Basic Financial Accounting-II

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MODULE-I

"A Company is an artificial person created by law, having separate entity with a perpetual succession and a common seal."- Prof. Haney

Characteristics (Features) of a company

1. The certificate of incorporation of a company is issued by registrar of companies as per procedure/guidelines given in the Companies Act, 2013. The law considers a company as an artificial legal person.
2. A Company is a separate legal entity from its owner (shareholders).
3. A company has perpetual existence, not affected by the death, lunancy or insolvency of its shareholders. It can be wounded up only by the law (Court or registrar of company.)
4. Every company has it own common seal, which act as the official signature of the company.
5. The shares of a company is transferable subject to certain conditions (e.g. some conditions for private company.)
6. The company is managed by the 'Board of Directors', the directors are representative of the shareholders (owners). So, management and ownership are separate in company organization.
7. The liability of a shareholder is limited upto the nominal price of shares subscribed by one.

Types of Companies

1. Private Company – Section 2 (68) of the Companies Act, 2013 defines "A private Company means a company which has a minimum paid up capital of Rs. 100,000 and which by its Articles of Association –
   (a) restricts the right to transfer its shares;
   (b) limits the number of its members to 200 excluding its part or present employee members;
   (c) Prohibits any invitation to public to subscribe for any of its securities.
2. Public Company – According to section 2 (71) of the Companies Act, 2013 a public company means a company which is not a private company and has a minimum paid up capital of L 500,000 or higher capital as may be prescribed a private company which is a subsidiary of a company not being a private company shall be deemed a public company.
3. One Person Company – Section 2 (62) of the Companies Act, 2013 states one person company is a company which has only one person as a member. Rule 3 of the Companies (In Corporation) Rules, 2014 provides that (i) only on Indian citizen resident in India can form one person company (ii) Its paid up capital is not more than 50 lakhs; (iii) Its Average annual turnover should not exceed Rs. 2 crores; (iv) It cannot carry out Non banking financial Investment activities.

Class / Types of Shares : There are two classes of shares

1. Preference shares: The shares which get preferential right in respect of (a) Right of dividend
   (b) Repayment of capital on winding up of the company.
2. Equity shares: The shares which are not preference shares are called equity shares and do not get preference in above respect.

Types OR Classes of Preference Shares

(a) With Reference to Dividend:

1. Cumulative Preference shares: Cumulative preference shares are these preference shares, the holders of which are entitled to receive arrears of dividend before any dividend is paid on equity shares.
2. Non-cumulative Preference shares: Non-cumulative preference shares are those preference share, the holders of which do not have the right to receive arrear of divided. If no dividend is declared in any year due to any reason. Such shareholders get nothing, nor they can claim unpaid dividend in any subsequent years.

(b) With Reference to Participation

1. Participating preference shares: such shares, in addition to the fixed preference dividend, carry a right to participate in the surplus profit, if any, after providing dividend at a stipulated rate to equity shareholders.
2. Non-Participating preference shares: Such shares get only a fixed rate of dividend every year and do not have a right to participate in the surplus profit.

(c) With Reference to Convertibility

1. Convertible preference shares: are those preference shares which have the right/option to be converted into equity shares.
2. Non-convertible preference shares: are those preference shares which do not have the right/option to be converted into Equity shares.

(d) With Reference to Redemption

1. Redeemable preference shares: are those preference shares the amount of which can be redeemed by the company at the time specified for their repayment or earlier.
2. Irredeemable preference shares: are those preference shares the amount of which cannot be refunded by the company unless the company is wound up. Now a company cannot issue irredeemable preference shares.

Some Important Terms used in Accounting for Share Capital

Note 1 : Minimum Subscription (Section 39) – It is the minimum amount stated in the prospectus that must be subscribed by the public before an allotment of any security is made.

Prospectus : It is an invitation to public for subscription of shares or debentures.

Capital : means amount invested in the business for the purpose of earning revenue. In case of company money is contributed by public and people who contributed money are called shareholders.

Share Capital: Capital raised by issue of shares is called share capital.

Authorised Capital: Also called as Nominal or registered capital. It is the maximum amount of capital a company can issue. It is stated in Memorandum of Association.

Issued Capital: This is part of authorized capital which is offered to public for subscription. It cannot exceed authorized capital.
Called Up Capital: It is the amount of nominal value of shares that has been called up by the company for payment by the subscriber towards the share.
Paid Up Capital: It is part of called up capital that the members of company or shareholders have paid.
Reserve Capital: It is part of increased capital and/or portion of uncalled share capital of an unlimited company which can be called only in case of winding up of the company.
Capital Reserve: It is capital profit not available for distribution as dividend. It is represented in balance sheet of company as Reserves and Surplus under the heading Shareholder's Funds.
Issues of Shares At Premium: It is issue of share at more than face value.
This premium can be utilized for: (Section 52)

1. Issue of fully paid bonus shares to the shareholders.
2. Write off preliminary expenses of the company.
3. Writing off securities issue expenses commission paid discount on issue of securities.
4. For providing the premium payable on redemption of Redeemable preference shares or debentures of the company.
5. For Buy back of its own shares as per Section 68.

Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders. The interest paid to them is a charge against profit in the company's financial statements.

TYPES OF DEBENTURES

Convertibility point of view: There are two types of debentures:

Convertible debentures, which can be converted into equity shares of the issuing company after a predetermined period of time.

These may be **Partly Convertible Debentures (PCD):** A part of these instruments are converted into Equity shares in the future at notice of the issuer. The issuer decides the ratio for conversion. This is normally decided at the time of subscription.

Fully convertible Debentures (FCD): These are fully convertible into Equity shares at the issuer's notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.

Non-convertible Debentures, which are simply regular debentures, cannot be converted into equity shares. These are debentures without the convertibility feature, these usually carry higher interest rates than their convertible counterparts.

On basis of Security, debentures are classified into:

Secured Debentures: These instruments are secured by a charge on the fixed assets of the issuer company. So if issuer fails to pay of either the principal or interest amount, its assets can be sold to repay the liability towards debenture holders.

Unsecured Debentures: These instruments are unsecured in the sense that if the issuer defaults on payment of the interest or principal amount, the investor is treated like other unsecured creditors of the company.

From Redemption point of view

Redeemable Debentures : Redeemable debentures are those which are redeemed or paid off after the termination of fixed term. The amount paid off includes the principal amount and the current year's interest. The company always has the option of either to redeem a specific number of debentures each year or redeem all the debentures at specified date.

Irredeemable or Perpetual Debentures : Irredeemable debentures are those debentures which do not have any fixed date of redemption. They are redeemed either in the event of winding up or at a very remote period of time. Irredeemable or perpetual debenture holders can never force the company to redeem their debentures.

Collateral Security : Collateral security means security provided to lender in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or from any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as 'issue of debentures as collateral security'. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise the right does not arise debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on loan.

