ACCOUNTING & FINANCIAL MANAGEMEN

MCA 102

SELF LEARNING MATERIAL

DIRECTORATE

OF DISTANCE EDUCATION

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ACCOUNTING AND FINANCIAL MANAGEMENT (MCA 102)

Unit I

Overview**:** Accounting concepts, conventions and principles; Accounting Equation, International Accounting principles and standards; Matching of Indian Accounting Standards with International Accounting Standards.

Unit II

Mechanics of Accounting: Double entry system of accounting, journalizing of transactions; preparation of final accounts, Profit & Loss Account, Profit & Loss Appropriation account and Balance Sheet, Policies related with depreciation, inventory and intangible assets like copyright, trademark, patents and goodwill.

Unit III

Analysis of financial statement*:* Ratio Analysis- solvency ratios, profitability ratios, activity ratios, liquidity ratios, market capitalization ratios ; Common Size Statement ; Comparative Balance Sheet and Trend Analysis of manufacturing, service & banking organizations.

Unit IV

Funds Flow Statement: Meaning, Concept of Gross and Net Working Capital, Preparation of Schedule of Changes in Working Capital, Preparation of Funds Flow Statement and its analysis ;

UNIT-V

Cash Flow Statement: Various cash and non-cash transactions, flow of cash, preparation of Cash Flow Statement and its analysis.

UNIT - I

Overview:

Accounting concepts

The first two accounting concepts, namely, Business Entity Concept and Money Measurement Concept are the fundamental concepts of accounting. Let us go through each one of them briefly:

Business Entity Concept

According to this concept, the business and the owner of the business are two different entities. In other words, I and my business are separate.

For example, Mr A starts a new business in the name and style of M/s Independent Trading Company and introduced a capital of Rs 2,000,000 in cash. It means the cash balance of M/s Independent Trading Company will increase by a sum of Rs 2,000,000/- . At the same time, the liability of M/s Independent Trading Company in the form of capital will also increase. It means M/s Independent Trading Company is liable to pay Rs 2,000,000 to Mr A.

Money Measurement Concept

According to this concept, “we can book only those transactions in our accounting record which can be measured in monetary terms.”

Example

Determine and book the value of stock of the following items:

Shirts Rs 5,000/-
Pants Rs 7,500/-

Coats 500 pieces
Jackets 1000 pieces

Value of Stock = ?

Here, if we want to book the value of stock in our accounting record, we need the value of coats and jackets in terms of money. Now if we conclude that the values of coats and jackets are Rs 2,000 and Rs 15,000 respectively, then we can easily book the value of stock as Rs 29,500 (as a result of 5000+7500+2000+15000) in our books. We need to keep quantitative records separately.

Going Concern Concept

Our accounting is based on the assumption that a business unit is a going concern. We record all the financial transaction of a business in keeping this point of view in our mind that a business unit is a going concern; not a gone concern. Otherwise, the banker will not provide loans, the supplier will not supply goods or services, the employees will not work properly, and the method of recording the transaction will change altogether.

For example, a business unit makes investments in the form of fixed assets and we book only depreciation of the assets in our profit & loss account; not the difference of acquisition cost of assets less net realizable value of the assets. The reason is simple; we assume that we will use these assets and earn profit in the future while using them. Similarly, we treat deferred revenue expenditure and prepaid expenditure. The concept of going concern does not work in the following cases:

- If a unit is declared sick (unused or unusable unit).
- When a company is going to liquidate and a liquidator is appointed for the same.
- When a business unit is passing through severe financial crisis and going to wind up.

Cost Concept

It is a very important concept based on the Going Concern Concept. We book the value of assets on the cost basis, not on the net realizable value or market value of the assets based on the assumption that a business unit is a going concern. No doubt, we reduce the value of assets providing depreciation to assets, but we ignore the market value of the assets.

The cost concept stops any kind of manipulation while taking into account the net realizable value or the market value. On the downside, this concept ignores the effect of inflation in the market, which can sometimes be very steep. Still, the cost concept is widely and universally accepted on the basis of which we do the accounting of a business unit.

Dual Aspect Concept

There must be a double entry to complete any financial transaction, means debit should be always equal to credit. Hence, every financial transaction has its dual aspect:

- we get some benefit, and
- we pay some benefit.

For example, if we buy some stock, then it will have two effects:

- the value of stock will increase (get benefit for the same amount), and
- it will increase our liability in the form of creditors.

Transaction	Effect
Purchase of Stock for Rs 25,000	Stock will increase by Rs 25,000 (Increase in debit balance) Cash will decrease by Rs 25,000 (Decrease in debit balance) or Creditor will increase by Rs 25,000 (Increase in credit balance)

Accounting Period Concept

The life of a business unit is indefinite as per the going concern concept. To determine the profit or loss of a firm, and to ascertain its financial position, profit & loss accounts and balance sheets are prepared at regular intervals of time, usually at the end of each year. This one-year cycle is known as the accounting period. The purpose of having an accounting period is to take corrective measures keeping in view the past performances, to nullify the effect of seasonal changes, to pay taxes, etc.

Based on this concept, revenue expenditure and capital expenditure are segregated. Revenues expenditure are debited to the profit & loss account to ascertain correct profit or loss during a particular accounting period. Capital expenditure comes in the category of those expenses, the benefit of which will be utilized in the next coming accounting periods as well.

Accounting period helps us ascertain correct position of the firm at regular intervals of time, i.e., at the end of each accounting period.

Matching Concept

Matching concept is based on the accounting period concept. The expenditures of a firm for a particular accounting period are to be matched with the revenue of the same accounting period to ascertain accurate profit or loss of the firm for the same period. This practice of matching is widely accepted all over the world. Let us take an example to understand the Matching Concept clearly.

The following data is received from M/s Globe Enterprises during the period 01-04-2012 to 31-03-2013:

S.No.	Particulars	Amount
1	Sale of 1,000 Electric Bulbs @ Rs 10 per bulb on cash basis.	10,000.00
2	Sale of 200 Electric Bulb @ Rs. 10 per bulb on credit to M/s Atul Traders.	2,000.00
3	Sale of 450 Tube light @ Rs.100 per piece on Cash basis.	45,000.00
4	Purchases made from XZY Ltd.	40,000.00
5	Cash paid to M/s XYZ Ltd.	38,000.00
6	Freight Charges paid on purchases	1,500.00
7	Electricity Expenses of shop paid	5,000.00
8	Bill for March-13 for Electricity still outstanding to be paid next year.	1,000.00

Based on the above data, the profit or loss of the firm is calculated as follows:

Particulars	Amount	Total
Sale		
Bulb	12,000.00	
Tube	45,000.00	57,000.00

Less -		
Purchases	40,000.00	
Freight Charges	5,000.00	
Electricity Expenses	1,500.00	
Outstanding Expenses	1,000.00	47,500.00
Net Profit		**9,500.00**

In the above example, to match expenditures and revenues during the same accounting period, we added the credit purchase as well as the outstanding expenses of this accounting year to ascertain the correct profit for the accounting period 01-04-2012 to 31-03-2013.

It means the collection of cash and payment in cash is ignored while calculating the profit or loss of the year.

Accrual Concept

As stated above in the matching concept, the revenue generated in the accounting period is considered and the expenditure related to the accounting period is also considered. Based on the accrual concept of accounting, if we sell some items or we rendered some service, then that becomes our point of revenue generation irrespective of whether we received cash or not. The same concept is applicable in case of expenses. All the expenses paid in cash or payable are considered and the advance payment of expenses, if any, is deducted.

Most of the professionals use cash basis of accounting. It means, the cash received in a particular accounting period and the expenses paid cash in the same accounting period is the basis of their accounting. For them, the income of their firm depends upon the collection of revenue in cash. Similar practice is followed for expenditures. It is convenient for them and on the same basis, they pay their Taxes.

Objective Evidence Concept

According to the Objective Evidence concept, every financial entry should be supported by some objective evidence. Purchase should be supported by purchase bills, sale with sale bills, cash payment of expenditure with cash memos, and payment to creditors with cash receipts and bank statements. Similarly, stock should be checked by physical verification and the value of it should be verified with purchase bills. In the absence of these, the accounting result will not be trustworthy, chances of manipulation in accounting records will be high, and no one will be able to rely on such financial statements.

Conventions

We will discuss the accounting conventions in this section.

Convention of Consistency

To compare the results of different years, it is necessary that accounting rules, principles, conventions and accounting concepts for similar transactions are followed consistently and continuously. Reliability of financial statements may be lost, if frequent changes are observed in accounting treatment. For example, if a firm chooses cost or market price whichever is lower method for stock valuation and written down value method for depreciation to fixed assets, it should be followed consistently and continuously.

Consistency also states that if a change becomes necessary, the change and its effects on profit or loss and on the financial position of the company should be clearly mentioned.

Convention of Disclosure

The Companies Act, 1956, prescribed a format in which financial statements must be prepared. Every company that fall under this category has to follow this practice. Various provisions are made by the Companies Act to prepare these financial statements. The purpose of these provisions is to disclose all essential information so that the view of financial statements should be true and fair. However, the term ‘disclosure’ does not mean all information. It means disclosure of information that is significance to the users of these financial statements, such as investors, owner, and creditors.

Convention of Materiality

If the disclosure or non-disclosure of an information might influence the decision of the users of financial statements, then that information should be disclosed.

For better understanding, please refer to General Instruction for preparation of Statement of Profit and Loss in revised scheduled VI to the Companies Act, 1956:

- A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs 1,00,000 whichever is higher.
- A Company shall disclose in Notes to Accounts, share in the company held by each shareholder holding more than 5% share specifying the number of share held.

Conservation or Prudence

It is a policy of playing safe. For future events, profits are not anticipated, but provisions for losses are provided as a policy of conservatism. Under this policy, provisions are made for doubtful debts as well as contingent liability; but we do not consider any anticipatory gain.

For example, If A purchases 1000 items @ Rs 80 per item and sells 900 items out of them @ Rs 100 per item when the market value of stock is (i) Rs 90 and in condition (ii) Rs 70 per item, then the profit from the above transactions can be calculated as follows:

Particulars	Condition(i)	Condition(ii)
Sale Value (A) (900x100)	90,000.00	90,000.00
Less - Cost of Goods Sold		
Purchases	80,000.00	80,000.00
Less - Closing Stock	8,000.00	7,000.00
Cost of Goods Sold (B)	72,000.00	73,000.00
Profit(A-B)	**18,000.00**	**17,000.00**

In the above example, the method for valuation of stock is ‘Cost or market price whichever is lower’.

The prudence however does not permit creation of hidden reserve by understating the profits or by overstating the losses.

Principles

Accounting principles are the rules and guidelines that companies must follow when reporting financial data. The Financial Accounting Standards Board (FASB) issues a standardized set of accounting principles in the U.S. referred to as generally accepted accounting principles (GAAP).[1] Some of the most fundamental accounting principles include the following:

- Accrual principle
- Conservatism principle
- Consistency principle
- Cost principle
- Economic entity principle
- Full disclosure principle
- Going concern principle
- Matching principle
- Materiality principle
- Monetary unit principle
- Reliability principle
- Revenue recognition principle
- Time period principle

KEY TAKEAWAYS

- Accounting standards are implemented to improve the quality of financial information reported by companies.
- In the United States, the Financial Accounting Standards Board (FASB) issues Generally Accepted Accounting Principles (GAAP).

- GAAP is required for all publicly traded companies in the U.S.; it is also routinely implemented by non-publicly traded companies as well.

- Internationally, the International Accounting Standards Board (IASB) issues International Financial Reporting Standards (IFRS).

- The FASB and IASB sometimes work together to issue joint standards on hot topic issues, but there is no intention for the U.S. to switch to IFRS in the forseeable future.

Understanding Accounting Principles

Generally Accepted Accounting Principles

Publicly traded companies in the United States are required to regularly file GAAP compliant financial statements in order to remain publicly listed on stock exchanges. Chief officers of publicly traded companies and their independent auditors must certify that the financial statements and related notes were prepared in accordance with GAAP.

Privately held companies and nonprofit organizations may also be required by lenders or investors to file GAAP compliant financial statements. For example, annual audited GAAP financial statements are a common loan covenant required by most banking institutions. Therefore, most companies and organizations in the United States comply with GAAP, even though it is not necessarily a requirement.

Accounting principles help govern the world of accounting according to general rules and guidelines. GAAP attempts to standardize and regulate the definitions, assumptions, and methods used in accounting. There are a number of principles, but some of the most notable include the revenue recognition principle, matching principle, materiality principle, and consistency principle. The ultimate goal of standardized accounting principles is to allow financial statement users to view a company's financials with the certainty that information disclosed in the report is complete, consistent, and comparable.

Completeness is ensured by the materiality principle, as all material transactions should be accounted for in the financial statements. Consistency refers to a company's use of accounting principles over time. When accounting principles allow choice between multiple methods, a company should apply the same accounting method over time or disclose its change in accounting method in the footnotes to the financial statements.

Comparability is the ability for financial statement users to review multiple companies' financials side by side with the guarantee that accounting principles have been followed to the same set of standards. Accounting information is not absolute or concrete, and standards such as GAAP are developed to minimize the negative effects of inconsistent data. Without GAAP, comparing financial statements of companies would be extremely

difficult, even within the same industry, making an apples-to-apples comparison hard. Inconsistencies and errors would also be harder to spot.

International Financial Reporting Standards

Accounting principles differ from country to country. The International Accounting Standards Board (IASB) issues International Financial Reporting Standards (IFRS). These standards are used in over 120 countries, including those in the European Union (EU).[2] The Securities and Exchange Commission (SEC), the U.S. government agency responsible for protecting investors and maintaining order in the securities markets, has expressed that the U.S. will not be switching to IFRS in the foreseeable future. However, the FASB and the IASB continue to work together to issue similar regulations on certain topics as accounting issues arise.[3] For example, in 2014 the FASB and the IASB jointly announced new revenue recognition standards.[4]

Since accounting principles differ across the world, investors should take caution when comparing the financial statements of companies from different countries. The issue of differing accounting principles is less of a concern in more mature markets. Still, caution should be used as there is still leeway for number distortion under many sets of accounting principles.

Accounting Equation

The accounting equation is considered to be the foundation of the double-entry accounting system. On a company's balance sheet, it shows that a company's total assets are equal to the sum of the company's liabilities and shareholders' equity.

Based on this double-entry system, the accounting equation ensures that the balance sheet remains “balanced,” and each entry made on the debit side should have a corresponding entry (or coverage) on the credit side.

KEY TAKEAWAYS

- The accounting equation is considered to be the foundation of the double-entry accounting system.
- The accounting equation shows on a company's balance that a company's total assets are equal to the sum of the company's liabilities and shareholders' equity.
- Assets represent the valuable resources controlled by the company. The liabilities represent their obligations.
- Both liabilities and shareholders' equity represent how the assets of a company are financed.
- Financing through debt shows as a liability, while financing through issuing equity shares appears in shareholders' equity.

Understanding the Accounting Equation

The financial position of any business, large or small, is assessed based on two key components of the balance sheet: assets and liabilities. Owners' equity, or shareholders' equity, is the third section of the balance sheet. The accounting equation is a representation of how these three important components are associated with each other. The accounting equation is also called the basic accounting equation or the balance sheet equation.

While assets represent the valuable resources controlled by the company, the liabilities represent its obligations. Both liabilities and shareholders' equity represent how the assets of a company are financed. If it's financed through debt, it'll show as a liability, and if it's financed through issuing equity shares to investors, it'll show in shareholders' equity.

The accounting equation helps to assess whether the business transactions carried out by the company are being accurately reflected in its books and accounts. Below are examples of items listed on the balance sheet:

Assets

Assets include cash and cash equivalents or liquid assets, which may include Treasury bills and certificates of deposit. Accounts receivables are the amount of money owed to the company by its customers for the sale of its product and service. Inventory is also considered an asset.

Liabilities

Liabilities are what a company typically owes or needs to pay to keep the company running. Debt, including long-term debt, is a liability, as are rent, taxes, utilities, salaries, wages, and dividends payable.

Shareholders' Equity

Shareholders' equity is a company's total assets minus its total liabilities. Shareholders' equity represents the amount of money that would be returned to shareholders if all of the assets were liquidated and all of the company's debt was paid off.

Retained earnings are part of shareholders' equity and are equal to the percentage of net earnings that were not paid to shareholders as dividends. Think of retained earnings as savings since it represents a cumulative total of profits that have been saved and put aside or retained for future use.

Accounting Equation Formula and Calculation

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

The balance sheet holds the basis of the accounting equation:

1. Locate the company's total assets on the balance sheet for the period.
2. Total all liabilities, which should be a separate listing on the balance sheet.
3. Locate total shareholder's equity and add the number to total liabilities.
4. Total assets will equal the sum of liabilities and total equity.

As an example, let's say for the fiscal year, leading retailer XYZ Corporation reported the following on its balance sheet:

- Total assets: $170 billion
- Total liabilities: $120 billion
- Total shareholders' equity: $50 billion

If we calculate the right-hand side of the accounting equation (equity + liabilities), we arrive at ($50 billion + $120 billion) = $170 billion, which matches the value of the assets reported by the company.

The Double-Entry System

The accounting equation forms the foundation of double-entry accounting and is a concise representation of a concept that expands into the complex, expanded, and multi-item display of a balance sheet. The balance sheet is based on the double-entry accounting system where the total assets of a company are equal to the total liabilities and shareholder equity.

Essentially, the representation equates all uses of capital (assets) to all sources of capital, where debt capital leads to liabilities and equity capital leads to shareholders' equity.

For a company keeping accurate accounts, every single business transaction will be represented in at least two of its accounts. For instance, if a business takes a loan from a financial entity like a bank, the borrowed money will raise the company's assets and the loan liability will also rise by an equivalent amount.

If a business buys raw material by paying cash, it will lead to an increase in the inventory (asset) while reducing cash capital (another asset). Because there are two

or more accounts affected by every transaction carried out by a company, the accounting system is referred to as double-entry accounting.

The double-entry practice ensures that the accounting equation always remains balanced, meaning that the left side value of the equation will always match with the right side value. In other words, the total amount of all assets will always equal the sum of liabilities and shareholders' equity.

The global adherence to the double-entry accounting system makes the account keeping and tallying processes much easier, standardized, and fool-proof to a good extent. The accounting equation ensures that all entries in the books and records are vetted, and a verifiable relationship exists between each liability (or expense) and its corresponding source; or between each item of income (or asset) and its source.

Limits of the Accounting Equation

Although the balance sheet always balances out, the accounting equation doesn't provide investors as to how well a company is performing. Instead, investors must interpret the numbers and decide for themselves whether the company has too many or too few liabilities, not enough assets, or perhaps too many assets, or is financing the company properly to ensure long term growth.

Real World Example

Below is a portion of Exxon Mobil Corporation's (XOM) balance sheet in millions as of Dec. 31, 2019:

- Total assets were $362,597 (highlighted in green).
- Total liabilities were $163,659 (first highlighted red area).
- Total equity was $198,938 (second highlighted red area).

The accounting equation whereby assets = liabilities + shareholders' equity is calculated as follows:

- **Accounting equation** = $163,659 (total liabilities) + $198,938 (equity) equals $362,597, (which equals the total assets for the period)

International Accounting principles and standards

The purpose of accounting is to communicate the organization’s financial position to company managers, investors, banks, and the government. Accounting

standards provide a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a firm's managers and investors can assess the financial health of the firm. Accounting standards cover topics such as how to account for inventories, depreciation, research and development costs, income taxes, investments, intangible assets, and employee benefits. Investors and banks use these financial statements to determine whether to invest in or loan capital to the firm, while governments use the statements to ensure that the companies are paying their fair share of taxes.

