flow statements and Statements of shareholders' equity. Financial Ratios as Perceived by Commercial Loan Departments, Most Significant Ratios and their primary measure, Ratios appearing most frequently in loan agreements	R4: Pg.No.: 200-204
3	1	Financial ratios as perceived by corporate controllers : Most significant ratios and their primary measure, Key financial ratios included as corporate objectives	R4: Pg.No.: 45-47
4	1	Financial Ratios as Perceived by Certified Public Accountants, Financial Ratios as Perceived by Chartered Financial Analysts, Financial Ratios Used in Annual Reports\	R4: Pg.No.: 47-57
5	1	Recapitulation and discussion of important questions	
Total No. of Hours Planned for Unit – V			**5**
6	1	Discussion of previous ESE Question papers	
7	1	Discussion of previous ESE Question papers	
8	1	Discussion of previous ESE Question papers	**3**
Total No. of Hours Planned for Unit – V & Previous ESE Question Papers Discussion			**08**

SUGGESTED READINGS:

TEXT BOOK

T1: Grewal, T.S (2018), Introduction to Accounting, (3rd ed.) Sultan Chand & Co, New Delhi.

REFERENCES

R1: Subramanyam, K.R and John, J.W. (2018), Financial Statement Analysis, (10th ed.), Tata McGraw Hill, New Delhi.

R2: Maheshwari S.N (2018) , An Introduction to Accountancy, (5th ed.), Vikas Publishing House Pvt.Ltd. New Delhi.

R3: M.S Narasimhan (2017), Financial Statement Analysis, 1st Edition, Cengage Learning India Private Limited, New Delhi.

R4: Deepa Agarwal (2017), Financial Reporting and Auditors Responsibility, 2nd edition, Bloomsbury Professional India, New Delhi.

WEBSITES

W1: www. edupristine.com/blog/financial-reporting/

W2: www.patriotsoftware.com/

W3: www.kfkknowledgebank.kalpana.co.uk/kfka/

W4: www.cleartax.in/s/auditreport/

W5: www.mca.gov.in/searchable-act/schedule3.htm

UNIT-I

SYLLABUS

FINANCIAL REPORTING: Accounting Standards, Accounting Standards Interpretations and Guidance Notes on various accounting aspects issued by the ICAI and their applications. Overview of International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS)- Interpretations by International Financial Reporting Interpretation Committee (IFRIC), Significant difference vis-a-vis IAS and IFRS.

Corporate Financial Reporting Issues and problems with special reference to published financial statements

FINANCIAL REPORTING:

FINANCIAL STATEMENT

Definition

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

FINANCIAL REPORTING

Meaning:

Financial reporting is the process of producing statements that disclose an organization's financial status to management, investors and the government.

In any industry, whether manufacturing or service, we have multiple departments, which function day in day out to achieve organizational goals. The functioning of these departments may or may not be interdependent, but at the end of day they are linked together by one common thread – Accounting & Finance department. The accounting & financial aspects of each and every department are recorded and are reported to various stakeholders. There are two different types of reporting – Financial reporting for various stakeholders & Management Reporting for internal Management of an organization. Both these reporting are important and are integral part of Accounting & reporting system of an organization. But considering the number of stakeholders involved and statutory & other regulatory requirements, Financial Reporting is very important and critical task of an organization. It is vital part of Corporate Governance. Let's discuss about various aspects of Financial Reporting in following paragraphs.

Definition of Financial Reporting

Financial Reporting involves the disclosure of financial information to the various stakeholders about the financial performance and financial position of the organization over a specified period of time. These stakeholders include – investors, creditors, public, debt providers, governments & government agencies. In case of listed companies the frequency of financial reporting is quarterly & annual.

Financial Reporting is usually considered as end product of Accounting.

The typical components of financial reporting are:

1. The financial statements – **Balance Sheet**, **Profit & loss account**, **Cash flow statement** & **Statement of changes in stock holder's equity**
2. The **notes** to **financial statements**
3. **Quarterly** & A**nnual reports** (in case of listed companies)
4. **Prospectus** (In case of companies going for IPOs) Any prospectus issued to potential investors concerning the issuance of securities by the organization
5. **Management Discussion & Analysis** (In case of public companies)

The Government and the Institute of Chartered Accounts of India (ICAI) have issued various accounting standards & guidance notes which are applied for the purpose of financial reporting. This ensures uniformity across various diversified industries when they prepare & present their financial statements. Now let's discuss about the objectives & purposes of financial reporting.

OBJECTIVES OF FINANCIAL REPORTING

According to International Accounting Standard Board (IASB), the objective of financial reporting is "to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions."

The following points sum up the objectives & purposes of financial reporting –

- Providing information to management of an organization which is used for the purpose of planning, analysis, benchmarking and decision making.
- Providing information to investors, promoters, debt provider and creditors which is used to enable them to male rational and prudent decisions regarding investment, credit etc.
- Providing information to shareholders & public at large in case of listed companies about various aspects of an organization.
- Providing information about the economic resources of an organization, claims to those resources (liabilities & owner's equity) and how these resources and claims have undergone change over a period of time.
- Providing information as to how an organization is procuring & using various resources.
- Providing information to various stakeholders regarding performance management of an organization as to how diligently & ethically they are discharging their fiduciary duties & responsibilities.
- Providing information to the statutory auditors which in turn facilitates audit.
- Enhancing social welfare by looking into the interest of employees, trade union & Government.

IMPORTANCE OF FINANCIAL REPORTING

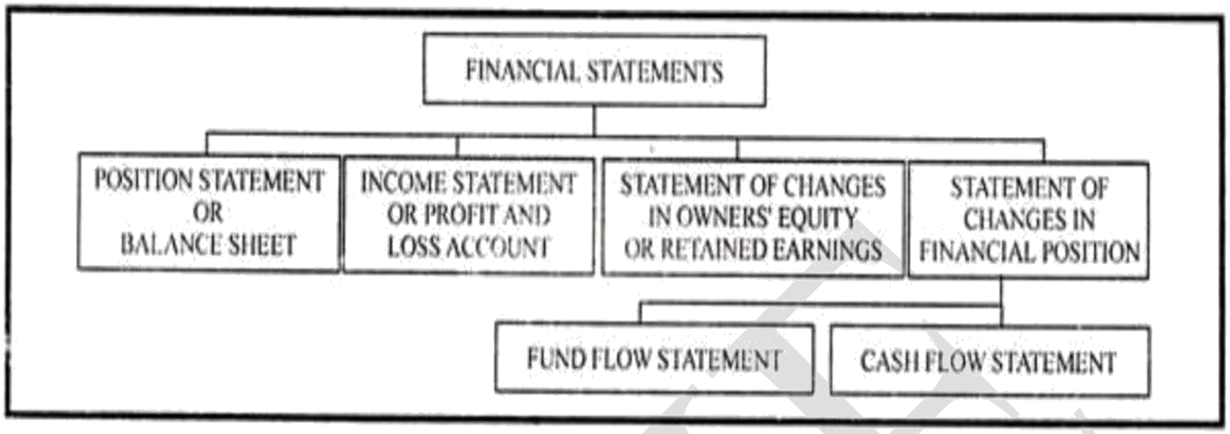
The importance of financial reporting cannot be over emphasized. It is required by each and every stakeholder for multiple reasons & purposes. The following points highlights why financial reporting framework is important –

- In helps and organization to comply with various statues and regulatory requirements. The organizations are required to file financial statements to ROC, Government Agencies. In case of listed companies, quarterly as well as annual results are required to be filed to stock exchanges and published.
- It facilitates statutory audit. The Statutory auditors are required to audit the financial statements of an organization to express their opinion.
- Financial Reports forms backbone for financial planning, analysis, bench marking and decision making. These are used for above purposes by various stakeholders.
- Financial reporting helps organizations to raise capital both domestic as well as overseas.
- On the basis of financials, the public in large can analyze the performance of the organization as well as of its management.
- For the purpose of bidding, labor contract, government supplies etc., organizations are required to furnish their financial reports & statements.

COMPONENTS OF IMPORTANT FINANCIAL STATEMENTS

Components of a financial statement can be described as the building blocks used for constructing the financial statement and these items represent, in words and numbers, various resources, claims to those resources, and any transactions that create changes in those resources and claims.

Below is a list of components of the most important financial statements – balance sheet, profit and loss (P&L) statement and cash flow statement – and their importance.



1. Balance Sheet

Balance Sheet is a statement of the assets, liabilities, and capital of an organization at one particular point in time. This statement gives an idea as to what the company owns and owes and also the amount of shareholding. The critical components of this statement are as below.

Assets:

An asset can be tangible or intangible and is often owned or controlled with the belief that it would provide some future benefit and can be tangible or intangible. While the former includes current assets and fixed assets, the latter refers to rights and other non physical resources that provide value to the business. Current assets consist of inventory, accounts receivables and other short term investments. Fixed assets could be buildings, equipment and other physical resources. Intangible assets usually include goodwill, copyright, trademarks and patents.

Liabilities:

Liabilities are a company's legal debts or obligations that might arise during the course of business operations. These are usually settled over time through the transfer of economic benefits like cash, goods or services. Liabilities include accounts payable, salaries or wages payable, interest due, customer deposits and other such obligations to third parties. Liabilities might be of two types – current or long term. While the former could be liquidated within a year, the latter can be repaid only in the long term (more than a year). Long-term liabilities include long-term bonds issued by the firm, notes payables, leases, pension obligations, and long-term product warranties.

Equity or owner's equity:

It is the residual assets of an entity that remain after deducting liabilities. Theoretically, this is the capital available for distribution to shareholders. Hence, from a company's liquidation perspective, equity would be considered the residual claim on the assets of a business, available to shareholders, after liabilities have been paid. For instance, if Company X has Rs. 3,000,000 as assets and Rs.800,000 as liabilities, then equity would be Rs.2,200,000 (=Rs.3,000,000 – Rs.800,000). Equity usually comprises funds contributed by shareholders, reserves and retained earnings. Therefore, the only way to increase the amount of owners' equity is by either getting more funds from investors or by increasing profits.

2. Profit and Loss Statement OR Income statement:

Income Statement:

An income statement is one of the three important financial statements used for reporting a company's financial performance over a specific accounting period, with the other two key statements being the balance sheet and the statement of cash flows. Also known as the profit and loss statement or the statement of revenue and expense, the income statement primarily focuses on company's revenues and expenses during a particular period.

The income statement focuses on the four key items - revenue, expenses, gains and losses. It does not cover receipts (money received by the business) or the cash payments/disbursements (money paid by the business). It starts with the details of sales, and then works down to compute the net income and eventually the earnings per share (EPS). Essentially, it gives an account of how the net revenue realized by the company gets transformed into net earnings (profit or loss).

The following are covered in the income statement, though its format may vary depending upon the local regulatory requirements, the diversified scope of the business and the associated operating activities:

REVENUES AND GAINS:

Operating Revenue: Revenue realized through primary activities is often referred to as operating revenue. For a company manufacturing a product, or for a wholesaler, distributor or retailer involved in the business of selling that product, the revenue from primary activities refers to revenue achieved from sale of the product. Similarly, for a company (or its franchisees) in the business of offering services, revenue from primary activities refers to the revenue or fees earned in exchange of offering those services.

Non-operating Revenue: Revenues realized through secondary, non-core business activities are often referred to as non-operating recurring revenues. These revenues are sourced from the earnings which are outside of purchase and sale of goods and services, and may include income from interest earned on business capital lying in the bank, rental income from business property, income from strategic partnerships like royalty payment receipts or income from an advertisement display placed on business property.

Gains: Also called as other income, gains indicate the net money made from other activities, like sale of long-term assets. These include the net income realized from one-time non-business activities, like a company selling its old transportation van, unused land, or a subsidiary company.

Revenue should not be confused with receipts. Revenue is usually accounted for in the period when sales are made or services are delivered. Receipts are the cash received, and are accounted for when the money is actually received. For instance, a customer may take goods/services from a company on 28 September which will lead to the revenue being accounted for in the month of September. Owing to his good reputation, the customer may be given a 30-day payment window.

It will give him time till 28 October to make the payment which is when the receipts are accounted for.

EXPENSES AND LOSSES:

Expenses linked to primary activities: All expenses incurred for earning the normal operating revenue linked to the primary activity of the business. They include cost of goods sold (COGS), selling, general and administrative expenses (SG&A), depreciation or amortization, and research and development (R&D) expenses. Typical items that make up the list are employee wages, sales commissions, and expenses for utilities like electricity and transportation.

Expenses linked to secondary activities: All expenses linked to non-core business activities, like interest paid on loan money.

Losses: All expenses that go towards loss-making sale of long-term assets, one-time or any other unusual costs, or expenses towards lawsuits.

While primary revenue and expenses offer insights into how well the company's core business is performing, the secondary revenue and expenses account for the company's involvement and its expertise in managing the ad-hoc, non-core activities. Compared to the income from sale of manufactured goods, a substantially high interest income from money lying in the bank indicates that the business may not be utilizing the available cash to its full potential by expanding the production capacity, or it is facing challenges in increasing its market share amid competition. Recurring rental income gained by hosting billboards at the company factory situated along a highway indicates that the management is capitalizing upon the available resources and assets for additional profitability.

INCOME STATEMENT STRUCTURE - FROM REVENUES TO NET INCOME

Mathematically, the Net Income is calculated based on the following:

Net Income = (Revenue + Gains) – (Expenses + Losses)

Profit and Loss Statement

This statement is a summary of the financial performance of a business over time. This is usually prepared after every quarter or year. The components in this statement include:

Revenues: The amount of cash that a company actually receives during a specific period, through the sale of goods or services, is referred to as the company's revenue. This would include discounts and deductions for returned merchandise. Revenues would also include the amount received as a result of using the capital or assets of the business as part of the operations of the business. Revenue is the "top line" or "gross income" of the business.

Expenses: The outflow of money or incurring of liabilities (or a combination of both) through production of goods, rendering services, or carrying out any activity that would form a part of the business's operations, are the expenses of the company. Typical business expenses include wages or salaries, utilities such as rent, depreciation of capital assets, and interest paid on loans. The purchase of an asset such as a building or equipment is not an expense. Expenses also include the Cost of Goods Sold (COGS), which is the cost incurred for selling goods during the period, and includes import duties, freight, handling and other costs for converting inventory to finished goods.

Gains: A company's gain is an increase in equity through peripheral or incidental transactions by a firm, other than those from revenue or investments by owners (shareholders). It refers to any economic benefit that is outside the normal operations of a business. Typically, gains refer to unusual and nonrecurring transactions, such as gain on sale of land, change in a stock's market price or a gift. It is often shown in the P&L statement as non-operating income.

Losses: A company's losses are decreases in equity through peripheral or incidental transactions carried out by the firm, other than those from expenses or distributions to owners. This could be loss on sale of an asset, writing down of assets or a loss from lawsuits. It could also include costs that give no benefit. It is often shown in the P&L statement as non-operating expense.

3. Cash Flow statement:

This statement is a summary of the actual or anticipated inflows and outflows of cash in a firm over an accounting period. This could be prepared at the end of a month, quarter or year.

The cash flow statement would reflect the liquidity position of the business. This is used as the basis for budgeting and business-planning. The components in this statement include:

Cash Flow from Operating Activities:

Operating activities of a business refer to the production, sales and delivery of the finished product and collection of payment from customers. Cash outflows here could include purchasing raw materials, advertising, and cost of shipping the product. They might not include payment to suppliers, employees and interest payments. Depreciation and amortization are also included in the cash flow statement. Cash inflows here consist of receipt from sale of goods and services and interest received.

Cash Flow from Investing Activities: These are cash flows related to investments and include purchase of assets, gains or losses through investments in the financial market or in subsidiaries, and other related items.

Cash Flow from Financing Activities: This would account for activities that aid a firm in raising capital and repaying investors. The cash flow might include cash dividends, adding or changing loans or issue of stock. Cash flow from financing activities reveals the company's financial strength. Financing activities that produce positive cash flow include cash from issued stocks and bonds. Financing activities that produce negative cash flow include cash for repurchasing stock, paying off debt or interest or payment of dividend to shareholders. Every item in financial statements is important and provides insights into the workings and performance of the firm. These components are useful to all stakeholders including the management, employees, suppliers and shareholders, for putting in place sound business plans and following a financially viable strategy.

4. Notes to the financial statements

The notes to the financial statements usually begin with a section on accounting policies. This is where the reader looks to see what accounting policies have been chosen for the company. For example, this section will explain whether shares that a company owns in other companies are recorded at cost or at fair market value. The type of valuation basis used can make a large difference to the values reported on the balance sheet.

The notes also include disclosures about the risks faced by the company, related party transactions (which can be transacted at a different amount than if they were with a party at arm's length), tax values of the capital stock, or loan repayment terms. These disclosures can be critical to understanding how the business has been operating and how it will operate in the coming year. For example, the disclosures may refer to a loan that has been repaid in previous years at Rs. 5,000 per month, but will need to be repaid in full in the coming year. This kind of information can help explain why the company has significantly more cash on hand this year compared to the year before.

ACCOUNTING STANDARDS

Accounting standards are authoritative **standards** for **financial reporting** and are the primary source of generally accepted **accounting** principles (GAAP). **Accounting standards** specify how transactions and other events are to be recognized, measured, presented and disclosed in financial statements.

Definition:

An accounting standard is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices".

Accounting standards improve the transparency of financial reporting in all countries. In the United States, the Generally Accepted Accounting Principles form the set of accounting standards widely accepted for preparing financial statements. International companies follow the International Financial Reporting Standards, which are set by the International Accounting Standards Board and serve as the guideline for non-U.S. GAAP companies reporting financial statements.

HISTORY OF ACCOUNTING STANDARDS AND PURPOSE

The American Institute of Accountants, which is now known as the American Institute of Certified Public Accountants, and the New York Stock Exchange attempted to launch the first accounting standards in the 1930s. Following this attempt came the Securities Act of 1933 and the Securities Exchange Act of 1934, which created the Securities and Exchange Commission. Accounting standards have also been established by the Governmental Accounting Standards Board for accounting principles for all state and local governments.

Accounting standards specify when and how economic events are to be recognized, measured and displayed. External entities, such as banks, investors and regulatory agencies, rely on accounting standards to ensure relevant and accurate information is provided about the entity. These technical pronouncements have ensured transparency in reporting and set the boundaries for financial reporting measures.

LIST OF ICAI'S MANDATORY ACCOUNTING STANDARDS (AS 1~29)

List of Mandatory Accounting Standards of ICAI (as on 1 July 2017 and onwards), is as under:

1. **AS 1 Disclosure of Accounting Policies:** This Standard deals with the disclosure of significant accounting policies which are followed in preparing and presenting financial statements.

2. **AS 2 Valuation of Inventories:** This Standard deals with the determination of value at which inventories are carried in the financial statements, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

3. **AS 3 Cash Flow Statements:** This Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a Cash Flow Statement which classifies cash flows during the period from operating, investing and financing activities.

4. **AS 4 Contingencies and Events Occurring After Balance Sheet Date:** This Standard deals with the treatment of contingencies and events occurring after the balance sheet date.

5. **AS 5 Net profit or Loss for the period, Prior Period Items and Changes in Accounting Policies:** This Standard should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the Statement of Profit and Loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

6. **AS 7 Construction Contracts:** This Standard prescribes the accounting for construction contracts in the financial statements of contractors.

7. **AS 9 Revenue Recognition:** This Standard deals with the bases for recognition of revenue in the Statement of Profit and Loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from: a) Sale of goods; b) Rendering of services; and c) Interest, royalties and dividends.

8. **AS 10 Property, Plant and Equipment:** The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment (PPE).

9. **AS 11 The Effects of Changes in Foreign Exchange Rates:** AS 11 lays down principles of accounting for foreign currency transactions and foreign operations, i.e., which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

10. **AS 12 Government Grants:** This Standard deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

11. **AS 13 Accounting for Investments:** This Standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.

12. **AS 14 Accounting for Amalgamations:** This Standard deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves.

13. **AS 15 Employee Benefits:** The objective of this Standard is to prescribe the accounting treatment and disclosure for employee benefits in the books of employer except employee share-based payments. It does not deal with accounting and reporting by employee benefit plans.

14. **AS 16 Borrowing Costs:** This Standard should be applied in accounting for borrowing costs. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

15. **AS 17 Segment Reporting:** The objective of this Standard is to establish principles for reporting financial information, about the different types of segments/ products and services an enterprise produces and the different geographical areas in which it operates.

16. **AS 18 Related Party Disclosures:** This Standard should be applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. The

requirements of this Standard apply to the financial statements of each reporting enterprise and also to consolidated financial statements presented by a holding company.

17. **AS 19 Leases:** The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.
18. **AS 20 Earnings Per Share:** AS 20 prescribes principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.
19. **AS 21 Consolidated Financial Statements:** The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. These statements are intended to present financial information about a parent and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, obligations of the group and results the group achieves with its resources.
20. **AS 22 Accounting for Taxes on Income:** The objective of this Standard is to prescribe accounting treatment of taxes on income since the taxable income may be significantly different from the accounting income due to many reasons, posing problems in matching of taxes against revenue for a period.
21. **AS 23 Accounting for Investments in Associates:** This Standard should be applied in accounting for investments in associates in the preparation and presentation of consolidated Financial Statements (CFS) by an investor.
22. **AS 24 Discontinuing Operations:** The objective of AS 24 is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of

financial statements to make projections of an enterprise's cash flows, earnings generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations. AS 24 applies to all discontinuing operations of an enterprise.

23. **AS 25 Interim Financial Reporting:** This Standard applies if an entity is required or elects to publish an interim financial report. The objective of AS 25 is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period.

24. **AS 26 Intangible Assets:** AS 26 prescribes the accounting treatment for intangible assets (i.e. identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes).

25. **AS 27 Financial Reporting of Interests in Joint Ventures:** The objective of AS 27 is to set out principles and procedures for accounting for interests in joint ventures and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors.

26. **AS 28 Impairment of Assets:** The objective of AS 28 is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. The asset is described as impaired if its carrying amount exceeds the amount to be recovered through use or sale of the asset and AS 28 requires the enterprise to recognise an impairment loss in such cases. It should be noted that AS 28 deals with impairment of all assets unless specifically excluded from the scope of the Standard.

27. **AS 29 Provisions, Contingent Liabilities and Contingent Assets:** The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of this Standard is also to lay down appropriate accounting for contingent assets.

INTERNATIONAL ACCOUNTING

INTERNATIONAL ACCOUNTING is the **international** aspects of **accounting**, including such matters as **accounting** principles and reporting practices in different countries and their classification; patterns of **accounting** development; **international** and regional harmonization, foreign currency translation; foreign exchange risk; ...

INTERNATIONAL ACCOUNTING STANDARDS

Understanding International Accounting Standards (IAS)

International Accounting Standards (IAS) were the first international accounting standards that were issued by the International Accounting Standards Committee (IASC), formed in 1973. The goal then, as it remains today, was to make it easier to compare businesses around the world, increase transparency and trust in financial reporting, and foster global trade and investment.

Globally comparable accounting standards promote transparency, accountability, and efficiency in financial markets around the world. This enables investors and other market participants to make informed economic decisions about investment opportunities and risks and improves capital allocation. Universal standards also significantly reduce reporting and regulatory costs, especially for companies with international operations and subsidiaries in multiple countries.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

The **International Financial Reporting Standards** (IFRS) are **accounting standards** that are issued by the **International Accounting Standards** Board (IASB) with the objective of providing a common **accounting** language to increase transparency in the presentation of **financial** information.

The goal of **IFRS** is to provide **a** global framework for how public companies prepare and disclose **their** financial statements. **IFRS** provides general guidance for the preparation of financial statements, rather than setting rules for industry-specific reporting.

1. List of IFRS The following International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the IASB which are in force: ¬ IAS-1 Presentation of Financial Statements ¬ IAS-2 Inventories ¬ IAS-7 Cash Flow Statements ¬ IAS-8 Accounting Policies, Changes in Accounting Estimates & Errors. ¬ IAS-10 Events After The Balance Sheet Date.

2. IFRS-1 First-time Adoption of International Financial Reporting Standards ¬ IFRS-2 Share-based Payment ¬ IFRS-3 Business Combinations ¬ IFRS-4 Insurance Contracts ¬ IFRS-5 Non-current Assets held for Sale & Discounted Operations ¬ IFRS-6 Exploration for & Evaluation of Mineral Resources ¬ IFRS-7 Financial Instrument: Disclosures

3. List of IND AS- ¬ IND AS-1 Presentation of Financial Statements. ¬ IND AS-2 Inventories. ¬ IND AS-7 Statement of Cash Flows. ¬ IND AS-8 Accounting Policies , Changes in Accounting Estimates & Errors ¬ IND AS-10 Events after the Reporting Period. ¬ IND AS-11 Construction Contracts. ¬ IND AS-12 Income Taxes.

