

UNIT - I

GUIDELINE 1: FINANCIAL ACCOUNTING: AN OVERVIEW

1.1 INTRODUCTION:

The role of accounting has been changing with the economic and social developments. The traditional view of accounting as a historical description of financial activities is no longer acceptable. Over a period of time new dimensions have been added to the discipline of accounting. Accounting has developed to meet challenges and requirements of growing society. Present -day accounting is a social system. It has developed by adapting to environment. Accounting is often called the language of business. As the function of any language is to serve as a means of communication of business information. Through the system of accounting was developed first in Italy it was England and Ireland that it grew to its full stature. Further large scale production, cut -throat competition. Widening of the market and changes in the technology have brought remarkable changing in the field of accounting.

Prior to 19th century, book-keeping system was popular and adequate to meet the requirements of a business. During 19th century there has been enormous expansion in the business activity-business organization have grown in size, concept of corporate sector has emerged investments started coming from various places-inside and outside the country. There has been diversity between owners and the management. To meet all the challenges book-keeping has been transformed into double entry book-keeping which not only performed the recording function but also dealt with measurement and reporting the results of business organizations. During 20th century, the quality of life of the people had improved a lot and the informational need of the people have also changed significantly. This has necessitated the measurement and communication of adequate, understandable and dependable financial information to the interested parties-internal and external. To meet this requirement several branches of accounting namely Management Accounting, Cost Accounting, Government Accounting, Social Accounting, Inflation Accounting, Human Resource Accounting and Environment Accounting etc., have emerged.

1.2 MEANING OF ACCOUNTING

The Committee on Terminology of the American Institute of Certified Public Accounts (AICP) defined accounting as "the art of recording, classifying and summarizing in a significant manner, and in terms of money transactions and events which are, in part at least, of a financial character, and interpreting the results thereof".

The American Accounting Association (AAA) defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information".

The AICPA defined accounting as "a service activity. Its function is to provide quantitative information, primarily financial in nature, and about economic activities that is intended to be useful in making economic decisions".

Smith and Ashburn defined accounting as "the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretation of those transactions and events and communicating the results to persons who must make decisions or form judgements".

Eric.L. Kohlen defined accounting as "the procedure of analyzing, classifying and recording transactions in accordance with a pre-conceived plan for the benefit of (a) providing a mean by which an enterprise can be conducted in orderly fashion and (b) establishing basis for reporting the financial condition of enterprise and the results of its operations".

From the above definitions, the following characteristics of accounting emerge:

1. Events and transactions of Business
2. Accounting is the art of recording business transactions
3. The business events and transactions are essentially in monetary terms
4. Accounting is the art of classifying business transactions.
5. Accounting is the art of summarizing financial transactions
6. Account is an art of analysis and interpretation of business transactions
7. The results of such analysis must be communicated to the persons who are to make decisions of form judgements

1.3 Need for Accounting

Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting serves this function. It communicates the result of business operations to various parties who have some stake in the business viz the proprietor, creditors, investors, government and other agencies. Accounting is primarily concerned with business entities although non-business entities such as schools, colleges, hospitals and other agencies also make enough use of accounting for keeping records of their money or financial transactions. A business who has invested his capital in a business enterprises would like to know whether enterprises is making profit or incurring losses: what is the position of assets and the liabilities as on a given data, he would also like to know whether his capital in the business has increased or decreased and so on. A business enterprise of even small and medium size deals with many transactions, many customers many employees and many suppliers.