<u>**MODULE-II**</u>

Disclosure in Annual Reports

The annual report of a company contains a number of useful reports. These reports give further insight into the financial performance and position of the company. An annual report is a document that public corporations must provide annually to shareholders that describes their operations and financial conditions. Some of these reports are mandatory in nature, whereas some are purely voluntary. Management of progressive companies uses their annual reports to communicate with various stakeholders on voluntary basis. The information contained in the annual report may be classified under four categories:

1. **Disclosure required under the Companies Act, 2013**: The companies registered in India are regulated in terms of the provisions of the Companies Act, 2013. The Act requires a number of disclosures to be incorporated in the annual report of the company. These disclosures are applicable to all companies and are mandatory in nature.
2. **Disclosure required under the listing agreement:** A company that has raised money by inviting public to subscribe for its shares is required to sign a listing agreement with the stock exchange where it wants its shares to be traded. The listing agreement imposes a number of disclosure requirements on such publicly held companies. As these requirements are originating from the listing agreement, they apply only to listed companies.
3. **Disclosures required under the relevant accounting standards:** Most of the accounting standards, in addition to providing guidance for accounting, also impose certain disclosure requirements. These disclosures are in addition to the requirements under the provisions of the Companies Act, 2013.
4. **Voluntary disclosures:** To ensure transparency, companies are making additional disclosures in their annual reports which go beyond the mandatory requirements as aforesaid. As these disclosures are voluntary in nature, there is no uniformity in the type of reports or content of reports across various companies.

DISCLOSURES UNDER THE COMPANIES ACT, 2013

Auditor's Report

The accounts of the company are required to be audited by an external auditor. Such an audit is called a statutory audit or an independent audit or an external audit. The statutory audit is performed by a Chartered Account holding a certificate of practice issued by the Institute of Chartered Accountants of India. Based upon their audit, the auditors are required to make a report to the shareholders of the company. In accordance with the provisions of Section 143 (2) of the Companies Act, the auditors are required to state in their report their opinion on the accounts audited by them. The auditors' report states the following:

- They have sought and obtained all the information and explanation necessary for the audit work.
- Proper books of accounts as required by law have been kept by the company.
- Financial statements are in compliance with the applicable accounting standards.

- The balance sheet gives a true and fair view of the state of affairs of the company at the end of the financial year and the profit and loss statement gives a true and fair view of the profit or loss of its financial year.
- Report on the accounts of branch office of the company audited by a person other than the company's auditor has been sent to him.
- Observations or comments on financial transactions or matters having any adverse effect on the functioning of the company.
- Any qualification, reservation or adverse remarks relating to maintenance of accounts and other matters connected thereto.
- Adequacy of internal financial control system and operating effectiveness of such controls.
- Any other specified matter. If auditors' opinion on all of the above is affirmative, the auditors' report is said to be a clean report. In an extreme case, if on the basis of the information available the auditors are not able to form an opinion, they may issue a disclaimer. However, such instances are rare. If the auditors are of the opinion that the financial statements do not represent a 'true & fair view', they may issue an adverse opinion. Again such instances are really rare.

If the auditors have any reservation but such reservations do not warrant a disclaimer or an adverse opinion being given, a qualified report may be given by the auditor. In a qualified report the auditors state that the financial statements present a true and fair view but subject to certain reservations or qualifications stated in the audit report. It may be noted that auditors' report is merely an opinion and not a certificate. For forming their opinion the auditors perform such audit test as may be appropriate with the size and complexity of the business. The audit is usually based upon sample testing and therefore a clean report does not ensure that the accounts are error free. However, while analyzing the financial statements of a company, qualifications in the audit report must be considered. Repeated qualified reports by the auditors also diminish the reliability of the numbers presented in the financial statements.

Directors' Report

In pursuant of Section 134 of the Companies Act, 2013, every year a report by the Board of Directors of the company is required to be attached to the financial statements. It is the formal communication from the board of directors to the shareholders. The board's report carries out a review of the company's affairs for the year gone by and also covers any significant developments that might have happened between the end of the financial year and the date of the report. Some of the important particulars to be included in the Directors' Report are stated below:

- Directors' Responsibility Statement stating that they had laid down internal financial controls to be followed by the Company and that such internal financial controls are adequate and were operating effectively. The statement also confirms that the proper systems to ensure compliance with the provisions of all applicable laws are in place and are adequate and operating effectively.
- A statement on declaration given by independent directors that they meet the criteria of independence.
- Company's policy on directors' appointment and remuneration including criteria for determining qualifications, positive attributes, independence of a director, etc.

- Explanations or comments by the board on every qualification, reservation or adverse remark or disclaimer made -By the auditor in his report. – By the company secretary in practice in his secretarial audit report.
- Particulars of contracts or arrangements with related parties.
- The state of the company's affairs highlighting business performance and financial overview. • The amounts which it proposes to carry to any reserves.
- The amount which it recommends should be paid by way of dividend.
- Material changes and commitments affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report.
- The conservation of energy, technology absorption and foreign exchange earnings and outgo.
- A statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk which in the opinion of the Board may threaten the existence of the company.
- The details about the policy developed and implemented by the company on corporate social responsibility initiatives taken during the year.
- A statement indicating the manner in which formal annual evaluation has been made by the Board of its own performance and that of its committees and individual directors.

Details Regarding Subsidiary Companies

As per Section 129 of the Companies Act, 2013, a statement containing the salient features of the financial statements of subsidiary or subsidiaries is required to be attached with the financial statements of the folding company. This is, in addition, to the requirement of preparing and presenting consolidated financial statements.

DISCLOSURES UNDER LISTING AGREEMENT

The key disclosures under this category are discussed below. These disclosure requirements are applicable only to listed companies.

Management Discussion and Analysis

Clause 34 of the Listing Agreement requires that a management discussion and analysis report should form part of the annual report to the shareholders. This report may either be given separately or may be included in the directors' report as discussed earlier. In this segment, the management (Board of Directors) discusses the following:

- Industry structure and developments
- Opportunities and threats
- Segment-wise or product-wise performance
- Outlook
- Risks and concerns
- Internal control systems and their adequacy
- Financial performance with respect to operational performance
- Material developments in human resources/industrial relations front, including number of people employed.

MDA and directors' report are useful to get an insider's view on the performance of the company.

DISCLOSURES UNDER ACCOUNTING STANDARDS

In addition to the disclosures discussed in the earlier chapters which directly relate to specific area of accounting, there are certain other disclosures mandated by accounting standards. These disclosures are usually included in the notes to accounts.