As countries developed different cultures, languages, and social and economic traditions, they developed different accounting practices as well. In an increasingly globalized world, however, these differences are not optimal for the smooth functioning of international business.

The Emergence of New International Accounting Standards

The International Accounting Standards Board (IASB) is the major entity proposing international standards of accounting. Originally formed in 1973 as the International Accounting Standards Committee (IASC) and renamed the International Accounting Standards Board in 2001, the IASB is an independent agency that develops accounting standards known as international financial reporting standards (IFRS).“History,” International Accounting Standards Board, accessed November 26, 2010, http://www.ifrs.org/Home.htm.

The IASB is composed of fifteen representatives from professional accounting firms from many countries.“About the IFRS Foundation and the IASB,” IFRS Foundation, accessed November 25,

2010, http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm. These board members formulate the international reporting standards. For a standard to be approved, 75 percent of the board members must agree. Often, getting agreement is

difficult given the social, economic, legal, and cultural differences among countries. As a result, most IASB statements provide two acceptable alternatives. Two alternatives aren't as solid or straightforward as one, but it's better than having a dozen different options.

Adherence to the IASB's standards is voluntary, but many countries have mandated use of IFRS. For example, all companies listed on EU stock exchanges are required to use IFRS.European Commission, "Report to the European Securities Committee and to the European Parliament," April 6, 2010, accessed November 26, 2010, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=com:2010:0292:fin:en:html. The same is true for all companies listed on South Africa's Johannesburg Stock Exchange and Turkey's Istanbul Stock Exchange. In all, over one hundred nations have adopted or permitted companies to use the IASB's standards to report their financial results.Neil Baker, "IFAC Calls for Crucial Reporting Roadmap," Compliance Week, July 27, 2009, accessed November 26,
2010, http://www.complianceweek.com/blog/glimpses/2009/07/27/ifac-calls-for-reporting-roadmap.

The United States doesn't mandate using the IFRS. Instead, the United States has the Financial Accounting Standards Board (FASB), which issues standards known as generally accepted accounting principles (GAAP). The US currently mandates following GAAP. However, the FASB and IASB are working on harmonizing the accounting standards; many IASB standards are similar to FASB ones. The United States is moving toward adopting the IFRS but hasn't committed to a specific time frame.Marie Leone, "Harvey Goldschmid Named IASB Trustee," CFO, December 11, 2009, accessed November 26,
2010, http://www.cfo.com/printable/article.cfm/14461503.

The primary reason for adopting one standard internationally is that if different accounting standards are used, it's difficult for investors or lenders to compare the

financial health of two companies. In addition, if a single international standard is used, multinational firms won't have to prepare different reports for the different countries in which they operate.

Accounting standards can be complex; and this makes modification of standards difficult. In addition, differing practices among various nations add to the complications of a unified accounting format. For example, in the United States and Great Britain, individual investors provide a substantial source of capital to companies, so accounting rules are designed to help individual investors.CIRCA, "International Accounting Norms: Background and Recent Developments in the EU," accessed November 26, 2010, http://circa.europa.eu/irc/dsis/accstat/info/data/en/accounting%20for%20website.htm. In contrast, the tradition in Switzerland, Germany, and Japan is for companies to rely more on banks for funding. Companies in these countries have a tighter relationship with banks. This means that less information is disclosed to the public. It also results in accounting rules that value assets conservatively to protect a bank's investment. In other countries, the government steps in to make loans or invest in companies whose activities are in the "national interest."

Finally, accounting rules in China follow neither IFRS nor GAAP, which makes it hard for investors to gauge the true value of a company.Doug McIntyre, "Chinese Accounting: Greek to Many," Forbes, June 18, 2007, accessed November 26, 2010, http://www.forbes.com/2007/06/18/china-accounting-gaap-pf-education-in_dm_0618investopedia_inl.html. To address this issue, some large Chinese companies report results in both Chinese accounting standards and the IASB's standards. The two accounting standards can show quite different results for the same company, which is why convergence proponents advocate using one global accounting standard.

Characteristics of International Accounting Standards and Their Implications for International Business

On one hand, having to adhere to GAAP rules as well as IFRS rules creates extra labor and paperwork for multinational firms. For example, a US company seeking to raise funds in Germany has to prepare a financial report according to IFRS accounting rules as well as US GAAP rules. Further problems arise when different country accounting rules make the financial statements look different. If the same transaction is accounted for in different ways based on different country accounting rules, the comparability of financial reports is undermined.

In some instances, the differences between US GAAP rules and IFRS are significant. For example, the last-in, first-out (LIFO) accounting method is allowed by GAAP but banned by IFRS. Some firms, such as aluminum company Alcoa, receive a tax benefit from using the LIFO method.Marie Leone, “Unfazed by IFRS,” CFO, April 30, 2010, accessed August 10, 2010, http://www.cfo.com/article.cfm/14495043. If IFRS is mandated for all US companies, firms like Alcoa may need to make significant cash-tax payments. This is why US adoption of IFRS is taking time, and why the FASB and IASB are working hard to harmonize the standards.

On the positive side, other companies, like IBM, may gain greater efficiencies and stronger controls from a move to IFRS. For example, converting to IFRS would make it possible for IBM to create a globally shared service center for accounting, rather than having accounting departments in different regions.Marie Leone, “Unfazed by IFRS,” CFO, April 30, 2010, accessed August 10, 2010, http://www.cfo.com/article.cfm/14495043.

US adoption of the IASB’s global accounting standards would be useful to big multinational companies. Tyco International, for example, is the parent of 1,200 legal entities, 900 of them outside the United States. For Tyco, having to follow only IFRS

rules would be positive, because it would enable Tyco to prepare financials on the same basis worldwide and to more freely move accounting staff from country to country and business to business. Nonetheless, given Tyco's massive network of information systems, making the switch would still be "a tremendous amount of work," according to John Davidson, the company's controller and chief accounting officer.David McCann, "IFRS: Jekyll or Hyde?," CFO, November 20, 2009, accessed October 28, 2010, http://www.cfo.com/article.cfm/14456597/c_14457492.

Some smaller public companies, however, would see only costs from a move to IFRS. Davey Tree Expert Company, for example, which only does business in the United States and Canada, sees no benefits. Because the company is unlikely to ever list on any national exchange, the argument that unified standards would allow comparability of financials has no value.David McCann, "IFRS: Jekyll or Hyde?," CFO, November 20, 2009, accessed October 28, 2010, http://www.cfo.com/article.cfm/14456597/c_14457492.

An interim step toward the United States adopting IFRS is to permit US firms that operate globally to file only under IFRS, rather than under both GAAP and IFRS, thereby reducing their financial-statement preparation costs.

KEY TAKEAWAYS

The purpose of accounting is to communicate an organization's financial position to company managers, investors, banks, and the government. Accounting provides a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a company's managers and investors can assess the financial health of the firm.

Historically, countries have followed different accounting standards. If different accounting standards are used, however, it's difficult for investors or lenders to compare two companies or determine their financial condition. US firms and any listed on a US stock exchange must prepare financial statements in accordance with the US Financial Accounting Standards Board (FASB) standards, which are known as generally accepted accounting principles (GAAP). Firms based in the European Union (EU) follow standards adopted by the International Accounting Standards Board (IASB) known as

international financial reporting standards (IFRS). Over one hundred nations have adopted or permit companies to use IFRS to report their financial results. The United States is moving toward adopting IFRS but hasn't committed to a time frame. The FASB and IASB are working on harmonizing the two accounting standards.

The three main advantages of a single set of international accounting standards are (1) an increased comparability between firms, which reduces investor risk and facilitates cross-border financing and investment; (2) a reduction in the cost of preparing consolidated financial statements for multinational firms; and (3) the improved reliability and credibility of financial reports.

Matching of Indian Accounting Standards with International Accounting Standards

Accounting Standards are written policy documents issued by expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation, and disclosure of accounting transactions in financial statements

Classification of Enterprises

The enterprises are classified and labeled as Level I, Level II and Level III companies. Based on this classification and the category in which they fall the Accounting standards are applicable to the enterprises

Level I Enterprises

Enterprises which fall under any one or more category below mentioned are termed as Level I Companies

1. Enterprises whose equity or debt securities are listed whether in India or outside India

2. Enterprises which are in the process of listing their equity or debt securities. Board of directors' resolution must be available as an evidence

3. Banks including co-operative banks

4. Financial institutions

5. Enterprises carrying on insurance business

6. All commercial, industrial and business reporting enterprises, whose turnover not including 'other income' for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore

7. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crores at any time during the accounting period

8. Holding and subsidiary enterprises of any one of the above at any time during the accounting period

Level II Enterprises

Enterprises which fall under any one or more category below mentioned are termed as Level II Companies

1. All commercial, industrial and business reporting enterprises, whose turnover (excluding 'other income') for the immediately preceding accounting period on the basis of audited financial statements is greater than Rs. 40 lakhs but less than Rs. 50 crore

2. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, is greater Rs. 1 crore but less than Rs. 10 crores at any time during the accounting period

3. Holding and subsidiary enterprises of any one of the above at any time during the accounting period

Level III Enterprises:

Enterprises which do not fall under Level I and Level II, are considered as Level III enterprises

Applicability of Accounting standards

Accounting Standard	Level I	Level II	Level III
AS 1 Disclosure of Accounting Principles	Yes	Yes	Yes
AS 2 Valuation of Inventories	Yes	Yes	Yes
AS 3 Cash Flow Statements	Yes	No	No
AS 4 Contingencies and Events Occurring After the Balance Sheet Date	Yes	Yes	Yes

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Yes	Yes	Yes
AS 6 Depreciation Accounting	Yes	Yes	Yes
AS 7 Construction Contracts (Revised 2002)	Yes	Yes	Yes
AS 9 Revenue Recognition	Yes	Yes	Yes
AS 10 Accounting for Fixed Assets	Yes	Yes	Yes
AS 11 The Effects Of Changes In Foreign Exchange Rates (Revised 2003)	Yes	Yes	Yes
AS 12 Accounting for Government Grants	Yes	Yes	Yes
AS 13 Accounting for Investments	Yes	Yes	Yes
AS 14 Accounting for Amalgamations	Yes	Yes	Yes
AS 15 Employee Benefits (Revised 2005)	Yes	Yes	Yes
AS 16 Borrowing Costs	Yes	Yes	Yes
AS 17 Segment Reporting	Yes	No	No
AS 18 Related Party Disclosures	Yes	No	No
AS 19 Leases	Yes	Partial	Partial
AS 20 Earnings Per Share	Yes	Partial	Partial

AS 21 Consolidated Financial Statements	Yes	No	No
AS 22 Accounting for taxes on income	Yes	Yes	Yes
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements	Yes	No	No
AS 24 Discontinuing Operations	Yes	No	No
AS 25 Interim Financial Reporting	Yes	No	No
AS 26 Intangible Assets	Yes	Yes	Yes
AS 27 Financial Reporting of Interests in Joint Ventures	Yes	No	No
AS 28 Impairment of Assets	Yes	Yes	Yes
AS 29 Provisions, Contingent Liabilities and Contingent Assets	Yes	Partial	Partial

1. AS 19 Leases

Paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of AS 19 does not apply to Level II and Level III enterprises

2. AS 20 Earnings Per Share

The provisions of Part IV of Schedule VI to the Companies Act, 1956 require all companies to disclose earning per share in their financial statements.

AS 2o does not mandate disclosure of diluted earning per share and information required by paragraph 48 for Level II and Level III enterprises.

Hence only Level I enterprises are required to apply AS 20 entirely without any relaxations.

3. AS 29, Provisions, Contingent Liabilities, and Contingent Assets

- Paragraph 67 does not apply to Level II enterprises
- Paragraphs 66 and 67 does not apply to Level II and Level III enterprises

UNIT - II

Mechanics of Accounting:

Double entry system of accounting

The double entry system of bookkeeping can be traced back to early middle age and if records are to be believed, it's been in practice even before the 12th century. The man behind this popular method of booking was the Italian mathematician Luca Pacioli who first published his comprehensive thesis on the principles of Double Entry System in 1494.

Since then, the double entry system is widely practised, and it made it possible for the business to record all sorts of business transactions, unlike only cash events.

Today, the double entry system of accounting is one of the widely used methods of booking as it proves to be the most accurate method of record keeping. You can talk about the history of double entry system for hours, that how the system has evolved over the years but let's keep it simple and understand how double entry system works.

We are sure you'll just love the way it works and resonate why it is popular among most of the business.

What is Double Entry Accounting System?

Double entry system of booking is an accounting system which recognizes the fact that every transaction has two aspects and both aspects of the transaction are recorded in the books of accounts. In other words, it recognizes that in order to receive some value, an equal value needs to be given.

Confused! Think like this, if you are buying a computer by paying 20,000 Rs in cash.

If you closely look at the above example, the transaction as two parts in it: You are receiving a computer which can be called as receiving aspect. The second one, you are paying cash which can be termed as giving aspect.

Now when you apply the double entry system of bookkeeping, it recognizes and records both the aspect; receiving and giving aspect in the books of accounts.

Considering the above definition, every transaction will have at least two accounts which are impacted. In the above example, computer is one account and cash is the other account.

So, when books are maintained using double entry accounting system, every transaction involves a debit entry in one account and credit entry in another account. This because, you have an account which receives the value and another account which has given the value.

When you look at the above example, computer account will be debited since it has received the value (inward) and cash account will be credited because it has given the value (outward).

To summarize, under double entry accounting system, in every transaction an account is debited, and some other account is credited.

Before you record, find out two accounts affected by a particular transaction and next, out of these two accounts which account is required to be debited and credited.

Wondering how will I know which account to be Debited and Credited?

No worries! To help you overcome this, a set of rules are defied which will guide you on accounts that should be debited and credited. This is famously called as ‘Golden Rules of Accounting’. Read our article ‘Golden Rules of Accounting – Debit and Credit’ to know in detail with examples.

Features of Double Entry Accounting system

- A transaction has two-fold aspects i.e. one giving the benefit and the other receiving the benefit.
- A transaction is divided into two aspects, Debit and Credit. One account needs to be debited and the other is to be credited.
- Every debit must have its corresponding and equal credit.

Advantages of Double Entry Accounting system

- As both the personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.
- It assures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is arrived by preparing a trial balanceperiodically or at the end of the financial year.
- Prevents and minimizes frauds. Frauds can be even detected early.
- Errors can be checked and rectified easily.

- The outstanding balances of receivables and payables are determined easily since the personal accounts are maintained.

- Businesses can compare the financial position of the current year with that of the past year/s.

- Helps to justify the standing of business on the valuation date in comparison with the previous years' purchase, sales, and stocks, incomes and expenses with that of the current year figures.

- The calculated net operating results can be ascertained by preparing the trading and profit and loss A/cfor the year ended and the financial position can be ascertained by the preparation of the balance sheet.

- Government can easily decide on the tax to be calculated on the businesses net earnings.

- Outsiders and stakeholders like suppliers, banks, holders of equity etc take a proper decision regarding grant of credit or loans or subscribing for the shares.

Double Entry System

Double Entry System of bookkeeping handles with two or more accounts for every monetary transaction. For instance, a person sold an item of furniture in the market. So, this will increase the cash balance account and simultaneously will decrease the furniture account with the respective amount.

It’s a central idea enveloping accounting and bookkeeping in present occasions. Each money related exchange has an equivalent and inverse impact in something like two unique accounts. The equation can be:

ASSETS = LIABILITIES + EQUITY

Recording System

Double entry system records the monetary transactions in terms of Credit and Debit item. Double Entry System impact both the side of accounts, for instance, a debit entry in one account also impacts the credit side of another related account or accounts. In simple words, the double entry system ensures that the sum of all Debit account is equal to that of Credit accounts. This strategy for accounting and bookkeeping results in the exact portrayal of financial position. In addition to this, it also brings down the rate of blunders by recognizing them timely.

Types of Accounts

The accounting and bookkeeping process measures, records and imparts everyday monetary activities or transactions. A transaction is an event that can be classified in monetary terms, for instance, an exchange of goods and services between a buyer and a seller. Further accounts are of three types:

- Personal Account
- Real Account
- Nominal Account

Under a precise accounting process, the financial activities are recorded into different accounts to keep the information bifurcated and arranged under particular account heads. There are significantly seven sorts of accounts wherein all the business accounting transactions and entries are grouped. These accounts are:

- Assets
- Equity
- Liabilities
- Profits
- Losses
- Expenditure
- Revenues

As the operations of a business are dynamic, the accounting and bookkeeping is a constant procedure of following changes in each account.

Debit and Credit

Debits and Credits are basics in a double entry system of bookkeeping and accounting. At the time of posting an accounting entry, an entry on the left half of the account ledger is a debit entry and right side entry is a credit entry.

At last, to finish an entry the aggregate of the Debit side and the Credit side ought to be equivalent. All debits don’t generally increase the account nor do all credits decreases the accounts. A debit entry may increase one record and in the meantime decline another record.

Double Entry System Process

To record a transaction as per the double entry bookkeeping system below are the processes:

Journal:

The financial transactions are recorded in the journal commonly known as journal entries.

Ledger:

After recording in the journal the entries are classified and posted in the ledger.

Trial Balance:

After posting in a ledger the closing balance will be transferred to the Trial balance for summarization.

Final Accounts:

With the help of trial balance financial Accounts are prepared that helps the owner/shareholder to analyze the true and fair view of a business.

Advantages of Double Entry System

The double entry system is recognized as the best strategy for bookkeeping in the cutting edge world. Following are the fundamental advantages of the double entry system:

- Under the Double Entry System, both the parts of every single transaction are recorded. So it is conceivable to keep the total record.
- Using this system Profit & Loss Statement as well as Balance Sheet can be easily prepared. Further, this helps in analyzing the financial position of a business.
- Through the Double Entry System, the accounts department can easily detect errors and omission in the various accounts.
- Every statistical data are effectively accessible under this system which helps in taking correct decisions so as to run the business smoothly.
- All the essential insights concerning transactions can be achieved rapidly and effectively.

Disadvantages of Double Entry System

In spite of so many advantages, double entry system has a few disadvantages which are discussed below:

- Under Double Entry System, every financial transaction is recorded in books of accounts in 2 phases (journal and ledger) and 2 sides (debit and credit). This results in an increment of books of accounts in terms of number and size. Further, making the whole process complicated.

- Double entry system of bookkeeping system requires a considerable time and human resources. So this makes a concern for the small businesses to maintain books of account under this system.

- It requires master learning to maintain accounts under this system.

- Due to the complexity of the double entry system, there is more prominent plausibility of submitting blunders and errors.

It is obvious from the above talk that the double entry system advantages far exceed its disadvantages. In this way, it is viewed as the best system in the cutting edge world.

journalizing of transactions

Journalizing is the foundation for your financial records. Accurate recordkeeping in accounting is vital to success.

Although there are different methods, this surface introduction will introduce you to a few methods for journalizing transactions in accounting.

What is journalizing in accounting?

Journalizing is the practice of documenting a business transaction in accounting records. Record keeping, especially for accountants, is a detail-oriented skill that requires commitment. Every business transaction is recorded in a journal, also known as a Book of Original Entry, in chronological order. It is a process initiated each time a transaction occurs.

If a client is closing out an account, you will want to record the payment as it occurs in the Book of Original Entry. Typical information to include is the date, the amount, the account being credited, and a brief description of the transaction itself.