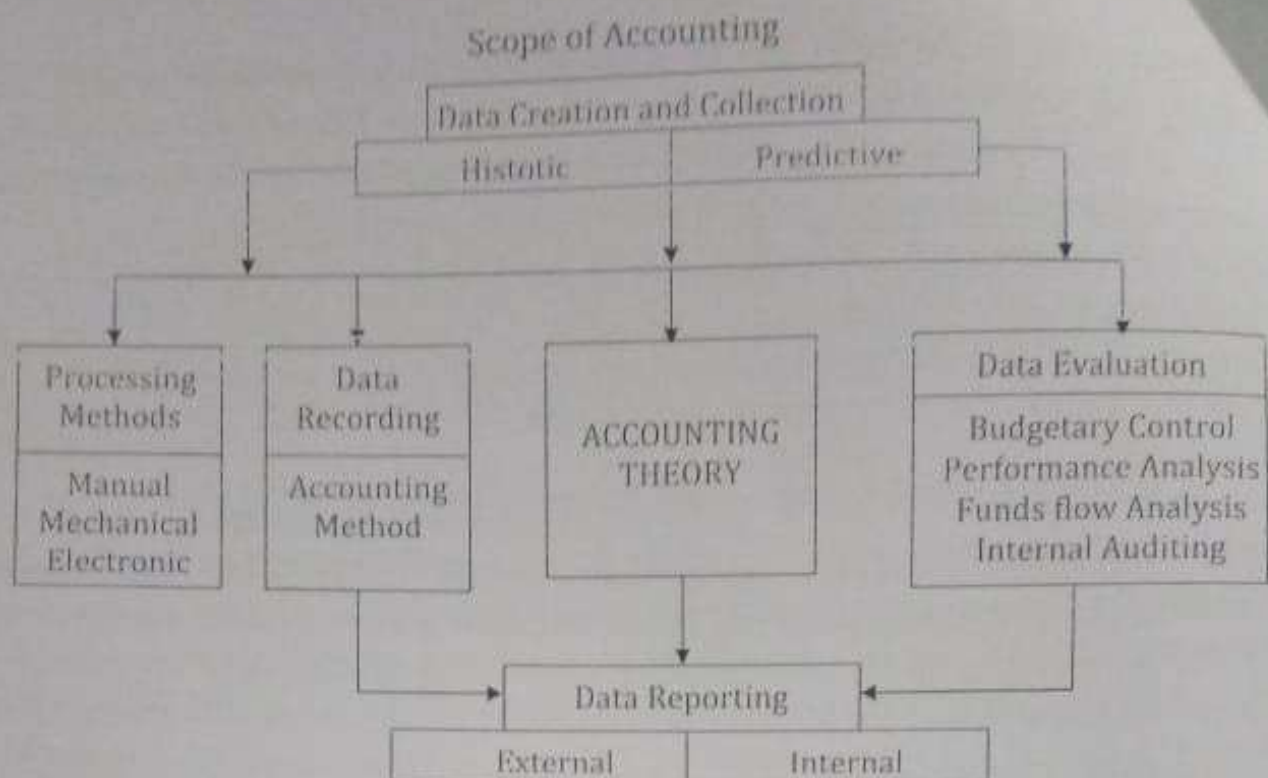
With the results that it has to record thousands of transactions every year. It is impossible to remember all the transactions in mind. Hence there is a need for a systematic and timely recording of numerous business transactions in order to get the necessary information in respect of profits, losses, assets, liabilities and capital of the business enterprise. Accounting plays an important role in achieving this purpose because it records the business transactions in an orderly manner, and to group and arrange them in the form of easily understandable financial statements-profit and loss account balance sheet and cash flow statement.

Further the need for accounting arises due to the following reasons:

1. **Internal Control:** As the size of the business grows, it becomes necessary to employ outsiders to assist in the business. Since outsiders are involved, it is necessary to have proper counting for the purpose of control.
2. **Accountability for Moneys Invested:** The proprietor in addition to his capital, may need additional funds from outsiders. These funds have to be properly accounted for. Thus the need arises in accounting to give information about the sources from which the funds are obtained and how these are used.
3. **Impersonal Nature of Business Enterprises:** In case of impersonal organizations like companies and other corporate bodies, management is different from ownership. The owners-share holders who have actually invested their money in the company will not take part in the management. On their behalf the elected representative Board of Directors Manage the company. Hence, the need for recording all financial all financial transactions.
4. **Various types of information:** The business requires various types of information for both external and internal use. For example, business information is required for filling income tax, sale tax and other tax returns. A systematic accounting record is a must for getting this information.
5. **Prevention of Manipulations or Frauds:** If proper records are maintained in the business enterprise, there is minimum scope for manipulation and frauds.