Segment Reporting (Ind AS 108)

The financial statements are prepared using entity concept, and accordingly they represent the results and financial position of the enterprise as a whole. A large enterprise usually operates in multiple business segments and in various geographies. The statement of profit and loss does not reveal the performance of different business or geographical segments. Likewise, the balance sheet also does not provide the detail of funds deployed in different segments. To better appreciate the performance of the business enterprise and the risk associated, information about segment-wise performance is essential. Information about significant components of an entity in contrast to its financial statements for the entity as a whole is very important to the users of financial statements, specifically, where an entity is engaged in different business activities or operates in different economic environments. An operating segment is defined as a component of an entity:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity).
- Whose operating results are reviewed regularly by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.
- For which discrete financial information is available

FORMAT OF BALANCE SHEET AS PER COMPANIES ACT 2013 (SCHEDULE-III)

Balance Sheet of L Company Ltd.			
Particulars	Note No.	Amount as on 31/3/2020	Amount as on 31/3/2019
I. EQUITY AND LIABILITIES			
1) Shareholders' Funds			
a) Share Capital	1	AMT	AMT
b) Reserves and Surplus	2	AMT	AMT
c) Money Received against share warrants		AMT	AMT
2) Share application money pending allotment			
3) Non-Current Liabilities			
a) Long-term borrowings	3	AMT	AMT
b)Deferred tax liabilities (Net)		AMT	AMT
c)Other Long term liabilities		AMT	AMT
d)Long term provisions		AMT	AMT
4) Current Liabilities			
a) Short term borrowings		AMT	AMT
b) Trade Payables		AMT	AMT
c) Other current liabilities		AMT	AMT
d) Short-term provisions		AMT	AMT
TOTAL		AMT	AMT
II. ASSETS			
1) Non-Current Assets			
a) Property, Plant and Equipment			
i) Tangible Assets	4	AMT	AMT
ii) Intangible Assets		AMT	AMT
iii) Capital Work-in-Progress		AMT	AMT
iv) Intangible assets under development		AMT	AMT
b) Non Current Investments		AMT	AMT
c) Deferred Tax Assets (net)		AMT	AMT
d) Long term loans and advances		AMT	AMT
e) Other non-current assets			
2) Current Assets			
a) Current investments		AMT	AMT
b) Inventories		AMT	AMT
c) Trade receivables		AMT	AMT
d) Cash and cash equivalents	5	AMT	AMT
e) Short-term loans and advances		AMT	AMT
f) Other current assets		AMT	AMT
TOTAL		AMT	AMT

MODULE-III

Introduction to financial statement

It is a systematic process of dividing the financial information into simple and valuable elements, establishing relationships between inter-related elements and interpreting the same to understand the working and financial position of an enterprise from its financial statements. It includes analysis of Statement of Profit and Loss, Balance Sheet and Cash Flow Statement of an enterprise. It provides information to understand complex financial data and helps in taking appropriate financial decisions.

Understanding Analysis and Interpretation: These two terms in understanding the meaning of financial statement analysis are complementary to each other and therefore, analysis cannot be complete without interpretation.

Analysis: It is concerned with simplification of financial data by proper classification of given in the financial statement.

Interpretation: It is concerned with explaining the meaning and significance of the financial data. As per Myer: Financial Statement Analysis is largely a study of relationships among the various financial factors in a business, as disclosed by a single set of statements, and a study of trends of these factors, as shown in a series of statements.

Objectives /Purposes (Objectives) and Significance of Financial Analysis:

1. To Assess the Earning Capacity or Profitability: Earning Capacity and Profitability of the enterprise can be assessed from the financial statement analysis. It also facilitates forecasting of the same for the future years. External users are interested in earnings and hence, this is their prime objective of analysing financial statement.
2. To Assess the Managerial Efficiency: This assessment is possible because financial statement analysis identifies the areas where managers have been efficient and where not. Favourable and unfavourable variations can be identified to pinpoint the managerial inefficiency.
3. To Assess the Short-term and Long-term Solvency of the Enterprise: This assessment is possible by analysing the financial statements minutely. Creditors or suppliers are interested to know the ability of the entity to meet the short-term liabilities and Debenture-holders and lenders are interested to know the long term and short-term solvency of the enterprise to assess the ability of the company to repay the principal and interest thereon.
4. To facilitate Inter-firm Comparison: Inter-firm Comparison helps an enterprise to assess its own performance as well as that of others if mergers and acquisitions are to be considered.
5. To Forecast and Prepare Budgets: Analysis of historical data in the financial statements helps in assessing developments in future. It facilitates forecasting and preparing budgets for the future years.
6. To Understand Complicated Matter: Financial Statement analysis helps the users in understanding the complicated matter. This can be facilitated by using charts, graphs and diagrams which are easy to explain and understand.

Uses of Financial Analysis:

Security Analysis: It is a process used by the investor to identify whether the firm is fulfilling his expectations with regard to dividends, capital appreciation, etc. Such analysis is done by a security analyst who is interested in cash generating ability, dividend pay-out policy and the behaviour of share prices.

Credit Analysis: It is useful when a firm or bank offers credit to a new customer or a dealer. Management is always interested to know credit worthiness of client so as to take decisions regarding whether to allow or extend credit to them or not.

Debt Analysis: It is useful when a firm wants to know its borrowing capacity.

Dividend Decision: It is useful in determining the rate of dividend in order to decide how much of the earnings are to be distributed in the form of dividends and how much is to be retained. Dividend decisions have a direct impact on profitability of the firm and behaviour of its share prices so are to be taken wisely using Financial Statement Analysis.

General Business Analysis: It is useful in identifying the key profit drivers and business risks in order to assess the profit potential of the firm and also assist in future growth scenarios.

Parties Interested in Financial Analysis:

Management: Financial analysis helps the management to ascertain overall as well as segment wise efficiency of the business. It also helps in decision making, controlling and self-evaluation.

Employees and Trade Unions: Financial Analysis is considered helpful for employees to get a clear idea of the emoluments, bonus, working conditions and security of their jobs by analysing profitability, sustainability and financial position of the enterprise from its financial statements. In order to take proper decisions and enter into beneficial wage agreements, trade unions also analyse financial statements to determine the degree of profitability of the enterprise based on which they can further negotiate.

Shareholder or Owners or Investors: These are the investors who invest or contribute their savings in the form of capital. Therefore, they are interested in the returns of the business which can be ascertained from the profitability of the business. Also, growth potential helps in investment appreciation.

Potential Investors: These are those who are interested to know the present profitability and the financial position as well as future prospects to make their mind on investment into business concern.

Suppliers or Creditors: This set of interested users are concerned whether the enterprise can make timely payments of the amounts due on account of credit transactions done with them and also whether to extend further credit to such enterprise. Such decision is based on the short-term solvency of the enterprise which can be determined by analysing the financial statements of the enterprise.

Bankers and Lenders: These are those parties to an enterprise who provide funds in the form of loans which is repayable at the end of a pre-determined term. In order to identify the repaying capacity of the enterprise, such parties should have a clear idea of the long-term solvency of the enterprise. Such information is obtained by analysing financial statements of respective enterprise.

Researchers: Parties engaged into research activity and wish to perform the same over the business entities so as to analyse the profitability, growth and financial position of an enterprise. To gather information on such areas, they are interested in analysing respective aspects of such areas which includes data related to business operations, finance, human resource, etc.

Tax Authorities: Tax Authorities are interested in ensuring proper assessment of tax liabilities of the enterprise as per the tax laws in force from time to time.

Customers: Customers have an interest in information about the continuance of an enterprise. This is particularly when they are either dependent on the enterprise or they have a long term involvement with the enterprise.