Recording each entry will facilitate the end-of-year taxes and business responsibilities in reporting to financial agencies. It will also prove important when analyzing your own business for leaks to create a more cost-effective business plan.

Why is journalizing for accounting important?

An accountant is tasked with keeping a ledger of all business transactions, which proves crucial to protecting the business and clients. A strategic plan in keeping records accurate and consistently journalizing transactions will ensure fidelity and protect the assets of your clients.

Types of journalizing transactions

For accounting, there are a selection of seven different methods to journalize transactions which serve a different purpose.

Below are the basic methods used to journalize transactions:

1. **Purchase journal:** You will use this to record all purchases of inventory made on credit.

2. **Sales journal:** This is where to record the credit sale of merchandise only

3. **Cash receipts journal:** You will record all types of cash receipts here. Cash shows cash only transactions and cash from accounts receivable.

4. **Cash payment/disbursement journal:** This is typically payments by check that are often made on a monthly basis.

5. **Purchase return journal:** You will use this to show all purchases on credit by your business. This is only necessary if a business has inventory in the form of trading or manufacturing goods.

6. **Sales or purchase return journal:** This is traditionally where any returns of merchandise will be documented. A reason for return will be recorded for future reference.

7. **Journal proper/general journal:** You will use this journal to record anything not recorded in the other journals. Something like equipment purchases would be recorded here as would similar company expenditures.

How to journalize transactions

Each time your company earns or spends money, post the transaction in at least two different accounts – a debit and a credit account. This is called the "double-entry method."

Describe the transaction. Your attention to the details of each transaction with thorough documentation is the key to quality bookkeeping.

1. **Identify transactions.** Identify the type of transaction that has occurred. If you are not the sole individual responsible for the transactions, receipts will be submitted to you. Sales, purchases, receipts, and payments will all fall under

different categories depending on the situation.

2. **Analyze transactions.** This is where the identified transaction is scrutinized to understand how the transaction altered the accounting equation.

3. **Journalize transactions.** This is the process of recording. A system of debits and credits is utilized to record changes in the balancing of accounts and the equation in the general journal. Traditional journal entry format dictates that debited accounts are listed before credited accounts. For each entry you will record the transaction date, title, and description of the event.

Common Questions

Below are some common questions regarding journalizing transactions:

When entering transactions, should the debit or credit be entered first?

Traditional formats list the debits first on the first line and you will include the amount on the left side.

What is single-entry accounting?

For some, a very basic form of accounting is needed. Freelancers will sometimes only use the minimal in order to simply document their spending and earning. Single entry accounting is used for these very basic systems. You will journalize each entry as a single transaction.

What is the double-entry accounting system?

Double-entry accounting is a more involved and comprehensive approach to bookkeeping you may consider. For every entry you make in an account, you must input an opposite entry in a different one. This system is used most often for completing end-of-year reports, taxes and balancing the books.

What is the difference between posting and journalizing?

Journalizing is the methodical documenting of transactions in the appropriate journals. Every event is documented with double-entry, and an opposite entry is completed as well.

Posting is where you transfer the data you have recording in journaling to to ledger accounts. Posting is the step after accurately journalizing.

preparation of final accounts

Final Accounts are the accounts, which are prepared at the end of a fiscal year. It gives a precise idea of the financial position of the business/organization to the owners, management, or other interested parties. Financial statements are primarily recorded in a journal; then transferred to a ledger; and thereafter, the final account is prepared (as shown in the illustration).

Usually, a final account includes the following components −

- Trading Account
- Manufacturing Account
- Profit and Loss Account
- Balance Sheet

Now, let us discuss each of them in detail −

Trading Account

Trading accounts represents the Gross Profit/Gross Loss of the concern out of sale and purchase for the particular accounting period.

Study of Debit side of Trading Account

- **Opening Stock** − Unsold closing stock of the last financial year is appeared in debit side of the Trading Account as “To Opening Stock“ of the current financial year.
- **Purchases** − Total purchases (net of purchase return) including cash purchase and credit purchase of traded goods during the current financial year appeared as “To Purchases” in the debit side of Trading Account.
- **Direct Expenses** − Expenses incurred to bring traded goods at business premises/warehouse called direct expenses. Freight charges, cartage or carriage charges, custom and import duty in case of import, gas, electricity fuel, water, packing material, wages, and any other expenses incurred in this regards comes under the debit side of Trading Account and appeared as “To Particular Name of the Expenses”.
- **Sales Account** − Total Sale of the traded goods including cash and credit sales will appear at outer column of the credit side of Trading Account as “By Sales.” Sales should be on net releasable value excluding Central Sales Tax, Vat, Custom, and Excise Duty.
- **Closing Stock** − Total Value of unsold stock of the current financial year is called as closing stock and will appear at the credit side of Trading Account.

closing Stock = Opening Stock + Net Purchases - Net Sale

- **Gross Profit** − Gross profit is the difference of revenue and the cost of providing services or making products. However, it is calculated **before** deducting payroll, taxation, overhead, and other interest payments. Gross Margin is used in the US English and carries same meaning as the Gross Profit.

Gross Profit = Sales - Cost of Goods Sold

- **Operating Profit** − Operating profit is the difference of revenue and the costs generated by ordinary operations. However, it is calculated **before** deducting taxes, interest payments, investment gains/losses, and many other non-recurring items.

Operating Profit = Gross Profit - Total Operating Expenses

- **Net Profit** − Net profit is the difference of total revenue and the total expenses of the company. It is also known as net income or net earnings.

Net Profit = Operating Profit - (Taxes + Interest)

Format of Trading Account

Trading Account of M/s ABC Limited (For the period ending 31-03-2014)			
Particulars	**Amount**	**Particulars**	**Amount**
To Opening Stock	XX	By Sales	XX
To Purchases	XX	By Closing Stock	XX
To Direct Expenses	XX	By Gross Loss c/d	XXX
To Gross Profit c/d	XXX		
Total	**XXXX**	**Total**	**XXXX**

Manufacturing Account

Manufacturing account prepared in a case where goods are manufactured by the firm itself. Manufacturing accounts represent cost of production. Cost of production then transferred to Trading account where other traded goods also treated in a same manner as Trading account.

Important Point Related to Manufacturing Account

Apart from the points discussed under the section of Trading account, there are a few additional important points that need to be discuss here −

- **Raw Material** − Raw material is used to produce products and there may be opening stock, purchases, and closing stock of Raw material. Raw material is the main and basic material to produce items.
- **Work-in-Progress** − Work-in-progress means the products, which are still partially finished, but they are important parts of the opening and closing stock. To know the correct value of the cost of production, it is necessary to calculate the correct cost of it.
- **Finished Product** − Finished product is the final product, which is manufactured by the concerned business and transferred to trading account for sale.
- **Raw Material Consumed (RMC)** − It is calculated as.

RMC = Opening Stock of Raw Material + Purchases - Closing Stock

- **Cost of Production** − Cost of production is the balancing figure of Manufacturing account as per the format given below.

Manufacturing Account

(For the year ending…….)

Particulars	Amount	Particulars	Amount
To Opening Stock of Work-in-Progress	XX	By Closing Stock of Work-in-Progress	XX
To Raw Material Consumed	XX	By Scrap Sale	XX
To Wages	XXX	By Cost of Production	XXX
To Factory overheadxx		(Balancing figure)	
Power or fuelxx			
Dep. Of Plantxx			
Rent- Factoryxx			
Other Factory Exp.xx	xxx		
Total	**XXXX**	**Total**	**XXXX**

Profit and Loss Account

Profit & Loss account represents the Gross profit as transferred from Trading Account on the credit side of it along with any other income received by the firm like interest, Commission, etc.

Debit side of profit and loss account is a summary of all the indirect expenses as incurred by the firm during that particular accounting year. For example, Administrative Expenses, Personal Expenses, Financial Expenses, Selling, and Distribution Expenses, Depreciation, Bad Debts, Interest, Discount, etc. Balancing figure of profit and loss accounts represents the true and net profit as earned at the end of the accounting period and transferred to the Balance Sheet.

Profit & Loss Account of M/s ……

(For the period ending ……..)

Particulars	Amount	Particulars	Amount
To Salaries	XX	By Gross Profit b/d	XX
To Rent	XX		
To Office Expenses	XX	By Bank Interest received	XX
To Bank charges	XX	By Discount	XX
To Bank Interest	XX	By Commission Income	XX
To Electricity Expenses	XX	By Net Loss transfer to Balance sheet	XX
To Staff Welfare Expenses	XX		
To Audit Fees	XX		
To Repair & Renewal	XX		
To Commission	XX		
To Sundry Expenses	XX		
To Depreciation	XX		
To Net Profit transfer to Balance	XX		

sheet			
Total	**XXXX**	**Total**	**XXXX**

Balance Sheet

A balance sheet reflects the financial position of a business for the specific period of time. The balance sheet is prepared by tabulating the assets (fixed assets + current assets) and the liabilities (long term liability + current liability) on a specific date.

Assets

Assets are the economic resources for the businesses. It can be categorized as −

- **Fixed Assets** − Fixed assets are the purchased/constructed assets, used to earn profit not only in current year, but also in next coming years. However, it also depends upon the life and utility of the assets. Fixed assets may be tangible or intangible. Plant & machinery, land & building, furniture, and fixture are the examples of a few Fixed Assets.
- **Current Assets** − The assets, which are easily available to discharge current liabilities of the firm called as Current Assets. Cash at bank, stock, and sundry debtors are the examples of current assets.
- **Fictitious Assets** − Accumulated losses and expenses, which are not actually any virtual assets called as Fictitious Assets. Discount on issue of shares, Profit & Loss account, and capitalized expenditure for time being are the main examples of fictitious assets.
- **Cash & Cash Equivalents** − Cash balance, cash at bank, and securities which are redeemable in next three months are called as Cash & Cash equivalents.
- **Wasting Assets** − The assets, which are reduce or exhausted in value because of their use are called as Wasting Assets. For example, mines, queries, etc.
- **Tangible Assets** − The assets, which can be touched, seen, and have volume such as cash, stock, building, etc. are called as Tangible Assets.

- **Intangible Assets** − The assets, which are valuable in nature, but cannot be seen, touched, and not have any volume such as patents, goodwill, and trademarks are the important examples of intangible assets.
- **Accounts Receivables** − The bills receivables and sundry debtors come under the category of Accounts Receivables.
- **Working Capital** − Difference between the Current Assets and the Current Liabilities are called as Working Capital.

Liability

A liability is the obligation of a business/firm/company arises because of the past transactions/events. Its settlement/repayments is expected to result in an outflow from the resources of respective firm.

There are two major types of Liability −

- **Current Liabilities** − The liabilities which are expected to be liquidated by the end of current year are called as Current Liabilities. For example, taxes, accounts payable, wages, partial payments of long term loans, etc.

- **Long-term Liabilities** − The liabilities which are expected to be liquidated in more than a year are called as Long-term Liabilities. For example, mortgages, long-term loan, long-term bonds, pension obligations, etc.

Grouping of Assets and Liabilities

There may be two types of Marshalling and grouping of the assets and liabilities −

- **In order of Liquidity** − In this case, assets and liabilities are arranged according to their liquidity.
- **In order of Permanence** − In this case, order of the arrangement of assets and liabilities are reversed as followed in order of liquidity.

Financial Statements with Adjustments Entries and their Accounting Treatment

In order to prepare a true and fair financial statement, there are some very important adjustments those have to be done before finalization of the accounts (as shown in the following illustration) –

Sr.No.	Adjustments	Accounting Treatments
1	**Closing Stock** Unsold stock at the end of Financial year called Closing stock and valued at "**Cost or market value whichever is less**"	**First Treatment** Where an opening and closing stock adjusted through a purchase account and the value of Closing Stock given in Trial Balance − Closing stock will be shown as adjusted purchase account on the debit side of Trading account and will appear in the Balance Sheet under current Assets.
2	**Outstanding Expenses** Expenses which are due or not paid called as outstanding expenses.	**Accounting Treatment** Outstanding expenses will be added in Trading or Profit & Loss account in particular expense account and will appear in liabilities side of the Balance Sheet under the current liabilities.
3	**Prepaid Expenses** Expenses which are paid in advance are called as	**Accounting Treatment** Prepaid Expenses will be deducted from the particular expenses as appear in Trading &

	Prepaid Expenses.	Profit & Loss account and will be shown in the Balance Sheet under the current assets.
4	**Accrued Income** The income, which is earned during the year, but not yet received at the end of the Financial Year is called as Accrued Income.	**Accounting Treatment** Accrued income will be added to a particular income under the Profit & Loss account and will be shown in the Balance Sheet as current assets.
5	**Income Received in Advance** An income received in advance, but not earned like advance rent etc.	**Accounting Treatment** An income to be reduced by the amount of advance income in profit & loss account and will appear as current liabilities in the Balance Sheet.
6	**Interest on Capital** Where an interest paid on the capital introduced by the proprietor or partner of the firm.	**Accounting Treatment** • Debit Side of Profit & Loss account • Add to capital account (Credit side of Capital account).
7	**Interest on Drawing** Where an interest paid on the capital introduced by the proprietor or partner of the firm.	**Accounting Treatment** • Credit Side of Profit & Loss account • Reduced from capital account (Debit side of Drawing account).
8	**Provision for Doubtful Debts** If there is any doubt on the recovery from Sundry Debtors.	**Accounting Treatment** • Debit Side of Profit & Loss Account • In a Balance Sheet, provision for the Doubtful will be deducted from the Sundry Debtors' Account.
9	**Provision for Discount on Debtors** If there is any offer of	**Accounting Treatment** • Debit Side of Profit & Loss Account

	discount to pay the debtors within certain period.	• In a Balance Sheet, provision for the Discount on Debtors will be deducted from the Sundry Debtors Account.
10	**Bad Debts** Unrecovered debts or irrecoverable debts	**Accounting Treatment** • Debit Side of Profit & Loss Account • In a Balance Sheet, Sundry debtors will be shown after deducting the Bad Debts.
11	**Reserve for Discount on Creditors** If there is any chance to get discount on the payment of sundry creditors within certain period.	**Accounting Treatment** • Credit Side of Profit & Loss Account • In a Balance Sheet, Sundry Creditors will be shown after deducting the Reserve for Discount.
12	**Loss of Stock by fire** There may be three conditions in this case	**Accounting Treatment** **1. If Stock is fully insured** • Credit Side of Trading Account • Assets side of Balance Sheet • (With full value of loss) **2. If Stock is partially insured** • Credit side of Trading Account (With Total value of Loss) • Debit side of Profit & Loss a/c (With value of loss unrecoverable) • Asset Side of Balance Sheet (With value recoverable) **3. If Stock is not insured** • Credit Side of Trading Account • Debit side of Profit & Loss Account

13	**Reserve Fund**	**Accounting Treatment** • Debit side of Profit & Loss Account • Liabilities side of Balance Sheet
14	**Free Sample to Customers**	**Accounting Treatment** • Credit side of Trading Account • Debit Side of Profit & Loss Account
15	**Managerial Commission**	**Accounting Treatment** • Debit side of Profit & Loss Account • Liabilities side of Balance Sheet as commission payable
16	**Goods on Sale or Approval Basis** If there is any un-approved stock lying with the customers at the end of financial year.	**Accounting Treatment** • Sales AccountDr To Debtors A/c (With Sale Price) • Stock AccountDr To Trading Account (with cost price)

Profit & Loss Account

The profit and loss (P&L) statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a fiscal quarter or year. The P&L statement is synonymous with the income statement. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. Some refer to the P&L statement as a statement of profit and loss, income statement, statement of operations, statement of financial results or income, earnings statement or expense statement.

P&L management refers to how a company handles its P&L statement through revenue and cost management.

KEY TAKEAWAYS

- The P&L statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period.

- The P&L statement is one of three financial statements every public company issues quarterly and annually, along with the balance sheet and the cash flow statement.

- It is important to compare P&L statements from different accounting periods, as the changes in revenues, operating costs, R&D spending, and net earnings over time are more meaningful than the numbers themselves.

- Together with the balance sheet and cash flow statement, the P&L statement provides an in-depth look at a company's financial performance.

- The P&L statement is one of three financial statements every public company issues quarterly and annually, along with the balance sheet and the cash flow statement. It is often the most popular and common financial statement in a business plan as it quickly shows how much profit or loss was generated by a business.

- The income statement, like the cash flow statement, shows changes in accounts over a set period. The balance sheet, on the other hand, is a snapshot, showing what the company owns and owes at a single moment. It is important to compare the income statement with the cash flow statement since, under the accrual method of accounting, a company can log revenues and expenses before cash changes hands.

- The income statement follows a general form as seen in the example below. It begins with an entry for revenue, known as the top line, and subtracts the costs of doing business, including the cost of goods sold, operating expenses, tax expenses, and interest expenses. The difference, known as the bottom line, is net income, also referred to as profit or earnings. You can find many templates for creating a personal or business P&L statement online for free.

- It is important to compare income statements from different accounting periods, as the changes in revenues, operating costs, research and development spending, and net earnings over time are more meaningful than the numbers themselves. For example, a company's revenues may grow, but its expenses might grow at a faster rate.

- Profit and Loss Statement (P&L) Example

- Below is Caterpillar Inc.'s income or P&L statement for 2013 and 2014 (all figures in USD millions except per-share data):[1]

-

Twelve Months Ended December 31,	2014	2013
Sales and revenues:		
Sales of Machinery, Energy & Transportation	52,142	52,694
Revenues of Financial Products	3,042	2,962
Total sales and revenues	55,184	55,656
Operating costs:		
Cost of goods sold	39,767	40,727
Selling, general and administrative expenses	5,697	5,547
Research and development expenses	2,135	2,046
Interest expense of Financial Products	624	727
Other operating (income) expenses	1,633	981
Total operating costs	49,856	50,028
Operating profit	5,328	5,628
Interest expense excluding Financial Products	484	465
Other income (expense)	239	(35)
Consolidated profit before taxes	5,083	5,128
Provision (benefit) for income taxes	1,380	1,319
Profit of consolidated companies	3,703	3,809
Equity in profit (loss) of unconsolidated affiliated companies	8	(6)
Profit of consolidated and affiliated companies	3,711	3,803
Less: Profit (loss) attributable to noncontrolling interests	16	14
Profit [footnote 1: Profit attributable to common shareholders]	3,695	3,789
Profit per common share	5.99	5.87
Profit per common share – diluted [footnote 2: Diluted by assumed exercise of stock-based compensation awards using the treasury stock method]	5.88	5.75
Weighted-average common shares outstanding (millions)		
- Basic	617.2	645.2
- Diluted [see footnote 2]	628.9	658.6
Cash dividends declared per common share	2.70	2.32

- tOne can use the income statement to calculate several metrics, including the gross profit margin, the operating profit margin, the net profit margin and the operating ratio. Together with the balance sheet and cash flow statement, the income statement provides an in-depth look at a company's financial performance.

Profit & Loss Appropriation account

The profit and loss appropriation account is an extension of profit and loss account prepared for the purpose of adjusting the transactions relating to amounts due to and amounts due from partners. It is nominal account in nature. It is credited with net profit, interest on drawings and it is debited with interest on capital, salary and other remuneration to the partners. The balance being the profit or loss is transferred to the partners' capital or current account in the profit sharing ratio.