1.4 SCOPE OF ACCOUNTING

Any business is a bundle of transactions. These transactions are to be identified, measured, classified, recorded, summarized, analysed, interpreted and communicated to an important wing of management information system. It helps the management in planning, controlling and evaluating its activities. The accounting information act as basis for decision making. The scope of accounting is presented in a diagrammatic form.



Source: Adopted from R.J Bull, Accounting in Business, Butter Worths, London, 1969P2

Data Creation and Collection

The business transactions provide the raw material for accounting, the data collected is historic, in the sense that it refers to events which have already taken place. Thus accounting is concerned with what had happened. It does not make an attempt to predict and prepare for the future.

Data Recording

After the collections of historic data, they are recorded in appropriate books of accounts in accordance with generally accepted accounting theory. A large numbers of business transactions have to be entered in the books of original entry (Journals) and ledgers in accordance with the classification scheme already decide upon.

Data Processing

After the transactions have been recorded in the books of accounts, the data is to be processed. For this purpose, manual, mechanical and electronic methods may be adopted.

Data Evaluation

Evaluation of data includes controlling the activities of business with the help of budgets and standard costs (Budgetary Control). Evaluating the performance of business, analyzing the flow of funds and analyzing the accounting information for decision making purposes by choosing among alternative courses of action. The

analytical and interpretive work of accounting may be internal or external and may range from simple answers to elaborate reports produced by extensive research. Capital project analysis, financial forecast, budgetary projections and analysis for reorganization, takeover, mergers often lead to research based reports.

Data Reporting

Data reporting is done in two ways external and internal.

External reporting refers to the communication of financial information about the business to outside parties-share holders, government agencies and regulatory bodies.

Internal reporting is concerned with the communication of results of financial analysis and evaluation to management for decision making purpose.

1.5 OBJECTIVES OF ACCOUNTING

Accounting is an information system basically designed to cater to the informational needs of both external and internal parties. Information to external parties is provided through external reporting known as annual reporting. Internal reporting is meant for providing information to the managers working within the organization at various levels for taking business decisions.

From the above discussion, the objectives of accounting can be stated as follows:

1. **Maintenance of Systematic Records:** Accounting is done to keep a systematic record of financial transactions. This is done in accordance with the universally accepted accounting concepts and conventions. Such as classified data certainly helps the users of accounting information in arriving at reliable decisions.
2. **Accepting the Operational Performance:** We know that the primary objectives of business is to make profit and a businessman is very much interested in knowing the profitability position. A proper record of incomes and expenses facilitate the preparation of income statement. It reveals the operational efficiency of the business concern in terms of profit earned or loss suffered during the period under consideration.
3. **To Ascertain the Financial Position:** The business is not only interested in knowing the operational performance, but also interested in knowing the financial position of his business i.e., where it stands. In other words, he wants to know what the business owes to others and what it owns, and what happened to his capital whether the capital has increased, decreased or remained constant. A systematic record of various assets and liabilities facilitates the preparation of a statement known as balance sheet. Which answers all the above questions.
4. **To Provide Accounting Information for Rational Decision Making:** Various parties are interested in knowing the financial position of the business firm, such as the government,

the management, the bank, the creditors, the tax authorities, employees, consumers. For this purpose the accounting has to provide the required information. This kind of information enables the users to access the financial strengths and weakness of the business and taking rational decisions concerning the appraisal of various proposals.

5. **Protecting Business Properties:** Every transaction is recorded systematically. The information in respect of assets and properties owned by the enterprise is also recorded and maintained properly. As such it checks the unauthorized use of business properties for personal use.

Accounting provides protection to business properties from unjustified and unwanted use.