Classification of Financial Statement Analysis:

External Analysis: This type of analysis is done by investors, credit agencies, researchers, etc. who do not have access to the confidential and complete records of an enterprise and therefore, have to depend on information published in various statements or reports which shall comprise of Statement of Profit and Loss, Balance Sheet, Auditor's Reports etc.

Internal Analysis: This is a detailed and accurate type of analysis done by the management of the enterprise to determine the financial position and operational efficiency of the organisation. Since, management has access of complete information, they perform an extensive type of analysis which is more detailed and accurate.

Horizontal Analysis: It is also known as Dynamic Analysis. It is done to review and analyse financial statement for a number of years and hence, is also known as time series analysis. It facilitates comparison of financial data for several years against a chosen base year.

Vertical Analysis: It is also known as Static Analysis. It is done to review and analyse the financial statements of one year only. It is useful in comparing the performance of several companies of the same type or divisions or departments in one enterprise.

Tools or Techniques used to Analyse Financial Statements:

Comparative Statements: It means a comparative study of individual components or elements or items of Balance Sheet and Statement of Profit or Loss for two or more years. At first, the value of each component or element or item of two or more financial years is placed alongside each other. After this, differences between the two amounts is determined. Lastly percentage change in the amount from the base year is ascertained. o Such comparative statements can be Intra-Firm or Inter-Firm Comparisons.

Common Size Financial Statements: It is a vertical analysis of Financial Statements in which amounts of individual items of Balance Sheet or Statement of Profit or Loss are written. These amounts are further converted into percentages to a common base. These percentages can be compared with the corresponding percentages in other periods and meaningful conclusions can be drawn. Such statements may be prepared for intra-firm and inter-firm comparison. Such statements may be prepared for Balance Sheet as well as Income Statement.

Ratio Analysis: It is a study of relationship among various financial factors in a business. o It is a technique of analysing the financial statements with the help of accounting ratio. It is a process of determining and interpreting relationships between items of financial statements to provide a meaningful understanding of the financial performance and position of an enterprise.

Cash Flow Statement: It is a statement that shows the inflows and the outflows of Cash and Cash Equivalents during the period. Inflows are those transactions that increase the Cash and Cash Equivalents and outflows are those transactions that decrease the Cash and Cash Equivalents. Such statement is prepared in accordance with the Accounting Standard-3(Revised) on Cash Flow Statement. As per this accounting standard, cash flows are showed under the following 3 heads: a. Cash Flow from Operating Activities; b. Cash Flow from Investing Activities; and c. Cash Flow from Financing Activities.

Following are the limitations of Financial Statement Analysis:

Historical Analysis: Financial Statements are prepared using the historical information of the financial transactions that have already taken place. As a result financial statements are correctly termed as historical records of financial transactions. Analysis of such transactions is therefore, a historical analysis. Therefore, the statement is incorrect as it makes reference to use of future data.

Price Level Changes are not considered: If there is a change in the price level, analysis of financial statements of different accounting years become invalid as accounting records ignore change in value of money.

Qualitative Aspect Ignored: Financial Statements record only monetary transactions which are quantitative in nature. Other important qualitative elements which affect the financial statements are not considered.

Financial Statements Limitations: Financial Statements are not always accurate and are subject to some limitations. Since, analysis is based on the information provided by financial statements, such limitations will therefore, have an impact on the decisions taken based on the analysis of information provided by such financial statement.

Not free from bias: Financial statements are the outcome of accounting concepts and conventions combined with estimates. Estimates cannot be relied upon completely as there are chances that the amounts may fluctuate and hence, are not free from bias. Therefore, the financial statements are not completely reliable.

Accounting Practices: In order to compare the profitability and the financial position of different firms, it is necessary that these firms follow same accounting practices. If different accounting practices are followed, inter-firm comparison is not possible.

Window Dressing: It refers to the presentation of a better financial position than what it actually is by way of manipulating the books of accounts. Such false representation will provide misleading information for analysis which will result in wrong decision making.

Symptoms: Financial statements analysis facilitates identifying symptoms or problems but it fails to provide solution or remedy for the same. Rectification of the error or problem has to be taken care of by the management based on their respective analysis.

Comparative Statements or Comparative Financial Statements:

It means a comparative study of components or elements or items of Balance Sheet and Statement of Profit or Loss for two or more years. At first, the value of each component or element or item of two or more financial years is placed alongside each other. After this, differences between the two amounts is determined. Lastly percentage change in the amount from the base year is ascertained. Such comparative statements can be Intra-Firm or Inter-Firm Comparisons. Objectives:

Data Presentation becomes Simple and Comparable: It is a statement with data for two or more years in a tabular form. Such tabular representation makes the data simple, understandable and comparable for drawing appropriate conclusions from the complex information.

Indicates Trend: It gives information about the changes affecting financial position and performance of an enterprise. It helps in forecasting by the way of indicating the trend.

Indicates Strengths and Weaknesses: It indicates the strengths and weaknesses of the enterprise with respect to liquidity, profitability and solvency.

Comparison with other Firms and Industry Performance: It helps in comparison of an enterprise's performance with that of other enterprises or with that of the industry.

Forecasting and Planning: Analysing changes and trend in the financial data of previous years helps the management in forecasting and planning.

Importance: Comparative Financial Statements is a tool of financial analysis that shows change in each item from the base year in absolute amount and in percentage, taking the amounts for the preceding or previous accounting period as the base. Therefore, preparation of such statement is important because for the following different reasons:

Shareholders: It provides meaningful information to the shareholders. Such statements are important to the shareholders being the owners of the company in making the timely decisions whether to hold the shares or sell them

Decisions and Plans: Such statements are important to the management of the company to take proper decisions and to formulate plans and policies accordingly.

Lenders: These are the funds providers in the form of loan. In order to evaluate as to whether the loan is safe, whether any further loan is to be made and at what rate, such statements are important information providers to the lenders.

Investment Decision: Such statements are important to the potential investors to decide whether to invest in the company's share. From such statements they can obtain the useful information to take appropriate investment decisions.

Limitations of Comparative Statements:

Historical Records: Financial Statements provide information which is historical in nature and therefore, it is not useful for the potential investors or lenders as it does not provide any information of the future business or its future financial position.

Affected by Estimates and Personal Judgement: Financial Statements are the outcome of accounting concepts and conventions combined with estimated and are therefore, not free from bias.

Different Accounting Practices: Financial Statements can be drawn up on the basis of different accounting practices. Profitability determined by each of these practise will be different and hence, there is no standard practice which can be followed by all.

Qualitative Elements are ignored: Financial Statements are based completely on monetary items and therefore, many non-monetary important factors which affect the profitability of the business are ignored.

Price Level Changes are ignored: Financial Statements follow the historical cost concept for showing assets at their historical cost. Because of such practices, current market value is not taken into consideration.

Cannot Meet the Purpose of all Parties: Financial Statements for a period are used by a number of interested users for various purposes and interests. It is not possible to meet the purpose of all interested parties.

Aggregate Information: Financial Statements show aggregate information and not detailed information and hence, it is not that useful for the users in decision making.