Format of Profit and loss appropriation account

The following is the format of profit and loss appropriation account:

Dr. **Profit and loss appropriation account** **Cr.**

Particulars	₹	Particulars	₹
To Interest on partners' capital A/c	xxx	By Profit and loss A/c *	xxx
To Partners' salary A/c	xxx	By Interest on partners'	
To Partners' commission A/c	xxx	drawings A/c	xxx
To Partners' capital/current A/c (Profit)	xxx		
	xxx		xxx

*Amount of profit transferred from profit and loss account.

Illustration 21

Arulappan and Nallasamy are partners in a firm sharing profits and losses in the ratio of 4:1. On 1st January 2018, their capitals were ₹ 20,000 and ₹ 10,000 respectively. The partnership deed specifies the following:

a) Interest on capital is to be allowed at 5% per annum.

b) Interest on drawings charged to Arulappan and Nallasamy are ₹ 200 and ₹ 300 respectively.

c) The net profit of the firm before considering interest on capital and interest on drawings amounted to ₹ 18,000.

Give necessary journal entries and prepare Profit and loss appropriation account for the year ending 31st December 2018. Assume that the capitals are fluctuating.

Solution

Journal entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2018	Interest on capital A/c	Dr.		1,500	
Dec. 31	To Arulappan's capital A/c				1,000
	To Nallasamy's capital A/c				500
	(Interest on capital @ 5% provided)				
,,	Profit and loss appropriation A/c	Dr.		1,500	
	To Interest on capital A/c				1,500
	(Interest on capital account closed)				
,,	Arulappan's capital A/c	Dr.		200	
	Nallasamy's capital A/c	Dr.		300	
	To Interest on drawings A/c				500
	(Interest on drawings charged)				
,,	Interest on drawings A/c	Dr.		500	
	To Profit and loss appropriation A/c				500
	(Interest on drawings account closed)				
,,	Profit and loss appropriation A/c	Dr.		17,000	
	To Arulappan's capital A/c				13,600
	To Nallasamy's capital A/c				3,400
	(Profit transferred)				

Dr. Profit and loss appropriation account for the year ended 31st December 2018 Cr.

Particulars	₹	₹	Particulars	₹
To Interest on capital A/c:			By Profit and loss A/c	18,000
Arulappan		1,000	By Interest on drawings A/c	
Nallasamy		500	Arulappan	200
To Partners' capital A/c (profit)			Nallasamy	300
Arulappan (4/5)	13,600			
Nallasamy (1/5)	3,400	**17,000**		
		18,500		18,500

Illustration 22

Durai and Velan entered into a partnership agreement on 1st April 2018, Durai contributing ₹ 25,000 and Velan ₹ 30,000 as capital. The agreement provided that:

a) Profits and losses to be shared in the ratio 2:3 as between Durai and Velan.

b) Partners to be entitled to interest on capital @ 5% p.a.

c) Interest on drawings to be charged Durai: ₹ 300 Velan: ₹ 450

d) Durai to receive a salary of ₹ 5,000 for the year, and

e) Velan to receive a commission of ₹ 2,000

During the year, the firm made a profit of ₹ 20,000 before adjustment of interest, salary and commission. Prepare the Profit and loss appropriation account.

Solution

Dr. Profit and loss appropriation account for the year ended 31st March 2019 Cr.

Particulars	₹	₹	Particulars	₹
To Interest on capital A/c:			By Profit and loss A/c	20,000
Durai (25,000 x 5%)		1,250	By Interest on drawings A/c	
Velan (30,000 x 5%)		1,500	Durai	300
To Salary to Durai A/c		5,000	Velan	450
To Commission to Velan A/c		2,000		
To Partners' capital A/c				
(profit transferred)				
Durai (11,000 x 2/5)	4,400			
Velan (11,000 x 3/5)	6,600	**11,000**		
		20,750		20,750

Illustration 23

Richard and Rizwan started a business on 1st January 2018 with capitals of ₹ 3,00,000 and ₹ 2,00,000 respectively.

According to the Partnership Deed

a) Interest on capital is to be provided @ 6% p.a.

b) Rizwan is to get salary of ₹ 50,000 per annum.

c) Richard is to get 10% commission on profit (after interest on capital and salary to Rizwan) after charging such commission.

d) Profit-sharing ratio between the two partners is 3:2.

During the year, the firm earned a profit of ₹ 3,00,000.

Prepare profit and loss appropriation account. The firm closes its accounts on 31st December every year.

Solution

Dr. Profit and loss appropriation account for the year ended 31st December 2018 Cr.

Dr. Profit and loss appropriation account for the year ended 31st December 2018 Cr.

Particulars	₹	₹	Particulars	₹
To Interest on capital A/c:			By Profit and loss A/c	3,00,000
Richard (3,00,000 x 6%)	18,000			
Rizwan (2,00,000 x 6%)	12,000	30,000		
To Salary to Rizwan		50,000		
To Commission to Richard		20,000		
To Partners' capital A/c (profit)				
Richard (3/5)	1,20,000			
Rizwan (2/5)	80,000	**2,00,000**		
		3,00,000		3,00,000

Note:

Calculation of commission:

Profit before commission = 3,00,000 – (50,000+30,000) = ₹ 2,20,000

Commission = Net profit before commission × Rate of commission / (100 + Rate of commission)

Commission = 2,20,000 × 10/110 = ₹ 20,000

Balance Sheet

A balance sheet gives a statement of a business's assets, liabilities and shareholders equity at a specific point in time. They offer a snapshot of what your business owns and what it owes as well as the amount invested by its owners, reported on a single day. A balance sheet tells you a business's worth at a given time, so you can better understand its financial position.

What is a balance sheet? These topics will help you understand what's included on a balance sheet and what it tells you about the financial position of your small business:

What Items Are on a Balance Sheet?

Balancing a Balance Sheet

Why Is a Balance Sheet Important?

Balance Sheet Example

What Are the Four Basic Financial Statements?

NOTE: FreshBooks Support team members are not certified income tax or accounting professionals and cannot provide advice in these areas, outside of supporting questions about FreshBooks. If you need income tax advice please contact an accountant in your area.

What Items Are on a Balance Sheet?

A balance sheet reports the assets, liabilities and shareholders equity of your business at a given point in time. The items reported on the balance sheet correspond to the accounts outlined on your chart of accounts. A balance sheet is made up of the following elements:

ASSETS

The assets section of the balance sheet breaks down what your business owns of value that can be converted into cash. Your balance sheet will list your assets in order of liquidity; that is, it reports assets in order of how easily they can be converted to cash. There are two main categories of assets included on your balance sheet:

- Current Assets: Current assets can easily be converted to cash within a year or less. Current assets are further broken down on the balance sheet into these accounts:
- Cash and cash equivalents: These are your most liquid assets, including currency, checks and money stored in your business's checking and savings accounts
- Marketable securities: Investments that you can sell within a year
- Accounts receivable: Money that your clients owe you for your services that will be paid in the short term
- Inventory: For businesses that sell goods, inventory includes finished products and raw materials

- Prepaid expenses: Things of value that you've already paid for, like your office rent or your business insurance

Long-Term Assets: Long-term assets won't be converted to cash within a year. They can be further broken down into:

- Fixed assets: Includes property, buildings, machinery and equipment like computers
- Long-term securities: Investments that can't be sold within one year
- Intangible assets: Assets that aren't physical objects, such as copyrights, franchise agreements and patents

LIABILITIES

The next section of a balance sheet lists a company's liabilities. Your liabilities are the money that you owe to others, including your recurring expenses, loan repayments and other forms of debt. Liabilities are further broken down into current and long-term liabilities.

Current liabilities include rent, utilities, taxes, current payments toward long-term debts, interest payments and payroll.

Long-term liabilities include long-term loans, deferred income taxes and pension fund liabilities.

SHAREHOLDERS EQUITY

Shareholders equity refers to the amount of money generated by a business, the amount of money put into the business by its owners (or shareholders) and any donated capital. Shareholders equity is your net assets. On your balance sheet it's calculated using this formula:

Stakeholders Equity = Total Assets – Total Liabilities

Balancing a Balance Sheet

When creating a balance sheet for your business it's important to understand that, as the name suggests, your balance sheet must always be balanced. A balance sheet is divided into two sections, with one side representing your business's assets and the other showing its liabilities and shareholders equity.

The total value of your assets must be equal to the combined value of your liabilities and equity. When that's the case, your document is said to be in balance. This idea is represented by the foundational formula of balance sheets:

Assets = Liabilities + Shareholder Equity

Why Is a Balance Sheet Important?

A balance sheet is an important financial statement that gives a snapshot of the financial health of your business at a point in time. You can also look at your balance sheet in conjunction with your other financial statements to better understand the relationships between different accounts. A balance sheet is important because it provides the following insights about your business:

LIQUIDITY

By comparing your business's current assets to its current liabilities, you'll get a clear picture of the liquidity of your company, or how much cash you have readily available. You always want to have a buffer between your current assets and liabilities to cover your short-term financial obligations, with assets always greater than liabilities.

EFFICIENCY

By comparing your income statement to your balance sheet, you can measure how efficiently your business uses its assets. For example, you can get an idea of how well your company is able to use its assets to generate revenue.

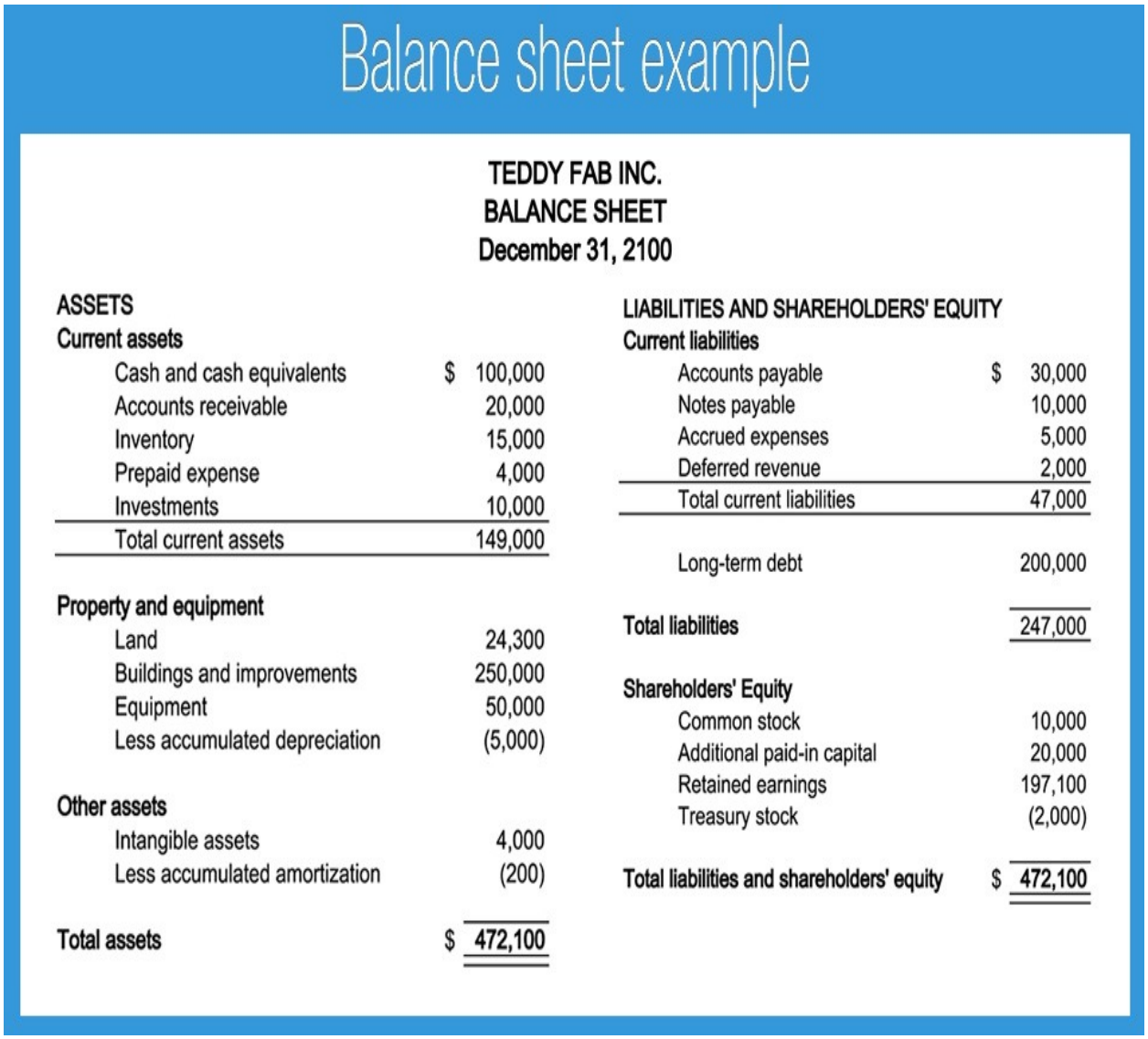
LEVERAGE

Your balance sheet can help you understand how much leverage your business has, which tell you how much financial risk you face. To judge leverage, you can compare the debts to the equity listed on your balance sheet.

Balance Sheet Example

This example of a completed balance sheet from Accounting Play can help you better understand what information is reported on a balance sheet, how it's laid out and how the two sides of the balance sheet balance each other out.

This example of a completed balance sheet from Accounting Play can help you better understand what information is reported on a balance sheet, how it's laid out and how the two sides of the balance sheet balance each other out.



We also have a balance sheet template you can download and use right now.

What Are the Four Basic Financial Statements?

The balance sheet is one element in a series of four basic financial statements that together give an overview of your business's financial performance. These are the four basic financial statements and how they're used to evaluate a business's finances:

Income Statement: A business's income statement, also called a profit and loss statement, reports the revenues, expenses and profits or losses generated during a specific reporting period. It's considered to be the most important of the four financial statements because it shows the profits a business is generating.

Balance Sheet: A balance sheet lists a company's assets, liabilities and shareholders equity at a specific point in time. It's usually thought of as the second most important financial statement, since it shows the liquidity and the theoretical value of the business.

Cash Flow Statement: The cash flow statement shows the money flowing into and out of a business during a specific reporting period. The cash flow statement is important to lenders and investors to determine whether a business has access to the cash needed to pay off its debts.

Statement of Retained Earnings: The statement of retained earnings shows the changes in equity within a business for a specific reporting period. The statement is typically made up of dividend payments, the sale or repurchase of stock and changes resulting from the reporting of profits or losses.

Policies related with depreciation

Depreciation is an accounting method of allocating the cost of a tangible or physical asset over its useful life or life expectancy. Depreciation represents how much of an asset's value has been used up. Depreciating assets helps companies earn revenue from an asset while expensing a portion of its cost each year the asset is in use. If not taken into account, it can greatly affect profits.

Businesses can depreciate long-term assets for both tax and accounting purposes. For example, companies can take a tax deduction for the cost of the asset, meaning it reduces taxable income. However, the Internal Revenue Service (IRS) states that when depreciating assets, companies must spread the cost out over time. The IRS also has rules for when companies can take a deduction.

KEY TAKEAWAYS

- Per the matching principle of accounting, depreciation ties the cost of using a tangible asset with the benefit gained over its useful life.
- There are many types of depreciation, including straight-line and various forms of accelerated depreciation.
- Accumulated depreciation refers to the sum of all depreciation recorded on an asset to a specific date.
- The carrying value of an asset on the balance sheet is its historical cost minus all accumulated depreciation.
- The carrying value of an asset after all depreciation has been taken is referred to as its salvage value.

- Understanding Depreciation

- Depreciation is an accounting convention that allows a company to write off an asset's value over a period of time, commonly the asset's useful life. Assets such as machinery and equipment are expensive. Instead of realizing the entire cost of the asset in year one, depreciating the asset allows companies to spread out that cost and generate revenue from it.

- Depreciation is used to account for declines in the carrying value over time. Carrying value represents the difference between the original cost and the accumulated depreciation of the years.

- Each company might set its own threshold amounts for when to begin depreciating a fixed asset–or property, plant, and equipment. For example, a small company may set a $500 threshold, over which it depreciates an asset. On the other hand, a larger company may set a $10,000 threshold, under which all purchases are expensed immediately.

- For tax purposes, the IRS publishes depreciation schedules detailing the number of years an asset can be depreciated, based on various asset classes.

- The entire cash outlay might be paid initially when an asset is purchased, but the expense is recorded incrementally for financial reporting purposes because assets provide a benefit to the company over a lengthy period of time. Therefore, depreciation is considered a non-cash charge since it doesn't represent an actual cash outflow. However, the depreciation charges still reduce a company's earnings, which is helpful for tax purposes.

- The matching principle under generally accepted accounting principles (GAAP) is an accrual accounting concept that dictates that expenses must be matched to the same period in which the related revenue is generated. Depreciation helps to tie the cost of an asset with the benefit of its use over time. In other words, each year, the asset is put to use and generates revenue, the incremental expense associated with using up the asset is also recorded.

- The total amount that's depreciated each year, represented as a percentage, is called the depreciation rate. For example, if a company had $100,000 in total depreciation over the asset's expected life, and the annual depreciation was $15,000; the rate would 15% per year.

- Recording Depreciation

- When an asset is purchased, it is recorded as a debit to increase an asset account, which then appears on the balance sheet, and a credit to reduce cash or increase accounts payable, which also appears on the balance sheet. Neither side of this journal entry affects the income statement, where revenues and

expenses are reported. In order to move the cost of the asset from the balance sheet to the income statement, depreciation is taken on a regular basis.

- At the end of an accounting period, an accountant will book depreciation for all capitalized assets that are not fully depreciated. The journal entry for this depreciation consists of a debit to depreciation expense, which flows through to the income statement, and a credit to accumulated depreciation, which is reported on the balance sheet. Accumulated depreciation is a contra asset account, meaning its natural balance is a credit which reduces the net asset value. Accumulated depreciation on any given asset is its cumulative depreciation up to a single point in its life.

- As stated earlier, carrying value is the net of the asset account and accumulated depreciation. The salvage value is the carrying value that remains on the balance sheet after all depreciation has been taken until the asset is sold or otherwise disposed. It is based on what a company expects to receive in exchange for the asset at the end of its useful life. As such, an asset's estimated salvage value is an important component in the calculation of depreciation.

- Example of Depreciation

- If a company buys a piece of equipment for $50,000, it could expense the entire cost of the asset in year one or write the value of the asset off over the asset's 10-year useful life. This is why business owners like depreciation. Most business owners prefer to expense only a portion of the cost, which boosts net income.
- In addition, the company can scrap the equipment for $10,000 at the end of its useful life, which means it has a salvage value of $10,000. Using these variables, the accountant calculates depreciation expense as the difference between the cost of the asset and its salvage value, divided by the useful life of the asset. The calculation in this example is ($50,000 - $10,000) / 10, which is $4,000 of depreciation expense per year.

- This means the company's accountant does not have to expense the entire $50,000 in year one, even though the company paid out that amount in cash. Instead, the company only has to expense $4,000 against net income. The company expenses another $4,000 next year and another $4,000 the year after that, and so on until the asset reaches its $10,000 salvage value in ten years.
- Types of Depreciation

- Straight-Line

- Depreciating assets using the straight-line method is typically the most basic way to record depreciation. It reports equal depreciation expense each year throughout the entire useful life until the entire asset is depreciated to its salvage value. The example above used straight-line depreciation.

- Assume, for another example, that a company buys a machine at a cost of $5,000. The company decides on a salvage value of $1,000 and a useful life of five years. Based on these assumptions, the depreciable amount is $4,000 ($5,000 cost - $1,000 salvage value) and the annual depreciation using the straight-line method is: $4,000 depreciable amount / 5 years, or $800 per year. As a result, the depreciation rate is 20% ($800/$4,000). The depreciation rate is used in both the declining balance and double-declining balance calculations.