OBJECTIVES

1. To harmonise different accounting policies & practices use in a country.
2. To standarize accounting methods & procedures.
3. To reduce the accounting alternatives in the preparation of financial statements.
4. To lay down principles for preparation & presentation.
5. To establish benchmark for evaluating the quality of financial statements.

5. Levels of AS Accounting standards are divided into three levels. Level I Enterprises : Enterprises which fall in any one or more of the following categories , at any time during the accounting period , are classified as Level I Enterprises.

1). Listed enterprises whether in India or outside India.

2). Enterprises proposing to list their equity or debt securities.

3). Bank including co-operative banks.

4). Financial institutions.

5). Enterprises carrying on insurance business.

6). All commercial , industrial and business reporting enterprises , whose Turnover for the immediately preceding accounting period exceeds Rs. 50 crore.

7). All commercial , industrial and business reporting enterprises having Borrowings , including public deposits , in excess of Rs. 10 crore.

8). Holding and subsidiary of any one of the above.

7. Level II Enterprises : 1). All commercial , industrial & business reporting enterprises , whose Turnover for the immediately preceding accounting period exceeds Rs.40 lakhs but does not exceed Rs.50 crore . 2). All commercial , industrial & business reporting enterprises having Borrowings ,including public deposits , in excess of Rs. 1 crore but not excess of Rs. 10 crore . 3). Holding & subsidiary enterprises of any one of the above at any time during the accounting period.

8. Level III Enterprises : Enterprises which are not covered under Level I and II are considered as Level III enterprises .

9. Recognition of Accounting Standard Accounting Standards(ASs) issued by the ICAI have legal recognition through Companies Act,2013. 1). Section 129(1) : The financial statements of every company shall comply with the accounting standards. 2). Section 129(5) : Where the P&L A/c & the balance sheet do not comply with the accounting standards, such companies shall disclose, the following: (a) The deviation from the AS (b) The reasons for such deviation. (c) The financial effect due to such deviation.

13. Advantages ¬ Increased comparability of financial information . ¬ The financial reporting process would become more transparent. ¬ The standardization of accounting methodology provides creditors & investors with the ability to analyze businesses around the world using the same financial methods. ¬ Permit international capital to flow more freely. ¬ Provide better understanding to financial statements . ¬ Assess the investment opportunities .

SIGNIFICANT DIFFERENCE BETWEEN IAS AND IFRS

The difference between IFRS vs IAS (International Accounting Standards) are mentioned here. By this article you can learn the difference between IFRS (International Financial Reporting Standards) vs IAS (International Accounting Standards), when was they implemented and the introduction of both IFRS and IAS.

IFRS: International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board **(IASB)**

IAS: The international accounting standards (IAS) were an older set of standards stating how particular types of transactions and other events should be reflected in financial statements. In the past, international accounting standards were issued by the Board of the International Accounting Standards Committee (IASC); since 2001, the new set of standards has been known as the international financial reporting standards (IFRS) and has been issued by the International Accounting Standards Board (IASB). Although IASC has no authority to require compliance with its accounting standards, many countries require the financial statements of publicly-traded companies to be prepared in accordance with IAS.

What is the difference between IAS and IFRS?

So how is IAS and IFRS different? Well, technically they are the same. IFRS is the current set of standards that is reflective of the changes in the accounting and business practices over the last two decades. IAS is what used to be prior to the introduction of IFRS. However, not all of the IAS are out dated. In fact, to date there are only 9 IFRS issued and the IAS that were not superseded by the IFRS are still in use. The IASB no longer issues IAS. Any future standards will now be called IFRS, and if they are contradictory to existing IAS, the IFRS will be followed.

IFRS vs IAS – Keypoints

- IAS stands for International Accounting Standards, while IFRS refers to International Financial Reporting Standards.
- IAS standards were published between 1973 and 2001, while IFRS standards were published from 2001 onwards.
- IAS standards were issued by the IASC, while the IFRS are issued by the IASB, which succeeded the IASC.
- Principles of the IFRS take precedence if there's contradiction with those of the IAS, and this results in the IAS principles being dropped.

USERS OF THE FINANCIAL STATEMENTS

The main users (Stakeholders) of financial statements are commonly grouped as follows:

Investors and potential investors: They are interested in their potential profits and the security of their investment. Future profits may be estimated from the target company's past performance as shown in the income statement. The security of their investment will be revealed by the financial strength and solvency of the company as shown in the statement of financial position. The largest and most sophisticated groups of investors are the institutional investors, such as pension funds and unit trusts.

Employees: Employees and trade union representatives need to know if an employer can offer secure employment and possible pay rises. They will also have a keen interest in the salaries and benefits enjoyed by senior management. Information about divisional profitability will also be useful if a part of the business is threatened with closure.

Lenders: Lenders need to know if they will be repaid. This will depend on the solvency of the company, which should be revealed by the statement of financial position. Long-term loans may also be backed by 'security' given by the business over specific assets. The value of these assets will be indicated in the statement of financial position.

Government agencies: need to know how the economy is performing in order to plan financial and industrial policies. The tax authorities also use financial statements as a basis for assessing the amount of tax payable by a business.

Suppliers: need to know if they will be paid. New suppliers may also require reassurance about the financial health of a business before agreeing to supply goods.

Customers: need to know that a company can continue to supply them into the future. This is especially true if the customer is dependent on a company for specialised supplies.

The public: may wish to assess the effect of the company on the economy, local environment and local community. Companies may contribute to their local economy and community through providing employment and business for local suppliers. Some companies also run corporate responsibility programmes through which they support the environment, economy and community by, for example supporting recycling schemes.

Management and competitors: would also use the financial statements of a business to make economic decisions. Management, however, would predominantly use monthly management accounts as their main source of financial information. It is also unlikely that a business would prepare financial statements for the purpose of aiding competitors.

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

The Conceptual Framework sets out the fundamental concepts for financial reporting that guide the Board in developing IFRS Standards. It helps to ensure that the Standards are conceptually consistent and that similar transactions are treated the same way, so as to provide useful information for investors, lenders and other creditors.

The Conceptual Framework also assists companies in developing accounting policies when no IFRS Standard applies to a particular transaction, and more broadly, helps stakeholders to understand and interpret the Standards.

The 2018 revised Conceptual Framework sets out by IFRS:

- the objective of general purpose financial reporting;
- the qualitative characteristics of useful financial information;
- a description of the reporting entity and its boundary;
- definitions of an asset, a liability, equity, income and expenses and guidance supporting these definitions;
- criteria for including assets and liabilities in financial statements (recognition) and guidance on when to remove them (derecognition);
- measurement bases and guidance on when to use them;
- concepts and guidance on presentation and disclosure; and
- Concepts relating to capital and capital maintenance.

INFORMATION USEFUL IN ASSESSING CASH FLOW PROSPECTS

To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows) That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.

An entity's investors and creditors (both present and potential) are directly interested in the amounts, timing, and uncertainty of their cash flows from dividends, interest, and the sale, redemption, or maturity of securities or loans. However, the prospects for those cash flows depend on the entity's present cash resources and, more importantly, on its ability to generate enough cash to pay its employees and suppliers and satisfy its other operating needs, to meet its obligations when due, to reinvest in operations, and to distribute cash to owners (for example, to pay cash dividends). The judgments of capital market participants about the entity's ability to generate net cash inflows affect the values of debt or equity interests. Therefore, those judgments also may affect cash flows to investors and creditors through sale of their interests.

In a cash-based exchange economy like those that generally exist in parts of the world in which financial reporting is important, cash (or its equivalent) is the medium of 1 exchange, as well as the store of value. In such an economy, most goods and services have money prices, and cash (including currency, coins, and money on deposit in financial institutions) is prized because of what it can buy. Members of the society carry out their consumption, saving, and investment decisions by allocating their present and expected cash resources. Thus, discussion of the objective focuses on an entity's cash-generating ability and on cash returns to investors and creditors. However, an entity might provide a return in ways other than by distributing cash. One example is a dividend-in-kind, which is a dividend distributed to owners in the form of noncash resources such as inventory. Investors and creditors may be indifferent about whether a return to them is in the form of cash, another asset that can be converted into the same amount of cash, or in some other form. The objective of financial reporting could have been stated in terms of cash, cash equivalents, or other resources that can be converted to cash or the like. The role of cash as a medium of exchange and store of value, and therefore the ultimate interest of investors and creditors in cash, makes it unnecessary to use such an unwieldy term.

POTENTIAL USERS OF FINANCIAL REPORTS AND THEIR INFORMATION NEEDS

Financial reporting is not an end in itself. It is a means of communicating to the users of financial reports information that is useful in making choices among alternative uses of scarce resources. Thus, the objective stems largely from the needs and interests of those users. Potential users of financial reports and their information needs include:

a. Equity investors: Equity investors in an entity are interested in the entity's ability to generate net cash inflows because their decisions relate to the amounts, timing, and uncertainties of those cash flows. To an equity investor, an entity is a source of cash in the form of dividends (or other cash distributions) and increases in the prices of shares or other ownership interests. Equity investors are directly concerned with the ability of the entity to generate net cash inflows and also with how the perception of that ability affects the prices of its equity interests.

b. Creditors. Creditors, including purchasers of traded debt instruments, provide financial capital to an entity by lending cash (or other assets) to it. Like investors, creditors are interested in the amounts, timing, and uncertainty of an entity's future cash flows. To a creditor, an entity is a source of cash in the form of interest, repayments of borrowings, and increases in the prices of debt securities.

c. Suppliers. Suppliers provide goods or services rather than financial capital. They are interested in assessing the likelihood that amounts an entity owes them will be paid when due.

d. Employees. Employees provide services to an entity; employees and their representatives are interested in evaluating the stability, profitability, and growth of their employer. They are interested in information that helps them to assess the entity's continuing ability to pay salaries and wages and to provide incentive payments and retirement and other benefits.

e. Customers. To its customers, an entity is a source of goods or services. Customers are interested in assessing the entity's ability to continue to provide those goods or services, especially if they have a long-term involvement with, or are dependent on, the entity.

f. Governments and their agencies and regulatory bodies. Governments and their agencies and regulatory bodies are interested in the activities of an entity because they are in various ways responsible for seeing that economic resources are allocated efficiently. They also need information to help in regulating the activities of entities, determining and applying taxation policies, and preparing national income and similar statistics.

g. Members of the public. An entity may affect members of the public in a variety of ways. For example, an entity may make a substantial contribution to the local economy by providing employment opportunities, patronizing local suppliers, paying taxes, and making charitable contributions. Financial reporting may assist members of the public and their representatives by providing information about the trends and recent developments in the entity's prosperity and the range of its activities, as well as the entity's ability to continue to undertake those activities.

LIMITATIONS OF ACCOUNTING & FINANCIAL REPORTING

Accountancy assists users of financial statements to make better financial decisions. It is important however to realize the limitations of accounting and financial reporting when forming those decisions.

- **Different accounting policies and frameworks**

Accounting frameworks such as IFRS allow the preparers of financial statements to use accounting policies that most appropriately reflect the circumstances of their entities.
Whereas a degree of flexibility is important in order to present reliable information of a particular entity, the use of diverse set of accounting policies amongst different entities impairs the level of comparability between financial statements. The use of different accounting frameworks (e.g. IFRS, US GAAP) by entities operating in different geographic areas also presents similar problems when comparing their financial statements. The problem is being overcome by the growing use of IFRS and the convergence process between leading accounting bodies to arrive at a single set of global standards.

- **Accounting estimates**

Accounting requires the use of estimates in the preparation of financial statements where precise amounts cannot be established. Estimates are inherently subjective and therefore lack precision as they involve the use of management's foresight in determining values included in the financial statements. Where estimates are not based on objective and verifiable information, they can reduce the reliability of accounting information.

- **Professional judgment**

The use of professional judgment by the preparers of financial statements is important in applying accounting policies in a manner that is consistent with the economic reality of an entity's transactions. However, differences in the interpretation of the requirements of accounting standards and their application to practical scenarios will always be inevitable. The greater the use of judgment involved, the more subjective financial statements would tend to be.

- **Verifiability**

Audit is the main mechanism that enables users to place trust on financial statements. However, audit only provides 'reasonable' and not absolute assurance on the truth and fairness of the financial statements which means that despite carrying audit according to acceptable standards, certain material misstatements in financial statements may yet remain undetected due to the inherent limitations of the audit.

- **Use of historical cost**

Historical cost is the most widely used basis of measurement of assets. Use of historical cost presents various problems for the users of financial statements as it fails to account for the change in price levels of assets over a period of time. This not only reduces the relevance of accounting information by presenting assets at amounts that may be far less than their realizable value but also fails to account for the opportunity cost of utilizing those assets.

Measurability

Accounting only takes into account transactions that are capable of being measured in monetary terms. Therefore, financial statements do not account for those resources and transactions whose value cannot be reasonably assigned such as the competence of workforce or goodwill.

- **Limited predictive value**

Financial statements present an account of the past performance of an entity. They offer limited insight into the future prospects of an enterprise and therefore lack predictive value which is essential from the point of view of investors.

- **Fraud and error**

Financial statements are susceptible to fraud and errors which can undermine the overall credibility and reliability of information contained in them. Deliberate manipulation of financial statements that is geared towards achieving predetermined results (also known as 'window dressing') has been a unfortunate reality in the recent past as has been popularized by major accounting disasters such as the Enron Scandal.

- **Cost benefit compromise**

Reliability of accounting information is relative to the cost of its production. At times, the cost of producing reliable information outweighs the benefit expected to be gained which explains why, in some instances, quality of accounting information might be compromised.

DIFFERENCE BETWEEN FINANCIAL REPORT AND FINANCIAL STATEMENT

The terms "financial reporting" and "financial statements" are often interchanged in the workplace. Both terms have some similarities, but financial reporting encompasses a much broader and detailed definition. Both the financial report and the individual statements play a role in creating the annual financial data report that investors and shareholders read as part of their financial research.

Financial report

- A financial report, also often referred to as financial reporting or annual report, is a large collective document that summarizes the financial spending and earning of a given business over the duration of a single year. It combines both the earnings of the income statements, provides an overlook of the net worth and shows the business' spending and expenses in great detail. It also provides a personal letter from the CEO or owner, along with a short predictions chapter that presents any direct plans to increase profits or increasing the net worth.
- Some financial reports are meant only for management and some are communicated to people outside the entity as well.
- Financial reporting includes providing information to stakeholders to make decisions.
- It is governed by the International Accounting Standards Board (IASB).

Financial statements

- Financial statements are short documents that present the income information for a business at any given point in time. The financial information will show a current balance sheet in terms of income, changes in the overall worth of the company based in income and a cash flow statement that shows where the funds are coming from. A financial statement does not include information about expenses or purchases.

- Some financial statements are prepared on regular basis at equal intervals and some are prepared as and when needed.
- Financial statements are the outcome of the process of financial reporting.
- It is governed by the International Financial Reporting Standards (IFRS).

POSSIBLE QUESTIONS

Part - B

1. What do you understand from the term financial reporting?

2. List out the elements of financial statements of revised (2018) by IFRS.

3. Give any two importance of financial reporting.

4. What is Income statement?

5. State the primary objective of financial reporting.

Part - C

1. Draw the pro-forma of the Balance Sheet of a Company.

2. What is financial statement? And explain the components of financial statements.

3. What is Income statement? What are all the items to be appeared in this statement?

4. State the concept of Financial Statements and Financial Reporting. Discuss the Limitations of Financial Reporting

5. Analyze the purposes of financial reporting to the various users.

6. Describe the various Potential Users of Financial Reports and their Information Needs.

7. Explain cash flow and its various activities.

8. Discuss any three revised (2018) Conceptual Framework sets out by IFRS.

9. Discuss the various importance of financial reporting to users.

10. Write shorts on: i) Revenue ii) Expenses iii) Losses iv) Gain

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Question	Option - I	Option - II	Option - III	Option - IV	Answer
Dividend received is _____________	Direct income	Indirect income	Direct expenses	Indirect expenses	Indirect income
Cash Credit (CC) is	Current Asset	Fixed Asset	Current Liability	Fixed Liability	Current Liability
A statement which presents the revenues and expenses of an enterprise for an accounting period is __________	Trading A/c	Profit & Loss A/c	Balance Sheet	Cash flow statement	Profit & Loss A/c
Which one is financial report _____________	Ledger	Trial Balance	Balance sheet	Sales account	Balance sheet
Goodwill is a _____________	a fixed asset	a current asset	a tangible asset	an intangible asset	an intangible asset
The term current asset doesn’t cover	Car	Debtors	Stock	Prepaid expenses	Car
Wages paid to workers is ______________	Direct income	Direct expenses	Indirect income	indirect expenses	Direct expenses
Shares which have no preferential rights over other class of shares is	Preference shares	Equity shares	Debentures	Loans & advances	Equity shares
IASB stands for	Indian Accounting Standard Board	International Accounting Standard Board	International Accounting Service Board	Indian Accounting Service Board	International Accounting Standard Board
An obligation to transfer economic benefit as a result of past transactions or events is called	Asset	Liability	Purchase	Trading	Liability
The process of recording, classifying, analyzing and communicating the financial transactions is called as	single entry	accounting	journalising	ledger	accounting
Accounting Standard-3 (AS-3), issued by The Institute of Chartered Accountants of India (ICAI) deals with the preparation and presentation of ………………	Trial Balance	Balance Sheet	Profit and loss a/c	Cash Flow statement	Cash Flow statement
Accounting Standard 3 deals with	Depreciation	Cash Flow Statement	Disclosures	Foreign Exchange	Cash Flow Statement
Fixed Assets is ______________	Cash at bank	Land	Sundry Debtors	Short term investments	Land

Owner's funds otherwise known as ____________________	Debt	Equity	Loan	Dividend	Equity
Financial reporting information is based on………………, of the financial effects on entities of transactions and other events and circumstances that have already happened or that already exist.	Exact measures	Scientific	Accurate	Estimates	Estimates
Income statement otherwise known as	Profit & Loss Statement	Balance sheet	Profit & Loss Statement appropriation Account	Cash flow statement	Profit & Loss Statement
The statement containing various ledger balances on a date is known as ---------------	Trial balance	balance sheet	profit/loss a/c	net profit	Trial balance
A statement of financial position of an enterprise at a given date is called as	Trading A/c	Profit & Loss A/c	Balance Sheet	Cash flow statement	Balance Sheet
Which one is a source of cash?	Dividend paid	Redemption of debenture	Tax paid	Issue of shares	Issue of shares
Accounting Standard 6 deals with	Depreciation	Cash Flow Statement	Disclosures	Foreign Exchange	Depreciation
One of the current assets is	Stock	Machinery	Land	Sale	Stock
Dividends are usually paid on	Authorised capital	Issued capital	Paid-up capital	called up capital	Paid-up capital
Application of Cash is ___________	Dividend paid	Sale of assets	Cash from operation	Loans received from bank	Dividend paid
Recording of capital contributed by the owner as liability ensures the adherence of principle of_______________	Consistency	Going concern	Separate entity	Materiality	Separate entity
Which of the following is not one of the four basis financial statements?	The balance Sheet	The audit Report	The income statement	The statement of cash flows	The audit Report

Which of the following is true regarding the income statement?	The income statement is sometimes called the statement of operations	The income statement reports revenue, expenses, and liabilities	The income statement only reports revenue for which cash was received at the point of sale	The income statement reports the financial position of a business at a particular point in	The income statement is sometimes called the statement of operations
Which of the following is false regarding the balance sheet?	The accounts shown on a balance sheet represent the basic accounting equation for a particular business.	earning balance shown on the balance sheet must agree with the ending retained earning balance shown on the statement of	The balance sheet summarizes the net changes in specific account balances over a period of time.	The balance sheet reports the amount of assets, liabilities, and stockholders equity of a business at a point in time	The balance sheet summarizes the net changes in specific account balances over a period of time.
Which of the following would not be a goal or external users reading a company's financial statements?	Understanding the current financial state of the company	company's contribution to social and environmental polices	Predicting the company's future financial performance	Evaluating the company's ability to generate cash from sales	Assessing the company's contribution to social and environmental polices
Balance sheet is also called as	Profit & Loss Statement	Statement of financial changes	Profit & Loss Statement appropriation Account	Cash flow statement	Statement of financial changes
Which of the following items is not specific account in a company's accounting record?	Accounts Receivable	Net Income	Sales Revenue	Unearned Income	Net Income
Which account is least likely to be debited when revenue is recorded?	Account Payable	Accounts receivable	Cash	Unearned	Account Payable
What financial statement lists assets from current to long term?	Balance Sheet	Income Statement	Cash Flow Statement	Statement of Retained Earnings	Balance Sheet
Income statement format that separates cost of goods sold into categories?	Standard	Detailed	Expanded	Multi-Step	Multi-Step

Net income equals:	Total revenues minus cost of goods sold	Total revenues minus total expenses	Operating revenues minus operating expenses	Revenues minus expenses plus income taxes	Total revenues minus total expenses
Which financial statement represents the accounting equation "assets = liabilities + owners' equity"	Trading account	Profit &loss account	Balance sheet	Statement of cash flows	Balance sheet
"Business unit separate and distinct from the owner of it ",is based on:	Money measurement	Going concern concept	Business entity concept	Dual aspect concept	Business entity concept
_______ principle requires that the same method should be used from one accounting period to the next .	Conservation	Business entity	Consistency	Money measurement	Consistency
Following is not the example of external users	Government	Management	Investors	Suppliers and other creditors	Management
_________ are liabilities which become due and payable within a short period	Fixed liabilities	Long term liabilities	Current liabilities	Contingent liabilities	Current liabilities
According to the conceptual framework the primary objective of financial information is	Decision Usefulness	Prediction	Stewardship	Accountability	Decision Usefulness
The constraints on financial reporting identified under the conceptual framework are:	Cost versus benefit	Timeliness and neutrality	Understandability and materiality	and cost versus benefit	Cost versus benefit
EOQ Stands for	Eligible order quantity	Economic ordering quantity	Economic outstanding quantity	Eligible outstanding quantity	Economic ordering quantity
Which of the following elements in the financial statement is NOT defined by reference to other elements?	Equity	Expenses	Liabilities	Income	Liabilities
The assessment of financial statements by a shareholder is an example of	Vertical Analysis	Horizontal Analysis	Internal Analysis	External Analysis	External Analysis

________________residual assets of an entity that remain after deducting liabilities	Asset	Liability	Equity	Profit and Loss Statement	Equity
_________________Cash outflows could include purchasing raw materials, advertising, and cost of shipping the product.	Cash Flow from Operating Activities	Cash Flow from Investing Activities	Cash Flow from Financing Activities	Not in Cash Flow statement	Cash Flow from Operating Activities
The objective of financial reporting is "to provide information about the financial position, performance and _____________ of an enterprise that is useful to a wide range of users in making economic decisions."	changes in financial position	changes in financial report	changes in Management	changes in Cash position	changes in financial position
__________________ forms backbone for financial planning, analysis, bench marking and decision making.	Financial Statement	Financial Reports	Cash Flow Statemtent	Balance Sheet	Financial Reports
_______________ users need to know if they will be paid	Lendors	Customers	Investors	Suppliers	Suppliers
_______________ users need to know if they will be repaid	Lendors	Customers	Investors	Suppliers	Lendors
______________ users need to know that a company can continue to supply them into the future.	Lendors	Customers	Investors	Suppliers	Customers
Which of the following is not available in the financial statements of a company _________________	Sales	Purchase	Management decisions	Cash	Purchase
Management Accounting is primarily concerned with the supply of information which is useful to ____________	Suppliers	Employees	Management	Supervisors	Management
Current asset is _____________	Cash balance	Furniture	Investments	Closing stock	Cash balance
The example of intangible asset is____________	Land	Building	Furniture	Patents.	Patents.