Comparative Balance Sheet:

It is a statement which is used for comparing the assets, liabilities and capital and ascertaining increase or decrease in those items. It is horizontal analysis of Balance Sheet in which each item of assets, equity and liabilities is analysed horizontally for two or more accounting periods.

Advantages:

Realistic Approach: This statement not only shows the balances of accounts at different dates but also the extent of their increase and decrease between these different dates.

Tracks Changes: It gives more importance to the changes that are tracked between different dates rather than the figures derived on a particular date.

Shows Trends: It helps in identifying an increasing or decreasing trend over a period of time along with the nature, size and direction of change in various items.

Assists in Planning: It shows an increasing or decreasing trend in the assets, liabilities and capital of the entity over a period of time which helps in designing effective plans for the entity as a whole.

Links Income statement and Balance Sheet: It shows the impact of various business operations on the assets, liabilities and capital of an entity over a period of time.

Comparative Statement Profit and Loss: t is a horizontal analysis of Income Statement which shows the operating results for more than one accounting period so that changes in absolute amounts and percentages from one period to another are known. It will consist of all the items that are present in the normal Income statement like revenue from operations, cost of materials consumed, employee benefit expenses, etc. The methodology or formulae used to compute all these amounts also remains the same.

Objectives:

To analyse every item of income and expense of two or more years.

To analyse the increase or decrease in every item of income and expense in absolute and percentage terms in order to identify the trend.

To determine the reasons for such change and improve the trends accordingly to enhance its performance.

Common Size Financial Statements:

It is a vertical analysis of Financial Statements in which amounts of individual items of Balance Sheet or Statement of Profit or Loss are written. These amounts are further converted into percentages to a common base. These percentages can be compared with the corresponding percentages in other period sand meaningful conclusions can be drawn. Such statements may be prepared for intra-firm and inter-firm comparison. Such statements may be prepared for Balance Sheet as well as Income Statement.

Meaning of Common Size Statement of Profit and Loss:

A Common-size Statement of Profit and Loss may be prepared for different periods of the firm or for the same period of two firms. It shows the relative efficiency in operating the business.

Objectives:

To analyse change in individual items of Income Statement.

To study the trend in different items of Incomes and Expenses.

To assess the efficiency.

Common-Size Balance Sheet:

It shows the percentage relation of each asset/liability to total assets/total liabilities including capital i.e., equity and liabilities. In this statement, total assets or total equity and liabilities are taken as 100 and all the figures are expressed as percentage of the total. If such statement is prepared for different periods, it helps in highlighting the trends in different items. iv. If it is prepared for different firms in an industry, it facilitates to assess the relative financial soundness and helps in understanding their financial strategy.

Objectives

To analyse the changes in individual items of Balance Sheet.

To see the trend of different items of assets, equity and liabilities.

To assess the financial soundness and understand financial strategy.

Trend analysis

Trend Analysis is a statistical technique that tries to determine future movements of a given variable by analyzing historical trends. In other words, it is a method that aims to predict future behaviors by examining past ones. Trend analysis is a technique employed by technical analyst in the financial industry to predict the future movements of a given asset. They employ historical data to determine the direction of the trend. The goal of this procedure is to identify attractive investment opportunities that are currently showing an upward trend; and of course, to identify downtrends too, so investors can get out before losing money.

Perhaps one of the disadvantages of trend analysis is that past behavior is not always consistent in the future, in other words, whatever the price of a given security did in the past is not necessary an indication of what it will do in the future because there are a lot of other significant elements that come into play when it comes to determining the value a financial security.

Fund Flow Statement

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 Preparing a Fund Flow Statement

Explains the Changes in the Financial Position-A fund flow statement discloses the cause of changes in the assets, liabilities and equity between two consecutive years. It shows changes in a company's financial position. Moreover, it identifies the different methods of obtaining and using the funds.

Analysing the Operational Position-A balance sheet shows the financial position of a firm, while a profit and loss statement shows the income statement. However, neither show the operation position of a company. A highly profitable company may not be able to pay off its liabilities due to a shortage of cash. The fund flow statement explains both – reasons for variations in different assets, liabilities, and capital accounts and their impact on the company's liquidity position.

Assists in the Allocation of Resources-The statement provides information regarding the internal and external sources of financing. Also, the purpose of a fund flow statement is to give information on the efficient and effective use of limited resources. Furthermore, it gives the data regarding unbalanced funds. A company may better manage its finances in both the short and long-term using this information.

Evaluate the Financial Position-Internal and external consumers of financial statements require a fund flow statement in order to analyse the firm's strengths and weaknesses. Hence through this statement users can analyse and evaluate the firm's financial situation.

Acts as a Future Guide-Fund flow statements explain the changes in net assets and capital that help the management forecast the fund flow statement. Such forecasted fund flow statements aid in determining the requirement and also identifying alternative financing sources.

Components of a Fund Flow Statement

- **Sources of funds:** It basically shows where the company has gotten the funds from. It can be from the owners or outsiders.
- **Application of funds:** It shows how the company uses the funds, mainly focusing on fixed assets and current assets.

Statement of Changes in Working Capital

Preparing this statement is the first step towards preparing a fund flow statement. In this statement, the company account for changes in working capital. Working capital is the net of current assets and current liabilities and it is calculated by subtracting current liabilities from current assets. Positive working capital is a good sign for any business. This statement shows an increase or decrease in working capital.

- **Increase in working capital:** An increase in the working capital can indicate an increase in current assets or a decrease in current liabilities. For example, extending credit which might shoot up the receivables or paying off short term loans and bills payable, which can reduce the current liabilities.
- **Decrease in working capital:** A decrease in the working capital can be due to a decrease in revenue, or unable to encash accounts receivable, or even mismanagement of inventory.

Statement Showing Funds from Operations

The next step is to estimate the funds from operations. It includes the funds used and generated from operating activities of the business and not from investing and financing activities. Here some adjustments that the company makes to the net profit for the year. They add back non-cash expenses like depreciation and amortisation. They subtract any profit from the sale of investments and fixed assets to arrive at the actual fund generated from operating activities.

Statement of Fund Flow

This is the final step that will calculate the flow of funds. This statement clearly shows the sources and application of funds. The different sources and applications of funds have to be clearly mentioned.

Sources of Funds

- **Issue of shares and debentures:** Only the issue of shares or debentures come under this head. Any bonus issue of convertible debentures do not come here as there is no cash inflow.
- **Long-term loans:** Only long-term loans and borrowings come under this section. This is because the short-term loans are already present in the working capital statement.
- **Sale of fixed assets:** The amount received from the buyer of the fixed assets.
- **Funds from operations:** It is the funds from the operating activities of the business. It is computed in the previous step in the statement showing funds from operations.
- **Decrease in working capital:** This is basically the balancing figure of the fund flow statement and will match the amount in the change in the working capital statement.

Application of Funds

- **Purchase of fixed assets and investments**: Only cash payments made for purchasing assets and investments have to be recorded. Also, purchases made in exchange for shares or debentures should not be recorded as there is no cash outflow.
- **Redemption of debentures and repayment of loans:** Payment made against debentures or loans, including premium and excluding discount, must be considered as the application of funds.
- **Payment of dividends and tax:** Payment of dividends and tax is the application of funds. However, the provisions are excluded from current liabilities and added back to determine funds from operations.