- Declining Balance

- The declining balance method is an accelerated depreciation method. This method depreciates the machine at its straight-line depreciation percentage times its remaining depreciable amount each year. Because an asset's carrying value is higher in earlier years, the same percentage causes a larger depreciation expense amount in earlier years, declining each year.

- Using the straight-line example above, the machine costs $5,000, has a salvage value of $1,000, a 5-year life, and is depreciated at 20% each year, so the expense is $800 in the first year ($4,000 depreciable amount * 20%), $640 in the second year (($4,000 - $800) * 20%), and so on.
- Double Declining Balance (DDB)

- The double-declining balance (DDB) method is another accelerated depreciation method. After taking the reciprocal of the useful life of the asset and doubling it, this rate is applied to the depreciable base, book value, for the remainder of the asset’s expected life. For example, an asset with a useful life of five years would have a reciprocal value of 1/5 or 20%. Double the rate, or 40%, is applied to the asset's current book value for depreciation. Although the rate remains constant, the dollar value will decrease over time because the rate is multiplied by a smaller depreciable base each period.

- Sum-of-the-Year's-Digits (SYD)

- The sum-of-the-year’s-digits (SYD) method also allows for accelerated depreciation. To start, combine all the digits of the expected life of the asset. For example, an asset with a five-year life would have a base of the sum of the digits one through five, or 1+ 2 + 3 + 4 + 5 = 15. In the first depreciation year, 5/15 of the depreciable base would be depreciated. In the second year, only 4/15 of the depreciable base would be depreciated. This continues until year five depreciates the remaining 1/15 of the base.

- Units of Production

- This method requires an estimate for the total units an asset will produce over its useful life. Depreciation expense is then calculated per year based on the

number of units produced. This method also calculates depreciation expenses based on the depreciable amount.

inventory and intangible assets like copyright

According to the IFRS, intangible assets are identifiable, non-monetary assets without physical substance. Like all assets, intangible assets are expected to generate economic returns for the company in the future. As a long-term asset, this expectation extends for more than one year or one operating cycle.

Intangible assets lack a physical substance like other assets such as inventory and equipment. They form the second largest category of long-term assets, behind number one – PP&E. They can be separated into two classes: identifiable and non-identifiable.

Identifiable and Unidentifiable Intangible Assets

Identifiable intangible assets are those that can be separated from other assets and can even be sold by the company. These are assets such as intellectual property, patents, copyrights, trademarks, and trade names. Software and other computer-related assets outside of hardware also classify as identifiable intangible assets.

Unidentifiable intangible assets are those that cannot be physically separated from the company. The most commonplace unidentifiable intangible asset is goodwill. Internally generated goodwill is expensed as a loss, but externally generated goodwill when a company acquires or merges with another company is capitalized as an asset. This means that when a company pays above the fair value of another company to acquire it, the difference is goodwill. This asset is not depreciated like PP&E. However, it is instead tested for impairment regularly. A company will record an impairment loss if it deems the goodwill's value has decreased from its recorded book value.

Another key unidentifiable asset is branding and reputation. While a company can sell its trademark, logos, and such, it can be very difficult to separate good branding and reputation from a strong company. Nonetheless, brand recognition and reputation are expected to generate good economic returns for the company in the future.

Amortization expense

While PP&E is depreciated, intangible assets are amortized (except for goodwill). These assets are amortized over the useful life of the asset. Generally, intangible assets are simply amortized using the straight-line expense method.

If an intangible asset has a perpetual life, it is not amortized. Consequently, if an intangible asset has a useful life but can be renewed easily and without substantial cost, it is considered perpetual and is not amortized.

Example

McRonald's has two intangible assets. The first is a patent worth $25,000,000 and with a useful life of 50 years. The patent expires and cannot be renewed. The second is a trademark worth $1,000,000 and with a useful life of 10 years, after which it expires. However, the trademark can be renewed at a marginal cost. What is McRonald's amortization expense per year?

The trademark is not amortized, as it virtually has a perpetual life. The patent, however, is amortized on the straight-line scale over its 50-year life. The amortization expense is $25,000,000 / 50 = $500,000. Thus, the yearly amortization expense for McRonald's is $500,000.

Goodwill

Referring to the identifiable intangible asset definition mentioned earlier, goodwill does not meet the IFRS definition, as it is not identifiable/not separable. However, goodwill is still an intangible asset, treated as a separate class. The main difference concerning goodwill, as compared to other intangibles, is that goodwill is never amortized. In accounting, goodwill represents the difference between the purchase price of a business and the fair value of its assets, net of liabilities.

What this essentially means is the difference represents how much the buyer is willing to pay for the business as a whole, over and above the value of its individual assets alone. For example, if XYZ Company paid $50 million to acquire a sporting goods business and $10 million was the value of its assets net of liabilities, then $40 million would be goodwill. Companies can only have goodwill on their balance sheets if they have acquired another business.

Government grants

Finally, another type of intangible asset is government grants. For several reasons, governments at all levels may choose to provide financial assistance to companies that engage in certain activities. The accounting treatment for grants involves two methods: the net method and the gross method. The net method deducts the grant to arrive at the carrying amount of the asset, while the gross method sets up the grant as deferred income.

Government grants may be in the form of a specific grant that includes specific requirements/stipulations such as employment levels or pollution control levels. If these

stipulations are not met, then the grants may need to be refunded by the company. Government grants may also include forgivable loans in situations where companies meet certain conditions. As the name implies, the loan does not need to be repaid. In terms of recognition, government grants should be recognized only if:

The entity will comply with the stipulations/requirements attached to them; and

The grants will actually be received.

Other resources

Thank you for reading CFI's explanation of intangible assets. To further your financial education, CFI suggests the following resources:

Inventory

Tangible Assets

Monetary Assets

Net Identifiable Assets

trademark

Trademarks are logos, symbols and designs registered with the federal government and used by a business to identify its brands or the entity itself. Trademarks are assets that are included on a small business' balance sheet as "intangible assets," since they lack material substance like machinery and equipment that occupy physical space. The cost of a trademark is "capitalized" -- or recorded -- as an asset on a company's books with the use of a standard journal entry.

Asset Account Numbers

Capitalization of a trademark requires that you record a journal entry to the company's general ledger. Since accounts are assigned to a general ledger based on a numbering system, the capitalization of an asset requires that you gather the general ledger account number for two asset accounts: "cash" and "trademark." The account numbers may be found on a report known as the "chart of accounts," which includes the individual account numbers for all accounts included on a company's books.

Account Balance of Trademarks Entry

The balance of asset accounts is always increased with a debit on the general ledger. To increase the trademark asset account, enter the general ledger account number for

"trademarks" you found on the chart of accounts on the first line of the journal entry in the column labeled "account number." Enter the total dollar amount of the trademark in the column labeled "debit."

Account Balance of Cash Entry

After you book the "trademarks" asset account increase, the asset account "cash" is reduced by a credit on the general ledger. To reduce the company's cash balance for the payment to obtain the trademark, enter the account number for cash -- as found on the chart of accounts -- on the second line, and enter the dollar amount of the cash payment in the column labeled "credit."

Example of Journal Entry

To illustrate the journal entries that capitalize trademark costs, assume your small business incurred $1,500 in trademark costs. The journal entries to capitalize the trademark costs appears as follows:

Debit intangible assets/trademark $1,500 Credit cash $1,500

Record the Journal Entry

Lastly, you need to make a permanent record of the entry on the company's general ledger by posting the entry to the company's books. To make sure the entry posted accurately, print and check a copy of the trial balance, a report that shows the debit and credit balances of a company's general ledger accounts. The trademark has now been capitalized to the corporation's books.

How to Capitalize an Asset & the Income Statement
When a fixed asset is capitalized at the time of installation, it simply means that the asset's total cost is gradually "depreciated," or amortized over future periods instead of expensing the total cost at the time of installation. According to Investopedia, the total cost of the capitalized asset is shown in the asset section of a corporation's balance sheet, but the depreciation charges related to the assets are shown on the income statement.

Capitalization or expensing an asset can impact profit and loss numbers, so it is important to carefully consider the optimal treatment for an asset according to GrowthForce Blog.

How to Record Capitalization on the Balance Sheet?

Add up the total costs incurred to obtain the asset and prepare it for use. Include in the calculation the invoice costs, shipping costs and installation costs of the asset. For example, if the asset was invoiced to the corporation for **$38,000**, and the company

incurred **$4,000** in delivery costs and **$3,000** in installation costs, the corporation should capitalize the asset's cost as **$45,000**. Prepare a journal entry to capitalize the total costs you've calculated. Increase the general ledger asset account with a debit on the first line of the entry. On the second line, record the offsetting decrease in the general ledger cash account with a credit.

For example, assume that a corporation purchases a piece of machinery to further new operations. The total costs incurred to purchase the asset and prepare it for operations is **$18,000**. The journal entry will appear as follows: Debit Machinery & Equipment 18,000 Credit Cash 18,000.

Post the entry to the company's books, and print a copy of the trial balance to confirm that the entry posted correctly. The value of the capitalized asset will appear in the value of the corporation's machinery and equipment on the balance sheet for the reporting period. The income statement will not be affected at the time of capitalization.

What Goes on the Income Statement?

The total cost of the asset will be expensed, or depreciated, over the time it remains in use. The resulting depreciation expense will be included on the corporation's income statement at the end of the corporation's reporting period. The actual amount of the expense varies based on the depreciation method used for the particular asset, the time the asset will be useful to the company and the value of the asset after it is no longer considered useful.

To illustrate the impact to the income statement from the depreciation of a capitalized asset, assume the **$18,000** asset in our example will remain in use for three years and have no remaining value after this time. Assume also that the corporation uses the straight-line method to depreciate the asset, a method that allocates the asset's total cost evenly over the number of years the asset remains in use. The impact to the income statement each year would be an expense of **$6,000**, or **$18,000** total cost divided by three years.

patents and goodwill

Goodwill in accounting is an intangible asset that arises when a buyer acquires an existing business. Goodwill represents assets that are not separately identifiable. Goodwill does not include identifiable assets that are capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability regardless of whether the entity intends to do so. Goodwill also does not include contractual or other legal rights regardless of whether those are transferable or separable from the entity or other rights and obligations. Goodwill is also only acquired through an acquisition; it cannot be self-created. Examples of identifiable assets that are goodwill

include a company’s brand name, customer relationships, artistic intangible assets, and any patents or proprietary technology. The goodwill amounts to the excess of the "purchase consideration" (the money paid to purchase the asset or business) over the net value of the assets minus liabilities. It is classified as an intangible asset on the balance sheet, since it can neither be seen nor touched. Under US GAAP and IFRS, goodwill is never amortized, because it is considered to have an indefinite useful life. Instead, management is responsible for valuing goodwill every year and to determine if an impairment is required. If the fair market value goes below historical cost (what goodwill was purchased for), an impairment must be recorded to bring it down to its fair market value. However, an increase in the fair market value would not be accounted for in the financial statements. Private companies in the United States, however, may elect to amortize goodwill over a period of ten years or less under an accounting alternative from the Private Company Council of the FASB.

Goodwill is a special type of intangible asset that represents that portion of the entire business value that cannot be attributed to other income producing business assets, tangible or intangible. [1]

For example, a privately held software company may have net assets (consisting primarily of miscellaneous equipment and/or property, and assuming no debt) valued at $1 million, but the company's overall value (including customers and intellectual capital) is valued at $10 million. Anybody buying that company would book $10 million in total assets acquired, comprising $1 million physical assets and $9 million in other intangible assets. And any consideration paid in excess of $10 million shall be considered as goodwill. In a private company, goodwill has no predetermined value prior to the acquisition; its magnitude depends on the two other variables by definition. A publicly traded company, by contrast, is subject to a constant process of market valuation, so goodwill will always be apparent.

While a business can invest to increase its reputation, by advertising or assuring that its products are of high quality, such expenses cannot be capitalized and added to goodwill, which is technically an intangible asset. Goodwill and intangible assets are usually listed as separate items on a company's balance sheet

UNIT - III

Analysis of financial statement:

Ratio Analysis

Ratio analysis is the comparison of line items in the financial statements of a business. Ratio analysis is used to evaluate a number of issues with an entity, such as its liquidity, efficiency of operations, and profitability. This type of analysis is particularly useful to analysts outside of a business, since their primary source of information about an organization is its financial statements. Ratio analysis is less useful to corporate insiders, who have better access to more detailed operational information about the organization. It is particularly useful when employed in the following two ways:

- Trend line. Calculate each ratio over a large number of reporting periods, to see if there is a trend in the calculated information. The trend can indicate financial difficulties that would not otherwise be apparent if ratios were being examined for a single period. Trend lines can also be used to estimate the direction of future ratio performance.
- Industry comparison. Calculate the same ratios for competitors in the same industry, and compare the results across all of the companies reviewed. Since these businesses likely operate with similar fixed asset investments and have similar capital structures, the results of a ratio analysis should be similar. If this is not the case, it can indicate a potential issue, or the reverse - the ability of a business to generate a profit that is notably higher than the rest of the industry. The industry comparison approach is used for sector analysis, to determine which businesses within an industry are the most (and least) valuable.

Categories of Ratio Analysis

Financial ratios can be grouped into the following clusters of ratios, where each cluster is targeted at a different type of analysis.

- Coverage ratios. These ratios are used to evaluate the ability of a business to meet its debt obligations. These ratios are most commonly used by lenders and creditors to review the finances of a prospective or current borrower. Examples of coverage

ratios are the interest coverage ratio, debt-service coverage ratio, and asset coverage ratio.

- Efficiency ratios. These ratios measure the ability of a business to use its assets and liabilities to generate sales. A highly efficient organization has minimized its net investment in assets, and so requires less capital and debt in order to remain in operation. Examples of efficiency ratios are accounts receivable turnover, inventory turnover, fixed asset turnover, and accounts payable turnover.
- Leverage ratios. These ratios are used to determine the relative level of debt load that a business has incurred. These ratios compare the total debt obligation to either the assets or equity of a business. Examples of leverage ratios are the debt ratio and debt to equity ratio.
- Liquidity ratios. These ratios are measurements used to examine the ability of an organization to pay off its short-term obligations. Liquidity ratios are commonly used by prospective creditors and lenders to decide whether to extend credit or debt, respectively, to companies. Examples of liquidity ratios are the cash ratio, current ratio, and quick ratio.
- Market value ratios. These ratios are used to evaluate the current share price of a publicly-held company's stock. These ratios are employed by current and potential investors to determine whether a company's shares are over-priced or under-priced. Examples of market value ratios are book value per share, earnings per share, and market value per share.
- Profitability ratios. Profitability ratios are a set of measurements used to determine the ability of a business to create earnings. Profitability ratios are derived from a comparison of revenues to difference groupings of expenses within the income statement. Examples of profitability ratios are the contribution margin ratio, gross profit ratio, and net profit ratio.

Examples of Ratios Used in Financial Analysis

There are several hundred possible ratios that can be used for analysis purposes, but only a small core group is typically used to gain an understanding of an entity. These ratios include the following:

- Current ratio. Compares current assets to current liabilities, to see if a business has enough cash to pay its immediate liabilities.
- Days sales outstanding. Determines the ability of a business to effectively issue credit to customers and be paid back on a timely basis.

- Debt to equity ratio. Compares the proportion of debt to equity, to see if a business has taken on too much debt.
- Dividend payout ratio. This is the percentage of earnings paid to investors in the form of dividends. If the percentage is low, it is an indicator that there is room for dividend payments to increase substantially.
- Gross profit ratio. Calculates the proportion of earnings generated by the sale of goods or services, before administrative expenses are included. A decline in this percentage could signal pricing pressure on a company's core operations.
- Inventory turnover. Calculates the time it takes to sell off inventory. A low turnover figure indicates that a business has an excessive investment in inventory, and therefore is at risk of having obsolete inventory.
- Net profit ratio. Calculates the proportion of net profit to sales; a low proportion can indicate a bloated cost structure or pricing pressure.
- Price earnings ratio. Compares the price paid for a company's shares to the earnings reported by the business. An excessively high ratio signals that there is no basis for a high stock price, which could presage a stock price decline.
- Return on assets. Calculates the ability of management to efficiently use assets to generate profits. A low return indicates a bloated investment in assets.

Solvency Ratios

Solvency ratios compare different elements of an organization's financial statements. The intent of this comparison is to discern the ability of the target entity to remain solvent. Solvency ratios are commonly used by lenders and in-house credit departments to determine the ability of customers to pay back their debts. Examples of solvency ratios are:

- Current ratio. This is current assets divided by current liabilities, and indicates the ability to pay for current liabilities with the proceeds from the liquidation of current assets. The ratio can be skewed by an inordinately large amount of inventory, which can be hard to liquidate in the short term.
- Quick ratio. This is the same as the current ratio, except that inventory is excluded (which makes it a better indicator of solvency). The remaining assets in the numerator are more easily convertible into cash.

- Debt to equity ratio. This compares the amount of debt outstanding to the amount of equity built up in a business. If the ratio is too high, it indicates that the owners are relying to an excessive extent on debt to fund the business, which can be a problem if cash flow cannot support interest payments.
- Interest coverage ratio. This measures the ability of a company to pay the interest on its outstanding debt. A high interest coverage ratio indicates that a company can pay for its interest expense several times over, while a low ratio is a strong indicator that a company may default on its loan payments.

If there is a specific ratio that is considered the essential solvency ratio, it is a comparison of profits before non-cash items, divided by all liabilities. The formula is:

(Net after-tax profits + Depreciation + Amortization) ÷All liabilities

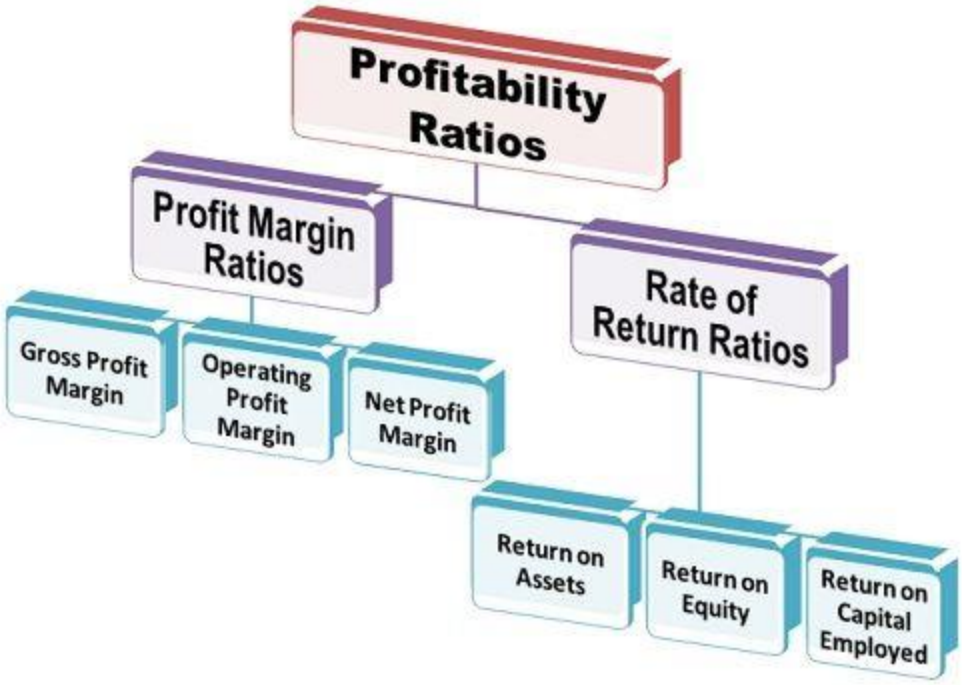
A high solvency ratio indicates a better ability to meet the obligations of the business. However, the ratio is not fully indicative of solvency, since it is based on profits, which do not necessarily equate to cash flows. A solvency analysis also does not account for the ability of a business to obtain new long-term funding, such as through the sale of shares or bonds. Thus, the use of solvency ratios should be supplemented with other information to gain a full understanding of the solvency of a business.