1.6 ROLE OF CORPORATE ACCOUNTANT:

The purpose of accounting is to provide financial information about an economic entity. The financial information provided by an accounting system is needed by decision makers so as to help them in planning monitoring and evaluating the activities of the economic entity. Therefore, the main functions of accountant are 1. Managerial Function and 2. Historical Function.

1. **Managerial Function**

Providing information to the management for planning, monitoring and evaluating the operations and to make decisions.

2. **Historical Function**

Recording of data, classification of data, summarizing the data, of financial nature, analysis and interpretation of financial statements, validating the data, communication and reporting the financial history of an organization to the interested parties.

A brief description of the above functions are described below.

1. **Recording:** This is the basic function of accounting. In a business organization everyday a number of transactions take place. Owing to the complexities of business events it is necessary to record them in journal and other subsidiary books in a classified manner. Thus the accounting system supplements human memory and facilitates the interested parties to make use of the accounting information in an effective manner.
2. **Classifying:** Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classification is done in the book termed as "Ledger" A Ledger contain different types of accounts namely personal accounts, Real accounts and Nominal accounts.

3. **Summarizing:** From the recorded and classified data, summary reports like income statements, balance sheet, cash flow statement are prepared. They are easy to understand and useful to the internal as well as external end – users.
4. **Deals with Financial Transactions:** Accounting records only those transactions and events in terms of money which are of a financial character. Transactions which are not of a financial character are not recorded in the books of account. Therefore, anything which cannot be expressed in monetary terms, does not form part of financial accounting even though it has a significant bearing on the working of the business.
5. **Analysis and interpretation of Financial Statements:** This is the final function of accounting. The data contained in the financial statements is to be analysed and interpreted in a suitable manner that the end users can make a meaningful judgement about the financial condition and profitability of the business. Analysis involves the segregation of data into various components and establishing relationship among them. On the other hand interpretation means explaining the meaning & significance finally drawing inferences regarding the phenomenon under consideration. Analysis and interpretation of data is important for decision making. However, it is said both 'Analysis' and Interpretation are complementary to each other. Interpretation requires Analysis, while Analysis is useless without interpretation.
6. **Communicating the Results:** More recording, classifying, and summarizing the business transactions is not enough but the analysed and interpreted data are to be communicated to the users. This is done through preparation and distribution of accounting reports which include besides the usual income statement and the balance sheet, additional information in the form of accounting ratios, graphics, diagrams, funds flow statements etc., communication should be done at regular intervals. Communication of the results helps the people understand the profitability and financial position of the firm.
7. **Validating the data:** The accountant has an obligation to supply, reliable, adequate, relevant timely and useful data to the interested parties.

1.7 ADVANTAGES OF ACCOUNTING

A number of advantages can be derived if a proper system of accounting is followed. These advantages are:

1. **Assistance to Management:** The accounting information helps the management to plan its future activities by preparing budgets in respect of sales, production, expenses, cash etc. Accounting helps in coordination of

various activities in different departments by providing financial details of each department.

2. **Records rather than memory:** it is not possible at all to do any business by just remembering the business transactions which have grown in size and complexity. Transactions therefore, must be recorded early in the books of accounts so that necessary information about them is available in time and free from bias.
3. **Operational Efficiency:** It can be easily known how much profit the concern has earned or how much loss it has incurred in a particular year. In addition to the operational efficiency, the financial position of an organization can also be known.
4. **Historical Record:** as all the financial transactions and events are recorded in the books at actual cost. Hence, they serve as historical records.
5. **Intra-period Comparisons:** Accounting information when recorded properly can be used to compare the results of one year with those of previous years.
6. **Aid in Legal Matters:** Systematically recorded accounting information can be produced as an evidence in a court of law.
7. **Help in Taxation Matters:** Income Tax and Sales Tax authorities could be convinced about the taxable income, sales as the case maybe, with the help of accounting statements.
8. **Sales of Business:** In case, a sole trader, or a partnership firm or even a company wants to sell business, the accounting information can be utilised to determine proper purchase price.