- **Increase in working capital:** This is basically the balancing figure of the fund flow statement and will match with the amount in a change in the working capital statement.

CASH FLOW STATEMENT

Cash flow from operating activities indicates the amount of money a company brings in from its ongoing, regular business activities, such as manufacturing and selling goods or providing a service to customers. It is the first section depicted on a company's cash flow statement. Cash flow from operating activities does not include long-term capital expenditures or investment revenue and expense. Cash flow from operating focuses only on the core business, and is also known as operating cash flow or net cash from operating activities.

Cash Inflows from operating activities

- cash receipts from sale of goods and the rendering of services.
- cash receipts from royalties, fees, commissions and other revenues.

Cash Outflows from operating activities

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

The net position is shown in case of operating cash flows. An enterprise may hold securities and loans for dealing or for trading purposes. In either case they represent Inventory specifically held for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to main activity of that enterprise

Cash from Investing Activities As per AS-3, investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Investing activities relate to purchase and sale of long-term assets or fixed assets such as machinery, furniture, land and building, etc. Transactions related to longterm investment are also investing activities. Separate disclosure of cash flows from investing activities is important because they represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

Cash Outflows from investing activities

- Cash payments to acquire fixed assets including intangibles and capitalised research and development.

- Cash payments to acquire shares, warrants or debt instruments of other enterprises other than the instruments those held for trading purposes.
- Cash advances and loans made to third party (other than advances and loans made by a financial enterprise wherein it is operating activities).

Cash Inflows from Investing Activities

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

Cash from Financing Activities As the name suggests, financing activities relate to long-term funds or capital of an enterprise, e.g., cash proceeds from issue of equity shares, debentures, raising long-term bank loans, repayment of bank loan, etc. As per AS-3, financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in case of a company) and borrowings of the enterprise. Separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of financing activities are:

Cash Inflows from financing activities

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

Cash Outflows from financing activities

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

It is important to mention here that a transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities. Moreover, same activity may be classified differently for different enterprises. For example, purchase of shares is an operating activity for a share brokerage firm while it is investing activity in case of other enterprises.

Provision for income tax

Provision for income tax appearing on the liabilities side of previous year's balance sheet will be treated as payment of tax during the year. Hence it will be deducted while calculating net cash from operating activities.

Provision for income tax appearing on the liabilities side of current year's balance sheet will be added back to profits because 'net profit before taxation' is to be shown under the heading 'Cash flow from operating activities'

Proposed dividend

Proposed dividend appearing on the liabilities side of previous year's balance sheet must have been paid during the year. It will be shown as a payment under the heading 'Cash flow from financing activities'

Proposed dividend appearing on the liabilities side of current year's balance sheet will be added back to profits under the heading of 'Cash flow from operating activities'

Preparation of fixed assets

Fixed assets (on original cost basis)- if the balance sheet contains an item of 'provision for depreciation' or 'accumulated depreciation' for both the years, it means that the fixed assets shown in balance sheet are shown at their original cost. In such cases, fixed assets account and provision for depreciation account should be prepared separately. By preparing 'fixed assets account' the amount of fixed assets purchased or sold during the year will be found out and by preparing 'provision for depreciation account' the amount of depreciation charged during the year will be found out

Fixed asset (on written down value basis)- if the balance sheet does not contain the item of 'provision for depreciation' or 'accumulated depreciation' for both the years, it means that the fixed assets shown in the balance sheet are shown at their written down value and hence fixed assets account will be prepared on written down value basis. In such cases, it should be noted that if the amount of current year's depreciation is given in adjustments, it should be shown on the credit side of asset account.

The balance of asset account will now show a purchase or sale of asset. If the credit side is in excess of the debit side, the amount of difference will be treated as purchase of asset and if the debit side is in excess, the amount of difference will be treated as sale of asset.

Loss or profit on sale fixed asset- if there is a loss on sale of fixed asset, it is put to the credit side of the asset account and if there is a profit on sale of fixed asset, it is put to the debit side of the asset account.

RATIO ANALYSIS

A ratio shows the relationship between two numbers. Accounting ratio shows the relationship between two accounting figures. Ratio analysis is the process of computing and presenting the relationships between the items in the financial statement. It is an important tool of financial analysis, because it helps to study the financial performance and position of a concern. Ratios show strengths and weaknesses of the business.

OBJECTIVES

Inter-company comparison is a technique of comparing the information of other similar concerns for Assessing company's own performance. Reasons for any difference in efficiency can be ascertained with the help of such comparison. Ratio Analysis has been widely used as a tool for analyzing the performance of the company over the years. Trend of the ratios indicates whether the company is moving in the right direction or not. There are certain ratios for which no standard is available to compare the performance with e.g. Gross Profit ratio, operating ratio etc. These ratios can be studied & interpreted only when they compared with the last years' ratios. Such comparison is known as inter-period comparison of the same company.

To show the firm's relative strengths and weaknesses.

To help to analyze the past performance of the firm and to make future projections.

To allow interested parties like shareholders, investors, creditors and the government to analyze and make evaluation of certain aspects of firm's performance.

To concentrate on inter-relationship among the figures appearing in the financial statements.

To provide an easy way to compare present performance with the past.

To depict the areas in which the business is competitively advantageous and disadvantageous.

To determine the financial condition and performance of the firm.

To help to make suitable corrective measures when the financial conditions and financial performance are unfavourable to the firm.

Liquidity ratios- "liquidity" refers to the ability of the firm to meet its current liabilities. The liquidity ratios, therefore, are also called "short term solvency ratios". These ratios are used to assess the short-term financial position of the concern. They indicate the firm's ability to meet is current obligations out of current resources. In the words of Herbert B. Mayo, Liquidity is the ease with which assets may be converted into cash without loss."

Short term creditors of the firm are primarily interested in the liquidity ratios of the firm as they want to know how promptly or readily the firm can meet its current liabilities. If the firm wants to take a short-term loan from the bank, the bankers also study the liquidity ratios of the firm in order to assess the margin between current assets and current liabilities.

Current ratio or working capital ratio- explains the relationship between current assets and current liabilities of a business.

Significance-this ratio is used to asses the firm's ability to meet its short-term liabilities on time. According to principles, a current ratio of 2:1 is supposed to be an ideal ratio. It means that current assets of a business should, at least, be twice of its current liabilities. The higher the ratio, the better it is, because the firm will be able to pay its current liabilities more easily. The reason of assuming 2:1 as the ideal ratio is that the current assets include such as assets as inventory, trade receivables etc., from which full amount cannot be realised in case of need. Hence, even if half the amount is realised from the current assets on time, the firm can still meet its current liabilities in full.