Which of the following is correct___________	Asset = Liabilities – Capital	Capital = Assets – Liabilities	Capital = Assets + Liabilities	Capital = Asset	Capital = Assets – Liabilities
The amount which the proprietor has invested in the business is ____________	Capital	Liabilities	Assets	Fund	Capital
Balance sheet is a ____________	Statement	Account	Ledger	Transaction	Statement
____________is a current liability	Plant	Machinery	Sundry Creditors	Building	Sundry Creditors

UNIT-II

SYLLABUS

Financial Statements – An Introduction: Traditional Assumptions of the Accounting Model: Business Entity – Going Concern or Continuity – Time period – Monetary Unit – Historical Cost – Conservatism – Realization – Matching – Consistency – Full Disclosure – Materiality – Industry Practices – Transaction Approach – Cash basis – Accrual basis

The Financial Statements: Balance sheet (Statement of Financial Position) – Statement of Stakeholder's Equity (Reconciliation of Stockholder's Equity Accounts) – Income Statement (Statement of Earnings) – Statement of Cash flows (Statement of Inflows and outflows of cash)

Auditors opinion : Auditors Report on the firm's internal controls – Report of Management on Internal control over Financial Reporting

Basic Elements of the Balance Sheet: Assets- Liabilities – Stockholders Equity – Quasi-Reorganization –Accumulated Other Comprehensive Income – Equity –Oriented Deferred Compensation – Employee Stock Ownership Plans (ESOPs) – Treasury Stock – Stockholders' Equity in Unincorporated Firms. Basic Elements of the Income Statement: Net Sales, Cost of goods sold, other operating revenue, operating expenses, other income or expenses

FINANCIAL STATEMENT

TRADITIONAL ASSUMPTIONS OF THE ACCOUNTING MODEL

DEFINITION OF ACCOUNTING

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

ACCOUNTING PRINCIPLES

The word 'Principle' has been differently viewed by different schools of thought. The American Institute of Certified Public Accountants (AICPA) has viewed the word 'principle' as a general law of rule adopted or professed as a guide to action; a settled ground or basis of conduct of practice"

Accounting principles refer, to certain rules, procedures and conventions which represent a consensus view by those indulging in good accounting practices and procedures. Canadian Institute of Chartered Accountants defined accounting principle as "the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices as a guide for the selection of conventions or procedures where alternatives exist. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experiences, historical precedent, statements by individuals and professional bodies and regulations of Governmental agencies". To be more reliable, accounting statements are prepared in conformity with these principles. If not, chaotic conditions would result. But in reality as all the businesses are not alike, each one has its own method of accounting.

However, to be more acceptable, the accounting principles should satisfy the following three basic qualities, viz., relevance, objectivity and feasibility. The accounting principle is considered to be relevant and useful to the extent that it increases the utility of the records to its readers. It is said to be objective to the extent that it is supported by the facts and free from personal bias.

ACCOUNTING CONCEPTS AND CONVENTIONS

Accounting concepts:

The term 'concept' is used to denote accounting postulates, i.e., basic assumptions or conditions upon the edifice of which the accounting super-structure is based. The following are the common accounting concepts adopted by many business concerns.

1. Business Entity Concept 2. Money Measurement Concept
3. Going Concern Concept 4. Dual Aspect Concept
5. Periodicity Concept 6. Historical Cost Concept
7. Matching Concept 8. Realization Concept
9. Accrual Concept 10. Objective Evidence Concept

i) Business Entity Concept

A business unit is an organization of persons established to accomplish an economic goal. Business entity concept implies that the business unit is separate and distinct from the persons who provide the required capital to it. This concept can be expressed through an accounting equation, viz.,

Assets = Liabilities + Capital. The equation clearly shows that the business itself owns the assets and in turn owes to various claimants. It is worth mentioning here that the business entity concept as applied in accounting for sole trading units is different from the legal concept. The expenses, income, assets and liabilities not related to the sole proprietorship business are excluded from accounting. However, a sole proprietor is personally liable and required to utilize non-business assets or private assets also to settle the business creditors as per law. Thus, in the case of sole proprietorship, business and non-business assets and liabilities are treated alike in the eyes of law. In the case of a partnership, firm, for paying the business liabilities the business assets are used first and it any surplus remains thereafter, it can be used for paying off the private liabilities of each partner. Similarly, the private assets are first used to pay off the private liabilities of partners and if any surplus remains, it is treated as part of the firm's property and is used for paying the firm's liabilities. In the case of a company, its existence does not depend on the life span of any shareholder.

ii) Money Measurement Concept

In accounting all events and transactions are recode in terms of money. Money is considered as a common denominator, by means of which various facts, events and transactions about a business can be expressed in terms of numbers. In other words, facts, events and transactions which cannot be expressed in monetary terms are not recorded in accounting. Hence, the accounting does not give a complete picture of all the transactions of a business unit. This concept does not also take care of the effects of inflation because it assumes a stable value for measuring.

iii) Going Concern Concept

Under this concept, the transactions are recorded assuming that the business will exist for a longer period of time, i.e., a business unit is considered to be a going concern and not a liquidated one. Keeping this in view, the suppliers and other companies enter into business transactions with the business unit. This assumption supports the concept of valuing the assets at historical cost or replacement cost. This concept also supports the treatment of prepaid expenses as assets, although they may be practically unsaleable.

iv) Dual Aspect Concept

According to this basic concept of accounting, every transaction has a two-fold aspect, Viz., 1.giving certain benefits and 2. Receiving certain benefits. The basic principle of double entry system is that every debit has a corresponding and equal amount of credit. This is the underlying assumption of this concept. The accounting equation viz.,

Assets = Capital + Liabilities or Capital = Assets – Liabilities, will further clarify this concept, i.e., at any point of time the total assets of the business unit are equal to its total liabilities. Liabilities here relate both to the outsiders and the owners. Liabilities to the owners are considered as capital.

V) Periodicity Concept

Under this concept, the life of the business is segmented into different periods and accordingly the result of each period is ascertained. Though the business is assumed to be continuing in future (as per going concern concept), the measurement of income and studying the financial position of the business for a shorter and definite period will help in taking corrective steps at the appropriate time. Each segmented period is called "accounting period" and the same is normally a year. The businessman has to analyze and evaluate the results ascertained periodically. At the end of an accounting period, an Income Statement is prepared to ascertain the profit or loss made during that accounting period and Balance Sheet is prepared which depicts the financial position of the business as on the last day of that period. During the course of preparation of these statements capital revenue items are to be necessarily distinguished.

vi) Historical Cost Concept

According to this concept, the transactions are recorded in the books of account with the respective amounts involved. For example, if an asset is purchases, it is entered in the accounting record at the price paid to acquire the same and that cost is considered to be the base for all future accounting. It means that the asset is recorded at cost at the time of purchase but it may be methodically reduced in its value by way of charging depreciation. However, in the light of inflationary conditions, the application of this concept is considered highly irrelevant for judging the financial position of the business.

vii) Matching Concept

The essence of the matching concept lies in the view that all costs which are associated to a particular period should be compared with the revenues associated to the same period to obtain the net income of the business. Under this concept, the accounting period concept is relevant and it is this concept (matching concept) which necessitated the provisions of different adjustments for recording outstanding expenses, prepaid expenses, outstanding incomes, incomes received in advance, etc., during the course of preparing the financial statements at the end of the accounting period.

viii) Realization Concept

This concept assumes or recognizes revenue when a sale is made. Sale is considered to be complete when the ownership and property are transferred from the seller to the buyer and the consideration is paid in full. However, there are two exceptions to this concept, viz., 1. Hire purchase system where the ownership is transferred to the buyer when the last installment is paid and 2. Contract accounts, in which the contractor is liable to pay only when the whole contract is completed, the profit is calculated on the basis of work certified each year.

ix) Accrual Concept: According to this concept the revenue is recognized on its realization and not on its actual receipt. Similarly the costs are recognized when they are incurred and not when payment is made. This assumption makes it necessary to give certain adjustments in the preparation of income statement regarding revenues and costs. But under cash accounting system, the revenues and costs are recognized only when they are actually received or paid. Hence, the combination of both cash and accrual system is preferable to get rid of the limitations of each system.

ACCOUNTING CONVENTIONS

The following conventions are to be followed to have a clear and meaningful information and data in accounting:

i) Consistency: The convention of consistency refers to the state of accounting rules, concepts, principles, practices and conventions being observed and applied constantly, i.e., from one year to another there should not be any change. If consistency is there, the results and performance of one period can he compared easily and meaningfully with the other. It also prevents personal bias as the persons involved have to follow the consistent rules, principles, concepts and conventions. This convention, however, does not completely ignore changes. It admits changes wherever indispensable and adds to the improved and modern techniques of accounting.

ii) Disclosure: The convention of disclosure stresses the importance of providing accurate, full and reliable information and data in the financial statements which is of material interest to the users and readers of such statements. This convention is given due legal emphasis by the Companies Act, 1956 by prescribing formats for the preparation of financial statements. However, the term disclosure does not mean all information that one desires to get should be included in accounting statements. It is enough if sufficient information, which is of material interest to the users, is included.

iii) Conservatism: In the prevailing present day uncertainties, the convention of conservatism has its own importance. This convention follows the policy of caution or playing safe. It takes into account all possible losses but not the possible profits or gains.

STATEMENT OF FINANCIAL POSITION

The statement of financial position, often called the balance sheet, is a financial statement that reports the assets, liabilities, and equity of a company on a given date. In other words, it lists the resources, obligations, and ownership details of a company on a specific day. You can think of this like a snapshot of what the company looked like at a certain time in history.

This definition is true in the sense that this statement is a historical report. It only shows the items that were present on the day of the report. This is in contrast with other financial reports like the income statement that presents company activities over a period of time. The statement of financial position only records the company account information on the last day of an accounting period.

In this sense, investors and creditors can go back in time to see what the financial position of a company was on a given date by looking at the balance sheet.

Example

Let's take a look at a statement of financial position example.

Paul's Guitar Shop, Inc.
Statement of Financial Position
December 31, 2015

Assets	
Current Assets	
Cash	32,800
Inventory	39,800
Total Current Assets	72,600
Fixed Assets	
Leasehold Improvements	100,000
Accumulated Depreciation	(2,000)
Total Fixed Assets	98,000
Other Assets	
Trademarks	20,000
Accumulated Amortization	(8,000)
Total Other Assets	12,000
Total Assets	182,600
Liabilities	
Current Liabilities	
Accounts Payable	49,000
Accrued Expenses	1,000
Total Current Liabilities	50,000
Long-term Liabilities	25,000
Total Liabilities	75,000
Owner's Equity	
Owner's Equity	
Common Stock	20,000
Retained Earnings	87,600
Total Owner's Equity	107,600
Total Liabilities and Owner's Equity	182,600

As you can see from our example template, each balance sheet account is listed in the accounting equation order. This organization gives investors and creditors a clean and easy view of the company's resources, debts, and economic position that can be used for financial analysis purposes.

Investors use this information to compare the company's current performance with past performance to gauge the growth and health of the business. They also compare this information with other companies' reports to decide where the opportune place is to invest their money.

Creditors, on the other hand, are not typically concerned with comparing companies in the sense of investment decision-making. They are more concerned with the health of a business and the company's ability to pay its loan payments. Analyzing the leverage ratios, debt levels, and overall risk of the company gives creditors a good understanding of the risk involving in loaning a company money.

Obviously, internal management also uses the financial position statement to track and improve operations over time.

Now that we know what the purpose of this financial statement is, let's analyze how this report is formatted in a little more detail.

Format

The statement of financial position is formatted like the accounting equation (assets = liabilities + owner's equity). Thus, the assets are always listed first.

Assets Section

Assets are resources that the company can use to create goods or provide services and generate revenues. There are many ways to format the assets section, but the most common size balance sheet divides the assets into two sub-categories: current and non-current. The current assets include cash, accounts receivable, and inventory. These resources are typically consumed in the current period or within the next 12 months.

The non-current assets section includes resources with useful lives of more than 12 months. In other words, these assets last longer than one year and can be used to benefit the company beyond the current period. The most common non-current assets include property, plant, and equipment.

Liabilities Section

Liabilities are debt obligations that the company owes other companies, individuals, or institutions. These range from commercial loans, personal loans, or mortgages. This section is typically split into two main sub-categories to show the difference between obligations that are due in the next 12 months, current liabilities, and obligations that mature in future years, long-term liabilities.

Current debt usually includes accounts payable and accrued expenses. Both of these types of debts typically become due in less than 12 months. The long-term section includes all other debts that mature more than a year into the future like mortgages and long-term notes.

Equity Section

Equity consists of the ownership of the company. In other words, this measures their stake in the company and how much the shareholders or partners actually own. This section is displayed slightly different depending on the type of entity. For example a corporation would list the
common stock, preferred stock, additional paid-in capital, treasury stock, and retained earnings. Meanwhile, a partnership would simply list the members' capital account balances including the
current earnings, contributions, and distributions.

In the world of non-profit accounting, this section of the statement of financial position is called the net assets section because it shows the assets that the organization actually owns after all the debts have been paid off. It's easier to understand this concept by going back to an accounting
equation example. If we rearrange the accounting equation to state equity = assets – liabilities, we can see that the equity of a non-profit is equal to the assets less any outstanding liabilities.

INCOME STATEMENT

The Income Statement is one of a company’s core financial statements that show their profit and loss over a period of time. The profit or loss is determined by taking all revenues and subtracting all expenses from operating and non-operating activities.

The income statement is one of three statements used in both corporate finance (including financial modelling) and accounting. The statement displays the company’s revenue, costs, gross profit, selling and administrative expenses, other expenses and income, taxes paid and net profit in a coherent and logical manner.
The statement is divided into time periods that logically follow the company’s operations. The most common periodic division is monthly (for internal reporting), although certain companies may use a thirteen-period cycle. These periodic statements will be aggregated into total values for quarterly and full year results.

FINANCIAL STATEMENTS	Historical Results				
	2012	2013	2014	2015	2016
Income Statement					
Revenue	**102,007**	**118,086**	**131,345**	**142,341**	**150,772**
Cost of Goods Sold (COGS)	39,023	48,004	49,123	52,654	56,710
Gross Profit	**62,984**	**70,082**	**82,222**	**89,687**	**94,062**
Expenses					
Salaries and Benefits	26,427	22,658	23,872	23,002	25,245
Rent and Overhead	10,963	10,125	10,087	11,020	11,412
Depreciation & Amortization	19,500	18,150	17,205	16,544	16,080
Interest	2,500	2,500	1,500	1,500	1,500
Other	8,820	6,225	1,659	3,911	5,996
Total Expenses	**68,210**	**59,658**	**54,323**	**55,977**	**60,233**
Earnings Before Tax	**(5,226)**	**10,424**	**27,899**	**33,711**	**33,829**
Taxes	1,120	4,858	8,483	10,908	11,598
Net Earnings	**(6,346)**	**5,566**	**19,416**	**22,802**	**22,231**

This statement is a great place to begin the financial model, as it requires the least amount of information from the balance sheet and cash flow statement. Thus, in terms of information, the income statement is a predecessor to the other two core statements.

The components of an Income Statement

The income statement may have minor variations between different companies, as expenses and income will be dependent on the type of operations or business conducted. However, there are several generic line items that are commonly seen in the income statement. The most common income statement items include:

Revenue/Sales

Sales Revenue is the company's revenue from sales or service is displayed at the very top of the statement. This value will be gross of the costs associated in creating the goods sold, or in providing the service.

Cost of Good Sold (COGS)

Cost of Goods Sold (COGS) is a line-item that aggregates the direct costs associated with achieving the revenue. Fixed costs and overhead are excluded.

Gross Profit

Gross Profit Gross profit is found by subtracting COGS from Sales or Revenue.

Selling General and Administrative

SG&A Expense includes the selling, general and administrative section will contain all other indirect costs associated with running the business. This includes salaries of management, advertising expenses, travel expenses, and sometimes depreciation and amortization, among others. Entities may, however, elect to separate out depreciation and amortization in its own section.

EBITDA

EBITDA, while not present in all income statements, stands for Earnings before Interest, Tax, Depreciation, and Amortization is calculated by subtracting SG&A expenses (excluding amortization and depreciation) from gross profit.

Depreciation & Amortization

Depreciation and amortization are non-cash expenses that are created by accountants to spread out the cost of capital assets such as Property, Plant, and Equipment (PP&E).

EBIT

EBIT, while not present in all income statements, stands for Earnings before Interest and Tax and is calculated by subtracting depreciation and amortization from EBITDA.

Interest

Interest Expense. It is common for companies to split out interest expense and interest income as a separate line item in the income statement. This is done to be able to reconcile the difference between EBIT and EBT. Interest expense is determined through the debt schedule.

EBT (pre-tax income)

EBT stands for Earnings Before Tax or pre-tax income is found by subtracting interest expense from EBIT. This is the final subtotal before finding net income.

Income Taxes

Income Taxes refer to the relevant taxes charged on pre-tax income. The total tax expense can consist of both current taxes and future taxes.

Net Income

Net Income is calculated by deducting income taxes from pre-tax income. This is the amount that flows into retained earnings on the balance sheet, after deductions for any dividends.

CASH FLOW STATEMENT

Till now you have learnt about the financial statements being primarily inclusive of Position Statement (showing the financial position of an enterprise as on a particular date) and Income Statement (showing the result of the operational activities of an enterprise over a particular period). There is also a third important financial statement known as Cash flow statement, which shows inflows and outflows of the cash and cash equivalents. This statement is usually prepared by companies which come as a tool in the hands of users of financial information to know about the sources and uses of cash and cash equivalents of an enterprise over a period of time from various activities o*f an enterprise.*

Accounting Standard-3 (AS-3), issued by The Institute of Chartered Accountants of India (ICAI) deals with the preparation and presentation of Cash flow statement. The revised AS-3 has made it mandatory for all listed companies to prepare and present a cash flow statement along with other financial statements on annual basis. A cash flow statement provides information about the historical changes in cash and cash equivalents of an enterprise by classifying cash flows into operating, investing and financing activities. It requires that an enterprise should prepare a cash flow statement and should present it for each accounting period for which financial statements are presented.

OBJECTIVES OF CASH FLOW STATEMENT

A Cash flow statement shows inflow and outflow of cash and cash equivalents from various activities of a company during a specific period. The primary objective of cash flow statement is to provide useful information about cash flows (inflows and outflows) of an enterprise during a particular period under various heads, i.e., operating activities, investing activities and financing activities.

This information is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

BENEFITS OF CASH FLOW STATEMENT

Cash flow statement provides the following benefits :

1. A cash flow statement when used along with other financial statements provides information that enables users to evaluate changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timings of cash flows in order to adapt to changing circumstances and opportunities.
2. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises.
3. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.
4. It also helps in balancing its cash inflow and cash outflow, keeping in response to changing condition. It is also helpful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and impact of changing prices.

CASH AND CASH EQUIVALENTS

As stated earlier, cash flow statement shows inflows and outflows of cash and cash equivalents from various activities of an enterprise during a particular period. As per AS-3, 'Cash' comprises cash in hand and demand deposits with banks, and 'Cash equivalents' means short-term highly liquid investments that are readily convertible into known amounts *of cash and which are subj*ect to an insignificant risk of changes in value.

CLASSIFICATION OF ACTIVITIES FOR THE PREPARATION OF CASH FLOW STATEMENT

Cash from Operating Activities

Operating activities are the activities that constitute the primary or main activities of an enterprise. For example, for a company manufacturing garments, operating activities are procurement of raw material, incurrence of manufacturing expenses, sale of garments, etc. These are the principal revenue generating activities (or the main activities) of the enterprise and these activities are not investing or financing activities. The amount of cash from operations' indicates the internal solvency level of the company, and is regarded as the key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, paying dividends, making of new investments and repaying of loans without recourse to external source of financing.

Cash flows from operating activities are primarily derived from the main activities of the enterprise. They generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

Cash Inflows from operating activities

1. Cash receipts from sale of goods and the rendering of services.
2. Cash receipts from royalties, fees, commissions and other revenues.

Cash Outflows from operating activities

1. Cash payments to suppliers for goods and services.
2. Cash payments to and on behalf of the employees.
3. Cash payments to an insurance enterprise for premiums and claims, annuities, and other policy benefits.
4. Cash payments of income taxes unless they can be specifically identified with financing and investing activities.

Cash from Investing Activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Investing activities relate to purchase and sale of long-term assets or fixed assets such as machinery, furniture, land and building, etc. Transactions related to long-term investment are also investing activities. Separate disclosure of cash flows from investing activities is important because they represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

Cash Outflows from investing activities

5. Cash payments to acquire fixed assets including intangibles and capitalised research and development.
6. Cash payments to acquire shares, warrants or debt instruments of other enterprises other than the instruments those held for trading purposes.
7. Cash advances and loans made to third party (other than advances and loans made by a financial enterprise wherein it is operating activities).

Cash Inflows from Investing Activities

- Cash receipt from disposal of fixed assets including intangibles.
- Cash receipt from the repayment of advances or loans made to third parties (except in case of financial enterprise).
- Cash receipt from disposal of shares, warrants or debt instruments of other enterprises except those held for trading purposes.
- Interest received in cash from loans and advances.
- Dividend received from investments in other enterprises.

Cash from Financing Activities

As the name suggests, financing activities relate to long-term funds or capital of an enterprise, e.g., cash proceeds from issue of equity shares, debentures, raising long-term bank loans, repayment of bank loan, etc. As per AS-3, financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in case of a

company) and borrowings of the enterprise. Separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of financing activities are:

Cash Inflows from financing activities

- Cash proceeds from issuing shares (equity or/and preference).
- Cash proceeds from issuing debentures, loans, bonds and other short/long-term borrowings.

Cash Outflows from financing activities

- Cash repayments of amounts borrowed.
- Interest paid on debentures and long-term loans and advances.
- Dividends paid on equity and preference capital.

Pro-forma of Cash from Operation

CASH FROM OPERATION

Particulars	Rs.	Rs.
Profit made during the year **Add:** Decrease in Debtors Increase in Creditors Increase in outstanding expenses Decrease in prepaid expenses		
Less: Increase in Bills receivable Decrease in bills payable Increase in Accrued income Decrease in interest received in advance Cash from operations		

Pro-forma of Cash Flow Statement

CASH FLOW STATEMENT

Particulars	Rs.	Rs.

Cash Flows from Operating Activities		
Cash from Operations		
Cash Flows from Investing Activities		
Purchase of Fixed Assets		
Proceeds from Sale of Equipment		
Interest Received		
Dividends Received		
Cash from Investing Activities (2)		
Cash flows from Financing Activities		
Proceeds from issuance of Share Capital		
Proceeds from Long-term Borrowings		
Repayment of Long-term Borrowings		
Interest Paid		
Dividends Paid		
Cash from Financing Activities(3)		
Net Increase in Cash and Cash Equivalents		
Cash and Cash Equivalents at the beginning of the period		
Cash and Cash Equivalents at the end of the period		

Repayment of Long-term Borrowings

Interest Paid

Dividends Paid

Cash from Financing Activities(3)

Net Increase in Cash and Cash Equivalents

Cash and Cash Equivalents at the beginning of the period

Cash and Cash Equivalents at the end of the period

ADDITIONAL DISCLOSURE STATEMENTS

Notes to the financial statement present all such information which cannot be presented on the face of income statement, balance sheet, statement of cash flows and statement of changes in equity.

Typical notes to the financial statement are:

1. An introduction of the business outlining its legal status, its country of incorporation and the name of its parents if any and a statement about the company's areas of business and its operations.
2. A summary of accounting policies related to revenue recognition, inventories, property, plant and equipment, financial instruments, etc.
3. A schedule of property plant and equipment showing the addition and deletion of assets, related movement in the accumulated depreciation account and book value.
4. A breakup of cost of sales, selling expenses and administrative expenses.
5. A detailed disclosure of different classes of financial instruments and their related risks.
6. A breakup of the gross amounts and present values of lease obligations of the business.
7. A detail of transactions with related parties.
8. A detail of contingencies that may affect the business in future, for example legal proceedings against the business.
9. A description of major events that occurred after the balance sheet date, etc.

Disclosures in Financial Reports: Supplementary Items

The financial report of a business includes more than just the financial statements; a financial report also needs information called *disclosures*. Supplementary items such as financial schedules and tables provide one form of disclosure in financial reports.

A wide variety of other information is also presented, some of which is required if the business is a public corporation subject to federal regulations regarding financial reporting to its stockholders. Other information is voluntary and not strictly required legally or according to GAAP.

In addition to the financial statements and footnotes to the financials, public corporations typically include some or all the following disclosures in their annual financial reports to their stockholders:

- **Cover (or transmittal) letter:** A letter from the chief executive of the business to the stockholders, which usually takes credit for good news and blames bad news on big government, unfavorable world political developments, a poor economy, or some other thing beyond management's control.
- **Management's report on internal control over financial reporting:** An assertion by the chief executive officer and chief financial officer regarding their satisfaction with the effectiveness of the internal controls of the business, which are designed to ensure the reliability of its financial reports (and to prevent financial and accounting fraud).
- **Highlights table:** A table that presents key figures from the financial statements, such as sales revenue, total assets, profit, total debt, owners' equity, number of employees, and number of units sold (such as the number of vehicles sold by an automobile manufacturer). The idea is to give the stockholder a financial thumbnail sketch of the business.