It is best to review all solvency ratios on a trend line, to see if the condition of a business is worsening over time.

Profitability Ratios

Definition: The Profitability Ratios measure the overall performance of the company in terms of the total revenue generated from its operations. In other words, the ratios that measure the capacity of a firm to generate profits out of the expenses and the other cost incurred over a period are called the profitability ratios.

Profit Margin Ratios and the Rate of Return Ratios are the two types of Profitability Ratios.The Profit Margin Ratio shows the relationship between the profit and sales and whereas the Rate of Return Ratios shows the relationship between the profits and the investments.



I Profit Margin Ratios

The most popular ratios are:

1. Gross Profit Margin Ratio
2. Operating Profit Margin Ratio
3. Net Profit Margin Ratio

II Rate of Return Ratios

The most popular ratios are:

1. Return on Assets Ratio
2. Return on Equity Ratio
3. Return on Capital Employed

Generally, the ratios with the higher value are favorable as it indicates that the company is doing well.

Activity Ratios

Activity ratios are used to determine the efficiency of the organisation in utilising its assets for generating cash and revenue. It is used to check the level of investment made on an asset and the revenue that it is generating. For this reason, the activity ratio is also known as the efficiency ratio or the more popular turnover ratio.

The role of activity ratio or turnover ratio is in the evaluation of the efficiency of a business by careful analysis of the inventories, fixed assets and accounts receivables.

Let us discuss the types of activity ratios.

Types of Activity Ratios

1. Stock Turnover ratio or Inventory Turnover Ratio
2. Debtors Turnover ratio or Accounts Receivable Turnover Ratio
3. Creditors Turnover ratio
4. Working capital turnover ratio.
5. Total Asset Turnover ratio
6.
7. Fixed Asset Turnover ratio
8. Current Asset Turnover ratio

The following are discussed below.

Stock Turnover Ratio

This is one of the most important turnover ratios which highlights the relationship between the inventory or stock in the business and cost of the goods sold. It shows how fast the inventory gets cleared in an accounting period or in other words, the number of times the inventory or the stock gets sold or consumed. For this reason, it is also known as the inventory turnover ratio.

It is calculated by the following formula

Stock Turnover Ratio = Cost of Goods Sold / Average Inventory

A high stock turnover ratio is indicative of fast moving goods in a company while a low stock turnover ratio indicates that goods are not getting sold and are being stored at warehouses for an extended period of time.

Debtor Turnover Ratio

This ratio is an important indicator of a company which shows how well a company is able to provide credit facilities to its customers and at the same time is also able to recover the due amount within the payment period.

It is also known as accounts receivable turnover ratio as the payments for credit sales that will be received in the future are known as accounts receivables.

The formula for calculating Debtor Turnover ratio is

Debtor Turnover Ratio = Credit Sales / Average Debtors

A higher ratio indicates that the credit policy of the company is sound, while a lower ratio shows a weak credit policy.

Creditors Turnover Ratio

Creditors turnover ratio is a measure of the capability of the company to pay off the amount for credit purchases successfully in an accounting period.

It shows the number of times the account payables are cleared by the company in an accounting period. For this reason, it is also known as the Accounts payable turnover ratio.

The formula for calculating creditors turnover ratio is

Creditors Turnover ratio = Net Credit Purchases / Average Creditors

Where average creditors are also known as average accounts payable.

A high ratio is indicative that a company is able to finance all the credit purchases and vice versa.

Working Capital Turnover Ratio

This ratio is helpful in determining the effectiveness with which a company is able to utilise its working capital for generating sales of its goods.

The formula for calculating working capital turnover ratio is

Working capital turnover ratio = Sale or Costs of Goods Sold / Working Capital

If a company has a higher level of working capital it shows that the working capital of the business is utilized properly and on the other hand, a low working capital suggests that business has too many debtors and the inventory is unused.

Total Asset Turnover Ratio

The total asset turnover ratio is a turnover ratio that measures the company’s ability to generate sales from its assets. The total asset turnover ratio calculates how much sales the assets are producing.

It is calculated by the following formula

Total Assets Turnover Ratio = Net Sales / Total Assets

Fixed Asset Turnover Ratio

Fixed asset turnover ratio is an indicator of how the company is using its fixed assets for generating sales. A high fixed asset turnover ratio shows the company's efficiency in utilising investment made on fixed assets, which resulted in more revenue generation.

It is generally used as a performance indicator for manufacturing industries.

The formula for calculating the fixed asset turnover ratio is

Fixed Asset Turnover Ratio = Net Sales / Fixed assets

Current Asset Turnover Ratio

Current Asset Turnover Ratio is an activity ratio or turnover ratio that measures a firm's ability in generating sales from the current assets, which includes cash, accounts receivables, inventory etc.

The current asset turnover ratio is calculated as follows

Current Asset Turnover Ratio = Net Sales / Current Assets

A higher current turnover ratio is indicative of the company's ability to generate more sales using minimum investment in the current assets.

This was all about the Activity Ratios. The concept presented in this article will be of great help to the students in developing a good understanding of the Activity or Turnover Ratios. For more such informative articles, stay tuned to BYJU'S.

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Statistics For Economics	Responsibility Accounting

Liquidity Ratios

Liquidity ratios are measurements used to examine the ability of an organization to pay off its short-term obligations. Liquidity ratios are commonly used by prospective

creditors and lenders to decide whether to extend credit or debt, respectively, to companies.

These ratios compare various combinations of relatively liquid assets to the amount of current liabilities stated on an organization's most recent balance sheet. The higher the ratio, the better the ability of a firm of pay off its obligations in a timely manner. Examples of liquidity ratios are:

- Current ratio. This ratio compares current assets to current liabilities. Its main flaw is that it includes inventory as a current asset. Inventory may not be that easy to convert into cash, and so may not be a good indicator of liquidity.
- Quick ratio. This is the same as the current ratio, but excludes inventory. Consequently, most remaining assets should be readily convertible into cash within a short period of time.
- Cash ratio. This ratio compares just cash and readily convertible investments to current liabilities. As such, it is the most conservative of all the liquidity ratios, and so is useful in situations where current liabilities are coming due for payment in the very short term.

Related Courses

Business Ratios Guidebook
Key Performance Indicators
The Interpretation of Financial Statements

Market Capitalization Ratios

The capitalization ratio, often called the Cap ratio, is a financial metric that measures a company’s solvency by calculating the total debt component of the company’s capital structure of the balance sheet. In other words, it calculates the financial leverage of the company by comparing the total debt with total equity or a section of equity. The most common capitalization ratios are:.

Debt to equity ratio

Long-term debt ratio

Debt to capitalization ratio

Debt and equity are the two main components of the capital structure of a company and are the main sources to finance its operations.

Definition: What is the Capitalization Ratio?

Capitalization ratio describes to investors the extent to which a company is using debt to fund its business and expansion plans. Generally, debt is considered riskier than equity (from company's point of view). Hence the higher the ratio, the riskier the company is. Companies with higher capitalization ratio run higher risk of insolvency or bankruptcy in case they are not able to repay the debt as per the predetermined schedule. However, higher debt on the books could also be earnings accretive if the business is growing in a profitable manner (more on this in the analysis section).

The company uses this ratio to manage its capital structure and determine the debt capacity. Investors use it to gauge the riskiness of investment and form an important component of asset valuation (higher risk implies higher expected return). Lenders use it to determine if the company is within the predetermined limits and if there is more headroom to lend more money.

Formula

The capitalization ratio formula is calculated by dividing total debt into total debt plus shareholders' equity. Here's an example:

Total Debt to Capitalization = Total Debt / (Total Debt + Shareholders' Equity)

You can also calculate the capitalization ratio equation by dividing the total debt by the shareholders' equity.

Debt-Equity ratio = Total Debt / Shareholders' Equity

As you can see that both these formulas are very similar and can be calculated by slight modification from one another. All of the components in these equations can be found on the face of the balance sheet.

Total debt refers to both long-term and short-term debts of a company

Common Size Statement

A common size financial statement displays line items as a percentage of one selected or common figure. Creating common size financial statements makes it easier to analyze a company over time and compare it with its peers. Using common size financial statements helps investors spot trends that a raw financial statement may not uncover.

All three of the primary financial statements can be put into a common size format. Financial statements in dollar amounts can easily be converted to common size statements using a spreadsheet, or they can be obtained from online resources like Mergent Online.[1] Below is an overview of each financial statement and a more detailed summary of the benefits, as well as drawbacks, that such an analysis can provide investors.

KEY TAKEAWAYS

- A common size financial statement displays items on a financial statement as a percentage of a common base figure.
- For example, if total sales revenue is used as the common base figure, then other financial statement items—such as operating expenses and cost of goods—will be compared as a percentage of total sales revenue.
- Investors use common size financial statements to make it easier to compare a company to its competitors and to identify significant changes in a company's financials.

Balance Sheet Analysis

The common figure for a common size balance sheet analysis is total assets. Based on the accounting equation, this also equals total liabilities and shareholders' equity, making either term interchangeable in the analysis. It is also possible to use total liabilities to indicate where a company's obligations lie and whether it is being conservative or risky in managing its debts.

The common size strategy from a balance sheet perspective lends insight into a firm's capital structure and how it compares to its rivals. An investor can also look to determine an optimal capital structure for a given industry and compare it to the firm being analyzed. Then the investor can conclude whether the debt level is too high, excess cash is being retained on the balance sheet, or inventories are growing too high. The goodwill level on a balance sheet also helps indicate the extent to which a company has relied on acquisitions for growth.

Below is an example of a common size balance sheet for technology giant International Business Machines (IBM). Running through some of the examples touched on above, we can see that long-term debt averages around 20% of total assets over the three-year

period, which is a reasonable level. It is even more reasonable when observing that cash represents around 10% of total assets, and short-term debt accounts for 6% to 7% of total assets over the past three years.

Analyzing the Income Statement

The common figure for an income statement is total top-line sales. This is actually the same analysis as calculating a company's margins. For instance, a net profit margin is simply net income divided by sales, which also happens to be a common size analysis.

The same goes for calculating gross and operating margins. The common size method is appealing for research-intensive companies, for example, because they tend to focus on research and development (R&D) and what it represents as a percent of total sales.

Below is a common size income statement for IBM. We will cover it in more detail below, but notice the R&D expense that averages close to 6% of revenues. Looking at the peer group and companies overall, according to a Booz & Co. analysis, this puts IBM in the top five among tech giants and the top 20 firms in the world (2013) in terms of total R&D spending as a percent of total sales.

Common Size and Cash Flow

In a similar fashion to an income statement analysis, many items in the cash flow statement can be stated as a percent of total sales. This can give insight on a number of cash flow items, including capital expenditures (CapEx) as a percent of revenue.

Share repurchase activity can also be put into context as a percent of the total top line. Debt issuance is another important figure in proportion to the amount of annual sales it helps generate. Because these items are calculated as a percent of sales, they help indicate the extent to which they are being utilized to generate overall revenue.

Below is IBM’s cash flow statement in terms of total sales. It generated an impressive level of operating cash flow that averaged 19% of sales over the three-year period. Share repurchase activity was also impressive at more than 11% of total sales in each of the three years. You may also notice the first row, which is net income as a percent of total sales, which matches exactly with the common size analysis from an income statement perspective. This represents the net profit margin.

How This Differs From Regular Financial Statements

The key benefit of a common size analysis is it allows for a vertical analysis by line item over a single time period, such as a quarterly or annual period, and also from a horizontal perspective over a time period such as the three years we analyzed for IBM above.

Just looking at a raw financial statement makes this more difficult. But looking up and down a financial statement using a vertical analysis allows an investor to catch significant changes at a company. A common size analysis helps put an analysis in context (on a percentage basis). It is the same as a ratio analysis when looking at the profit and loss statement.

What the Common Size Reveals

The biggest benefit of a common size analysis is that it can let an investor identify large or drastic changes in a firm’s financials. Rapid increases or decreases will be readily observable, such as a rapid drop in reported profits during one quarter or year.

In IBM's case, its results overall during the time period examined were relatively steady. One item of note is the Treasury stock in the balance sheet, which had grown to more than a negative 100% of total assets. But rather than alarm investors, it indicates the company had been hugely successful in generating cash to buy back shares, which far exceeds what it had retained on its balance sheet.

A common size analysis can also give insight into the different strategies that companies pursue. For instance, one company may be willing to sacrifice margins for market share, which would tend to make overall sales larger at the expense of gross, operating, or net profit margins. Ideally, the company that pursues lower margins will grow faster. While we looked at IBM on a stand-alone basis, like the R&D analysis, IBM should also be analyzed by comparing it to key rivals.

The Bottom Line

As the above scenario highlights, a common size analysis on its own is unlikely to provide a comprehensive and clear conclusion on a company. It must be done in the context of an overall financial statement analysis, as detailed above.

Investors also need to be aware of temporary versus permanent differences. A short-term drop in profitability could only indicate a short-term blip, rather than a permanent loss in profit margins.

Comparative Balance Sheet and Trend Analysis of manufacturing

Every business needs to prepare basic financial statements that summarize its operating results and financial position for a particular period. These statements primarily include income statements, balance sheets, and cash flow statements. Thus, the purpose of preparing these statements is to ascertain the profitability and financial soundness of a business. But the detailed information reflected in such statements alone is not sufficient to reach meaningful managerial conclusions. Therefore, detailed **financial analysis** and interpretation of these statements is required using various tools and techniques.

This analysis helps to understand the relationship between various components showcased in each of these statements. So, one of the tools commonly used to undertake financial statement analysis is creating comparative financial statements. Other techniques include:

- Common Size Statement Analysis
- Ratio Analysis
- Cash Flow Analysis
- Trend Analysis

This article talks about Comparative Financial Statements Analysis. Hence, let's understand:

- what are comparative financial statements,
- how such statements are prepared and
- why are these comparative statements important.

What Are Comparative Financial Statements?

Preparing Comparative Financial Statements is the most commonly used technique for analyzing financial statements. This technique determines the profitability and financial position of a business by comparing financial statements for two or more time periods. Hence, this technique is also termed as Horizontal Analysis. Typically, the income statements and balance sheets are prepared in a comparative form to undertake such an analysis.

Furthermore, there is a provision attached to comparing the financial data showcased by such statements. This relates to making use of the same accounting principles for preparing each of the comparative statements. In case the same accounting principles are not followed to prepare such statements, then the difference must be disclosed in the footnote below.

Comparative Balance Sheet

A comparative balance sheet showcases:

- Assets and liabilities of business for the previous year as well as the current year
- Changes (increase or decrease) in such assets and liabilities over the year both in absolute and relative terms

Thus, a comparative balance sheet not only gives a picture of the assets and liabilities in different accounting periods. It also reveals the extent to which the assets and liabilities have changed during such periods.

Furthermore, such a statement helps managers and business owners to identify trends in the various performance indicators of the underlying business.

What To Study While Analyzing A Comparative Balance Sheet?

A business owner or a financial manager should study the following aspects of a comparative balance sheet:

1. Working Capital

Working capital refers to the excess of current assets over current liabilities.This helps a financial manager or a business owner to know about the liquidity position of the business.

2. Changes in Long-Term Assets, Liabilities, and Capital

The next component that a financial manager or a business owner needs to analyze is the change in the fixed assets, long-term liabilities and capital of a business. This analysis helps each of the stakeholders to understand the long-term financial position of a business.

3. Profitability

Working capital refers to the excess of current assets over current liabilities.This helps a financial manager or a business owner to know about the liquidity position of the business.

Steps To Prepare a Comparative Balance Sheet

1. Step 1

Firstly, specify absolute figures of assets and liabilities relating to the accounting periods considered for analysis. These amounts are mentioned in Column I and Column II of the comparative balance sheet.

2. Step 2

Find out the absolute change in the items mentioned in the balance sheet. This is done by subtracting the previous year's item amounts from the current year ones. This increase or decrease in absolute amounts are mentioned in Column III of the comparative balance sheet.

3. Step 3

Finally, calculate the percentage change in the assets and liabilities of the current year relative to the previous year. This percentage change in assets and liabilities is mentioned in Column V of the comparative balance sheet.

Percentage Change = (Absolute Increase or Decrease)/Absolute Figure of the Previous Year's Item) * 100

So, let's understand a comparative balance sheet through an example. Consider the following balance sheets of M/s Kapoor and Co as on December 31st, 2017 and December 31st, 2018 for the illustration.

Balance Sheet of M/s Kapoor and Co. as of December 31, 2017, and December 31,

2018.

Particulars		December 31, 2017	December 31, 2018
Current Assets:			
Cash and Bank Balance		23,600	2,000
Debtors		41,800	38,000
Inventory		32,000	26,000
Other Current Assets		6,400	2,600
	(A)	1,03,800	68,000
Fixed Assets:			
Land and Building		54,000	34,000
Plant and Machinery		62,000	1,57,200
Furniture		5,800	9,600
	(B)	1,21,800	2,00,800
Long Term Investment	(C)	9,200	11,800
Total Assets (A+B+C)		2,34,800	2,81,200
Current Liabilities	(D)	52,400	25,400
Long-Term Debt	(E)	40,000	65,000
Owner's Equity:			
Equity Share Capital		80,000	1,20,000
Reserve and Surplus		62,400	70,800
	(F)	1,42,400	1,90,800
Total Liabilities and Capital (D+E+F)		2,34,800	2,81,200

Comparative Balance Sheet of M/s Kapoor and Co. as on December 31, 2017, and December 31, 2018.

Particulars	December 31, 2017	December 31, 2018	(+)/(-)	% (+)/(-)
Current Assets:				
Cash and Bank Balance	23,600	2,000	(-) 21,600	(-) 91.50
Debtors	41,800	38,000	(-) 3,800	(-) 9.10
Inventory	32,000	26,000	(-) 6,000	(-) 18.80
Other Current Assets	6,400	2,600	(-) 3,800	(-) 59.40
(A)	1,03,800	68,000	(-) 35,200	(-) 33.90
Fixed Assets:				
Land and Building	54,000	34,000	(-) 20,000	(-) 37.00
Plant and Machinery	62,000	1,57,200	(+) 95,200	(+) 153.50
Furniture	5,800	9,600	(+) 3,800	(+) 65.50
(B)	1,21,800	2,00,800	(+) 79,000	(+) 64.90
Long Term Investment (C)	9,200	11,800	(+) 2,600	(+) 28.30
Total Assets (A+B+C)	2,34,800	2,81,200	(+) 46,400	(+) 19.80
Current Liabilities (D)	52,400	25,400	(-) 27,000	(-) 51.50
Long-Term Debt (E)	40,000	65,000	(+) 25,000	(+) 62.50
Owner's Equity:				
Equity Share Capital	80,000	1,20,000	(+) 40,000	(+) 50.00
Reserve and Surplus	62,400	70,800	(+) 8,400	(+) 13.50
(F)	1,42,400	1,90,800	(+) 48,400	(+) 34.00
Total Liabilities and Capital (D+F	2,34,800	2,81,200	(+) 46,400	(+) 19.80

Analysis

As we can see in the comparative balance sheet above, the current assets of Kapoor and Co. have decreased by Rs 35,200 in the year 2018 over 2017.