If current ratio is less than 2:1, it indicates lack of liquidity and shortage of working capital. But a much higher, even though it is beneficial to the short-term creditors, is not necessarily good for the company. A much higher ratio than 2:1 may indicate the poor investment policies of the management. A much higher ratio may be considered to be adverse from the viewpoint of management on account of the following reasons-

- A much higher ratio indicates that inventory might be piling up because of poor sales
- Large amount is locked up in trade receivables due to inefficient collection policy
- The cash or bank balances might be lying idle because of no proper investment opportunities are available

Quick ratio or acid test ratio or liquid ratio- indicates whether the firm is in a position to pay its quick liabilities within a month or immediately. Liquid assets means those assets which will yield cash very shortly. All current assets except inventories and prepaid expenses are included in liquid assets. Inventory is excluded from liquid assets because it ahs to be sold before it can be converted into cash. Prepaid expenses too are excluded from the list of liquid assets because they are not expected to be converted into cash.

Significance- an ideal quick ratio is said to be 1:1. If it is more, it is considered to be better. The idea is that for every rupee of current liabilities, there should at least be one rupee of liquid assets. This ratio is better test of short-term financial position of the company than the current ratio, as it considers only those assets which can be easily and readily converted into cash. Inventory is not included in liquid assets as it may take a lot of time before it is converted into cash.

Quick ratio thus is more rigorous test of liquidity than the current ratio and, when used together with current ratio. It gives a better picture of the short-term financial position of the firm.

Solvency ratio- these ratios are calculated to assess the ability of the firm to meet its long-term liabilities as and when they become due. These ratios reveal as to how much amount in a business has been invested by proprietors and how much amount has been raised from outside sources. Solvency ratios disclose the firm’s ability to meet the interest costs regularly and long-term indebtedness at maturity.

Debt-equity ratio- this ratio expresses the relationship between long-term debts and shareholder’s fund. It indicates the proportion of funds which are acquired by long term borrowings in comparison to shareholder’s fund. This ratio is calculated to ascertain the soundness of the long-term financial policies of the firm.

Significance- this ratio is calculated to assess the ability of the firm to meet its long-term liabilities. Generally, debt-equity ratio is 2:1 is considered safe. If the debt-equity is more than that, it shows a rather risky financial position from the long-term point of view, as it indicates that more and more funds invested in the business are provided by long term-lenders. A high debt-equity ratio is a danger-signal for, long term lenders. The lower this ratio, the better it is for long-term lenders because they are more secure in that case. Lower than 2:1 debt equity provides sufficient protection to long term lenders.

Decrease in long term debts decreases the debt equity ratio

Increase in long term debts increases the debt equity ratio
Decrease in shareholder’s fund decreases the debt equity ratio
Increase in shareholder’s fund increases the debt equity ratio

Total assets to debt ratio- this ratio is a variation of the debt equity ratio and gives the same indication as the debt equity ratio. In this ratio, total assets are expressed in relation to long term debts.

Significance- this ratio expresses the relationship between total assets and long-term loans are covered by assets which indicates the margin of safety available to providers of long-term debt. A higher total assets to debt ratio implies reh use of lower debts in financing the assets which means a larger safety of margin for lenders. Low ratio represents risky financial position as it implies the sue of higher debts in financing the assets of the business.

Proprietary ratio- this ratio indicates the proportion of total assets funded by owners or shareholders.

Significance- a higher proprietary ratio is generally treated an indicator of sound financial position from long term point of view, because it means that a large proportion of total assets is provided by equity and hence the firm is less dependent on external sources of finance. A low proprietary ratio is a danger signal for long term lenders as it indicates a lower margin of safety available to them. The lower the ratio, the less secured are the long-term loans and they face the risk of losing their money.

Interest coverage ratio-It is a ratio which deals with the servicing of interest on loan. It is a measure of security of interest payable on long-term debts. It expresses the relationship between profits available for payment of interest and the amount of interest payable.

Significance: It reveals the number of times interest on long-term debts is covered by the profits available for interest. A higher ratio ensures safety of interest on debts.

Activity (or Turnover) Ratio-These ratios indicate the speed at which, activities of the business are being performed. The activity ratios express the number of times assets employed, or, for that matter, any constituent of assets, is turned into sales during an accounting period. Higher turnover ratio means better utilisation of assets and signifies improved efficiency and profitability, and as such are known as efficiency ratios.

Inventory Turnover Ratio-It determines the number of times inventory is converted into revenue from operations during the accounting period under consideration. It expresses the relationship between the cost of revenue from operations and average inventory.

Significance: It studies the frequency of conversion of inventory of finished goods into revenue from operations. It is also a measure of liquidity. It determines how many times inventory is purchased or replaced during a year. Low turnover of inventory may be due to bad buying, obsolete inventory, etc., and is a danger signal. High turnover is good but it must be carefully interpreted as it may be due to buying in small lots or selling quickly at low margin to realise cash. Thus, it throws light on utilisation of inventory of goods.

Trade Receivables Turnover Ratio-It expresses the relationship between credit revenue from operations and trade receivable.

Significance: The liquidity position of the firm depends upon the speed with which trade receivables are realised. This ratio indicates the number of times the receivables are turned over and converted into cash in an accounting period. Higher turnover means speedy collection from trade receivable. This ratio also helps in working out the average collection period. The ratio is calculated by dividing the days or months in a year by trade receivables turnover ratio.

Trade Payable Turnover Ratio-Trade payables turnover ratio indicates the pattern of payment of trade payable. As trade payable arise on account of credit purchases, it expresses relationship between credit purchases and trade payable.

Significance: It reveals average payment period. Lower ratio means credit allowed by the supplier is for a long period or it may reflect delayed payment to suppliers which is not a very good policy as it may affect the reputation of the business. The average period of payment can be worked out by days/ months in a year by the Trade Payable Turnover Ratio.

Profitability Ratios-The profitability or financial performance is mainly summarised in the statement of profit and loss. Profitability ratios are calculated to analyse the earning capacity of the business which is the outcome of utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilised.

Gross Profit Ratio-Gross profit ratio as a percentage of revenue from operations is computed to have an idea about gross margin.

Significance: It indicates gross margin on products sold. It also indicates the margin available to cover operating expenses, non-operating expenses, etc. Change in gross profit ratio may be due to change in selling price or cost of revenue from operations or a combination of both. A low ratio may indicate unfavourable purchase and sales policy. Higher gross profit ratio is always a good sign.

Operating Ratio-It is computed to analyse cost of operation in relation to revenue from operations Operating expenses include office expenses, administrative expenses, selling expenses, distribution expenses, depreciation and employee benefit expenses etc. Cost of operation is determined by excluding non-operating incomes and expenses such as loss on sale of assets, interest paid, dividend received, loss by fire, speculation gain and so on

Operating Profit Ratio-It is calculated to reveal operating margin. It may be computed directly or as a residual of operating ratio.

Significance: Operating ratio is computed to express cost of operations excluding financial charges in relation to revenue from operations. A corollary of it is ‘Operating Profit Ratio’. It helps to analyse the performance of business and throws light on the operational efficiency of the business. It is very useful for inter-firm as well as intra-firm comparisons. Lower operating ratio is a very healthy sign.