- **Management discussion and analysis (MD&A):** Deals with the major developments and changes during the year that affected the financial performance and situation of the business. The SEC requires this disclosure to be included in the annual financial reports of publicly owned corporations.

- **Historical summaries:** A financial history that extends back beyond the years (usually three) included in the primary financial statements.
- **Graphics:** Bar charts, trend charts, and pie charts representing financial conditions; photos of key people and products.
- **Promotional material:** Information about the company, its products, its employees, and its managers, often stressing an overarching theme for the year. Most companies use their annual financial report as an advertising opportunity.
- **Profiles:** Information about members of top management and the board of directors. Of course, everyone appears to be well qualified for his or her position. Negative information (such as prior brushes with the law) is not reported.
- **Quarterly summaries of profit performance and stock share prices:** Shows financial performance for all four quarters in the year and stock price ranges for each quarter (required by the SEC).
- **Management's responsibility statement:** A short statement indicating that management has primary responsibility for the accounting methods used to prepare the financial statements, for writing the footnotes to the statements, and for providing the other disclosures in the financial report. Usually, this statement appears near the independent CPA auditor's report.
- **Independent auditor's report:** The report from the CPA firm that performed the audit, expressing an opinion on the fairness of the financial statements and accompanying disclosures. Public corporations are required to have audits; private businesses may or may not have their annual financial reports audited.

- **Company contact information:** Information on how to contact the company, the Web site address of the company, how to get copies of the
- reports filed with the SEC, the stock transfer agent and registrar of the company, and other information.

Managers of public corporations rely on lawyers, CPA auditors, and their financial and accounting officers to make sure that everything that should be disclosed in the business's annual financial reports is included, and that the exact wording of the disclosures is not misleading, inaccurate, or incomplete. This is a tall order. The field of financial reporting disclosure changes constantly.

AUDIT REPORT – BASICS, FORMAT AND CONTENT

For any enterprise, the audit report is a key deliverable which shows the end results of the entire audit process. The users of financial statements like Investors, Lenders, Customers, and others base their decisions and plans on audit reports of any enterprise. An audit report is always critical to influencing the perceived value of any financial statement's audit.

The auditor should be careful in issuing the audit report as there is are a large number of people placing reliance on such report and taking decisions accordingly. The report should be issued by being unbiased and objective in discharging the functions.

CONTENTS OF AN AUDIT REPORT

The basic structure of an audit report as prescribed by the Standards on Auditing is as follows:

Heading	Brief of contents
Title	Title should mention that it is an 'Independent Auditor's Report'.
Addressee	Should mention clearly as to whom the report is being given to. For example Members oMentions that it is the Management's responsibility to Prepare the Financial Statements. f the company, Board of Directors
Management's Responsibility for Financial Statements	
Auditor's Responsibility	Mention that responsibility of the Auditor is to express an unbiased opinion on the financial statements and issue an audit report.
Opinion	Should mention the overall impression obtained from the audit of financial statements. For example Modified Opinion, Unmodified Opinion
Basis of the Opinion	State the basis on which the opinion as reported has been achieved. Facts of the basis should be mentioned.
Other Reporting Responsibility	If any other reporting responsibility exists, the same should be mentioned. For example Report on Legal or Regulatory requirements
Signature of the Auditor	The engagement partner (auditor) shall sign the audit report.
Place of Signature	The city in which audit report is signed.
Date of Audit Report	Date on which the audit report is signed.

Other headings being basic and self-explanatory in nature, we need to understand the about the opinion part precisely. This part forms the basic crux of an audit report.

Opinion in an Audit Report

There are primarily two kinds of opinions issued by an auditor in his / her audit report:

Unmodified Opinion (also called Unqualified report)

MODIFIED OPINION (ALSO CALLED QUALIFIED REPORT)

1. Unmodified Opinion

Issued for any audit where the auditor is satisfied that the financial statements present a true and fair view of the operations and transactions in an enterprise during the period.

An audit report with an Unmodified Opinion is also known as a 'Clean Report'. An Unmodified report develops confidence among users of Financial statements and annual reports of an enterprise.

It provides an impression that the financial statements are reasonably free from any misstatements and results as appearing there are true and fair.

2. Modified Opinion

Whenever the auditor has specific findings during his / her audit and concludes that an Unmodified Opinion cannot be issued due to the nature of findings, a Modified Opinion is issued in the audit report.

There are two basic reasons due to which an auditor concludes on issuing a Modified Opinion:

Based on the audit and evidence, finds out that the financial statements contain a certain degree of material misstatements. Unable to obtain sufficient and appropriate evidences to conclude that the financial statements are free from material misstatements.

There are three kinds of modified opinions which are issued according to the findings and circumstances:

A. Adverse Opinion

B. Qualified Opinion

C. Disclaimer of Opinion

A. Qualified Opinion

A Qualified Opinion is given in a situation where:

The auditor concludes that misstatements are material but the impact is not so high that it would render the whole financial statements unacceptable; or The auditor is unable to obtain sufficient or appropriate audit evidence but concludes that there are indications of misstatements in the financial statements (but the degree is not high).

Example of a Qualified Opinion paragraph in audit report:

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Companies Act, 2013, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

In case of the Balance Sheet, of the state of affairs of the company as at March 31, XXXX;
In case of Profit and Loss Account, of the profit/loss for the year ended on that date; and
In case of the Cash Flow Statement, of the cash flows for the year ended on that date.

B. Adverse Opinion

An Adverse opinion shall be issued by the auditor where he concludes that on the basis of evidence obtained and procedures performed, there are material misstatements in the financial statements and the impact of the same is high.

Example of a Qualified Opinion paragraph in audit report:

In our opinion, because of the omission of the information in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013, in the manner so required and also, do not give a true and fair view in conformity with the accounting principles generally accepted in India:

In case of the Balance Sheet, of the state of affairs of the company as at March 31, XXXX; In case of Profit and Loss Account, of the profit/loss for the year ended on that date; and In case of the Cash Flow Statement, of the cash flows for the year ended on that date.

C. Disclaimer of Opinion

A Disclaimer of Opinion is to be issued by an auditor in cases where the auditor concludes that he / she is not able to obtain sufficient and appropriate evidences. In such scenario, the auditor is not able to form an opinion and thus, disclaims form providing an opinion on the financial statements. The impact of material misstatements and degree of the same is high enough.

Example of a Draft Disclaimer of Opinion:

We were engaged to audit the financial statements of ABC Private Limited ("the entity") which comprises the Balance Sheet as at March 31, XXXX, the statement of Profit and Loss, (the statement of changes in equity) and statement of Cash Flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient and appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

DIRECTOR REPORT:

Definition of directors report:

A statement by a company's directors in its annual accounts giving the directors' opinion of the state of the company, and how much should be paid to people owning shares in the company.

It is mandatory for every company, to forward to its members, along with its annual Financial Statement the Board of Director's report. Report of Board of Directors should be 'ATTACHED' to the Balance Sheet laid before the AGM.

A director's report is intended to explain to shareholders, the overall financial position of the Company and its operation & Business Scope. In Companies Act, 2013 , lot of sections makes it mandatory to make disclosure in Boards report contrary to previous Act, where only section 217, talks about the Boards Report.

Directors report under companies act, 2013 & SEBI (LODR) regulations, 2015

The Director Report is the part of Annual Report in which the details of Company is mentioned and laid before the Annual General Meeting. It is imperative to consider the provisions of the Companies Act, 2013, Secretarial Standard on Board Meetings and General Meeting and SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 relating to the disclosure of contents in the Board's report and other related matters.

APPLICABILITY

Provisions of Section 134 are applicable only for F.Y. commencing on or after 1st April, 2014. The provision of Director Report (u/s 134) is applicable only to financial year commencing on or after 1st April, 2014. Directors Report shall be prepared on the basis of Standalone financial statements.

BASIS OF PREPARATION OF DIRECTOR'S REPORT

The Board's report shall be prepared based on "stand alone financial statements of the company".

SIGNING OF DIRECTOR'S REPORT

As per Section 134(6) Board Report and annexure thereto shall be signed by

- its 'CHAIRPERSON' if he is authorized by Board of director; Where he is not so authorized by,
- At least 2 (Two) Director, one of whom shall be a Managing Director.
- If there is no Managing Director then by Two Directors.

APPROVAL OF DIRECTOR'S REPORT

Section 179(3) states that approval of Board's report shall be done in meeting of the Board of director only. This means that approval of Board's report shall not be done by resolution by circulation or by committee or by a meeting through video conferencing or other audio visual means.

E-FILING OF RESOLUTION

Section 117 states that every public company shall file resolution of approval of Board's report via E-Form MGT-14 within 30days of passing of Board resolution.

IN CASE OF ONE PERSON COMPANY

In case of a One Person Company, the Board's report mean a report containing explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made by the auditor in his report.

CONTENTS OF DIRECTOR'S REPORT

This outline mandatory items of director's report. However, there is no restriction to put any matter in the director's report if the directors have intention to mention therein apart from legal provisions.

- ***GOVERNING PROVISIONS (Section 92(3) read with Section 134(3)(a))***

  Form MGT-9 provides for basic details of the Company such as name, CIN, DOI, Registered office Address, Principal Business activites of the Company, Holding, subsidiary and associate company details, shareholding pattern, remuneration of directors and KMP, penalties, punish

  ent, compounding details etc

- ***GOVERNING PROVISIONS (Section 134(3)(c) & Section 134(5))***

The Directors' Responsibility Statement shall state that—

DIRECTORS' RESPONSIBILITY STATEMENT- DETAILED CONTENT		
S. No.	Content	Content of DRS in Detail
A.	Accounting Standard	In the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures
B.	Accounting Policies	The directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period
C.	Proper & efficient care for 3 things	The directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding, the assets of the company and for preventing and detecting fraud and other irregularities.
D.	Going Concern Basis	the directors had prepared the annual accounts on a going concern basis.
E.	Internal Financial Controls- applicable to "Listed Entity only"	the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.
F.	Compliance with all laws	The director has devised proper system to ensure compliance with the provisions of all applicable laws and that such system were adequate and operating effectively.

Fund Flow Statement Definition:

A statement showing money coming into and going out of a business in a particular period of time, where this money came from, and what it was used for. Two types of this statement are the source and application of funds statement and the cash flow statement.

Meaning of Funds Flow Statement:

The profit and loss account and balance sheet statements are the common important accounting statements of a business organization. The profit and loss account provides financial information relating to only a limited range of financial transactions entered into during an accounting period and its impact on the profits to be reported.

The balance sheet contains information relating to capital or debt raised or assets purchased. But both the above two statements do not contain sufficiently wide range of information to make assessment of organization by the end user of the information.

In view of recognized importance of capital inflows and outflows, which often involve large amounts of money should be reported to the stakeholders, the funds flow statement is devised.

In a funds flow analysis, the details of financial resources availed and the ways in which such resources are used during a particular accounting period, are given in a statement form called 'Funds flow statement'. The sources of funds also include the funds generated from operations internally.

The funds flow statement can explain the reasons for liquidity problems of the firm even though it is earning profits. It helps the efficient working capital management and indicates the ability of the firm in servicing its long-term debt obligations. The changes in working capital position can also be tracked by observing the surplus/deficit of funds during a particular accounting period.

This statement is also called 'statement of sources and application of funds 'and 'statement of changes in financial position'. While preparation of funds flow statement, non-fund transactions are ignored. A funds flow statement is based on the accrual accounting system, and does not provide explanation as to transactions affecting the cash or cash equivalents. Funds flow is a broader concept than 'cashflow'.

A funds flow statement fails to give reasons for excess or shortage of cash and cash equivalents. The funds flow statement contains all the details of the financial resources which have become available during an accounting period and the ways in which those resources have been used up.

This statement discloses the amounts raised from various sources of finance during a period and then explains how that finance has been used in the business. This statement is valuable in interpretation of the accounts. It is a very useful tool in analysis of financial statements which analyses the changes taking place between two balance sheet dates.

The statement analyses the changes between the opening and closing balance sheets for the period. A balance sheet sets out the financial position at a point of time, setting liabilities from which funds have been raised against assets acquired by the use of those funds.

A funds flow statement analyses the changes which have taken place in the assets and liabilities during certain period as disclosed by a comparison of the opening and closing balance sheets.

Meaning of 'Fund' and 'Flow':

For preparation of a funds flow statement, the whole items of the balance sheet are classified into the following four categories as shown below:

The excess of current assets over current liabilities is called 'working capital'. The excess of funds generated over funds outgo from non-current assets and non-current liabilities will lead to increase or decrease in working capital.

This can further be analyzed into increase or decrease in respective current assets and current liabilities. The term 'fund' has been defined and interpreted differently by different experts. Broadly, the term 'fund' refers to all the financial resources of the company.

On the other extreme, 'fund' has been understood as 'cash' only. However, the most acceptable meaning of the 'fund' is 'working capital'. Working Capital is the excess of current assets over current liabilities.

In funds flow analysis, we shall also abide by the popular definition of funds, meaning working capital. The 'flow' of funds refer to transfer of economic values from one asset equity to another. When 'fund 'mean working capital, flow of funds refers to movement of funds which cause a change in working capital of the organization.

Identification of Flow of Funds:

A 'flow' of funds takes place only if a current account is involved. To identify a flow, journalize the transaction, identify the two accounts involved as 'current' and 'non-current' and apply the general rule.

(a) Transactions which involve only current accounts do not result in a flow.

(b) Transactions which involve only non-current accounts do not result in a flow.

(c) Transactions which involve one current account and one non-current account results in a flow of funds.

Preparation of Funds Flow Statement:

Sources and Application of Funds:

The relationship between sources and application of funds and its impact on working capital is explained in the format of statement of sources and application of funds as given below:

Note: Payment of dividend and tax will appear as an application of funds only when these items are appropriations of profits and not current liabilities.

SOURCES OF FUNDS:

The funds inflow into the organization will come from the following sources:

Funds Generated from Operations – During the course of trading activity, a company generates revenue mainly in the form of sale proceeds and paid out for costs. The difference between these two items will be the amount of funds generated by the trading operations.

The funds generated from business operations are arrived at after making the following adjustments:

Notes:

(a) Depreciation on fixed assets or amortization of intangible assets like preliminary expenses, patents, goodwill, etc., written off is charged against profit to reflect the use of fixed assets or written-off of intangible asset. In these transactions there is no corresponding cash outlay occurs and hence, add back the amount charged against profit, to arrive at the total funds generated from business operations.

(b) The profit or loss on sale of non-current assets (fixed assets and long-term investments) is adjusted to arrive at the true funds from operations.

(c) The provision for tax made in the profit and loss account is to be added back to the reported profit. The actual amount paid as tax is to be shown as the application of funds in the funds flow statement. The provision for tax, if it is shown in the balance sheet, need not be considered for calculation of funds generated from operations.

(d) Any amount appropriated in the profit and loss account towards transfer to reserves or proposed dividend is to be added back to arrive at the funds generated from operation. The actual amount paid as dividend is to be shown as application of funds in the funds flow statement. The dividend proposed but awaiting payment is a current liability in the balance sheet. If this amount increases, from one year end to the next, the extra liability appears as a source of funds.

Funds Raised from Shares, Debentures and Long-Term Loans:

The long-term funds injected into the business during the year by issue of new shares or debentures and by raising long-term loans, and any premium collected on such issues.

Sale of Fixed Assets and Long-Term Investments:

Any amount generated from sale of fixed assets or long-term investments is a source of funds. While preparation of the funds flow statement the gross sale proceeds from sale is taken as source of funds. This activity does not produce fresh funds, but it releases funds used to finance the assets. Any profit or loss arising from such sale is adjusted in the funds generated from operations.

Application of Funds:

The use of funds in an organization takes place in the following forms:

i. Repayment of Preference Capital or Debentures or Long-Term Debt: This represents the application of organization's funds released from business through redemption of preference shares or debentures, repayment of long-term loans previously made by the organization. Any reduction in equity capital is also taken as application of funds.

ii. Purchase of Fixed Assets or Long-Term Investments:

The funds used to purchase long-term assets are usually the most significant application of funds during the year. This group includes capital expenditures on land, buildings, plant and machinery, furniture and fittings, vehicles and long- term investments outside the business.

iii. Distribution of Dividends and Payment of Taxes:

The dividends distributed to the shareholders and tax paid during the year is the application of funds for the firm.

iv. Loss from Operations:

Losses made in the trading activities use up the funds. If costs exceed revenue, a cash outflow will be experienced.

Changes in Working Capital Position:

This statement follows the statement of sources and application of funds. The primary purpose of the statement is to explain the net change in working capital, as arrived in the funds flow statement. In this statement, all current assets and current liabilities are individually listed.

Against each account, the figure pertaining to that account at the beginning and at the end of the accounting period is shown. The net change in its position is also shown. The changes taking place with respect to each account should add up to equal the net change in working capital, as shown by the funds flow statement.

i. Increase in Current Assets and Decrease in Current Liabilities:

The acquisition of current assets and repayment of current liabilities will result in funds outflow. The funds may be applied to finance an increase in stock, debtors etc. or to reduce trade creditors, bank overdraft, bills payable etc.

ii. Decrease in Current Assets and Increase in Current Liabilities:

The reduction in current assets e.g., stock or debtors balances will result in release of funds to be applied elsewhere. Short-term funds raised during the period by any increase in the current liabilities like trade creditors, bank overdraft and tax dues, means that these sources have lent more at the end of the year than at the beginning.

The basic rules in preparation of the funds flow statement is as follows:

(a) An increase in an asset over the year is an application of fund.

(b) A decrease in an asset over the year is a source of fund.

(c) A decrease in a liability over the year is an application of fund.

(d) An increase in a liability over the year is a source of fund.

BENEFITS AND DRAWBACKS OF FUNDS FLOW ANALYSIS:

BENEFITS:

To determine financial consequences of operations – Funds flow analysis determines the financial consequences of business operations.

In the following cases, funds flow analysis helps the management to understand the movement of funds and in effective funds management:

1. Many a time, a company in spite of earning large profits may have unsatisfactory liquidity position.

2. The company may be incurring losses but its liquidity position is sound or the firm will be investing in fixed assets despite losses.

3. The firm may declare dividend in spite of losses or low profits.

4. The profit earned by the firm from different sources is not easily understood by the management.

5. There may be sufficient cash in the business. But how such high liquidity is existing, is not known.

i. To Fill Financial Blind Spots:

The funds flow statement is designed to fill financial blind spots of the operating statement. It translates the economic consequences of operations into financial information as a basis for action.

ii. Working Capital Utilization:

The funds flow statement helps the management in assessing the activity of working capital and whether the working capital has been effectively used to the maximum extent in business operations or not.

The statement also depicts the surplus or deficit in working capital than required. This helps the management to use the surplus working capital profitably or to locate the sources of additional working capital in case of scarcity.

iii. To Aid in Securing New Finances:

A statement of changes in financial position is useful for the creditor in considering the company’s request for new term loan.

iv. Helps in Allocation of Financial Resources:

It helps the management in taking decisions regarding allocation of limited financial resources among different projects on priority basis.

v. Helps in Deciding the Urgency of a Problem: Funds flow analysis helps to relate the time factor to financial planning. This enables the management to identify critical points throughout the passage of time. The management as also the outsiders concern themselves with the informa-tion system geared up towards strategic planning and control of the firm.

This places emphasis on the importance of the statement of changes in financial position as the behaviour of funds flow figures relates to the criteria upon which management strategy is based.

vi. Helps in Evaluation of Operational Issues:

The statement of changes functions as an analytical guide for evaluating operational issues. The statement enables the management to ascertain in which the study of trends of success or failure of operations and available resources.

Drawbacks:

a. Historical Nature:

The funds flow statement is historical in nature like any other financial statement. It does not estimate the sources and application of funds for the near future.

b. Structural Changes are not Disclosed:

The funds flow statement does not disclose the structural changes in financial relationship in a firm nor it discloses the major policy changes with regard to investment in current assets and short-term financing. Significant additions to inventories financed by short-term creditors are not furnished in the statement as they are offset by each other while computing net changes in working capital.

c .New Items are not Disclosed:

The funds flow statement does not disclose any new or original items which affect the financial position of the business. The funds flow statement simply rearranges the data given in conventional financial statements and schedules.

d. Not Relevant:

A study of changes in cash is more relevant than a study of changes in funds for the purpose of managerial decision making.

e. Not Foolproof:

The funds flow statement is prepared from the data provided in the balance sheet and profit and loss account. Hence, the defects in financial statements will be carried over to funds flow statement also.

ELECTRONIC DISSEMINATION

Data dissemination is the distribution or transmitting of statistical, or other, data to end users. There are many ways organisations can release data to the public, i.e. electronic format, CD-ROM and paper publications such as PDF files based on aggregated data. The most popular dissemination method today is the 'non-proprietary' open systems using internet protocols. "They are used in data dissemination through various communication infrastructures across any set of interconnected networks." Data is made available in common open formats.

Some organisations choose to disseminate data using 'proprietary' databases in order to protect their sovereignty and copyright of the data. Proprietary data dissemination requires a specific piece of software in order for end users to view the data. The data will not open in common open formats. The data is first converted into the propitiatory data format and specifically designed software is provided by the organisation to users.

Dissemination formats and standards Under the Special Data Dissemination Standard, the formats are divided into two categories: "hardcopy" and "electronic" publications

Some examples of Hardcopy publications:

- yearbook
- panorama of municipalities
- monthly review
- trends
- pocketbook
- periodical

POSSIBLE QUESTIONS

Part - B

1. Auditor's report – Explain.
2. What is Cash from operation?
3. Expand and explain **EBITDA.**
4. List out any four examples in Data Dissemination format and standard.