1.8 LIMITATIONS OF FINANCIAL ACCOUNTING

The nature of information shown by the financial accounts and the way in which they are reported may give the impression that the financial accounts are precise, exact and final. But they suffer from serious limitations. They are:

- i. **Accounting information is expressed in terms of money:** Non-monetary transactions, however, important they may be are completely omitted. As such the information supplied by financial accounting is not complete and does not portray true and fair view of the business.
- ii. **Historic Data:** Financial statements contain past data and the use of such data amounts to postmortem analysis. Financial account gives information about what has happened and not about what will happen. As such the decisions based on this information pertaining to future cannot be realistic.
- iii. **Aggregate Data:** In financial accounting the information is recorded for the whole concern. It does not provide information in respect of individual items.

For effective decision making information about individual products, processes, departments, activities etc., is needed.

- iv. **Subjectivity:** Recording of transactions is based on certain generally accepted accounting principles but there exists more than one principle for the treatment of certain items. In respect of depreciation, inventory valuation etc., Further the personal bias of the accountant affects the accounting statements and thus permits the alternative treatments. Thus the possibility of alternative treatments makes the results different and incomparable.
- v. **In accurate Estimates:** Accounting information sometimes based on estimates is often inaccurate. For example, it is not possible to predict with any degree of accuracy the actual useful life of a fixed asset for the purpose of depreciation of affixed asset for the purpose of depreciation.
- vi. **Price Fixation:** The price of a product is determined on the basis of total cost of the product. But the total cost of the product can be ascertained only after all the expenses are incurred.
In financial accounting there is no provision in forecasting the expenses in advance. Therefore financial accounting there is not helpful for preparing price quotations. Further price taxation requires information regarding variable and fixed costs. However, in financial accounting records are not maintained to furnish any such defaults.
- vii. **Cost control:** In financial accounting aggregation of costs of possible only at the end of accounting period. As such the data provided by financial accounting will not help controlling the costs. Any such effort will result in postmortem analysis as the costs are already incurred. It does not help fixing up responsibility for incurring higher costs. Cost control requires a constant review of actual costs from time to time which is not possible in financial accounting.
- viii. **Price Level Changes:** Fixed assets are recorded in the financial accounting records at the original cost. But the prices of fixed assets vary from time to time on account of changes in price levels. The direct results of this practice is that balance sheet does not portray the true financial position of the business.
- ix. **Appraisal of polices:** It does not facilitate the comparison of actual performance with the desired performance. Hence accurate appraisal of projects is not possible.
- x. **Strategic Decision:** Business management has to take certain strategic decision in respect of replacement of labour by machinery, introduction of a new product, discontinuation of an existing of an existing line of production, expansion of capacity etc.

For taking these decisions cost benefit analysis will have to be carried out considering their future implications. Financial Accounting does not provide any such information.

- xi. **Technical Subject:** Financial Accounting is a technical subject. Financial accounting is governed by the Generally Accepted Accounting principles. As such the persons who are not conversant with accounting subject cannot effectively use the data for decision making purpose.

In view of the limitations mentioned above one must be very careful while using the accounting information. One should not just depend on the statements of a single year. But statements of a number of years are to be studied systematically.

GUIDELINE 2: ANALYSIS OF FINANCIAL STATEMENTS

2.1 INTRODUCTION

Financial statements are end products of business transactions. They are prepared following the consistent accounting concepts, principles, procedures and also the legal environment in which the business organization operates. These statements are the outcome of the summarising process of accounting and are therefore the source of information on the basis of which conclusions are drawn about the profitability and the financial position of a business enterprise. Hence financial statements are to be arranged in proper form in their economic decision in a meaningful way.