On the other hand, the current liabilities have decreased by Rs 27,000 only. Now, such a change does not have a negative impact on the liquidity position of M/s Kapoor and Co. This is because current assets have decreased by 33.9% whereas current liabilities have declined by 51.5%.

Secondly, the cash and bank balance of Kapoor and Co. have decreased by 91.5%. This indicates a negative cash position of the company. It further hints towards the fact that the company might find it challenging to meet its short-term obligations.

Next, the long-term debt of M/s Kapoor and Co. has increased by 62.5%. On the other hand, the owner's equity has improved by only 34%. This indicates that the company is way too dependent on the external lenders thus leading to a great financial risk for the firm.

Finally, there is a considerable increase seen in the fixed assets of the company. Accordingly, the fixed assets increased by Rs 79,000 or 64.9% from the year 2017 to 2018. This was on account of the huge addition made to the plant and machinery by the company in the given accounting periods.

Plant and machinery increased by Rs 95,200 that is by 153.5%. Such additional machinery leads to an incredible improvement in the production capacity of the company during the year. This expenditure was provided for by the company proprietors and the external lenders.

Comparative Income Statement

A comparative income statement showcases the operational results of the business for multiple accounting periods. It helps the business owner to compare the results of business operations over different periods of time. Furthermore, such a statement helps in a detailed analysis of the changes in line-wise items of the income statement.

Comparative Balance Sheet Format

The format of the comparative income statement puts together several income statements into a single statement. This helps the business owner in understanding the trends and measuring the business performance over different time periods.

Apart from comparing income statements of its own business over different time periods, a business owner can compare the operating results of its competitor firms as well.

Thus, this analysis helps the business owner to compare his business performance with other businesses in the industry. So, business owners can also understand the various causes that lead to changes in different accounting periods. This is achieved by comparing the operating results of the business over multiple accounting periods.

What To Study While Analyzing A Comparative Income Statement?

1. Comparing Sales With Cost of Goods Sold

Changes in the sales in the given accounting periods should be compared with the changes in the cost of goods sold for the same accounting periods.

2. Change in Operating Profits

Change in the operating profits should be analyzed.

3. The profitability of a Business

Understanding the overall profitability of a business concern taking into consideration the changes in the net profit of the given accounting periods.

Steps To Prepare A Comparative Income Statement

1. Step1

Firstly, specify absolute figures of items such as cost of goods sold, net sales, selling expenses, office expenses, etc. relating to the accounting periods considered for analysis. These amounts are mentioned in Column I and Column II of the comparative income statement.

2. Step 2

Find out the absolute change in the items mentioned in the income statement. This is done by subtracting the previous year’s item amounts from the current year ones. This increase or decrease in absolute amounts is mentioned in Column III of the comparative income statement.

3. Step 3

Finally, calculate the percentage change in the income statement items of the current year relative to the previous year. This percentage change in items is mentioned in Column V of the comparative income statement.

Now given this, let's try to understand how a comparative statement is interpreted using an example. Consider the following income statement for M/s Singhania for the years ended December 31st, 2017 and December 31st, 2018.

Income Statement of M/s Singhania as of December 31, 2017, and December 31, 2018.

Particulars	December 31, 2017	December 31, 2018
Net Sales	1,70,000	1,90,400
Less: Cost of Goods Sold	1,05,000	1,20,000
Gross Profit (P)	65,000	70,400
Administrative Expenses (A)	13,200	14,960
Selling Expenses:		
Advertisement Expenses	3,000	4,000
Other Selling Expenses	40,800	41,800
Total Selling Expenses (B)	43,800	45,800
Operating Expenses (A+B)	57,000	60,760
Operating Profit (D) (D = P - (A+B))	8,000	9,640
Other Incomes (E)	6,400	9,200
Other Expenses (F)	6,800	4,800
Profit Before Tax (PBT) (PBT = D+E-F)	7,600	14,040
Income Tax (T)	3,800	6,200
Profit After Tax (PAT) (PAT = PBT - T)	3,800	7,840

Comparative Income Statement of M/s Singhania For The Years Ended December 31, 2017, and December 31, 2018.

Particulars	December 31, 2017	December 31, 2018	(+/(-)	%(+)/(-)
Net Sales	1,70,000	1,90,400	(+) 20,400	(+) 12.00
Less: Cost of Goods Sold	1,05,000	1,20,000	(+) 15,000	(+) 14.30
Gross Profit	65,000	70,400	(+) 5,400	(+) 8.3
Administrative Expenses	13,200	14,960	(+) 1,760	(+) 13.3
Selling Expenses:				
Advertisement Expenses	3,000	4,000	(+) 1,000	(+) 33.3
Other Selling Expenses	40,800	41,800	(+) 1,000	(+) 2.5
Total Selling Expenses	43,800	45,800	(+) 2,000	(+) 4.6
Operating Expenses	57,000	60,760	(+) 3,760	(+) 6.6
Operating Profit	8,000	9,640	(+) 1,640	(+) 20.5
Other Incomes	6,400	9,200	(+) 2,800	(+) 43.8
Other Expenses	6,800	4,800	(-) 2,000	(-) 29.4
Profit Before Tax	7,600	14,040	(+) 6,440	84.7
Income Tax	3,800	6,200	(+) 2,400	(+) 63.2
Profit After Tax	3,800	7,840	(+) 4,040	(+) 106.3

Analysis

As is evident from the above comparative income statement, the sales of M/s Singhania increased by Rs 20,400 during 2018 as against 2017. However, the cost of goods sold for the company increased by just Rs 15,000 in the same period. If you see carefully, sales increased by 12% whereas the cost of goods sold increased by 14.3%. Thus, the Gross Profit for M/s Singhania did not increase significantly. Now, there can be several reasons for accounting lower Gross Profit during the year:

Increase In Cost of Goods Sold

Firstly, a higher increase in the cost of goods sold can be on account of either increased sales volume or higher input cost. Furthermore, it is evident that the cost of goods sold for the company improved as an outcome of increased sales volume. This is because the sales increased during the year.

Now, the sales value would have increased significantly if the company would have made sales at the previous sales price. But that is not the case as sales value did not change to a greater extent. This hints towards the fact that incremental sales have been made at a price lower than the sales price.

Furthermore, this analysis is supported by the increase in the advertisement expenses of the company for the year 2018. These increased by 33% which is much higher as against the increase in net sales that was just 12%. Thus, this entire scenario indicates that it was quite challenging to sell the goods during 2018.

Hence, the company increased its advertisement cost significantly and reduced the selling price in order to achieve higher sales volume. Also, This scenario could be an outcome of a new product launch. In such a case, the company had to spend a huge amount on the advertisement and reduce the selling price for market penetration.

Increase In Other Income and Decrease in Other Expenses
There has been a significant increase in “Other Income” both in absolute and relative terms. Also, there has been a substantial decrease in “Other Expenses” both in absolute and relative terms. Thus, these items on the income statement lead to an improvement in the Profit Before Tax for the year 2018 as against 2017.

Hence, such a fact indicates that the company gave more importance to earning non-operating profits over operating one.

service & banking organizations

In today's financial services marketplace, a financial institution exists to provide a wide variety of deposit, lending and investment products to individuals, businesses or both. While some financial institutions focus on providing services and accounts for the general public, others are more likely to serve only certain consumers with more specialized offerings.

To know which financial institution is most appropriate for serving a specific need, it is important to understand the difference between the types of institutions and the purposes they serve.

KEY TAKEAWAYS

- There are 9 major types of financial institution that provide a variety of services from mortgage loans to investment vehicles.
- As financialization continues to permeate our lives, it is increasingly likely that you will have an account or product offered by several of these types.
- Here we take a look at these, from central banks to neighborhood banks and everything in between.

Central Banks

Central banks are the financial institutions responsible for the oversight and management of all other banks. In the United States, the central bank is the Federal Reserve Bank, which is responsible for conducting monetary policy and supervision and regulation of financial institutions.[1]

Individual consumers do not have direct contact with a central bank; instead, large financial institutions work directly with the Federal Reserve Bank to provide products and services to the general public.

Retail and Commercial Banks

Traditionally, retail banks offered products to individual consumers while commercial banks worked directly with businesses. Currently, the majority of large banks offer deposit accounts, lending and limited financial advice to both demographics.

Products offered at retail and commercial banks include checking and savings accounts, certificates of deposit (CDs), personal and mortgage loans, credit cards, and business banking accounts.

Internet Banks

A newer entrant to the financial institution market are internet banks, which work similarly to retail banks. Internet banks offer the same products and services as conventional banks, but they do so through online platforms instead of brick and mortar locations. (For related reading, see: The Pros and Cons of Internet Banks.)

Credit Unions

Credit unions serve a specific demographic per their field of membership, such as teachers or members of the military. While products offered resemble retail bank offerings, credit unions are owned by their members and operate for their benefit.

Savings and Loan Associations

Financial institutions that are mutually held and provide no more than 20% of total lending to businesses fall under the category of savings and loan associations. Individual consumers use savings and loan associations for deposit accounts, personal loans, and mortgage lending.[2]

Investment Banks and Companies

Investment banks do not take deposits; instead, they help individuals, businesses and governments raise capital through the issuance of securities. Investment companies, more commonly known as mutual fund companies, pool funds from individual and institutional investors to provide them access to the broader securities market.

Brokerage Firms

Brokerage firms assist individuals and institutions in buying and selling securities among available investors. Customers of brokerage firms can place trades of stocks, bonds, mutual funds, exchange-traded funds (ETFs), and some alternative investments.

Insurance Companies

Financial institutions that help individuals transfer risk of loss are known as insurance companies. Individuals and businesses use insurance companies to protect against financial loss due to death, disability, accidents, property damage, and other misfortunes.

Mortgage Companies

Financial institutions that originate or fund mortgage loans are mortgage companies. While most mortgage companies serve the individual consumer market, some specialize in lending options for commercial real estate only.
(For related reading, see: Banking: How to Choose a Bank.)

UNIT - IV

Funds Flow Statement:

Meaning

A fund flow statement is a statement prepared to analyse the reasons for changes in the financial position of a company between two balance sheets. It portrays the inflow and outflow of funds i.e. sources of funds and applications of funds for a particular period.

It is also righteous to say that a fund flow statement is prepared to explain the changes in the working capital position of a company.

Objectives of fund flow statement

A question arises as to why prepare fund flow Statement when we already prepare profit and loss and balance sheet. The need here arises because the profit and loss and balance sheet will not explain the reasons for a change in the financial position.

Profit and loss a/c and balance sheet will give two years figures i.e., current years and previous years. But it will not explain as to why the movement has happened, let's say, the extent of use of long-term funds for a long-term needs and the use of short-term funds for a long term and short term. Here is why fund flow statement is prepared.

Broadly, a fund flow statement will give us the following two information:

- **Sources of funds** - From where the funds have come in
- **Application of funds** - Where these funds have been used

Components of a fund flow statement

A fund flow statement comprises of :

- **Sources of funds**: It talks about the extent of funds availed from
    - Owners
    - Outsiders
- **Application of funds**: It talks about how the funds have been utilized
    - Funds deployed in Fixed assets
    - Funds deployed in Current assets

Fund flow statement explained with examples

National Enterprises raised its funds from the following equation listed below:

- Long term funds for its noncurrent assets.

Explanation: Noncurrent assets are a company's long-term investments for which the full value will not be realized within the accounting year. Examples of noncurrent assets include investments in other companies, intellectual property (e.g. patents), and property, plant and equipment.

So, going by the accounting parlance, long term funds are generally raised by a company to meet its long-term requirements. So National Enterprises using its long-term funds for its non-current assets are the right utilization of funds and these details are explained by fund flow statement.

- What if National Enterprises uses its short-term funds to finance its long-term assets?

Here the fund flow statement when prepared conveys the users of financial information that the usage of the fund has not been made properly by the company as it is living dangerously by utilizing its short-term funds for financing long term assets.

It means that when the company is in need for funds for repaying it to the short-term obligation, it will be in cash crunch situation since once an investment is made into long term assets by the company it, it will not be in a position to convert it into liquid cash at a later stage due to the nature of the investment.

This is how the fund flow statement explains the source of funds and its utilization or application, allowing the users of financial information interpret and know the impact on the business.

Benefits of preparing a fund flow Statement

- It helps to explain the managers of funds as to why the company is sitting in liquidity strain despite making profits as reflected in profit and loss statement.

- On the contrary, it helps the managers to understand as to how a company is financially strong despite losses made by it in its operation front.

- A fund flow statement helps us to analyze whether any short-term funds are being used for long term purposes. The grey area which can only be highlighted by preparation of fund flow Statement.

Users of funds flow Statement

The most interested users of fund flow statements are the lenders of capital. They pay more attention to the fund Flow Statements than the Profit and Loss and Balance sheet.

For Example, Bankers who lend money to the company as Overdraft or Cash Credit in return for interest. The bankers use the information provided by the company in its profit and loss statement and balance sheet in preparing fund flow statements, which then enables them to take decisions as whether to provide its overdraft or cash credit facilities to its clients or not.

Fund flow statement format

Sources of Funds		**Application of Funds**	
Capital	xxx	Funds utilised in creation of Fixed assets	xxx
Debts	xxx		
Funds generated from operations	xxx	Funds utilised in creation of other Non- current assets.	xxx
Sale of assets (if any)		Funds utilised in repaying existing loans.	
			xxx
		Funds utilised for paying dividends, taxes	
			xxx
		*(Bal.fig) Excess of Funds over application of funds –	
· (Bal.fig) Excess usage of funds over sources.			**xxx**
[**Decrease in working capital**]		**[Increase in working capital]**	
Total	**xxx**		**xxx**

- Increase in working capital

Possibilities may arise when long term sources are in abundance of uses or application resulting in a gap. Which we call in fund flow statement as ‘Increase in working capital’. As it is a free flexible source which can now be used by the company for funding its working capital requirements. Say short term loans outstanding (if any) can be paid from the long-term sources slot or dividends be paid etc.,

- Decrease in working capital

Possibilities that the company has more uses of funds, but it has very limited long-term source available. At that time, the company will go for funds which are available in the nature of working capital.

As a result, the company will reduce the funds available for working capital and divert it for long term uses. So, by decreasing the working capital, we get the funds which are available for long term uses which form part of the source of funds.

The increase or decrease in working capital can be known by preparing a statement of changes in working capital. This statement compares the values of two years of the difference between Current asset and Current Liabilities and tells as to whether there is an increase or decrease in working capital.

How do modern businesses prepare a fund flow statement?

Given the importance of fund flow statements brings to the table, most of the businesses prepare and analyze this statement more frequently. Today, most businesses use ERP software or accounting software which automatically prepares the fund flow statement along with various other financial statements. This allows business owners and other users of financial information to analyze and make on-time smart business decisions.

Concept of Gross and Net Working Capital

There are two concepts or senses used for working capital.

These are:

1. Gross Working Capital

2. Net working Capital

Let us explain what these two concepts mean.

1. Gross Working Capital:

The concept of gross working capital refers to the total value of current assets. In other words, gross working capital is the total amount available for financing of current assets. However, it does not reveal the true financial position of an enterprise. How? A

borrowing will increase current assets and, thus, will increase gross working capital but, at the same time, it will increase current liabilities also.

As a result, the net working capital will remain the same. This concept is usually supported by the business community as it raises their assets (current) and is in their advantage to borrow the funds from external sources such as banks and the financial institutions.

In this sense, the working capital is a financial concept. As per this concept:

Gross Working Capital = Total Current Assets

2. Net Working Capital:

The net working capital is an accounting concept which represents the excess of current assets over current liabilities. Current assets consist of items such as cash, bank balance, stock, debtors, bills receivables, etc. and current liabilities include items such as bills payables, creditors, etc. Excess of current assets over current liabilities, thus, indicates the liquid position of an enterprise.

The ratio of 2:1 between current assets and current liabilities is considered as optimum or sound. What this ratio implies is that the firm/ enterprise have sufficient liquidity to meet operating expenses and current liabilities. It is important to mention that net working capital will not increase with every increase in gross working capital. Importantly, net working capital will increase only when there is increase in current assets without corresponding increase in current liabilities.

Thus, in the form of a simple formula:

Net Working Capital = Current Assets-Current Liabilities

After subtracting current liabilities from current assets what is left over is net working capital.

This process functions much like the following:

Current Assets

Current Liabilities

Working Capital

Working capital normally refers to net working capital. The banks and financial institutions do also adopt the net working capital concept as it helps assess the requirement of the borrower. Yes, if in any particular case, the current assets are less than the current liabilities, then the difference between the two will be called 'Working Capital Deficit.'

What this deficit in working capital indicates is that the funds from current sources, i.e., current liabilities have been diverted for acquiring fixed assets. In such case, the enterprise cannot survive for a long period because current liabilities are to be paid out of the realisation made through current assets which are insufficient. Let us understand the two concepts of Gross Working Capital and Net Working Capital with the help of an example also.

Example:

The following is the Balance Sheet of Bhilwara Textiles Private Ltd. as at 31st December, 2011:

Liabilities	₹	*Assets*	₹
Capital	1,00,000	Plant & Machinery	75,000
Profit	20,000	Land & Building	50,000
Long-term Borrowings	60,000	Furniture	25,000
Sundry Creditors	21,500	Stock	20,000
Bills payables	8,500	Sundry Debtors	25,000
		Bills Receivables	10,500
		Semi-Finished Goods	4,500
	2,10,000		**2,10,000**

Now, the Gross Working Capital will be:

	₹
Stock	20,000
Sundry Debtors	25,000
Bills Receivables	10,500
Semi-Finished Goods	4,500
Gross Working Capital	60,000

Accordingly, Net Working Capital will be:

	₹
Total Current Assets	60,000
Less: Total Current Liabilities:	
(*i*) Sundry Creditors 21,500	
(*ii*) Bills Payables 8,500	30,000
Net Working Capital	30,000

Preparation of Schedule of Changes in Working Capital

Preparing the schedule/statement of changes in working capital requires us to present the information relating to the current area of the balance sheets pertaining to the two periods in the format given below and deriving and presenting the changes within them.

Schedule/Statement of Changes in Working Capital for the period from __ to __

Particulars/Account	Balance as on 31st March		Working Capital Change	
	2007	2008	Increase	Decrease
a) CURRENT ASSETS				
1) Cash Balance	56,000	78,000	22,000	
2) Bills Receivable	5,75,000	8,25,000	2,50,000	
3) Sundry Debtors	9,15,000	12,25,000	3,10,000	
4) Stocks/Inventories	9,48,000	12,00,000	2,52,000	
5) Prepaid Expenses	3,24,000	2,84,000		40,000
TOTAL	28,18,000	36,12,000	8,34,000	40,000

b) CURRENT LIABILITIES				
1) Sundry Creditors	7,40,000	11,00,000		3,60,000
2) Bills Payable	2,20,000	4,00,000		1,80,000
3) Bank Overdraft	2,81,000	2,50,000	31,000	
4) Outstanding Expenses	1,23,000	1,00,000	23,000	
5) Provision for Taxation	2,38,000	3,00,000		62,000
6) Provision for Dividends	1,98,000	2,50,000		52,000
7) Reserve for Bad Debts	18,000	12,000	6,000	
TOTAL	18,18,000	24,12,000	60,000	6,72,000
Working Capital [(a) - (b)]	10,00,000	12,00,000		
		TOTAL	8,94,000	6,94,000
		Net Change in Working Capital	2,00,000	

- Identify all the Current natured accounts on the assets as well as the liabilities sides of the two balance sheets in consideration.