Part - C

1. Draw the specimen of Income statement and explain it.

2. What is a 'Fund Flow Statement'? What are the various sources and uses of Funds?

3. How is the 'Balance sheet' prepared? Give its basic format with some items of Assets and Liabilities.

4. What is Additional disclosure of statements and state the needs for additional disclosure.

5. Write short notes on

   i) EBIT

   ii) Cash and Cash Equivalents

   iii) Cost of Good Sold (COGS)

6. What is Additional disclosure of statements and state the needs for additional disclosure.

7. Draw the specimen of Income statement and explain it.

8. Discuss supplementary items in disclosure in financial report.

9. Explain in detail about the auditor's report and director's reports published in a company.

10. State the various benefit and objectives of cash flow statements.

11. Write short notes on

    i) EBIT

    ii) Cash and Cash Equivalents

    iii) Cost of Good Sold (COGS)

12. Draw the Pro-forma of Cash Flow Statement as per AS-3.

Karpagam Academy of Higher Education
Department of Management
Financial Analysis and Reporting - 18BAU403A
II BBA - Unit - II

Question	Option - I	Option - II	Option - III	Option - IV	Answer
The term ‘Financial Statement’ covers	Profit & Loss Statement	Balance sheet and Profit & Loss Statement appropriation Account	Profit & Loss Statement and Balance sheet	Profit & Loss Statement appropriation Account	Profit & Loss Statement and Balance sheet
___________ of the cash flow generated by the firm's operations, investments and financial activities.	The balance sheet is a report	The income statement is a report	The statement of cash flows is a report	The auditor's statement of financial condition is a report	The statement of cash flows is a report
ABC Ltd. has a Current Ratio of 1.5: 1 and Net Current Assets of Rs. 5,00,000. What are the Current Assets?	Rs. 5,00,000	Rs. 10,00,000	Rs. 15,00,000	Rs. 25,00,000	Rs. 15,00,000
___________ of the profitability of the firm over a period of time such as a year.	The balance sheet is a summary	The income statement is a summary	That statement of cash flows is a summary	The audit report is a summary	The income statement is a summary
___________ a snapshot of the financial condition of the firm at a particular time.	The balance sheet provides	The income statement provides	The statement of cash flows provides	The audit report is a summary	The balance sheet provides
Which of the following ratios gives information on the amount of profits reinvested in the firm over the years?	Sales/total assets	Debt/total assets	Debt/equity	Retained earnings/total assets	Retained earnings/total assets
The overall net increase or decrease in working capital is found out by preparing _________	Fund flow statement	Cash flow statement	Schedule of changes in working capital	Income statement	Schedule of changes in working capital
Economic value added (EVA) is also known as	excess capacity	excess income	accounting value added	residual income	residual income

Which of the financial statements recognizes only transactions in which cash changes hands?	Balance Sheet	Income Statement	Statement of Cash Flows	Balance Sheet, and Income Statement	Statement of Cash Flows
The goal of corporate governance and business ethics education is to__________	Teach students their professional accountability and to uphold their personal Integrity to society	Change the way in which ethics is taught to students	Create more ethics standards by which corporate professionals must operate	Increase the workload for accounting students	Create more ethics standards by which corporate professionals must operate
The form of balance sheet is	Vertical	Horizontal	Horizontal and vertical	Horizontal or vertical	Horizontal or vertical
As per Accounting Standard-3, Cash Flow is classified into	Operating activities and investing activities	Investing activities and financing activities	Operating activities and financing activities	Operating activities, financing activities and investing activities	Operating activities, financing activities and investing activities
As per AS-3,__________means short-term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.	Cash in Hand	Demand Deposit in Bank	Cash equivalents	Building	Cash equivalents
Which one of the following contains Auditor's report____________?	Creditors responsibility	share holder's responsibility	Bankers responsibility	Auditor's responsibility	Auditor's responsibility
A large amount spent on special advertisement is–	Capital Expenditure	Revenue Expenditure	Revenue Loss	Deferred Revenue Expenditure	Deferred Revenue Expenditure
Double Entry System was introduced in–	America	Japan	India	Italy	Italy
What does management audit imply ?	Complete audit	Detailed audit	Efficiency audit	Interim audit	Efficiency audit

Which one of the following statements is correct ?	Internal audit and Management audit are the same	Internal audit and statutory audit are the same	Internal audit is compulsory in all cases	Statutory audit of company accounts is compulsory	Statutory audit of company accounts is compulsory
The assets of a business can be classified as	Only fixed assets	Only current assets	Fixed and current assets	Equity	Fixed and current assets
Which of the following is the test of the long term liquidity of a business?	Interest coverage ratio	Stock turnover ratio	Operating ratio	Current ratio	Interest coverage ratio
ROI stands for?	Return on Investment	Ratio of Investment	Return of Income	None of these	Return on Investment
Which of the following is not one of the items required to be shown in the heading of a financial statement?	The Financial statement prepares name	The title of the financial report	The financial reporting date or period	The name of the business entity	The Financial statement prepares name
Which of the following is not an asset?	Cash	Land	Equipment	Contributed Capital	Contributed Capital
Which of the following statements describe transactions that would be recorded in the accounting system?	An exchange of an asset for a promise to pay	An exchange of an promise for another promise to pay	Both of the above	None of the above	An exchange of an asset for a promise to pay
Total assets on a balance sheet prepared on any date must agree with which of the following?	The sum of total liabilities and net income as shown on the income statement	The sum of total liabilities and contributed capital	The sum of total liabilities and contributed capital	The sum of total liabilities and contributed capital and retained earnings	The sum of total liabilities and contributed capital and retained earnings
The T-account is used to summarize which of the following?	Increases and decrease to a single account in the accounting system	Debits and credits to a single account in the accounting system	Changes in specific account balance over a time period	All of the above describe how T-accounts are used by accountants	All of the above describe how T-accounts are used by accountants
The statement of financial position is formed like accounting equation as	Asset = Liability + Owners equity	Asset = Liability – Creditors	Asset = Liability + Creditors	Asset = Liability – Owners equity	Asset = Liability + Owners equity

Which of the following describes how assets are listed on the balance sheet?	In alphabetical order	In order of magnitude, lowest value to highest value	In the order they will be used up or turned in cash	From least current to most current	In the order they will be used up or turned in cash
Which is not a cash activity listed on the cash flow statememt?	Operating activities	Investing activities	Purchasing activities	Financing activities	Purchasing activities
The primary stakeholders are:	Customers.	Suppliers.	Shareholders.	Creditors.	Shareholders.
Plant & Machinery is	Fixed asset	Current asset	Fictitious asset	Intangible asset	Fixed asset
Depreciations arises because of :	Fall in the market value of the asset	Fall in the value of money	Physical wear and tear of asset	Inflation in the market	Physical wear and tear of asset
Capital expenditure are recorded in the __________	Balance sheet	Profit & loss account	Trading account	Manufacturing account	Balance sheet
Carriage outward is debited to _______________	Trading account	P/L account	Profit and loss appropriation account	Balance sheet	P/L account
Which of the following is correct?	Capital = Asset – Liabilities	Capital = Asset + Liabilities	Asset = Liabilities – capital	Liabilities = Asset + capital	Capital = Asset – Liabilities
Wages and salary is debited to:	Trading account	P/L Account	Profit and loss appropriations account	Balance sheet	Trading account
Land & building is a …………………………………	Fixed asset	Current asset	Fictitious asset	Intangible asset	Fixed asset
Which of the following account will have credit balance?	Bank over draft	Carriage inwards	Prepaid expenses	Bills receivable	Bank over draft
Assets acquired for long use in the business are called ………………….	Fixed assets	Current assets	Fictitious asset	Liquid asset	Fixed assets
Assets acquired for short term use in the business are called……………..	Fixed assets	Current assets	Fictitious assets	Liquid assets	Current assets

Which of the following transactions will result in inflow of funds?	Issue of debentures	Conversion of debentures into equity shares	Redemption of long term loan	Creation of General Reserve	Issue of debentures
Which of the following transactions will result in outflow of funds?	Issue of debentures	Conversion of debentures into equity shares	Redemption of long term loan	Creation of General Reserve	Redemption of long term loan
The analysis and interpretations of the financial statement will reveal …	the financial position & the profibility	Budget	Sources of fund	Fund flow statement	the financial position & the profibility
The process of explaining the meaning, significance and relationship between two financial factors is called …	Summarisation	Analysis	Interpretation	Reporting	Interpretation
Increase in working capital is ____________	Sources of Fund	Uses of fund	source of cash	uses of cash	Sources of Fund
EBIT stands for	Earnings before Interest and Tax	Earnings before Income and Tax	Expenses before Interest and Tax	Equity before Income and Tax	Earnings before Interest and Tax
Which of the following is not one the underlying principles of the corporate governance Combined Code of Practice?	acceptability	openness	integrity	accountability	acceptability
External audit of the accounts of a limited company is required	because it is demanded by the company's bankers	to detect fraud	at the discretion of the shareholders	by the Companies Act 2006	by the Companies Act 2006
Directors' responsibilities are unlikely to include	a duty to keep proper accounting records	a duty to propose high dividends for shareholders	a duty of care	a fiduciary duty	a duty to propose high dividends for shareholders
A company may become insolvent if it	cannot pay creditors in full after realisation of its assets	cannot meet its budgeted level of profit	has negative working capital	makes a loss	cannot pay creditors in full after realisation of its assets

Which one of these is not a mechanism for ensuring good corporate governance?	Requiring periodic reports by directors to shareholders on governance issues and practices	Ensuring the topic is an explicit part of the responsibilities of each director	Publishing a statement of corporate responsibility principles	Requiring certain actions to be approved by shareholders	Publishing a statement of corporate responsibility principles
Effective tool of excellent corporate governance corporation are	Board of directors	Common stock shareholders	Top executive officers	Lenders	Board of directors
A letter from the ___________ of the business to the share holder which usually takes credit for good news and bad news or some other things beyond management control.	Union	Governmnet	Employees	Chief Executive	Chief Executive
A financial hisory that extend back beyond the years included int the primary financial statement is ______	Promotinal Materials	Segment information	Historical summary	Profiles	Historical summary
Most companies uses their annual financial report as an _______________	Promotional Material	Segment Information	Profile Information	History	Promotional Material
Standard on Auditing specified under Section _______________ of the Act.	Sec 142 (10)	Sec 142 (12)	Sec 143 (10)	Sec 143 (12)	Sec 143 (10)
_____________ is the distribution or transmitted of statistical or other data to end users.	Electronic Dissemination	Auditor Report	Financial Statement	employee Stoc options scheme	Electronic Dissemination
Electronic copy publication is_________________	Year book	Monthly review	CD Rom	Pocket Book	CD Rom
Hardcopy publications is _________________	Periodical	CD ROM	Web page	PDF	Periodical

_______________ provides the framework for attaining a company objectives, it encompasses practically every sphere of management, from action plan and internal controls to performance management and corporate disclosure.	Corporate objectives	Corporate Governance	Auditors Report	Balance Sheet	Corporate Governance

UNIT-III

SYLLABUS

Financial Analysis – I: Common-Size Analysis (Vertical and Horizontal), Year-to-Year Change Analysis, Ratio Analysis - Liquidity of Short-Term Assets, Current Assets, Current Liabilities, and the Operating Cycle,Cash - Marketable Securities - Receivables - Inventories - Prepayments - Other Current Assets - Current Liabilities, Current Assets Compared with Current Liabilities, Working Capital - Current Ratio - Acid-Test Ratio

FINANCIAL STATEMENT ANALYSIS:

The term Financial Statement refer to a package of statements such as Balance Sheet, Income Statement, Statement of retained earnings, Funds Flow Statement, Cash Flow statement. The Balance Sheet and Income statements are traditionally viewed, others are prepared to supplement them.

DEFINITION

According to American Institute of Certified Public Accounts (AICPA):

"Financial Statements reflect a combination of recorded facts, accounting principles and personnel judgments"

NATURE OF FINANCIAL STATEMENTS :

Recording of facts

Accounting Principles

Personnel Judgments

TOOLS OF FINANCIAL STATEMENT ANALYSIS:

Comparative Statements - a) Comparative Income Statement

b) Comparative Balance Sheet

Common Size Statements - a) Common Size Income Statement

b) Common Size Balance Sheet

Trend Analysis, Ratio Analysis, Funds Flow Statement Cash Flow Statement

TYPES OF FINANCIAL ANALYSIS

Financial Analysis can be classified into different categories depending upon

(i) The materials used and (ii) The modus operandi of analysis

ON THE BASIS OF MATERIAL USED: According to this basis financial analysis can be of two types.

(i) **External Analysis:**

This analysis is done by those who are outsiders for the business. The term outsiders includes investors, credit agencies, government and other creditors who have no access to the internal records of the company.

(ii) **Internal Analysis:**

This analysis is done by persons who have access to the books of account and other information related to the business. On the basis of modus operandi. According to this, financial analysis can also be two types.

i) Horizontal analysis:

In case of this type of analysis, financial statements for a number of years are reviewed and analyzed. The current year's figures are compared with the standard or base year. The analysis statement usually contains figures for two or more years and the changes are shown recording each item from the base year usually in the from of percentage. Such an analysis gives the management considerable insight into levels and areas of strength and weakness. Since this type of analysis is based on the data from year to year rather than on the date, it is also termed as Dynamic Analysis.

(ii) Vertical analysis:

In case of this type of analysis a study is made of the quantitative relationship of the various terms in the financial statements on a particular date. For example, the ratios of different items of costs for a particular period may be calculated with the sales for that period such an analysis is useful in comparing the performance of several companies in the same group, or divisions or departments in the same company.

TECHNIQUES OF FINANCIAL ANALYSIS

A financial analyst can adopt one or more of the following techniques/tools of financial analysis.

1. **Comparative Financial Statements:**

   Comparative financial statements are those statements which have been designed in a way so as to provide time perspective to the consideration of various elements of financial position embodied in such statements. In these statements figures for two or more periods are placed side by side to facilitate comparison. Both the income statement and Balance Sheet can be prepared in the form of Comparative Financial Statements.

Comparative Income Statement:

The Income statement discloses net profit or Net Loss on account of operations. A comparative Income Statement will show the absolute figures for two or more periods, the absolute change from one period to another and if desired the change in terms of percentages. Since, the figures for two or more period are shown side by side, the reader can quickly ascertain whether sales have increased or decreased, whether cost of sales has increased or decreased etc. Thus, only a reading of data included in Comparative Income Statements will be helpful in deriving meaningful conclusions.

Comparative Balance Sheet: Comparative Balance Sheet as on two or more different dates can be used for comparing assets and liabilities and finding out any increase or decrease in those items. Thus, while in a single Balance Sheet the emphasis is on present position, it is on change in the comparative Balance Sheet. Such a Balance sheet is very useful in studying the trends in an enterprise.

The preparation of comparative financial statements can be well understood with the help of the following illustration.

ILLUSTRATION : From the following Profit and Loss Accounts and the Balance Sheet of Swadeshi polytex Ltd. For the year ended 31st December, 2009 and 2010, you are required to prepare a comparative Income Statement and Comparative Balance Sheet.

PROFIT AND LOSS ACCOUNT

(In Lakhs of Rs.)

Particular	2009	2010	*Assets	2009	2010
To Cost of Goods sold	Rs. 600	Rs. 750	By Net	Rs. 800	Rs. 1,000

To operating Expenses Administrative Expenses Selling Expenses To Net Profit	 20 30 150	 20 40 190	Sales		
	800	1,000		800	1,000

BALANCE SHEET AS ON 31ST DECEMBER

(In Lakhs of Rs.)

Liabilities	2009	2010	Assets	2009	2010
	Rs.	Rs.		Rs.	Rs.
Bills Payable	50	75	Cash	100	140
Sundry Creditors	150	200	Debtors	200	300
Tax Payable 6%	100	150	Stock	200	300
Debentures 6%	100	150	Land	100	100
Preference Capital	300	300	Building	300	270
Equity Capital	400	400	Plant	300	270
Reserves	200	245	Furniture	100	140
	1300	1520		1300	1520

SOLUTION:

Swadeshi Polytex Limited
COMPARATIVE INCOME STATEMENT
FOR THE YEARS ENDED 31ST DECEMBER AND 2010

(In Lakhs of Rs.)

Particulars	2009	2010	Absolute increase or decrease in 2010	Percentage increase or decrease in 2010
Net Sales Cost of Goods Sold	800 600	1000 750	+200 +150	+25 +25
Gross Profit	200	350	+50	+25
Operating Expenses Administration Expenses Selling Expenses	20 30	20 40	- +10	- +33.33
Total Operating	50	60	10	+20

Expenses				
Operating Profit	150	190	+40	+26.67

Swadeshi Polytex Limited
COMPARATIVE BALANCE SHEET
AS ON 31ST DECEMBER, 1987, 1988

Figures in lakhs of rupees

Assets	2009	2010	Absolute increase or decrease during 1988	Percentage increase (+) or decrease (-) during 1988
Current Assets:				
Cash	100	140	40	+40
Debtors	200	300	100	+50
Stock	200	300	100	+50
Total Current Assets	500	740	240	+50
Fixed Assets:				
Land	100	100	-	-
Building	300	270	-30	-10%
Plant	300	270	-30	-10%
Furniture	100	140	+40	+40%
Total Fixed Assets	800	780	-20	-2.5%
Total Assets	1300	1520	220	+17%
Liabilities & Capital:				

Current Liabilities				
Bills Payable	50	75	+25	+50%
Sundry Creditors	150	200	+50	+33.33%
Tax Payable	100	150	+50	+50%
Total Current Liabilities	300	425	+125	+41.66%
Long-term Liabilities : 6% Debentures	100	150	+50	+50%
Total Liabilities	400	575	+175	+43.75%
Capital & Reserves				
6% Pre. Capital	300	300	-	-
Equity Capital	400	400	-	-
Reserves	200	245	45	22.5
Total Shareholders' Funds	900	945	45	5%
Total Liabilities and Capital	1300	1520	220	17%

2. Common – size Financial Statements:

Common – size Financial Statements are those in which figures reported are converted into percentages to some common base. In the Income Statement that sale figure is assumed to be 100 and all figures are expressed as a percentage of this total.

Illustration: Prepare a Common – size Income Statement & Common-size Balance Sheet of Swadeshi Polytex Ltd., for the years ended 31st December, 2009 & 2010

SOLUTION:

Swadeshi Polytex Limited

COMMON – SIZE INCOME STATEMENT

FOR THE YEARS ENDED 31ST DECEMBER 2009 AND 2010

(Figures in Percentage)

	2009	2010
Net Sales	100	100
Cost of Goods Sold	75	75
Gross Profit	25	25
Opening Expenses:		
Administration Expenses	2.50	2
Selling Expenses	3.75	4
Total Operating Expenses	6.25	6
Operating Profit	18.75	19

Interpretation:

The above statement shows that though in absolute terms, the cost of goods sold has gone up, the percentage of its cost to sales remains constant at 75%, this is the reason why the Gross Profit continues at 25% of sales. Similarly, in absolute terms the amount of administration expenses remains the same but as a percentage to sales it has come down by 5%. Selling expenses have increased by 25%. This all leads to net increase in net profit by 25% (i.e., from 18.75% to 19%)

3. Trend Percentage:

Trend Percentages are immensely helpful in making a comparative study of the Financial statements for several years. The method of calculating trend percentages involves the calculation of percentage relationship that each item bears to the same item in the base year. Any year may be taken as base year. It is usually the earliest year. Any intervening year may also be taken as the base year. Each item of base year is taken as 100 and on that basis the percentages for each of the years are calculated. These percentages can also be taken as Index Numbers showing relative changes in the financial data resulting with the passage of time.

The method of trend percentages is useful analytical device for the management since by substitution percentages for large amounts, the brevity and readability are achieved. However, trend percentages are not calculated for all of the items in the financial statements. They are usually calculated only for major items since the purpose is to highlight important changes.

Besides, Fund flow Analysis, Cash Flow Analysis and Ratio Analysis are the other tools of Financial Analysis which have been discussed in detail as separate chapters.

RATIO ANALYSIS

INTRODUCTION

Of all the tools of financial analysis available with a financial analyst the most important and the most widely used tool is ratio analysis. Simply stated ratio analysis is an analysis of financial statements done with the help of ratios. A ratio expresses the relationship that exists between two numbers and in financial statement analysis a ratio shows the relationship between two interrelated accounting figures. Both the accounting figures may be taken from the balance sheet and the resulting ratio is called a balance sheet ratio or both the figures may be taken from profit and loss account when the resulting ratio is called as profit and loss account ratio and composite ratio is that ratio which is calculated by taking one figure from profit and loss account and the other figure from balance sheet.

To evaluate the financial performance of a company, the financial ratios are used as a very sophisticate tool. But, the type of analysis varies according to the specific interests of the party involved. Trade creditors are interested primarily in the liquidity of a firm. Their claims are short term, and the ability of a firm to pay these claims is best judged by means of a thorough analysis of its liquidity. The claims of bondholders, on the other hand, are long term. Accordingly, they are more interested in the cash-flow ability of the company to service debt over the long run. The bondholder may evaluate this ability by analyzing the capital structure of the firm, the major sources and uses of funds, its profitability over time, and projections of future profitability.

Investors in a company's common stock are concerned principally with present and expected future earnings and the stability of these earnings about a trend, as well as their covariance with the earnings of other companies. As a result, investors might concentrate their analysis on a company's profitability. They would be concerned with its financial condition insofar as it affects the ability of the company to pay dividends and to avoid bankruptcy. In order to bargain more effectively for outside funds, the management of a firm should be interested in all aspects of financial analysis that outside suppliers of capital use in evaluating the firm. Management also employs financial analysis for purposes of internal control. In particular, it is concerned with profitability on investment in the various assets of the company and in the efficiency of asset management.

IMPORTANCE OF RATIO ANALYSIS

The inter relationship that exists among the current items appeared in the financial statements, are revealed by accounting ratios. Ratio analysis of a firm's financial statements is of interest to a number of parties, mainly, shareholders, creditors, financial executives etc. Shareholders are interested with earning capacity of the firm: creditors are interested in knowing the ability of firm to meet its financial obligations ; and financial executives are concerned with evolving analytical tools that will measure and compare costs, efficiency, liquidity and profitability with a view to making intelligent decisions.

The importance of ratio analysis are discussed below, in brief:

Aid to Measure General Efficiency

Ratios enable the mass of accounting data to be summarized and simplified. They act as an index of the efficiency of the enterprise. As such they serve as an instrument of management control.

Aid to Measure Financial Solvency

Ratios are useful tools in the hands of management and other concerned to evaluate the firms performance over a period of time by comparing the present ratio with the past ones. They point out firm's liquidity position to meet its short term obligations and long term solvency.

Aid in Forecasting and Planning

Ratio analysis is an invaluable aid to management in the discharge of its basic function such as planning, forecasting, control etc. The ratios that are derived after analyzing and scrutinizing the past result, help the management to prepare budgets to formulate policies and to prepare the future plan of action etc.

Facilitate Decision-making

It throws light on the degree of efficiency of the management and utilization of the assets and that is why it is called surveyor of efficiency. They help management in decision-making.

Aid in Corrective Action

Ratio analysis provides inter firm comparison. They highlight the factors associated with successful and unsuccessful firms. If comparison shows an unfavorable variance, corrective actions can be initiated. Thus, it helps the management to take corrective action.

Aid in Intra Firm Comparison

Intra firm comparisons are facilitated. It is an instrument for diagnosis of financial health of an enterprise. It facilitates the management to know whether the firm's financial position is improving or deteriorating by setting a trend with the help of ratios.

Acts as a Good Communication : Ratios are an effective means of communication and play a vital role in informing parties. The communications by the use of simplified and summarized ratios are more easy and understandable

Evaluation of Efficiency

Ratio analysis is an effective instrument which, when properly used, is useful to assess important characteristics of business – liquidity, solvency, profitability etc. A study of these aspects may enable conclusions to be drawn relating to capabilities of business.

Effective Tool

Ratio analysis helps in making effective control of the business – measuring performance, control of cost etc. Effective control is the keynote of better management. Ratio ensures secrecy.. Figures in the absolute forms, shown in the financial statements are neither significant nor able to be compared. In fact, they are dump. But ratios have power to speak.

USE OF FINANCIAL RATIOS

For analysing the financial condition and performance of a company, the financial analyst needs certain yardsticks. The yardstick frequently used is a ratio, or index, relating two pieces of financial data to each other. Analysis and interpretation of various ratios should give experienced, skilled analysts a better understanding of the financial condition and performance of the firm than they would obtain from analysis of the financial data alone.

The analysis of financial ratios involves two types of comparison. First, the analyst can compare a present ratio with past and expected future ratios for the same company. The current ratio (the ratio of current assets to current liabilities) for the present year end could be compared with the current ratio for the preceding year end. When financial ratios are arrayed on a spreadsheet over a period of years, the analyst can study the composition of change and determine whether there has been an improvement or deterioration in the financial condition and performance over time. The above is termed as trend analysis. Financial ratios also can be computed for projected, or pro forma, statements and compared with present and past ratios. In the comparison over time, it is best to compare not only financial ratios but also the few figures.

The second method of comparison involves comparing the ratios of one firm with those of similar firms or with industry averages at the same point in time. Such a comparison gives insight into the relative financial condition and performance of the firm. Sometimes a company will not fit neatly into an industry category. In such situations, one should try to develop a set, albeit usually small, of peer firms for comparison purposes.

TYPES OF RATIOS

CAPITAL STRUCTURE OR LEVERAGE RATIOS

Financial strength indicates the soundness of the financial resources of an organisation to perform its operations in the long run. The parties associated with the organisation are interested in knowing the financial strength of the organisation. Financial strength is directly associated with the operational ability of the organisation and its efficient management of resources. The financial strength analysis can be made with the help of the following ratios:

1. Debt-Equity Ratio
2. Capital Gearing Ratio
3. Financial Leverage
4. Proprietary Ratio and Interest Coverage

1. Debt-Equity Ratio

The debt-equity ratio is determined to ascertain the soundness of the long-term financial policies of the company. This ratio indicates the proportion between the shareholders' funds (i.e. tangible net-worth) and the total borrowed funds. Ideal ratio is 1. In other words, the investor may take debt equity ratio as quite satisfactory if shareholders' funds are equal to borrowed funds. However, creditors would prefer a low debt-equity ratio as they are much concerned about the security of their investment. This ratio can be calculated by dividing the total debt by shareholders' equity. For the purpose of calculation of this ratio, the term shareholders' equity includes share capital, reserves and surplus and borrowed funds which includes both long-term funds and short-term funds.

Debt – Equity Ratio = Debt / Equity

A high ratio indicates that the claims of creditors are higher as compared to owners' funds and a low debt-equity ratio may result in a higher claim of equity.

2. Capital Gearing Ratio

This ratio establishes the relationship between the fixed interest-bearing securities and equity shares of a company.

It is calculated as follows:

$$\text{Capital Gearing Ratio} = \frac{\text{Fixed Interest-bearing securities}}{\text{Equity Shareholders' Funds}}$$

Fixed-interest bearing securities carry with them the fixed rate of dividend or interest and include preference share capital and debentures. A firm is said to be highly geared if the lion's share of the total capital is in the form of fixed interest-bearing securities or this ratio is more than one. If this ratio is less than one, it is said to be low geared. If it is exactly one, it is evenly geared. This ratio must be carefully planned as it affects the firm's capacity to maintain a uniform dividend policy during difficult trading periods that may occur. Too much capital should not be raised by way of debentures, because debentures do not share in business losses.