As we all know the primary objectives of any business is to earn profit. The finances of a firm obtained from its owners are invested in assets. The assets are used to generate sales and thus to earn profits. The quantum of profits ultimately depends upon the efficiency with which the assets of the firm are managed. Therefore, the management is interested in analyzing the factors contributing to the state of affairs either good or bad. Having understood the factors, we should learn the meaning, nature, objectives of financial statements, types, their forms and contents, use and limitations. This unit further helps the students to equip themselves with the basic requirements for understanding financial statements and subsequently analyzing the financial statements and preparing necessary reports for the specific decision making purpose of the various levels of management.

2.2 MEANING AND NATURE OF FINANCIAL STATEMENTS

A financial statement is an organized collection of data according to the logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a business firm. It may show a position at a moment of time as in the case of balance sheet, or may reveal a series of activities over a given period of time as in the case of profit and loss account.

Thus, the term financial statements generally refers to two basic statements: i) the Profit and Loss Account or the Income Statement and ii) the balance sheet or the position statement. Of course, a business may also prepare a) statement of retained earnings and b) statement of changes in financial position in addition to the above two statements.

These statements are the basic and formal means through which the corporate management communicates financial information to various users. They are primarily directed towards the needs of owners and incidentally to the needs of external parties, which includes investors, tax authorities, government, employees etc.

Smith and Osborne

"The end product of financial accounting is a set of financial statements prepared by the accountants of a business enterprise that purport to reveal the financial position of the enterprise, the result of its recent activities and an analysis of what has been done with earnings".

Anthony

"Financial statements, are essentially, are interim reports presented annually and reflects a division of the life of an enterprise into more or less arbitrary accounting period more frequently a year".

2.3 FEATURES OF FINANCIAL STATEMENTS

Various definitions given above reveal the following features:

- i. **Intended Users:** The financial statements are prepared intending towards those users who have interest in the business enterprise. These statements are prepared with an assumption that the users are familiar with the business practices and the meaning and implications of the terms used in the business.
- ii. **Report History:** Financial statements are prepared on the basis of past financial transactions of a concern during specified period and generally report what has happened in the past. However, these statements provide basis for the future of the prospective investors and creditors in the form of estimates of future activities and its effect on income and on the equity of the investors.
- iii. **Legal and Economic Consequences:** Since financial statements reflect the elements of economics and law, they are conceptually oriented towards economy but many of the concepts have the origin in law. For example, convention of disclosure and convention of materiality.

- iv. **Use Specific Terminology:** Financial statements are end product of accounting process. In this process, specific terminology assigned with distinct meanings is used, which indicate the users to be conversant with it so as to understand the interpretation.
- v. **Financial statements are interrelated:** The basic financial statements viz., the balance sheet and profit and loss account are interrelated. The profit and loss account shows the financial results of the business operations, which ultimately reflect in various balances in the balance sheet.
- vi. **Presents Summarised and Classified Data:** The volumes of business transactions convey no meaning unless they are classified and summarized. Financial statements help in classification and summarisation of the business data.
- vii. **Expressed in Money Units:** All the business transactions and events are quantified, measured and expressed in monetary units such as rupees, dollars etc., non-monetary items find no place in financial statements.
- viii. **Uses different Methods of Valuation:** Different methods are used for valuation of assets. For example, inventories are valued at cost or market value, whichever is lower. Fixed assets are valued at cost less depreciation. Cash-in-hand and bank balances are valued at current exchange value.
- ix. **Follow Accrual Basis of Accounting:** Most of the financial statements are prepared on accrual basis rather than on cash basis. It takes into consideration all incomes due but not received and all expenses due but not paid.
- x. **Amenable for Verification:**

The facts of the data presented through financial statements are amenable to objective verification and hence these statements are verifiable which improves its reliability.

2.4 OBJECTIVES OF FINANCIAL STATEMENTS

Financial statements are the sources of information to the users-internal and external for understanding the profitability and financial position of any concern. The primary objectives of financial statements is to assist the users in their economic decision making. The Accounting Principles Board of America (APBA) states the following objectives of financial statements.