- Fill the statement with the data relating to those accounts, taking current assets as a group and current liabilities as another group.

  A balance sheet item may have data in only one of the balance sheets or in both. Each item should appear only once in the statement.

Preparation of Funds Flow Statement and its analysis

A **Funds Flow Statement** is a financial document that analyses a company's Balance Sheet of two years to validate the movement of funds from the previous financial year to the current year. In other words, it compares the source of inflow and outflow of funds during the concerned accounting period and analyses how it affects the working capital of an organization.

It is an essential determiner that shows how funds are used. With the help of this statement, financial analysts can assess the fund flow of an organization in the near future.

As this statement portrays the movement of funds among several sources and their applications, it is also known as the Application of the Funds and Statement of Sources.

Usually, the preparation of these statements is followed by a funds flow analysis. It serves as a financial parameter that helps a company to control its finance and develop a better strategy to utilize funds.

In this article [show]

What is a Funds Flow Statement Analysis?

Funds Flow Statement analysis is a comparison between various aspects of a Balance Sheet. While evaluating this statement, it is also vital to understand all the aspects.

- **Assets**

If the asset section of a Balance Sheet experiences increment, it implies that the concerned institution has purchased assets by spending funds. These assets might thus result in the inflow of funds in the future. Here are some examples –

- Fixed assets
- Short-term loans
- Long-term loans
- Inventory
- Cash and cash equivalents
- Receivables
- Present investments

Contrarily, if the assets section shows a decline, it means that the company has sold some of its assets to maintain fund inflow.

- **Liabilities**
- Lenders

- Customers
- Vendors
- Employees
- Shareholders

And, a decline in liabilities implies that the current obligations have been satisfied.

How is a Funds Flow Statement Prepared?
Preparation of Funds Flow Statement is done in the following three steps –

- **Statement depicting differences in working capital**

According to the formula for working capital calculation,

Working capital = Current assets – Current liabilities

This particular statement focuses on the effects that modify working capital. Here are some reasons that are responsible for a change in the company's working capital.

- If the company keeps investing in fixed assets or long term business avenues without accumulating any long term funds, the working capital can reduce significantly.
- If the company is spending most of its profit in paying dividends and not accumulating any assets.
- Working capital can also change with an over-extension in lending.
- Again, without any advancement of long term funds, if the firm needs to repay a long-term obligation or preferred stockholders, the concerned firm can come across working capital deficiency.
- Example

Following is an example of changes in working capital in the statement –

Particulars	Amount in 2018	Amount in 2019	Changes in Working Capital
Current Assets			

Inventories	Rs. 100 Crore	Rs. 150 Crore	+30
Cash and equivalent	Rs. 60 Crore	Rs. 90 Crore	+30
Accounts receivables	Rs. 90 Crore	Rs. 65 Crore	-25
Advance expenses	Rs. 20 Crore	Rs. 25 Crore	-5
Bills receivables	Rs. 45 Crore	Rs. 35 Crore	-10
Total current assets	Rs. 315 Crore	Rs. 325 Crore	+20
Current Liabilities			
Bills payable	Rs. 25 Crore	Rs. 15 Crore	-10
Accounts payable	Rs. 45 Crore	Rs. 65 Crore	+20
Outstanding expenses	Rs. 10 Crore	Rs. 15 Crore	+5
Total current liabilities	Rs. 80 Crore	Rs. 95 Crore	+15
Working capital	Current assets – current liabilities	+20-15 = Rs. 5 Crore	

Statement depicting funds from various operations

In the next step, the report carries only the funds flow from operational activities. In this statement, the current year's profit and loss are calculated along with an adjustment in depreciation or accounting of the loss on fixed asset sales. Now, the previous year's profit or loss is to be deducted from the previous calculation to arrive at the value of funds from operations.

Note that no financing or investing activities will be accounted for in this statement.

Particulars	Amount	Amount
Profit and Loss Balance for 2019		**Rs. 200 Crore**
Depreciation on fixed assets	Rs. 25 Lakh	
Loss on sale of fixed assets	Rs. 5 Lakh	
Loss on sale of investments	Rs. 10 Lakh	
Tax provision	Rs. 30 Lakh	
Proposed dividend	Rs. 20 Lakh	
The amount transferred to reserve	Rs. 15 Lakh	
Depreciation of preliminary expenses	Rs. 5 Lakh	
Total Adjustments	Rs. 110 Crore	
Add Total Adjustments to Profit and Loss Balance	Rs. (220+110) Crore = Rs. 330 Crore	
Profit and Loss Balance for 2018	Rs. 200 Crore	
Funds from Operation (Profit and Loss Balance after Adjustment for 2019 – Profit and Loss Balance 2018)	Rs. (330-200) Crore = Rs. 130 Crore	

Statement depicting the flow of funds

This is the final step to calculate the flow of funds. Thus, the effect of previous calculations will be taken into account to understand the accurate use of funds. The adjustments are elaborated below.

Particulars	Amount	Amount
Funds from Different Sources		
Funds from operation	Rs. 130 Crore	
Fixed assets selling price	Rs. 40 Crore	
Total preferred shareholders issue	Rs. 70 Crore	
Total Sources		**Rs. 240 crore**
Application of Funds		
Purchase of fixed assets	Rs. 70 Lakh	
Tax payments	Rs. 40 Lakh	
Dividend payments	Rs. 60 Lakh	
Preferred shares redemption	Rs. 40 Lakh	
Total Application		**Rs. 210 Crore**
Funds Used for Working Capital	**Rs. (240-210) Crore = Rs. 30 Crore**	

Uses of Funds Flow Statement

A statement of the business's funds flow is an essential financial tool to monitor and regulate working capital. Below are some **uses of Funds Flow Statement** that financial analysts and managers opt for.

Analytical importance in financial operations

Even though financial statements show the resources and their utilisations, it doesn't reveal the reasons for such changes in the Balance Sheet. The statement thus provides an analytical view of the differences between current assets and current liabilities. Hence, it also explains how these changes take place in the context of the funds of a concerned company. In some cases, even if the company runs on profit, scenarios of cash shortage may arise. In such circumstances, this statement provides a clear picture of the profit earned by an organization.

Helps to form effective dividend policy

Sometimes a firm possesses substantial available profit to be distributed as a dividend but finds it difficult to do so due to a lack of sufficient liquidity. A **Funds Flow Statement** thus helps identify liquidity blockage and assists in planning an effective dividend policy.

Works as a financial guide

This statement also serves as a financial guide for a company. It brings out the financial issues that a concerned company could face in the near future. The management can thus chalk out an appropriate strategy to protect the company from any significant future financial loss.

Helps to determine the creditworthiness of an organization

Institutions lending finances often opt to evaluate this statement for a series of years to assess the creditworthiness of an applicant company before approving a loan. Hence, it also portrays the credibility of a firm in terms of fund management.

Limitations of Funds Flow Statement

In spite of several essential utilities, financial analysts encounter some Funds Flow Statement problems indicating at the limitations to its use.

- This statement cannot portray financial parameters represented in a Balance Sheet or Income Statement. It only focuses on the movement of funds during a specific timeline and does not quantify other essential items.

- The statement doesn’t add any new numerical value to a company’s financial standing. It only re-arranges the available information to identify issues with fund management.
- Due to its historical nature, this statement can’t conclude with accuracy the present-day financial standing of a business.
- Working capital plays an essential role in business finance. However, the movement of cash is more important for a promising financial future of a business. Thus, the flow of funds does not serve as an effective barometer for the purpose.

However, even with the limitations of this statement, it helps financial analysts to evaluate the balance sheet and come up with suggestions to operate funds effectively. Hence, every small and big organization must know about their fund movement to make improved financial decisions.

UNIT-V

Cash Flow Statement:

Various cash and non-cash transactions

Cash transactions:-

A cash transaction is a transaction where there is an immediate payment of cash for the purchase of an asset. It differs from other types of transactions that involve delayed delivery of the purchased item, or delayed payment for the item, such as forward contracts, futures contracts, credit transactions, and margin transactions.

KEY TAKEAWAYS:

- A cash transaction is the immediate payment of cash for the purchase of an asset.
- Some market stock transactions are considered cash transactions although the trade may not settle for a few days.
- A futures contract is not considered a cash transaction.

Understanding a Cash Transaction

A cash transaction can have many different definitions. Essentially, it is an immediate cash payment in exchange for the receipt of an item. Under some definitions, market stock transactions can be considered cash transactions because they happen close to instantly in the marketplace at whatever the current price is at that point in time. The trade is executed, and the parties involve exchange money for shares, despite the fact that the trade may not settle for a few days.

In contrast, a futures contract is not considered a cash transaction. Although the price and quantity of an item to be sold are agreed upon when the parties enter into the contract, the exchange of money and delivery of the item does not happen immediately. Purchase with a credit card is not considered a cash transaction, as the person making the purchase does not pay for the item until they pay their credit card bill, which may not occur until much later. Under some definitions of a cash transaction, all aspects of the trade, including the delivery of payment, must be be finalized on the trade date.

Example of a Cash Transaction

For example, a person walks into a store and uses a debit card to purchase an apple. The debit card functions the same as cash as it removes the payment for the apple immediately from the purchaser's bank account. This is a cash transaction. If the person had used a credit card to purchase the apple, no money would have been immediately forfeited by the purchaser, so it would not be a cash transaction. The purchaser would not actually give up money for the apple until they paid the "apple" line item on their credit card bill.

Federal law requires a person to report cash transactions of more than $10,000 to the IRS. Here are some facts about reporting these payments.

Cash Transactions and the Internal Revenue Service (IRS)

According to federal law, cash transactions in excess of $10,000 must be reported to the Internal Revenue Service (IRS) using Form 8300. Cash includes "coins and currency of the United States or any foreign country. For some transactions (PDF), it’s also a cashier’s check, bank draft, traveler’s check or money order with a face amount of $10,000 or less."

A person must report cash of over $10,000 received as either a lump sum, in two or more payments within 24 hours, as a single transaction within 12 months, or as two or more transactions within 12 months.

Non-Cash transactions

A non-cash item has two different meanings. In banking, the term is used to describe a negotiable instrument, such as a check or bank draft, that is deposited but cannot be credited until it clears the issuer's account.

Alternatively, in accounting, a non-cash item refers to an expense listed on an income statement, such as capital depreciation, investment gains, or losses, that does not involve a cash payment.

KEY TAKEAWAYS

- In banking, a non-cash item is a negotiable instrument—such as a check or bank draft—that is deposited but cannot be credited until it clears the issuer's account.
- In accounting, a non-cash item refers to an expense listed on an income statement, such as capital depreciation, investment gains, or losses, that does not involve a cash payment.

Understanding Non-Cash Items

Accounting

Income statements, a tool used by companies in financial statements to tell investors how much money they made and lost, can include several items that affect earnings but not cash flow. That's because in accrual accounting, companies measure their income by also including transactions that do not involve a cash payment to give a more accurate picture of their current financial condition.

Examples of non-cash items include deferred income tax, write-downs in the value of acquired companies, employee stock-based compensation, as well as depreciation and amortization.

Banking

Banks often put a hold of up to several days on a large non-cash item, such as a check, depending upon the customer's account history and what is known about the payor (e.g., if the issuing organization has the financial means to cover the check presented).

The short period during which both banks have the funds available to them—between when the check is presented and the money is withdrawn from the payor's account—is called the float.

Depreciation and Amortization Example

Depreciation and amortization are perhaps the two most common examples of expenses that reduce taxable income without impacting cash flow. Companies factor in the deteriorating value of their assets over time in a process known as depreciation for tangibles and amortization for intangibles.

For example, say a manufacturing business called company A forks out $200,000 for a new piece of high-tech equipment to help boost production. The new machinery is expected to last 10 years, so company A's accountants advise spreading the cost over the entire period of its useful life, rather than expensing it all in one big hit. They also factor in that the equipment has a salvage value, the amount it will be worth after 10 years, of $30,000.

Depreciation seeks to match up revenue with its associated expenses. Dividing $170,000 by 10 means that the equipment purchased will be shown as a non-cash item expense of $17,000 per year over the next decade. However, no money was actually paid out when these annual expenses were recorded, so they appear on income statements as a non-cash charge.

Special Considerations

Non-cash items frequently crop up in financial statements, yet investors often overlook them and assume all is above board. Like all areas of financial accounting, it sometimes pays to take a more skeptical approach.

One of the biggest risks associated with non-cash items is that they are often based on guesswork, influenced by past experiences. Users of accrual accounting have regularly been found guilty, innocently or not, of failing to accurately estimate revenues and expenses.

For example, company A's equipment may need to be written off before 10 years, or perhaps prove to be useful for longer than expected. Its estimated salvage value may be wrong, too. Eventually, businesses are required to update and report actual expenses, which can lead to big surprises.

flow of cash, preparation of Cash Flow Statement and its analysis

The Statement of Cash Flows (also referred to as the cash flow statement) is one of the three key financial statements that report the cash generated and spent during a specific period of time (e.g., a month, quarter, or year). The statement of cash flows acts as a bridge between the income statement and balance sheet by showing how money moved in and out of the business.

Three Sections of the Statement of Cash Flows:

Operating Activities: The principal revenue-generating activities of an organization and other activities that are not investing or financing; any cash flows from current assets and current liabilities

Investing Activities: Any cash flows from the acquisition and disposal of long-term assets and other investments not included in cash equivalents

Financing Activities: Any cash flows that result in changes in the size and composition of the contributed equity capital or borrowings of the entity (i.e., bonds, stock, dividends)

Cash Flow Definitions

Cash Flow: Inflows and outflows of cash and cash equivalents (learn more in CFI's Ultimate Cash Flow Guide)

Cash Balance: Cash on hand and demand deposits (cash balance on the balance sheet)

Cash Equivalents: Cash equivalents include cash held as bank deposits, short-term investments, and any very easily cash-convertible assets – includes overdrafts and cash equivalents with short-term maturities (less than three months).

Cash Flow Classifications

1. Operating Cash Flow

Operating activities are the principal revenue-producing activities of the entity. Cash Flow from Operations typically includes the cash flows associated with sales, purchases, and other expenses.

The company's chief financial officer (CFO) chooses between the direct and indirect presentation of operating cash flow:

- **Direct Presentation**: Operating cash flows are presented as a list of cash flows; cash in from sales, cash out for capital expenditures, etc. This is a simple but rarely used method, as the indirect presentation is more common.
- **Indirect Presentation**: Operating cash flows are presented as a reconciliation from profit to cash flow:

Profit	**P**
Depreciation	D
Amortization	A
Impairment expense	I
Change in working capital	ΔWC
Change in provisions	ΔP
Interest Tax	(I)
Tax	(T)
Operating cash flow	**OCF**

The items in the cash flow statement are not all actual cash flows, but “reasons why cash flow is different from profit.”

Depreciation expense reduces profit but does not impact cash flow (it is a non-cash expense). Hence, it is added back. Similarly, if the starting point profit is above interest and tax in the income statement, then interest and tax cash flows will need to be deducted if they are to be treated as operating cash flows.

There is no specific guidance on which profit amount should be used in the reconciliation. Different companies use operating profit, profit before tax, profit after tax, or net income. Clearly, the exact starting point for the reconciliation will determine the exact adjustments made to get down to an operating cash flow number.

2. Investing Cash Flow

Cash Flow from Investing Activities includes the acquisition and disposal of non-current assets and other investments not included in cash equivalents. Investing cash flows typically include the cash flows associated with buying or selling property, plant, and equipment (PP&E), other non-current assets, and other financial assets.

Cash spent on purchasing PP&E is called capital expenditures (or CapEx for short).

3. Financing Cash Flow

Cash Flow from Financing Activities are activities that result in changes in the size and composition of the equity capital or borrowings of the entity. Financing cash flows typically include cash flows associated with borrowing and repaying bank loans, and issuing and buying back shares. The payment of a dividend is also treated as a financing cash flow.

Statement of Cash Flows Example

Below is an example from Amazon’s 2017 annual report, which breaks down the cash flow generated from operations, investing, and financing activities. Learn how to analyze Amazon’s consolidated statement of cash flows in CFI’s Amazon Advanced Financial Modeling Course.

Interest and Cash Flow

Under IFRS, there are two allowable ways of presenting interest expense in the cash flow statement. Many companies present both the interest received and interest paid as operating cash flows. Others treat interest received as investing cash flow and interest paid as a financing cash flow. The method used is the choice of the finance director.

Under U.S. GAAP, interest paid and received are always treated as operating cash flows.

Free Cash Flow

Investment bankers and finance professionals use different cash flow measures for different purposes. Free cash flow is a common measure used typically for DCF valuation. However, free cash flow has no definitive definition and can be calculated and used in different ways.

Learn more, in CFI's Ultimate Cash Flow Guide.

How to Prepare a Statement of Cash Flows?

The operating section of the statement of cash flows can be shown through either the direct method or the indirect method. With either method, the investing and financing sections are identical; the only difference is in the operating section. The direct method shows the major classes of gross cash receipts and gross cash payments. The indirect method, on the other hand, starts with the net income and adjusts the profit/loss by the effects of the transactions. In the end, cash flows from the operating section will give the same result whether under the direct or indirect approach, however, the presentation will differ.

The International Accounting Standards Board (IASB) favors the direct method of reporting because it provides more useful information than the indirect method. However, it is believed that greater than 90% of companies use the indirect method.

Direct Method vs Indirect Method of Presentation

There are two methods of producing a statement of cash flows, the direct method, and the indirect method.

In the direct method, all individual instances of cash that is received or paid out are tallied up and the total is the resulting cash flow.

In the indirect method, the accounting line items such as net income, depreciation, etc. are used to arrive at cash flow. In financial modeling, the cash flow statement is always produced via the indirect method.

What Can the Statement of Cash Flows Tell Us?

Cash from operating activities can be compared to the company's net income to determine the quality of earnings. If cash from operating activities is higher than net income, earnings are said to be of "high quality."

This statement is useful to investors because, under the notion that cash is king, it allows investors to get an overall sense of the company's cash inflows and outflows and obtain a general understanding of its overall performance.

If a company is funding losses from operations or financing investments by raising money (debt or equity) it will quickly become clear on the statement of cash flows

SUGGESTED READINGS

1) Narayanswami - Financial Accounting: A Managerial Perspective (PHI, 2nd Edition).

2) Mukherjee - Financial Accounting for Management (TMH, 1st Edition).

3) Ramchandran & Kakani - Financial Accounting for Management (TMH, 2nd Edition).

4) Ghosh T P - Accounting and Finance for Managers (Taxman, 1st Edition).

5) Maheshwari S.N & Maheshwari S K – An Introduction to Accountancy (Vikas, 9th Edition)

6) Ashish K. Bhattacharya- Essentials of Financial Accounting (PHI, New Delhi)

7) Ghosh T.P- Financial Accounting for Managers (Taxman, 3rd Edition)

8) Maheshwari S.N & Maheshwari S K – A text book of Accounting for Management (Vikas, 1st Edition)

9) Gupta Ambrish - Financial Accounting for Management (Pearson Education, 2nd Edition)

10) Chowdhary Anil - Fundamentals of Accounting and Financial Analysis (Pearson Education, 1st Edition).