3. Financial Leverage Ratio

Financial leverage results from the presence of fixed financial charges in the firm's income stream. These fixed charges do not vary with the earnings before interest and tax (EBIT) or operating profits. They have to be paid regardless of the amount of earnings before interest and taxes available to pay them. After paying them, the operating profits (EBIT) belong to the ordinary shareholders. Financial leverage is concerned with the effects of changes in earnings before interest and taxes on the earnings available to equity holders. It is defined as the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the firm's earning per share. Financial leverage and trading on equity are synonymous terms. The EBIT is calculated by adding back the interest (interest on loan capital + interest on long term loans + interest on other loans) and taxes to the amount of net profit. Financial leverage ratio is calculated by dividing EBIT by EBT (earnings before tax). Neither a very high leverage nor a very low leverage represents a sound picture. (EBIT ÷ EBT).

4. **Proprietary Ratio**

This ratio establishes the relationship between the proprietors' funds and the total tangible assets. The general financial strength of a firm can be understood from this ratio. The ratio is of particular importance to the creditors who can find out the proportion of shareholders' funds in the capital assets employed in the business. A high ratio shows that a concern is less dependent on outside funds for capital. A high ratio suggests sound financial strength of a firm due to greater margin of owners' funds against outside sources of finance and a greater margin of safety for the creditors. A low ratio indicates a small amount of owners' funds to finance total assets and more dependence on outside funds for working capital. In the form of formula this ratio can be expressed as:-

$$\text{Proprietary Ratio} = \frac{\text{Net Worth}}{\text{Total Assets}}$$

5. Interest Coverage Ratio

This ratio measures the debt servicing capacity of a firm in so far as fixed interest on long-term loan is concerned. It is determined by dividing the operating profits or earnings before interest and taxes (EBIT) by the fixed interest charges on loans. Thus,

$$\text{Interest Coverage} = \frac{\text{EBIT}}{\text{Interest}}$$

It should be noted that this ratio uses the concept of net profits before taxes because interest is tax-deductible so that tax is calculated after paying interest on long-term loans. This ratio, as the name suggests, shows how many times the interest charges are covered by the EBIT out of which they will be paid. In other words, it indicates the extent to which a fall in EBIT is tolerable in the sense that the ability of the firm to service its debts would not be adversely affected. From the point of view of creditors, the larger the coverage, the greater the ability of the firm to handle fixed-charge liabilities and the more assured the payment of interest to the creditors. However, too high a ratio may imply unused debt capacity. In contrast, a low ratio is danger signal that the firm is using excessive debt and does not have the ability to offer assured payment of interest to the creditors.

FIXED ASSETS ANALYSIS

The successful operation of a business generally requires some assets of fixed character. These assets are used primarily in producing goods and in operating the business. With the help of these, raw materials are converted into finished products. Fixed assets are not meant for sale and are kept as a rule permanently in the business in order to carry on day-to-day operations.

Analysis of fixed assets is very important from investors' point of view because investors are more concerned with long term assets. Fixed assets are property of non-current nature which are acquired to provide facilities to carry on business. They include land, building, equipment, furniture, etc. They are generally shown in balance sheet by aggregating them into groups of gross block as reduced by the accumulated amount of depreciation till date. Investment in fixed assets is of a permanent nature and therefore should be financed by owners' funds (permanent sources of funds). The owners' funds should be sufficient to provide for fixed assets. Fixed assets are generally financed by owners' equity and long-term borrowings. The long-term borrowings are in the form of long-term loans and of almost permanent nature. Under such a situation it becomes more or less irrelevant to relate the fixed assets with only the owners' equity. Therefore, the analysis of the source of financing of fixed assets has been done with the help of the following ratios:-

1. Fixed Assets to Net Worth
2. Fixed Assets to Long-term Funds

1. Fixed Assets to Net Worth

In the words of Anil B.Roy Choudhary, "this ratio indicates the relationship between Net Worth (i.e. shareholders' funds) and investments in net fixed assets (i.e. Gross Block minus depreciation)".

The higher the ratio the lesser would be the protection to creditors. If the ratio is less than 1, it indicates that the net worth exceeds fixed assets. It will further indicate that the working capital is partly financed by shareholders' funds. If the ratio exceeds 1, it would mean that part of the fixed assets has been provided by creditors. The formula for derivation of this ratio is:-

$$\text{Fixed Assets to Net Worth Ratio} = \frac{\text{Net Fixed Assets}}{\text{Net Worth}}$$

2. Fixed Assets to Long-term Funds

This ratio establishes the relationship between the fixed assets and long-term funds and it is obtained by the formula:

$$\text{FIXED ASSET RATIO} = \frac{\text{Fixed Assets}}{\text{Long-term Funds}}$$

The ratio should be less than one. If it is less than one, it shows that a part of the working capital has been financed through long-term funds. This is desirable because a part of working capital termed as "core working capital" is more or less of a fixed nature. The ideal ratio is 0.67.

If this ratio is more than one, it indicates that a part of current liability is invested in long-term assets. This is a dangerous position. Fixed assets include "net fixed assets" i.e. original cost less depreciation to date and trade investments including shares in subsidiaries. Long-term funds include share capital, reserves and long-term borrowings.

ANALYSIS OF TURNOVER (OR) ANALYSIS OF EFFICIENCY

Turnover ratios also referred to as Activity Ratios are concerned with measuring the efficiency in asset management. Sometimes, these ratios are also called as efficiency ratios or asset utilisation ratios. The efficiency with which the assets are used would be reflected in the speed and rapidity with which assets are converted into sales. The greater the rate of turnover or conversion, the more efficient the utilisation/management, other things being equal. For this reason such ratios are also designated as turnover ratios. Turnover is the primary mode for measuring the extent of efficient employment of assets by relating the assets to sales. An activity ratio may, therefore, be defined as a test of the relationship between sales (more appropriately with cost of sales) and the various assets of a firm. Depending upon the various types of assets, there are various types of activity ratios. Some of the more widely used turnover ratios are:-

1. Fixed Assets Turnover Ratio
2. Current Assets Turnover Ratio
3. Working Assets Turnover Ratio
4. Inventory (or stock) Turnover Ratio
5. Debtors Turnover Ratio
6. Creditors Turnover Ratio

1. Fixed Assets Turnover Ratio

The Fixed Assets Turnover Ratio measures the efficiency with which the firm is utilising its investment in fixed assets, such as land, building, plant and machinery, furniture, etc. It also indicates the adequacy of sales in relation to investment in fixed assets. The fixed assets turnover ratio is sales divided by the net fixed assets (i.e., the depreciated value of fixed assets).

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Net Fixed Assets}}$$

The turnover of fixed assets can provide a good indicator for judging the efficiency with which fixed assets are utilised in the firm. A high fixed assets turnover ratio indicates efficient utilisation of fixed assets in generating operating revenue. A low ratio signifies idle capacity, inefficient utilisation and management of fixed assets.

2. Current Assets Turnover Ratio

The current assets turnover ratio ascertains the efficiency with which current assets are used in a business. Professor Guthmann observes that "current assets turnover is to give an overall impression of how rapidly the total investment in current assets is being turned". This ratio is strongly associated with efficient utilisation of costs, receivables and inventory. A higher value of this ratio indicates greater circulation of current assets while a low ratio indicates a stagnation of the flow of current assets. The formula for the computation of current assets turnover ratio is:

$$\text{Current Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Current Assets}}$$

3. Working Capital Turnover Ratio

This ratio shows the number of times working capital is turned-over in a stated period. Working capital turnover ratio reflects the extent to which a business is operating on a small amount of working capital in relation to sales. The ratio is calculated by the following formula:-

$$\text{Working Capital Turnover Ratio} = \frac{\text{Sales}}{\text{Net Working Capital}}$$

The higher the ratio, the lower is the investment in working capital and greater are the profits. However, a very high turnover of working capital is a sign of over trading and may put the firm into financial difficulties. On the other hand, a low working capital turnover ratio indicates that working capital is not efficiently utilised.

4. Inventory Turnover Ratio

The inventory turnover ratio, also known as stock turnover ratio normally establishes the relationship between cost of goods sold and average inventory. This ratio indicates whether investment in inventory is within proper limit or not. In the words of S.C.Kuchal, “this relationship expresses the frequency with which average level of inventory investment is turned over through operations”. The formula for the computation of this ratio may be expressed thus:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

In general, a high inventory turnover ratio is better than a low ratio. A high ratio implies good inventory management. A very high ratio indicates under-investment in, or very low level of inventory which results in the firm being out of stock and incurring high stock-out cost. A very low inventory turnover ratio is dangerous. It signifies excessive inventory or over-investment in inventory. A very low ratio may be the results of inferior quality goods, over-valuation of closing inventory, stock of unsaleable/obsolete goods.

5. Debtors Turnover Ratio and Collection Period

One of the major activity ratios is the receivables or debtors turnover ratio. Allied and closely related to this is the average collection period. It shows how quickly receivables or debtors are converted into cash. In other words, the debtors turnover ratio is a test of the liquidity of the debtors of a firm. The liquidity of a firm's receivables can be examined in two ways: (i) debtors/receivables turnover and (ii) average collection period. The debtors turnover shows the relationship between credit sales and debtors of a firm. Thus,

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Debtors}}$$

Net credit sales consists of gross credit sales minus returns if any, from the customers. Average debtors is the simple average of debtors at the beginning and at the end of the year.

The second type of ratio measuring the liquidity of a firm's debtors is the average collection period. This ratio is, in fact, interrelated with and dependent upon, the receivables turnover ratio. It is calculated by dividing the days in a year by the debtors turnover. Thus,

$$\text{Average Collection Period} = \frac{\text{Days in year}}{\text{Debtors turnover}}$$

This ratio indicates the speed with which debtors/accounts receivables are being collected. The higher the turnover ratio and shorter the average collection period, the better the trade credit management and better the liquidity of debtors. On the other hand, low turnover ratio and long collection period reflects that payments by debtors are delayed. In general, short collection period (high turnover ratio) is preferable.

6. Creditors' Turnover Ratio and Debt Payment Period

Creditors' turnover ratio indicates the speed with which the payments for credit purchases are made to the creditors. This ratio can be computed as follows:-

$$\text{Creditors' Turnover Ratio} = \frac{\text{Average Accounts Payable}}{\text{Net Credit Purchases}}$$

The term accounts payable include trade creditors and bills payable. A high ratio indicates that creditors are not paid in time while a low ratio gives an idea that the business is not taking full advantage of credit period allowed by the creditors.

Sometimes, it is also required to calculate the average payment period or average age of payables or debt period enjoyed to indicate the speed with which payments for credit purchases are made to creditors. It is calculated as:

$$\text{Average age of payables} = \frac{\text{Days in a year}}{\text{Creditors' Turnover Ratio}}$$

Both the creditors' turnover ratio and the debt payment period enjoyed ratio indicate about the promptness or otherwise in making payment for credit purchases. A higher creditors' turnover ratio or lower credit period enjoyed ratio signifies that the creditors are being paid promptly.

ANALYSIS OF LIQUIDITY POSITION

The liquidity ratios measure the ability of a firm to meet its short-term obligations and reflect the short-term financial strength/solvency of a firm. The term liquidity is described as convertibility of assets ultimately into cash in the course of normal business operations and the maintenance of a regular cash flow. A sound liquid position is of primary concern to management from the point of view of meeting current liabilities as and when they mature as well as for assuring continuity of operations. Liquidity position of a firm depends upon the amount invested in current assets and the nature of current assets. The under mentioned ratios are used to measure the liquidity position:-

1. Current Ratio
2. Liquid (or) Quick Ratio
3. Cash to Working Capital Ratio

1. Current Ratio

The most widely used measure of liquid position of an enterprise is the current ratio, i.e., the ratio of the firm's current assets to current liabilities. It is calculated by dividing current assets by current liabilities:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The current assets of a firm represent those assets which can be in the ordinary course of business, converted into cash within a short period of time, normally not exceeding one year and include cash and bank balance, marketable securities, inventory of raw materials, semi-finished (work-in-progress) and finished goods, debtors net of provision for bad and doubtful debts, bills receivable and pre-paid expenses. The current liabilities defined as liabilities which are short-term maturing obligations to be met, as originally contemplated, within a year, consist of trade creditors, bills payable, bank credit, provision for taxation, dividends payable and outstanding expenses. N.L.Hingorani and others observe: "Current Ratio is a tool for measuring the short-term stability or ability of the company to carry on its day-to-day work and meet the short-term commitments earlier". Generally 2:1 is considered ideal for a concern i.e., current assets should be twice of the current liabilities. If the current assets are two times of the current liabilities, there will be no adverse effect on business operations when the payment of current liabilities is made. If the ratio is less than 2, difficulty may be experienced in the payment of current liabilities and day-to-day operations of the business may suffer. If the ratio is higher than 2, it is very comfortable for the creditors but, for the concern, it indicates idle funds and lack of enthusiasm for work.

2. Liquid (or) Quick Ratio

Liquid (or) Quick ratio is a measurement of a firm's ability to convert its current assets quickly into cash in order to meet its current liabilities. It is a measure of judging the immediate ability of the firm to pay-off its current obligations. It is calculated by dividing the quick assets by current liabilities:

$$\text{Liquid Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

The term quick assets refers to current assets which can be converted into cash immediately or at a short notice without diminution of value. Thus quick assets consists of cash, marketable securities and accounts receivable. Inventories are excluded from quick assets because they are slower to convert into cash and generally exhibit more uncertainty as to the conversion price.

This ratio provides a more stringent test of solvency. 1:1 ratio is considered ideal ratio for a firm because it is wise to keep the liquid assets atleast equal to the current liabilities at all times.

3. Cash to Working Capital Ratio: Efficient management of the inflow and outflow of cash plays a crucial role in the overall performance of a business. Cash is the most liquid form of assets which safeguards the security interest of a business. Cash including bank balances plays a vital role in the total net working capital. The ratio of cash to working capital signifies the proportion of cash to the total net working capital and can be calculated by dividing the cash including bank balance by the working capital. Thus,

$$\text{Cash to Working Capital Ratio} = \frac{\text{Cash}}{\text{Working Capital}}$$

Cash is not an end in itself, it is a means to achieve the end. Therefore, only a required amount of cash is necessary to meet day-today operations. A higher proportion of cash may lead to shrinkage of profits due to idleness of resources of a firm.

Questions

1. State the meaning of Ratio analysis.
2. Give any two examples of Liquidity ratios.
3. State the meaning of Comparative Statements.
4. State the meaning of Common size analysis.
5. State the concept of current asset?
6. What is comparative statement?
7. List out any four features of common size statement.
8. How financial statements are varies by Type of Industry?
9. Write about graphing financial information.
10. What is mean by Financial Ratios?
11. Write the advantage of financial ratios.

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Question	Option - I	Option - II	Option - III	Option - IV	Answer
In lease system, interest is calculated on	Cash down payment	Cash price outstanding	Hire purchase price	first instalment	Cash price outstanding
If cash discount is offered to customers, then which of the following would increase?	Sales	Debtors	Debt collection period	Creditors	Sales
Which of the following is true?	Retained earnings are cost free	External Equity is cheaper than Internal Equity	Retained Earnings are cheaper than External Equity	Retained Earnings are costlier than External Equity	Retained Earnings are cheaper than External Equity
Inventory Turnover measures the relationship of inven-tory with:	Average Sales	Cost of Goods Sold	Total Purchases	Total Assets	Cost of Goods Sold
Which of the following is not a standard method of inventory valuation?	First in First out	Standard Cost	Average Pricing	Realizable Value	Average Pricing
A short-term lease which is often cancellable is known as	Finance Lease	Net Lease	Operating Lease	Leverage Lease	Operating Lease
If the sales of the firm are 60,00,000 and the average debtors are 15,00,000 then the receivables turnover is	4 times	25%	400%	0.25 times	4 times
General Profitability ratios are based on	Investments	Sales	Expenses	Purchases	Sales
Inventory is generally valued as lower of	Market Price and Replacement Cost	Cost and Net Realizable Value	Cost and Sales Value	Sales Value and Profit	Cost and Net Realizable Value
Under the provisions of AS-19 'Leases', a leased asset is shown is the balance sheet of	Manufacturer	Lessor	Lessee	Financing bank	Lessee
If a company sells its receivable to another party to raise funds, it is known as	Securitization	Factoring	Pledging	Budgeting	Factoring
Prepaid insurance given in trial balance will appear in _____________	Trading a/c	Profit & Loss a/c	Balance sheet	Bank a/c	Balance sheet

Which of the following is not included in cost of inventory?	Purchase cost	Transport in Cost	Import Duty	Selling Costs	Selling Costs
A lease which is generally not cancellable and covers full economic life of the asset is known as	Sale and leaseback	Operating Lease	Finance Lease	Economic Lease	Finance Lease
Receivables Management deals with	Receipts of raw materials	Debtors collection	Creditors Management	Inventory Management	Debtors collection
Depreciation is charged to which one of the asset __________	Land	Machinery	Sundry debtors	Investments	Machinery
One difference between Operating and Financial lease is:	There is often an option to buy in operating lease	There is often a call option in financial lease	An operating lease is generally cancellable by lease	A financial lease in generally cancellable by lease	An operating lease is generally cancellable by lease
Which of the following is related to Receivables Management?	Cash Budget	Economic Order Quantity	Ageing schedule	Factoring	Ageing schedule
Which Accounting Standard is a deal with Intangible Assets?	AS - 3	AS - 6	AS - 26	AS - 11	AS - 26
Income tax paid is appeared in___________	Trading a/c	Profit & Loss a/c	Balance sheet	Trial balance	Profit & Loss a/c
Which of the following regarding retained earnings is false?	Retained earnings is increased by net income	Retained earnings is a component of stockholders' equity on the balance sheet	Retained earnings is an asset on the balance sheet	Retained earnings represents earning not distributed to stockholders in the form of dividends	Retained earnings is an asset on the balance sheet
Which of the following accounts normally has a debit balance?	Unearned Revenue	Retained Earnings	Rent expense	Sales Revenue	Retained Earnings
Goodwill is ____________	Current account	Fictitious asset	Tangible asset	Intangible asset	Intangible asset
Accounts receivable normally has __________ Balance	Credit	Debit	Favorable	Negative	Debit
Bills receivable is a _________	Tangible asset	Intangible asset	Fixed asset	Current asset	Current asset
________ is the major source of revenue of any business.	Investment	Advances	Loan	Sales	Sales

_____________ refers the amount invested by the owner into business.	Loan	Advance	Capital	Prepaid expences	Capital
Aseets having definite shape and physical existensce are called……….	Tangible asset	Intangible asset	Wasting asset	Fictitious asset	Tangible asset
Assets which get exhausted to the extent of extraction are called ……….	Tangible asset	Intangible asset	Wasting asset	Fictitious asset	Wasting asset
_________ is an example for fictitious asset.	Machinery	Stock	Patent	Preliminary expenses	Preliminary expenses
The receivables turnover ratio is defined as:	sales divided by receivables;	receivables divided by sales;	receivables divided by one days' sales;	receivables plus bad debt allowances.	sales divided by receivables;
221. In ABC inventory management system, class A items may require	Higher Safety Stock	Frequent Deliveries	Periodic Inventory system	Updating of inventory records	Higher Safety Stock
EOQ is the quantity that minimizes	Total Ordering Cost	Total Inventory Cost	Total Interest Cost	Safety Stock Level	Total Ordering Cost
Inventory is generally valued as lower of	Market Price and Replacement Cost	Cost and Net Realizable Value	Cost and Sales Value	Sales Value and Profit	Cost and Net Realizable Value
What is Economic Order Quantity?	Cost of an Order	Cost of Stock	Reorder level	Optimum order size.	Optimum order size.
A short-term lease which is often cancellable is known as	Finance Lease	Net Lease	Operating Lease	Leverage Lease	Operating Lease
Which of the following is not a usual type of lease arrangement?	Sale & leaseback	Goods on Approval	Leverage Lease	Direct Lease	Goods on Approval
Under the provisions of AS-19 'Leases', a leased asset is shown is the balance sheet of	Manufacturer	Lessor	Lessee	Financing bank	Lessee
Lease which includes a third party (a lender) is known as	Sale and leaseback	Direct Lease	Inverse Lease	Leveraged Lease	Leveraged Lease
One difference between Operating and Financial lease is:	There is often an option to buy in operating lease	There is often a call option in financial lease.	An operating lease is generally cancelable by lease	A financial lease in generally cancelable by lease.	An operating lease is generally cancelable by lease

From the point of view of the lessee, a lease is a:	Working capital decision	Financing decision	Buy or make decision	Investment decision	Financing decision
For a lesser, a lease is a	Investment decision	Financing decision	Dividend decision	Working capital decision	Investment decision
Which of the following is not true for a "Lease decision for the lessee"?	Helps in project selection	Helps in project financing	Helps in project location	Helps in Working capital decision	Helps in project financing
Which of the following statements is correct?	A Higher Receivable Turnover is not desirable,	Interest Coverage Ratio depends upon Tax Rate,	Increase in Net Profit Ratio means increase in Sales,	Lower Debt-Equity Ratio means lower Financial Risk.	Lower Debt-Equity Ratio means lower Financial Risk.
Which of the following is not a technique of receivables Management?	Funds Flow Analysis	Ageing Schedule	Days sales outstanding	Collection Matrix	Funds Flow Analysis
If the closing balance of receivables is less than the opening balance for a month then which one is true out of	Collections>Current Purchases	Collections>Current Sales	Collections<Current Purchases	Collections < Current Sales.	Collections>Current Sales
Securitization is related to conversion of	Receivables	Stock	Investments	Creditors	Receivables
80% of sales of 10,00,000 of a firm are on credit. It has a Receivable Turnover of 8 What is the Average collection period (360 days a year) and Average Debtors of the firm?	45 days and 1,00,000	360 days and 1,00,000	45 days and 8,00,000	360 days and 1,25,000	45 days and 1,00,000
If a company sells its receivable to another party to raise funds, it is known as	Securitization	Factoring	Pledging	None of the above	Factoring
If the sales of the firm are . 60,00,000 and the average debtors are . 15,00,000 then the receivables turnover is	4 times	25%	400%	0.25 times	4 times
Intangible assets usually fall in the category of:	Current assets	Fixed assets	Semi fixed assets	Current Liability	Fixed assets
An example of fixed asset is	Live stock	Value stock	Income stock	Depreciation expenses	Live stock

In depreciation calculation, the useful life of a fixed asset is:	a certain figure	an estimate	a predetermined figure for all fixed assets	Actual life	an estimate
Depreciable amount + Residual value of a fixed asset =?	Depreciation expenses	Accumulated depreciation	Cost of the fixed asset	Future economic benefits of a fixed asset	Cost of the fixed asset
Cost of a fixed asset – Accumulated depreciation expenses of the fixed asset=?	Book value of a fixed asset	Market value of a fixed asset	Historical cost of a fixed asset	Recoverable amount of a fixed asset	Book value of a fixed asset
Which of the following fixed assets is not depreciated in the ordinary circumstances?	Plant and machinery	Building	Land	Equipments	Land
Under which method of depreciation the amount of depreciation expenses remains constant throughout the useful life of a fixed asset	Reducing balance method	Unit of activity method	Straight line method	Annuity Method	Straight line method
Which of the following is related to Receivables Management?	Cash Budget	Economic Order Quantity	Ageing schedule	Fund flow Analysis	Ageing schedule
Which of the following is not true for a "Lease decision for the lessee?	Helps in project selection	Helps in project financing	Helps in project location	Helps in Working capital decision	Helps in project financing
One advantage of a financial lease is that	it has a shorter maturity than term loans.	it never appears as a liability on the balance sheet.	it eliminate the needs to make periodic payments.	it provides a way to indirectly depreciate land.	it provides a way to indirectly depreciate land.