- i. To provide reliable financial information about economic resources and obligations of a business firm.
- ii. To provide other needed information about changes in such economic resources and obligations.
- iii. To provide reliable information about changes in net resources arising out of

- iv. To provide useful financial information, which can gainfully be utilized to predict, compare, evaluate the business firms earning capacity.
- v. To disclose to the extent possible, other information related to the financial statements that is relevant to the needs of users of these statements.

2.5 FINANCIAL STATEMENT ANALYSIS

In the proceeding paragraphs you are exposed to financial statements in greater detail regarding their meaning, objectives, importance and limitations. It was mentioned that, financial statements provide, for the reader, an understanding of some financial aspects of a firm and also reveal the operating results over a given period of time. The above said functions delivered by financial statements one can unravel much more important aspects like financial strength and weakness of a firm. In the following pages the meaning, types, uses and techniques of financial analysis are discussed.

2.6 MEANING AND CONCEPT OF FINANCIAL ANALYSIS:

Financial statements, as discussed earlier are prepared primarily for decision making. They play a dominant role in setting the framework of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from this statement alone. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretations of financial statements. Financial analysis is the process of identifying the financial strength and weakness of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account. There are various methods or techniques used in analyzing financial statements such as comparative statements, trend analysis, Common-size statements, schedule of changes in working capital, funds flow and cash flow analysis, cost-volume profit analysis and Ratio analysis.

Analyzing financial statements according to Metcalf and Titard "is a process of evaluating relationship between component parts of financial statements to obtain a better understanding of firm's position and performance". In the words of Myer, Financial statements analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trend of these factors as shown in a series of statements.

The analysis of financial statements thus, refers to the treatment of the information contained in the financial statements in a way so as to afford a full diagnosis of the profitability and financial position of the firm concerned. For this purpose financial statements are classified methodically, analysed and compared with the figures of previous years of other similar firms.

2.7 MEANING OF INTERPRETATION

Analysis and interpretation are closely related, interpretation is not possible without analysis and without interpretation analysis has no value. "To interpret means to put the meaning of statement in simple terms of the benefit of a person". Thus defines F. Wood in his work 'Business accounting' vol. II. In any case, Interpretation is a wider term and includes criticism examination and analysis. Thus interpretation may be defined as critical examination of some financial transactions effected during a definite period of time. In the words of Kennedy and Muller, "Analysis and Interpretation of financial statements are an attempt to determine to significance and meaning of the Financial Statements data, so that forecast maybe made of the prospects for future earnings, ability to pay intent and debit maturity, and profitability of sound dividend policy.

It is only by interpreting the balance sheet and the profit and loss account, we make the figures appearing there at to tell the story of actual progress and financial position of a business concerned in a clear and simple language easily understood even by the layman. Interpretation of financial statements is really an art it involves many process like arrangement, analysis, establishing relationship between available facts and drawing conclusion on that basis. It has become a very interesting and significant function of management accounting. It broadly includes the following.

i) Criticism, ii) Analysis, iii) Comparison, iv) Study of Trend, v) Drawing Conclusion.

The term financial statement analysis includes both analysis and interpretation. The term analysis means simplification of financial data, by methodical classification given in the financial statements. Interpretation means explaining the meaning and significance of the data so simplified. However, both analysis and interpretation are interlinked and complementary to each other as mentioned earlier. Analysis is useless without interpretation without analysis only to cover the meanings of both analysis and interpretation since analysis involves interpretation.

TYPES OF FINANCIAL ANALYSIS

We have already learnt that various users of financial statements study them from different angles, for different purposes. However, we can classify various types of financial analysis into different categories depending upon the a) material used b) the object of the analysis and c) internal analysis. These are explained one by one.

On the basis of Material Used

According to this, financial analysis cab be of two types. i) external analysis, ii) internal analysis

- i. **External Analysis:** This is done by outsiders who do not have access to the detailed internal accounting records o the business firm. These outsiders include, Investors, Creditors, government agencies and the general public

- ii. **Internal Analysis:** The internal analysis is made by those persons who have access to the books of accounts. They are the members of the organization - executives, employees, officers appointed for this purpose by the government or the court. The internal analyst can give more reliable result than the external analyst because every type of information is at his disposal.