Net Profit Ratio-Net profit ratio is based on all inclusive concept of profit. It relates revenue from operations to net profit after operational as well as non-operational expenses and incomes. Significance: It is a measure of net profit margin in relation to revenue from operations. Besides revealing profitability, it is the main variable in computation of Return on

Investment. It reflects the overall efficiency of the business, assumes great significance from the point of view of investors.

Return on Capital Employed or Investment-It explains the overall utilisation of funds by a business enterprise. Capital employed means the long-term funds employed in the business and includes shareholders' funds, debentures and long-term loans. Alternatively, capital employed may be taken as the total of non-current assets and working capital. Profit refers to the Profit Before Interest and Tax (PBIT) for computation of this ratio.

Significance: It measures return on capital employed in the business. It reveals the efficiency of the business in utilisation of funds entrusted to it by shareholders, debenture-holders and long-term loans. For inter-firm comparison, return on capital employed funds is considered a good measure of profitability. It also Accounting Ratios helps in assessing whether the firm is earning a higher return on capital employed as compared to the interest rate paid

Return on Shareholders' Funds-This ratio is very important from shareholders' point of view in assessing whether their investment in the firm generates a reasonable return or not. It should be higher than the return on investment otherwise it would imply that company's funds have not been employed profitably. A better measure of profitability from shareholders point of view is obtained by determining return on total shareholders' funds, it is also termed as Return on Net Worth (RONW)

Earnings per Share-This ratio is very important from equity shareholders point of view and also for the share price in the stock market. This also helps comparison with other to ascertain its reasonableness and capacity to pay dividend.

MODULE-IV

Financial shenanigans are actions taken by companies to misrepresent their financial performance. These actions by managements mislead the users, some of them being investors, government authorities, banks and credit rating agencies about the true economic health of the company.

Financial Shenanigans includes aggressive or creative accounting, window dressing and accounting frauds with an intent to create a wrong impression about the financial performance and health of the enterprise. Dishonest companies have often used these tricks to attract investors. The lure of these techniques is often strong with companies which are not able to meet stakeholders expectation or are not able to compete effectively in the market. Financial shenanigans can range from relatively insignificant breaches involving creative interpretation of accounting rules/policies to absolute scam over several years. Although, financial shenanigans are used to present a healthy picture of financial performance of a company but it may lead to consequences like fall in stock price, bad reputation, bankruptcy, imprisonment of senior management personnel, dissolution of the company etc.

Financial shenanigans can be used both ways

a. To overstate revenues and profits with the purpose of increasing EPS and having positive impact on stock prices

b. To understate revenue and profits to smoothen the profits over a span of years or to evade taxes.

Key Drives for Financial Shennaigans :- A number of companies use window dressing of their financial statements to hide the correct picture of their financial performance .Although, there can be multiple factors which prompt companies to go for financial shenanigans, the most common motivational factors are

Cover up company’s declining financial performance- If the company is facing a declining profitability and financial condition, the management may be prompted to use techniques to misrepresent the profits and /or financial condition

Avoid taxes- One of the common reasons that companies go for financial shenanigans is to reduce their tax liability. It may include use of an accounting policy which may help the management in reducing the company’s tax liability

Raising funds through banks-If a company plans to take a large loan from the bank and it’s financial condition is not pretty good. It may resort to falsify its financial performance to become eligible for getting funds from the bank.

Satisfy the earning anticipations of shareholders/general public- In case of listed companies results are shared on a quarterly basis with different stakeholders with focus on expected future earnings. This may lead to creation of market expectation for the future performance of the company and then management may manipulate the results to meet those expectation in order to maintain their reputation in the market.

When compensation is linked to performance-Sometimes, managerial self-interest becomes a motivation for use of aggressive accounting practices. Particularly in cases where the senior management people hold a significant number of ESOP , they may be tempted to falsify financial statements to improve stock price which will improve their personal wealth.

Techniques for Financial Shenanigans

Although, companies have number of ways to window dress or falsify their financial statements if they so desire.

Improper or premature revenue recognition-It may include i. Recording revenue in excess of the work done ii. Recording revenue when the payments is not certain iii. Recording revenue without delivery/acceptance of goods by buyer iv. Recording bogus revenue by raising false invoices

Channel Stuffing-Channel stuffing is shipment of goods to dealers/wholesalers in excess of honest demand from the end users by extending rewarding incentives. It is the name given to dishonest business practice used by a company to inflate its sales and earnings figures by deliberately sending more material in its distribution channel than they are able to sell. The channel partners are given the freedom to later on return the goods. Thus , by using this technique companies can achieve higher deceptive sales in a particular period. This technique is often used at year end by the corporates.

Shifting financing cash inflows to operating sections- It is a technique used to deceive the investor by showing Financing cash inflows in operating section of CFS. This way the company reports a good cash flow from operation to attract investors. Sales versus Commission- An enterprise may be engaged in the business of trading in goods for other entities. In such a transaction the enterprise should record only commission as it's revenue. But, in order to boost their top line/revenue some companies may record purchase price plus commission as their sales revenue. Although, it will not impact the net income as the company will also show purchase price in it's cost of goods sold. However, this financial shenanigan has the effect of enhancing the top line Boosting income using one time or unsustainable activities- It may include a. Selling undervalued assets for a profit b. Selling investments for a gain and recording it as revenue, or using it to reduce current operating expenses

Reclassifying certain balance sheet accounts to create income for eg one time customer advance of huge amount is recorded as revenue, One time loan taken is recorded as revenue Shifting current expenses to a later period- In order to increase revenue for a particular period , company may shift it's current expenses to future period via Prepaid expenses. Backdating of transactions- In order to increase revenue to meet the targets, an enterprise may keep its accounts open for an extended period of time. Sales of subsequent period may then be backdated and included in previous accounting period. For eg, the accounts for the year ended 31st March 2012 may be kept open till 20th April 2012. Any sales order received till 20th April 2012 may be backdated and recognized as revenue for the year ended 31st March 2012.

Using aggressive accounting policies- Some of these can be i. Lengthening asset lives so that depreciation charge is reduced and profits can be increased ii. Using straight line depreciation method so that there is lower depreciation expenses in earlier periods iii. Choosing FIFO against LIFO in period of rising prices so that COGS is lower and profits are on higher side

Capitalisation of operating cost of expenses Income Smoothening/Cookie Jar Accounting- It is the practice of income smoothening by creating reserves during good periods and utilizing the same during not so goods period. This is based on assumption that companies reporting smooth profits are viewed to be less risky by the investors than the companies with unstable profits. For eg, a company with quarterly profits of Rs 4000 million, Rs 1200 million, Rs 3500 million and Rs 1800 million will be considered volatile compared to another company with quarterly profits of Rs 2800 million, 2600 million, 2700 million and 2400 million. In both the cases , total absolute profits are same. But second income stream is more stable and this company will enjoy better valuations in market. Improper Classification An enterprise may use improper classification of incomes, expenses, assets and liabilities. For example extra ordinary incomes may be clubbed with operating incomes to create a wrong impression about revenue growth of the company.