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Question	Option - I	Option - II	Option - III	Option - IV	Answer
In Current Ratio, Current Assets are compared with:	Current Profit	Current Liabilities	Fixed Assets	Equity Share Capital	Current Liabilities
___________analysis is useful in comparing performance of several companies in the same group, or division or department of the same company.	Vertical analysis	Horizontal analysis	External analysis	Internal Analysis	Vertical analysis
In Ratio Analysis, the term Capital Employed refers to	Equity Share Capital	Net worth	Shareholders' Funds	Net worth +Total Debt	Net worth +Total Debt
A Current Ratio of Less than One means:	Current Liabilities < Current Assets	Fixed Assets > Current Assets	Current Assets < Current Liabilities	Share Capital > Current Assets	Current Assets < Current Liabilities
Common size income statements make it easier to compare firms____________.	That use different inventory valuation methods	in different industries	with different degree of leverage	of different sizes	of different sizes
Which among the following is an example for horizontal analysis?	Comparative balance sheet	Ratio Analysis	common size statements	Extra Value Analysis	Comparative balance sheet
In Net Profit Ratio, the denominator is	Net Purchases	Net Sales	Credit Sales	Cost of goods sold	Net Sales
Which of the following helps analysing return to equity Shareholders?	Return on Assets	Earnings Per Share	Net Profit Ratio	Return on Investment	Earnings Per Share
The annual reports are presented in the form of chart is called as	Accounting	auditing	graphing	disclosing	graphing
In Current Ratio, Current Liabilities are compared with:	Current Profit	Current Assets	Fixed Assets	Equity Share Capital	Current Assets
Inventory Turnover measures the relationship of inven-tory with:	Average Sales	Cost of Goods Sold	Total Purchases	Total Assets	Cost of Goods Sold
Return on Assets and Return on Investment Ratios be-long to:	Liquidity Ratios	Profitability Ratios	Solvency Ratios	Turnover	Profitability Ratios

Common size financial statements make it easier to compare firm's ___________.	of different sizes	in different industries	with different degree of leverage	that use different inventory valuation methods	of different sizes
Total asset turnover, receivables turnover and inventory turnover ratios measure:	Liquidity	profitability	efficiency	debt	efficiency
The term 'EVA' is used for:	Extra Value Analysis	Economic Value Added	Expected Value Analysis	Engineering Value Analysis	Economic Value Added
What does Debt-Equity Ratio help to study?	Solvency	Liquidity	Profitability	Turnover	Solvency
In Inventory Turnover calculation, what is taken in the numerator?	Sales	Cost of Goods Sold	Opening Stock	Closing Stock	Cost of Goods Sold
Common size balance sheets make it easier to compare firms ___________.	with different degree of leverage	of different sizes	in different industries	that use different inventory valuation methods	of different sizes
Identify the item that is not taken into account in computing the current ratio.	Bank overdraft	Bank	Stock	Cash	Bank overdraft
Recording of capital contributed by the owner as liability ensures the adherence of principle of	Consistency	going concern	Separate entity	Materiality	Separate entity
The sale of inventory on account will cause the quick ratio to	Decrease	Increase	Not change	Become zero	Increase
Price-earning ratio is equal to market price per equity share divided by ___	Earning per share	Current assets	Current liabilities	Liquid assets	Earning per share
Return on total assets ratio is equal to _____ divided by total asset	Current liabilities	Net income before preference dividend and interest paid	Current assets	Earning per share	Net income before preference dividend and interest paid
In Net Profit Ratio, the denominator is	Net Purchases	Net Sales	Credit Sales	Cost of goods sold	Net Sales
The stock turnover ratio is ____	Financial ratio	Activity ratio	Solvency ratio	Profitability ratio	Activity ratio

The stock turnover ratio may be calculated as ___	Cost of goods sold / Average stock	Turnover at cost / stock at cost	Turnover at selling price / Stock at selling price	Turnover at Cost/ Average Stock	Cost of goods sold / Average stock
In the debt equity ratio, external equity refers to	Only Debentures	Only current liabilities	Debentures and current liability	Reserves	Debentures and current liability
The days' sales in inventory ratio formula uses which of the following:	Current year sales	Beginning inventory	Prior year sales	Ending inventory	Ending inventory
While calculating Gross Profit ratio __________	Closing stock is deducted from cost of goods sold	Closing stock is added to cost of goods sold	Closing stock is ignored	Opening stock is ignored	Closing stock is deducted from cost of goods sold
There is deterioration in the management of working capital of XYZ Ltd. What does it refer to?	That the Capital Employed has reduced	That the Profitability has gone up	That debtors collection period has increased	That Sales has decreased	That debtors collection period has increased
Which of the following does not help to increase Current Ratio?	Issue of Debentures to buy Stock	Issue of Debentures to pay Creditors	Sale of Investment to pay Creditors	Avail Bank Overdraft to buy Machine.	Avail Bank Overdraft to buy Machine.
Debt to Total Assets Ratio can be improved by:	Borrowing More	Issue of Debentures	Issue of Equity Shares	Redemption of Debt	Redemption of Debt
Ratio of Net Income to Number of Equity Shares known as:	Price Earnings Ratio	Net Profit Ratio	Earnings per Share	Dividend per Share	Earnings per Share
In the debt equity ratio, external equity refers to	Only Debentures	Only current liabilities	Debentures and current liability	Reserves	Debentures and current liability
The financial information is presented in the form of graph is __________	Presenting data	graphing of financial information	giving data	accounting	graphing of financial information
Suppliers and Creditors of a firm are interested in__________	Profitability Position	Liquidity Position	Market Share Position	Debt Position	Liquidity Position
An association of cement manufacturers is an example of–	Diagonal combination	Vertical combination	Horizontal combination	Lateral combination	Horizontal combination

Which of the following statements is correct?	A Higher Receivable Turnover is not desirable	Interest Coverage Ratio depends upon Tax Rate	Increase in Net Profit Ratio means increase in Sales	Lower Debt-Equity Ratio means lower Financial Risk	Lower Debt-Equity Ratio means lower Financial Risk
Return on Assets and Return on Investment Ratios be-long to:	Liquidity Ratios	Profitability Ratios	Solvency Ratios	Turnover	Profitability Ratios
The assets of a business can be classified as	Only fixed assets	Only current assets	Fixed and current assets	Fixed asset or Current Asset	Fixed and current assets
Ratio Analysis can be used to study liquidity, turnover, profitability, etc. of a firm. What does Debt-Equity Ratio help to study?	Solvency	Liquidity	Profitability	Turnover	Solvency
Current assets does not include :	Cash	Stock	Debtors	Furniture	Furniture
Which one of the following is shown first when the assets are arranged in the order of their liquidity?	Cash in hand	Debtors	Investment	Bills receivable	Cash in hand
Which of the following statements are true?	Vertical Analysis is also termed as dynamic analysis.	Horizontal analysis is also termed as dynamic analysis.	Static Analysis	long-term financial planning	Horizontal analysis is also termed as dynamic analysis.
Which of the following statements are true about Horizontal Analysis?	It do not examines the periodical trend	It is useful for long-term analysis.	It is useful for Short –term planning.	It is useful for Short-term analysis.	It is useful for long-term analysis.
Which of the following statements are true?	Comparative financial statement is an example of horizontal analysis.	Trend Analysis is an example of vertical analysis.	Vertical Analysis is also termed as dynamic analysis.	Revenue has no impact on sahares holders equity	Comparative financial statement is an example of horizontal analysis.
A technique uses in comparative analysis of financial statement is	graphical analysis	preference analysis	common size analysis	returning analysis	common size analysis
A techniques uses to identify financial statements trends are included	Average Analysis	percent change analysis	returning ratios analysis	Static Analysis	percent change analysis

Revenue ___________	causes a decrease in shareholder's equity	causes a decrease or an increase in shareholder's equity	has no impact on shareholder's equity	causes an increase in shareholders' equity	causes an increase in shareholders' equity
The process of comparing various financial factors of a company over a period of time is known as …	Inter-firm comparison	Ratio Analysis	Intra-firm comparison	Inter-industry comparison	Intra-firm comparison
Which technique used for figures of two or more periods are placed side by side to facilitate easy and meaningful comparisons?	Comparative statement	Common-size statement	Trend Analysis	Ratio Analysis	Comparative statement
_______________ measure the earning ability of a firm.	Profitability ratios	Cash flow ratios	Ratio Analysis	Static Analysis	Profitability ratios
____________ of the firm are primarily interested in the liquidity ratios of the firm as they want to know how promptly or readily the term can meet its current liabilities.	Short-term creditors	Long term Creditors	Short term Debtors	Long Term Debtors	Short-term creditors
Current Ratio is equal to ___________	Current Liability/ Current Asset	Current assets / Net Profit	Current Assets / Current Liabilities	Net Profit/ Current Asset	Current Assets / Current Liabilities
An ideal acid test ratio is said to be _______________	1:1	1<n	1<n	0	1:1
Net Profit Margin Ratio:	Gross Profit / Net Sales x100	Net Profit / Net Sales x100	Net Profit / Gross Profit x100	Net Profit / Gross Profit	Net Profit / Net Sales x100
____________________measures the profit available to the equity share holders on a per share basis	Number of Ordinary Per share	Price per share	Ratio Analysis	Earning per Share Ratio	Earning per Share Ratio
__________________ ratio is also known as the investment turnover ratio	Investment Turnover Ratio	Fixed Assets Turnover Ratio	Debtors Turnover Ratio	Inventory Turnover Ratio	Fixed Assets Turnover Ratio
____________is the ability of the firm to meet its current obligations as they fall due	Liquidity	Creditors	Profitability	Debtors	Liquidity

Net Profit Ratio Signifies	Operational Profitability	Liquidity Position	Big-term Solvency	Profit for Lenders	Operational Profitability

UNIT-V

SYLLABUS

The Users of Financial Statements: Financial Ratios as perceived by commercial loan department : Most significant ratios and their primary measure, ratios appearing most frequently in loan agreements. Financial ratios as perceived by corporate controllers: Most significant ratios and their primary measure, key financial ratios included as corporate objectives, Financial ratios as perceived by certified public accountants, Financial ratios as perceived as by chartered financial analysts, Financial ratios used in annual reports.

FINANCIAL STATEMENT

Financial Statement prepared by the Companies are used by different categories of individuals, corporates in the sense relevant to them. The most common users to the financial statements are listed below:

- Management of the Company
- Investors
- Customers
- Competitors
- Government and Government Agencies
- Employees
- Investment Analysts
- Lenders, Rating Agency, Suppliers

1 – Management of the Company

The management of the Company is the first and foremost user of the financial statements. Although, they are the ones who prepare the financial statements the board and the management as a whole need to refer to them while considering the progress and growth of the Company. The management of the Company looks at the financial statement from the perspective of liquidity, profitability, cash flows, assets and liabilities, cash balances, fund requirements, debt to be paid, project financing and various other days to day operational activity. Simply put, management of the Company needs the financial statements to make decisions about the business.

2 – Investors

Investors are the owners of the Company, they would like to understand keep update with the financial performance of the Company. They would like to take the decision based on the financial statement whether they need to keep invested or move out of the Company based on its performance.

3 – Customers

Customers need to view the financial statements of the Company from which they are procuring goods or services. Big clients would like to have a long-term partnership or contracts with the Company thus they would like to work with a Company which is financially stable. Further, a financially strong Company can provide its customers with credit sales and can deliver products and services at some discount than the market.

4 – Competitors

Competitors would like to know the financial status of the competing Company. They would like to maintain the competitive edge on their competitors and hence, would like to know the financial health of the other Company. Further, they could decide to change their strategy looking at the statements.

5 – Government and Government Agencies

Government agencies like the Income-tax department, the sales tax department would like to go through the Company's financial statements to keep a check if the Company paid appropriate taxes. They would like to do future tax predictions based on the performance of the Company and industry practices.

6 – Employees

Employees look at the financial statement of the Company from different perspectives. They would like to know if the Company is doing as their bonus and increments depend on the financial performance of the Company. Also, they would look to have a deep understanding of the business and the current industry situation which will be available in the financial statements. The Company may choose to involve employees in decision making hence, it would like the employees to know and understand the financials of the Company.

7 – Investment Analysts

Investment analysts keep a close eye on the financial statements of the Company. They have good industry knowledge and be updated about how the Company is performing. Based on their analysis from the financial statements, the investment analysts make the decision whether to recommend the stock of the Company to their clients or not.

8 – Lenders

lenders like traditional banks, financial institutions, creditors would like to check the ability of the Company to pay the debt. Thus, they go through the financial statements of the Company and see if they would provide a loan.

9 – Rating Agency

A credit rating agency reviews the financial statement of the Company to give credit rating to the debt instruments of the Company. The issuing Company has to provide all information to the credit rating agency so as to get a rating of the securities it is issuing to raise funds. The investors of these securities can make an informed decision once a rating agency has provided a rating which is obviously based on the financials of the Company.

10 – Suppliers

Suppliers like the customers would like to deal with the Companies which has good financial health. Thus, they are also users of financial statements and make decisions to provide credit to the Company.

FINANCIAL RATIOS BY PERCEIVED BY COMMERCIAL LOAN DEPARTMENTS - FINANCIAL REPORTING AND ANALYSIS

Financial ratios can be used by a commercial loan department to aid the loan officers in deciding whether to grant a commercial loan and in maintaining control of a loan once it is granted. In order to gain insights into how commercial loan departments view financial ratios, a questionnaire was sent to the commercial loan departments of the 100 largest banks in the United States. Usable responses were received from 44% of them.

A list of 59 financial ratios was drawn from financial literature, textbooks, and published industry data for this study. The study set three objectives:

1. the significance of each ratio,in the opinion of commercial loan officers,
2. how frequently each ratio is included in loan agreements,
3. what a specific financial ratio primarily measures, in the opinion of commercial loan officers.

For the primary measure, the choices were liquidity, long-term debt-paying ability, profitability, or other. Figure lists the ratios included in this study.

RATIOS RATED BY COMMERCIAL LOAN OFFICERS

Ratio	Ratio
Cash ratio	Sales/fixed assets
Accounts receivable turnover in days	Sales/working capital
Accounts receivable turnover—times per year	Sales/net worth
Days' sales in receivables	Cash/sales
Quick ratio	Quick assets/sales
Inventory turnover in days	Current assets/sales
Inventory turnover—times per year	Return on assets:
Days' sales in inventory	before interest and tax
Current debt/inventory	before tax
Inventory/current assets	after tax
Inventory/working capital	Return on operating assets
Current ratio	Return on total invested:
Inventory/current assets	before tax
Inventory/working capital	after tax
Current ratio	Return on equity:
Net fixed assets/tangible net worth	before tax
Cash/total assets	after tax
Quick assets/total assets	Net profit margin:
Current assets/total assets	before tax
Retained earnings/total assets	after tax
Debt/equity ratio	Retained earnings/net income
Total debt as a % of net working capital	Cash flow/current maturities of long-term debt
Total debt/total assets	Cash flow/total debt
Short-term debt as a % of total invested capital	Times interest earned
Long-term debt as a % of total invested capital	Fixed charge coverage
Funded debt/working capital	Degree of operating leverage
Total equity/total assets	Degree of financial leverage
Fixed assets/equity	Earnings per share
Common equity as a % of total invested capital	Book value per share
Current debt/net worth	Dividend payout ratio
Net worth at market value/total liabilities	Dividend yield
Total asset turnover	Price/earnings ratio
Sales/operating assets	Stock price as a % of book value

MOST SIGNIFICANT RATIOS AND THEIR PRIMARY MEASURE

Figure displays the ten financial ratios given the highest significance rating by the commercial loan officers, as well as the primary measure of these ratios. The highest rating is a 9, and the lowest rating is a 0.

Most of the ratios given a high significance rating were regarded primarily as measures of liquidity or debt. Only two of the top ten ratios measure profitability, five measure debt, and three measure liquidity. The two profitability ratios were two different computations of the net profit margin:

1. net profit margin after tax and
2. net profit margin before tax.

Two of the top three ratios were measures of debt, and the other was a measure of liquidity. The debt / equity ratio was given the highest significance rating, with the current ratio second highest. We can assume that the financial ratios rated most significant by commercial loan officers would have the greatest influence on a loan decision.

Ratios Appearing Most Frequently in Loan Agreements

A commercial bank may elect to include a ratio as part of a loan agreement. This would be a way of using ratios to control an outstanding loan. Figure contains a list of the ten financial ratios that appear most frequently in loan agreements, along with an indication of what each ratio primarily measures. For the two ratios that do not have a primary measure indicated, there was no majority opinion as to what the ratio primarily measured. Six of the ratios that appear most frequently in loan agreements primarily measure debt, two primarily measure liquidity, and none primarily measure profitability.

The two top ratios, debt / equity and current ratio, were given the highest significance rating. The dividend payout ratio was the third most likely ratio to appear in loan agreements, but it was not rated as a highly significant ratio. Logically, this ratio appears in loan agreements as a means of controlling outflow of cash for dividends.

COMMERCIAL LOAN DEPARTMENTS

Ratio	Significance Rating	Primary Measure
Debt/equity	8.71	Debt
Current ratio	8.25	Liquidity
Cash flow/current maturities of long-term debt	8.08	Debt
Fixed charge coverage	7.58	Debt
Net profit margin after tax	7.56	Profitability
Times interest earned	7.50	Debt
Net profit margin before tax	7.43	Profitability
Degree of financial leverage	7.33	Debt
Inventory turnover in days	7.25	Liquidity
Accounts receivable turnover in days	7.08	Liquidity

COMMERCIAL LOAN DEPARTMENTS

Ratio	Percentage of Banks Including Ratio in 26% or More of Their Loan Agreements	Primary Measure
Debt/equity	92.5	Debt
Current ratio	90.0	Liquidity
Dividend payout ratio	70.0	*
Cash flow/current maturities of long-term debt	60.3	Debt
Fixed charge coverage	55.2	Debt
Times interest earned	52.6	Debt
Degree of financial leverage	44.7	Debt
Equity/assets	41.0	*
Cash flow/total debt	36.1	Debt
Quick ratio	33.3	Liquidity

FINANCIAL RATIOS AS PERCEIVED BY CORPORATE CONTROLLERS - FINANCIAL REPORTING AND ANALYSIS

To get the views of corporate controllers on important issues relating to financial ratios, a questionnaire was sent to the controllers of the companies included in the Fortune 500 list of the largest industrials. The study excluded companies 100% owned or controlled by another firm. The survey received a usable response rate of 19.42%. The questionnaire used the same ratios used for the commercial loan department survey. Three objectives of this study were the determination of:

1. The significance of a specific ratio as perceived by controllers,
2. Which financial ratios are included as corporate objectives,
3. The primary measure of each ratio.

MOST SIGNIFICANT RATIOS AND THEIR PRIMARY MEASURE

Figure displays the ten financial ratios given the highest significance rating by the corporate controllers, along with the primary measure of these ratios. The highest rating is a 9 and the lowest is a 0.

The financial executives gave the profitability ratios the highest significance ratings. The highest rated debt ratio was debt / equity, while the highest rated liquidity ratio was the current ratio. In comparing the responses of the commercial loan officers and the controllers, the controllers rate the profitability ratios as having the highest significance, while the commercial loan officers rate the debt and liquidity ratios highest.

KEY FINANCIAL RATIOS INCLUDED AS CORPORATE OBJECTIVES

Many firms have selected key financial ratios to be included as part of their corporate objectives. The next section of the survey was designed to determine what ratios the firms used in their corporate objectives. Figure lists the ten ratios most likely to be included in corporate objectives according to the controllers. Nine of the ratios included in Figure

Corporate Controllers

Ratio	Significance Rating	Primary Measure
Earnings per share	8.19	Profitability
Return on equity after tax	7.83	Profitability
Net profit margin after tax	7.47	Profitability
Debt/equity ratio	7.46	Debt
Net profit margin before tax	7.41	Profitability
Return on total invested capital after tax	7.20	Profitability
Return on assets after tax	6.97	Profitability
Dividend payout ratio	6.83	Other*
Price/earnings ratio	6.81	Other*
Current ratio	6.71	Liquidity

RATIOS APPEARING IN CORPORATE OBJECTIVES AND THEIR PRIMARY MEASURES:

Ratio	Percentage of Firms Indicating That the Ratio Was Included in Corporate Objectives	Primary Measure
Earnings per share	80.6	Profitability
Debt/equity ratio	68.8	Debt
Return on equity after tax	68.5	Profitability
Current ratio	62.0	Liquidity
Net profit margin after tax	60.9	Profitability
Dividend payout ratio	54.3	Other
Return on total invested capital after tax	53.3	Profitability
Net profit margin before tax	52.2	Profitability
Accounts receivable turnover in days	47.3	Liquidity
Return on assets after tax	47.3	Profitability

were also included in Figure. One ratio, accounts receivable turnover in days, appears in the top ten ratios in relation to corporate objectives but not in the top ten significant ratios. One ratio, the price / earnings ratio, appears in the top ten ratios in relation to significance but not in the top ten ratios used for corporate objectives.

Logically, there would be a high correlation between the ratios rated as highly significant and those included in corporate objectives. The debt / equity ratio and the current ratio are rated higher on the objectives list than on the significance list. This makes sense since a firm has to have some balance in its objectives between liquidity, debt, and profitability.

FINANCIAL RATIOS AS PERCEIVED BY CERTIFIED PUBLIC ACCOUNTANTS - FINANCIAL REPORTING AND ANALYSIS

A research study performed in 1984 dealt with financial ratios as perceived by certified public accountants (CPAs). A questionnaire was sent to one-third of the members of The Ohio Society of Certified Public Accountants who were registered as a partner in a CPA firm. A total of 495 questionnaires were sent and the usable response rate was 18.8%. This questionnaire used the same ratios as were used for the commercial loan department and corporate controllers. The specific objectives of this study were to determine the following from the view point of the CPA:

1. The specific financial ratios that CPAs view primarily as a measure of liquidity, debt, and profitability.
2. The relative importance of the financial ratios viewed as a measure of liquidity, debt, or profitability.

Figure displays the ten financial ratios given the highest significance rating by the CPAs and the primary measure of these ratios. The highest rating is a 9 and the lowest is a 0.

The CPAs gave the highest significance rating to two liquidity ratios—the current ratio and the accounts receivable turnover in days. The highest rated profitability ratio was after tax return on equity, and the highest rated debt ratio was debt / equity.

CPAS MOST SIGNIFICANT RATIOS AND THEIR PRIMARY MEASURES

Ratio	Significance Rating	Primary Measure
Current ratio	7.10	Liquidity
Accounts receivable turnover in days	6.94	Liquidity
After-tax return on equity	6.79	Profitability
Debt/equity ratio	6.78	Debt
Quick ratio (acid test)	6.77	Liquidity
Net profit margin after tax	6.67	Profitability
Net profit margin before tax	6.63	Profitability
Return on assets after tax	6.39	Profitability
Return on total invested capital after tax	6.30	Profitability
Inventory turnover in days	6.09	Liquidity

FINANCIAL RATIOS AS PERCEIVED BY CHARTERED FINANCIAL ANALYST - FINANCIAL REPORTING AND ANALYSIS

Figure displays the ten financial ratios given the highest significance rating by chartered financial analysts (CFAs) and the primary measure of these ratios. Again, the highest rating is a 9 and the lowest rating is a 0.

The surveyed CFAs gave the highest significance ratings to profitability ratios, with the exception of the price / earnings ratio. Return on equity after tax received the highest significance by a wide margin. Four of the next five most significant ratios were also profitability ratios—earnings per share, net profit margin after tax, return on equity before tax, and net profit margin before tax.

The price / earnings ratio—categorized by the analysts as an "other" measure—received the second highest significance rating. CFAs apparently view profitability and what is being paid for those profits before turning to liquidity and debt.

Chartered Financial Analysts

MOST SIGNIFICANT RATIOS AND THEIR PRIMARY MEASURES

Ratio	Significance Rating	Primary Measure
Return on equity after tax	8.21	Profitability
Price/earnings ratio	7.65	*
Earnings per share	7.58	Profitability
Net profit margin after tax	7.52	Profitability
Return on equity before tax	7.41	Profitability
Net profit margin before tax	7.32	Profitability
Fixed charge coverage	7.22	Debt
Quick ratio (acid test)	7.10	Liquidity
Return on assets after tax	7.06	Profitability
Times interest earned	7.06	Debt

The two highest rated debt ratios were fixed charge coverage and times interest earned, rated seventh and tenth, respectively. Both of these ratios indicate a firm's ability to carry debt. The highest rated debt ratio relating to the balance sheet was the debt / equity ratio, rated as the eleventh most significant. Surprisingly, more significance was placed on debt ratios relating to the ability to carry debt than on those relating to the ability to meet debt obligations.

The highest rated liquidity ratio was the acid-test ratio, rated eighth. The second highest liquidity ratio was the current ratio, rated twentieth.

FINANCIAL RATIOS USED IN ANNUAL REPORTS - FINANCIAL REPORTING AND ANALYSIS

Financial ratios are used to interpret and explain financial statements. Used properly, they can be effective tools in evaluating a company's liquidity, debt position, and profitability. Probably no tool is as effective in evaluating where a company has been financially and projecting its financial future as the proper use of financial ratios.

A firm can use its annual report effectively to relate financial data by the use of financial ratios. To determine how effectively firms use ratios to communicate financial data, the annual reports of 100 firms identified in the Fortune 500 industrial companies were reviewed. The 100 firms represented the first 20 of each 100 in the Fortune 500 list. The objective of this research project was to determine:

1. which financial ratios were frequently reported inannual reports,
2. where the ratios were disclosed in the annual reports,
3. what computational methodology was used to compute these ratios.

Figure indicates the ratios disclosed most frequently in the annual reports reviewed and the section of the annual report where the ratios were located. The locations were the president's letter, management discussion, management highlights, financial review, and financial summary. In many cases, the same ratio was located in several sections, so the numbers under the sections in Figure do not add up to the total number of annual reports where the ratio was included.

Seven ratios appeared more than 50% of the time in one section or another. These ratios and the number of times found were earnings per share (100), dividends per share (98), book value per share (84), working capital (81), return on equity (62), profit margin

RATIOS DISCLOSED MOST FREQUENTLY IN ANNUAL REPORTS*

	Number Included	President's Letter	Management Discussion	Management Highlights	Financial Review	Financial Summary
Earnings per share	100	66	5	98	45	93
Dividends per share	98	53	10	85	49	88
Book value per share	84	10	3	53	18	63
Working capital	81	1	1	50	23	67
Return on equity	62	28	3	21	23	37
Profit margin	58	10	3	21	23	35
Effective tax rate	50	2	1	2	46	6
Current ratio	47	3	1	16	12	34
Debt/capital	23	9	0	4	14	23
Return on capital	21	6	2	8	8	5
Debt/equity	19	5	0	3	8	8
Return on assets	13	4	1	2	5	10
Dividend payout	13	3	0	0	6	6
Gross profit	12	0	1	0	11	3
Pretax margin	10	2	0	3	6	6
Total asset turnover	7	1	0	0	4	4
Price/earnings ratio	7	0	0	0	1	6
Operating margin	7	1	0	2	6	1
Labor per hour	5	0	2	2	2	2

(58), and effective tax rate (50). The current ratio was found 47 times, and the next ratio in order of disclosure, the debt / capital ratio, appeared 23 times. From this listing, we can conclude that profitability ratios and ratios related to investing were the most popular. Figure excludes ratios not disclosed at least five times.

Logically, profitability ratios and ratios related to investing were the most popular for inclusion in the annual report. Including ratios related to investing in the annual report makes sense because one of the annual report's major objectives is to inform stockholders.

A review of the methodology used indicated that wide differences of opinion exist on how some of the ratios should be computed. This is especially true of the debt ratios. The two debt ratios most frequently disclosed were the debt / capital ratio and the debt / equity ratio. This book does not cover the debt / capital ratio. It is similar to the debt / equity ratio, except that the denominator includes sources of capital, in addition to stockholders' equity.

The annual reports disclosed the debt / capital ratio 23 times and used 11 different formulas. One firm used average balance sheet amounts between the beginning and the end of the year, while 22 firms used ending balance sheet figures. The debt / equity ratio was disclosed 19 times, and 6 different formulas were used. All firms used the ending balance sheet accounts to compute the debt / equity ratio.

In general, no major effort is being made to explain financial results by the disclosure of financial ratios in annual reports. Several financial ratios that could be interpreted as important were not disclosed or were disclosed very infrequently. This is particularly important for ratios that cannot be reasonably computed by outsiders because of a lack of data such as accounts receivable turnover.

At present, no regulatory agency such as the SEC or the FASB accepts responsibility for determining either the content of financial ratios or the format of presentation for annual reports, except for the ratio earnings per share. Many practical and theoretical issues relate to the computation of financial ratios. As long as each firm can exercise its opinion as to the practical and theoretical issues, there will be a great divergence of opinion on how a particular ratio should be computed.

DEGREE OF CONSERVATISM AND QUALITY OF EARNINGS - FINANCIAL REPORTING AND ANALYSIS

A review of financial statements, including the footnotes, indicates their conservatism in regard to accounting policies. Accounting policies that result in the slowest reporting of income are the most conservative. When a firm has conservative accounting policies, it is said that its earnings are of high quality. This section reviews a number of areas that often indicate a firm's degree of conservatism in reporting income.

Inventory

Under inflationary conditions, the matching of current cost against the current revenue results in the lowest income for a period of time. The LIFO inventory method follows this procedure.

FIFO, the least conservative method, uses the oldest costs and matches them against revenue. Other inventory methods fall somewhere between the results of LIFO and FIFO.

For a construction firm that has long-term contracts, the two principal accounting methods that relate to inventory are the completed-contract method and the percentage - of completion method. The conservative completed-contract method recognizes all of the income when the contract is completed; the percentage-of-completion method recognizes income as work progresses on the contract.

Fixed Assets

Two accounting decisions related to fixed assets can have a significant influence on income: the method of depreciation and the period of time selected to depreciate an asset.

The conservative methods, sum - of - the - years' - digits and declining - balance, recognize a large amount of depreciation in the early years of the asset's life. The straight - line method, the least conservative method, recognizes depreciation in equal amounts over each year of the asset's life.

Sometimes a material difference in the asset's life used for depreciation occurs between firms. Comparing the lives used for depreciation for similar firms can be a clue as to how conservative the firms are in computing depreciation. The shorter the period of time used, the lower the income.

Intangible Assets

Intangible assets include goodwill, patents, and copyrights. Research and development (R&D) costs are a type of intangible asset, but they are expensed as incurred. The shorter the period of time used to recognize the cost of the intangible asset, the more conservative the accounting.

Some firms spend very large sums on R&D, and others spend little or nothing. Because of the requirement that R&D costs be expensed in the period incurred, the income of a firm that does considerable research is reduced substantially in the period that the cost is incurred. This results in more conservative earnings.

Intangible assets must be amortized over 40 years or fewer, unless they were acquired prior to 1970. Intangibles that have a legal or economic life shorter than 40 years should be amortized over the shorter period.

The intangible asset, goodwill, results when a firm buys another firm and pays a price greater than the value of the identifiable assets. Conservative firms expense goodwill over a relatively short period of time such as five years. Other firms use the maximum time allowed of 40 years (which the FASB has proposed changing to 20 years).

Pensions

Two points relating to pensions should be examined when the firm has a defined benefit plan. One is the assumed discount rate used to compute the actuarial present value of the accumulated benefit obligation and the projected benefit obligation. The higher the interest rate used, the lower the present value of the liability and the lower the immediate pension cost. The other item is the rate of compensation increase used in computing the projected benefit obligations. If the rate is too low, the projected benefit obligation is too low. If the rate is too high, the projected benefit obligation is too high.

FORECASTING FINANCIAL FAILURE - FINANCIAL REPORTING AND ANALYSIS

There have been many academic studies on the use of financial ratios to forecast financial failure. Basically, these studies try to isolate individual ratios or combinations of ratios that can be observed as trends that may forecast failure.

A reliable model that can be used to forecast financial failure can also be used by management to take preventive measures. Such a model can aid investors in selecting and disposing of stocks. Banks can use it to aid in lending decisions and in monitoring loans. Firms can use it in making credit decisions and in monitoring accounts receivable. In general, many sources can use such a model to improve the allocation and control of resources.

A model that forecasts financial failure can also be valuable to an auditor. It can aid in the determination of audit procedures and in making a decision as to whether the firm will remain as a going concern.

Financial failure can be described in many ways. It can mean liquidation, deferment of payments to short-term creditors, deferment of payments of interest on bonds, deferment of payments of principal on bonds, or the omission of a preferred dividend. One of the problems in examining the literature on forecasting financial failure is that different authors use different criteria to indicate failure. When reviewing the literature, always determine the criteria used to define financial failure.

This book reviews two of the studies that deal with predicting financial failure. Based on the number of references to these two studies in the literature, they appear to be particularly significant on the subject of forecasting financial failure.

Univariate Model

William Beaver reported his univariate model in a study published in The Accounting Review in October 1968. A univariate model uses a single variable. Such a model would use individual financial ratios to forecast financial failure. The Beaver study classified a firm as failed when any one of the following events occurred in the 1954–1964 period: bankruptcy, bond default, an overdrawn bank account, or non-payment of a preferred stock dividend.

Beaver paired 79 failed firms with a similar number of successful firms drawn from Moody's Industrial Manuals. For each failed firm in the sample, a successful one was selected from the same industry. The Beaver study indicated that the following ratios were the best for forecasting financial failure (in the order of their predictive power):

1. Cash flow / total debt
2. Net income / total assets (return on assets)
3. Total debt / total assets (debt ratio)

Beaver speculated as to the reason for these results:

My interpretation of the finding is that the cash flow, net income, and debt positions cannot be altered and represent permanent aspects of the firm. Because failure is too costly to all involved, the permanent, rather than the short-term, factors largely determine whether or not a firm will declare bankruptcy or default on a bond payment.

Assuming that the ratios identified by Beaver are valid in forecasting financial failure, it would be wise to pay particular attention to trends in these ratios when following a firm. Beaver's reasoning for seeing these ratios as valid in forecasting financial failure appears to be very sound. These three ratios for Nike for 1999 have been computed earlier. Cash flow / total debtwas 50.23%, which appears to be very good. Net income / total assets (return on assets) was 8.48%, which appears to be good. The debt ratio was 36.46%, which is very good. Thus, Nike appears to have minimal risk of financial failure.

The Beaver study also computed the mean values of 13 financial statement items for each year before failure. Several important relationships were indicated among the liquid asset items.

1. Failed firms have less cash but more accounts receivable.
2. When cash and receivables are added together, as they are in quick assets and current assets, the differences between failed and successful firms is obscured because the cash and receivables differences are working in opposite directions.
3. Failed firms tend to have less inventory.

These results indicate that particular attention should be paid to three current assets when forecasting financial failure: cash, accounts receivable, and inventory. The analyst should be alert for low cash and inventory and high accounts receivable.

Multivariate Model

Edward I. Altman developed a multivariate model to predict bankruptcy. His modeluses five financial ratios weighted in order to maximize the predictive power of the model.

The model produces an overall discriminant score, called a **Z score**. The Altman model is as follows:

$$Z = .012\, X_1 + .014\, X_2 + .033\, X_3 + .006\, X_4 + .010\, X_5$$

$$X_1 = \text{Working Capital/Total Assets}$$

This computation is a measure of the net liquid assets of the firm relative to the total capitalization.

X2 = Retained Earnings (balance sheet) /Total Assets

This variable measures cumulative profitability over time.

X3 = Earnings Before Interest and Taxes / Total Assets

This variable measures the productivity of the firm's assets, abstracting any tax or leverage factors.

This variable measures how much the firm's assets can decline in value before the liabilities exceed the assets and the firm becomes insolvent. Equity is measured by the combined market value of all shares of stock, preferred and common, while debt includes both current and long-term debts.

X5 = Sales / Total Assets

This variable measures the sales-generating ability of the firm's assets.

When computing the Z score, the ratios are expressed in absolute percentage terms. Thus, X1 (working capital / total assets) of 25% is noted as 25.The Altman model was developed using manufacturing companies whose asset size was between $1 million and $25 million. The original sample by Altman and the test samples used the period 1946–1965. The model's accuracy in predicting bankruptcies in more recent years (1970–1973) was reported in a 1974 article. Not all of the companies included in the test were manufacturing companies, although the model was initially developed by using only manufacturing companies.

With the Altman model, the lower the Z score, the more likely that the firm will go bankrupt. By computing the Z score for a firm over several years, it can be determined if the firm is moving toward a more likely or less likely position in regard to bankruptcy. In a later study that covered the period 1970–1973, a Z score of 2.675 was established as a practical cutoff point.

Firms that scored below 2.675 are assumed to have characteristics similar to those of past failures. Current GAAP recognizes more liabilities than the GAAP used at the time of this study. Thus, we would expect firms to score somewhat less than in the time period 1970–1973. The Altman model is substantially less significant if there is no firm market value for the stock (preferred and common), because variable X4 in the model requires that the market value of the stock be determined.

$$
\begin{aligned}
Z = {} & .012 \text{ (working capital/total assets)} \\
& + .014 \text{ (retained earnings [balance sheet]/total assets)} \\
& + .033 \text{ (earnings before interest and taxes/total assets)} \\
& + .006 \text{ (market value of equity/book value of total debt)} \\
& + .010 \text{ (sales/total assets)} \\
Z = {} & .012 ([\$3{,}264{,}900{,}000 - \$1{,}446{,}900{,}000]/\$5{,}247{,}700{,}000) \\
& + .014 (\$3{,}066{,}500{,}000/\$5{,}247{,}700{,}000) \\
& + .033 ([\$746{,}100{,}000 + \$44{,}100{,}000])/\$5{,}247{,}700{,}000) \\
& + .066 ([\$282{,}300{,}000 \times \$60.938]/\$1{,}913{,}100{,}000) \\
& + .010 (\$8{,}776{,}900{,}000/\$5{,}247{,}700{,}000) \\
Z = {} & .012 (34.64) \\
& + .014 (58.44) \\
& + .033 (15.06) \\
& + .006 (899.21) \\
& + .010 (167.25) \\
Z = {} & .42 + .82 + .50 + 5.40 + 1.67 \\
Z = {} & 8.81
\end{aligned}
$$

The Z score for Nike for 1999 was 8.81. Considering that higher scores are better and that companies with scores below 2.675 are assumed to have characteristics similar to those of past failures, Nike is a very healthy company.

There are many academic studies on the use of ratios to forecast financial failure. These studies help substantiate that firms with weak ratios are more likely to go bankrupt than firms with strong ratios. Since no conclusive model has yet been developed, the best approach is probably an integrated one. As a supplemental measure, it may also be helpful to compute some of the ratios that appear useful in forecasting financial failure.

1. Describe the various users of Financial Statment

2. State the meaning of following terms i) Retained earnings ii) Income Tax and

   iii) Inventories.

3. Give details on various inflows and outflows of cash.

4. Define Inventory. Why proper inventory valuation is important?

5. Define the term ratio and explain its significant role in using for analyzing the financial statement?

6. State the various salient features of AS – 2 (Revised) regarding inventory valuations.

7. Write short notes for the following:

   i) Retained earnings

   ii) Income Tax and

   iii) Inventories.

8. What is financial aspect of corporate ratio and explain its importance?

9. Write a short note for the following:

   i) Goodwill

   ii) Copyright and

   iii) Trademark

10. Define the term Intangible Assets and also discuss its characteristics.

11. Illustrate why proper inventory valuation is important in a company?

12. Discuss the various important ratios in auditing and analysis?

13. Elucidate the significant ratio in commercial loan?

Karpagam Academy of Higher Education
Department of Management
Financial Analysis and Reporting - 18BAU403A
II BBA - Unit - V

Question	Option - I	Option - II	Option - III	Option - IV	Answer
The receivables turnover ratio is defined as	sales divided by receivables	receivables divided by sales	receivables divided by one days’ sales	receivables plus bad debt allowances	sales divided by receivables
The convergence of the Indian Accounting Standards with IFRS began in __________	Aug-09	Apr-10	Dec-11	Apr-11	Apr-11
The underlying assumption that presumes a company will continue indefinitely is	Periodicity	Going concern	Economic entity	Monetary unit	Going concern
The global key professional accounting body is ____________	The International Accounting Standards Committee	The International Accounting Standards Board	The Financial Accounting Standards Board	The Institute of Chartered Accountants of India	The International Accounting Standards Board
Accounting for Intangible Assets are related to	AS - 10	AS – 12	AS - 24	AS - 26	AS - 26
The original cost at which an asset or liability is acquired is known as —	carrying cost	amortization	replacement cost	historical cost	historical cost
The International Accounting Standards Committee was set up in —	2009	1976	1967	1982	1967
The process of converting foreign-subsidiary financial statements into the home currency is known as —	reconstruction	translation	consolidation	transmission	translation
The accounting process in which the financial statements of a parent company and its subsidiaries are added together to yield a unified set of financial statements is called —	amortization	amalgamation	translation	consolidation	consolidation
AS – 14 is meant for __________	Disclosure of Accounting Policies	Accounting for Fixed Assets	Discounting operations	Accounting for Amalgamation	Accounting for Amalgamation

The primary objective of the matching principle is to	Provide timely information to external decision-makers	Provide full disclosure	Recognize expenses in the same period as the related revenue	Provide timely information to Governmnet Bodies	Recognize expenses in the same period as the related revenue
Recording of capital contributed by the owner as liability ensures the adherence of principle of	Consistency	going concern	Separate entity	Materiality	Separate entity
Net income divided by shareholders' equity is the definition of ___________	return on sales	return on assets	return on equity	asset turnover	return on equity
A price on goods and services sold by one member of a corporate family to another, such as from a parent to its subsidiary in a foreign country, is known as —	transfer price	arm's length price	export price	import price	transfer price
Accounting standards are statements prescribed by	Law	Govt. regulatory bodies	Bodies of share holders	Professional accounting bodies	Professional accounting bodies
Triple bottom line accounting is also called —	management accounting	incremental costing	full cost accounting	historical accounting	full cost accounting
The IFRSs are issued by ___________	ASB	ICAI	IASB	IASC	IASB
International Accounting Standard Boards came into being in __________	2000	2001	2002	2003	2000
AS – 1 is meant for __________	Disclosure of Accounting Policies	Accounting for Fixed Assets	Discounting operations	Depreciation	Disclosure of Accounting Policies
Accounting in India is governed by the —	Income Tax Department	Institute of Chartered Accountants of India	Company Law Board	Reserve Bank of India	Institute of Chartered Accountants of India
Earnings per share is affected by: a) Net Income, b) Number of Shares, c) Dividents	all a, b and c	a only	c only	a & b, but not c	a & b, but not c

Accounting Standards in India are issued by __________	IASB	Council of ICAI	IASC	IFRS	Council of ICAI
IFRS – 1 deals with _____________	Leases	Segment reporting	first time adoption of IFRS	Intangible assets	first time adoption of IFRS
AS-19 deals with	Borrowing Costs	Earning Per share	Leases	Segment Reporting	Leases
Indian Accounting Standard – 28 is related to–	Accounting for taxes on income	Financial Reporting of Interests in Joint Venture	Impairment of Assets	Provisions, Contingent Liabilities and Contingent Assets	Impairment of Assets
AS 26 deals with	Intangible Assets	Depreciation	Cash fow statements	Inventories	Intangible Assets
AS 2 deals with	Intangible Assets	Depreciation	Cash fow statements	Inventories	Inventories
According to going concern concept a business entity is assumed to have–	A long life	A small life	A very short life	A definite life	A long life
How does an entity adopt IFRSs for the first time?	By reporting on its financial position, financial performance and cash flows in accordance with IFRSs	By issuing its first financial statements in which the entity adopts IFRSs, by an explicit and unreserved statement of compliance with IFRSs	By reporting on its financial position, financial performance and cash flows in accordance with national requirements, which do not contradict IFRSs	By issuing its first financial statements in accordance with national requirements, which contain explicit and unreserved statement of compliance with IFRSs	By issuing its first financial statements in which the entity adopts IFRSs, by an explicit and unreserved statement of compliance with IFRSs

Which of the following regarding GAAP is true?	GAAP is an abbreviation for generally applied accounting principles	Changes in GAAP always affect the amount of income reported by a company	GAAP is the abbreviation for generally accepted accounting principles	Changes to GAAP must be approved by the Senate Finance Committee	GAAP is the abbreviation for generally accepted accounting principles
Which of the following is true?	FASB creates SEC	GAAP creates FASB	SEC creates CPA	FASB creates GAAP	FASB creates GAAP
Which of the following is the starting point for an entity accounting in accordance with IFRSs?	The date when the decision about adopting IFRS has been made	The date of issuance of the first financial statement in accordance with IFRS	The date of transition to IFRSs	The date when the explicit and unreserved statement of compliance with IFRSs has been made	The date of transition to IFRSs
Earnings per share shows investors the ___________ earned per outstanding share of stock.	Operating income	Income before taxes	Net income	Income before interest and taxes	Net income
AS – 6 deals with __________	Disclosure of Accounting Policies	Accounting for Fixed Assets	Discounting operations	Depreciation	Depreciation
The dividend payout ratio is calculated by dividing total dividends by:	Operating income	Income before taxes	Income before interest and taxes	Net income	Net income
An entity shall explain how the transition from previous GAAP to IFRSs ___________ its reported financial position, financial performance and cash flows.	Corroborated	Adjusted	Affected	Benefited	Affected

For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the ___________ of the goods or services received, unless that it cannot be estimated reliably.	Amortised cost	Fair Value	Net book value	Historical cost	Fair Value
Which of the following is not a disadvantage of having a conceptual framework of accounting?	It does not allow for different conceptual bases depending on the user	It does not make the setting of accounting standards easier	It may hamper the development of preparing accounting standards	It may lead to inconsistent accounting practices	It may lead to inconsistent accounting practices
Which of the following relate to financial position in a set of financial statements?	Assets, liabilities, income and expenses	Assets, liabilities and equity	Income and expenses	Income, expenses and liabilities	Assets, liabilities and equity
Which of the following is not a chapter of the IASB Framework?	The objective of financial statements	The elements of financial statements	Concepts of capital and capital maintenance	Concepts of income and expenditure	Concepts of income and expenditure
Which of the following is a measure of Debt Service capacity of a firm?	Current Ratio	Acid Test Ratio	Interest Coverage Ratio	Debtors Turnover	Interest Coverage Ratio
Current assets does not include :	Cash	Stock	Debtors	Furniture	Furniture
Which of the following would not be included in the cost of a separately acquired intangible asset?	Employee costs incurred in preparing the asset for its intended use	Non-refundable value added tax	Testing costs	Costs incurred in using the asset	Costs incurred in using the asset
Which of the following helps analysing return to equity Shareholders?	Return on Assets	Earnings Per Share	Net Profit Ratio	Return on Investment	Earnings Per Share

Accounting standards are seen to be political because	They can create wealth transfers between different groups in society	They will not affect the competitiveness of organisations	They cannot influence perceptions about organisations	They can create problems between different groups in society	They can create wealth transfers between different groups in society
According to IFRS 15, the asset is transferred to a customer…	When the asset is physically delivered to the customer's premises	On the day specified by a contract with the customer	When the customer obtains control over it	on the day when the entity satisfies all performance obligations, specified in the contract with the customer	When the customer obtains control over it
Under IFRS, interest received is reported as what type of cash flow?	Operating only	Financing only	Operating or Financing	Operating or Financing	Operating or Financing
Goodwill does not fall within the IAS38 definition of an intangible asset because:	It is not separable	It may not generate future economic benefits	It is a monetary asset	Historical cost	It is not separable
In financial statement the stock is valued at cost or market price whichever is less on the basis of…	Accounting concepts	Accounting conventions	Accounting principles	Dual Concept	Accounting conventions
IFRS 3 explains about	First-time Adoption of IFRS	Share-based Payment	Business Combinations	Insurance Contracts	Business Combinations
IFRS 1 deals with	First-time Adoption of IFRS	Share-based Payment	Business Combinations	Insurance Contracts	First-time Adoption of IFRS

At the commencement of a finance lease, IAS17 requires that the lessee should recognise both an asset and a liability to the lessor. These should be measured at:	The present value of the minimum lease payments	The fair value of the leased item	The higher of the fair value of the leased item and the present value of the minimum lease payments	The lower of the fair value of the leased item and the present value of the minimum lease payments	The lower of the fair value of the leased item and the present value of the minimum lease payments
IFRS 6 related to	First-time Adoption of IFRS	Share-based Payment	Exploration for and Evaluation of Mineral Resources	Insurance Contracts	Exploration for and Evaluation of Mineral Resources
Accounting Standards Board (ASB), which was constituted as a body in the year ______________	1975	1976	1977	1978	1977
ICAI stands for _______________.	Institute of Chartered Accountants of India	Inter of Chartered Accountants of India	Institute of Company Accountants of India	Institute of Chartered Arts of India	Institute of Chartered Accountants of India
IFRS stands for _____________	International Financial Resource Standards	International Financial Reporting Standards	Indian Financial Reporting Standards	International Financial Reporting Statement	International Financial Reporting Standards
IFRS 2 explain of International Financial Reporting Standards is_____________	Financial Instruments	Operating Segments	Business Combinations	Share-based Payment	Share-based Payment
IFRS 16 explain of International Financial Reporting Standards is_____________	Financial Instruments	Leases	Business Combinations	Share-based Payment	Leases
"First-time Adoption of International Financial Reporting Standards" was listed under_______	IFRS 1	IFRS 2	IFRS 3	IFRS 4	IFRS 1

"Financial Instruments" was listed under________	IFRS 6	IFRS 7	IFRS 8	IFRS 9	IFRS 9

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3	18BAU005	AKASH S	Importance of Financial Analysis
4	18BAU006	ANNAPOORANI K	Principles of Financial Accounting
5	18BAU007	ARAVINDHKUMAR B	Significant difference between IAS and IFRS
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