On the basis objectives

On the basis the analysis can be i) long-term and ii) short term analysis.

- i. **Long term analysis:** this analysis is made in order to study long-term financial stability, solvency and liquidity as well as profitability and earning capacity of a business concern - this type of analysis helps the long-term financial planning which is essential for the continued success of a business.
- ii. **Short term analysis:** this is made to determine the short term solvency, stability and liquidity as well as earning capacity of the business. The purpose of this analysis is to know whether in the short term a business concern will have adequate funds readily available to meet its short term requirements and sufficient borrowing capacity to meet contingencies in the near future.

On the basis of Modus operandi of the analysis

On this basis, the analysis may be i) Horizontal analysis and ii) Vertical analysis

Horizontal analysis: it is also known as 'dynamic analysis' or trend analysis. When the analysis of financial statement of the firm is made for two or more years it is called horizontal analysis. Since the data for more than one year is used. It is possible to compare the performance of the company during a year with that of the previous year. This helps to identify the trend in various indicators of performance such as profitability, solvency liquidity etc., over the year

Vertical Analysis: It is also known as 'static analysis' or 'structural analysis'. When the analysis of financial statements of an organization is made for only one accounting period, it is called as vertical analysis. For instance analyzing and interpreting the performance of a company for the year 2006 with the help of profit and loss account of that company for the year ending 31st December 2006 and balance sheet of that company as on that date. Under this analysis quantitative relationship is established between different items shown in a particular statement (P/L a/c and B/S). Common size statements are the form of vertical analysis.

PROCEDURE FOR ANALYSIS AND INTERPRETATION:

Broadly speaking there are steps involved in the analysis of financial statements. These are a) selection b) classification and c) Interpretation. The first step involved selection of information (data) relevant to the purpose of analysis of

financial statements. The second step involved is the methodical classification of data and the third step includes drawing of inferences and conclusions.

The following preliminaries are required to be completed for making analysis and interpretation of financial statements.

- i. The objective and extent of analysis and interpretation should be determined. The analyst should acquaint himself with the principles and postulates of accounting. He should know the plans and policies of the management so that he may be able to find out whether these plans are properly executed or not.
- ii. The financial data given in the statements should be re-organised and re-arranged. It will involve the grouping of similar data under same heads, breaking down of individual components of statement according to nature.
- iii. A relationship is established among financial statement, with the help of tools and techniques of analysis such as ratios, trends, common-size, funds flow etc.
- iv. The information is interpreted in a simple and understandable way. The significance and utility of financial data is explained for helping decision taking.
- v. The conclusion drawn from interpretation are presented to the management in the form of reports.

OBJECTIVES OF ANALYSIS AND INTERPRETATION:

Every users of financial statement has a distinct object for which he attempts to analyse and interpret. In spite of the variation in the objective of interpretation by various classes of people, there are some common objectives of interpretation which are as follows:

1. To examine the earning capacity and efficiency of various business activities with the help of income statement
2. To estimate about the performance efficiency and managerial ability by the management of a business concern.
3. To determine short-term and long-term solvency of the business concern with the help of balance sheet.
4. To enquire about the financial position and ability to pay of the concerns seeking loans and credits
5. To determine the profitability and future prospects of the concern.
6. To investigate the future potential of the concern.
7. To make comparative study of operational efficiency of similar concern engaged in the identical industry.

TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS

The following techniques are adopted in analysis of financial statements of a business organization.

- i) Comparative statements
- ii) Common size statements
- iii) Trend analysis
- iv) Ratio Analysis
- v) Funds flow analysis
- vi) Cash flow analysis

UNIT - I

Price Level Accounting (INFLATION ACCOUNTING)

Introduction

Prices do not remain constant over a period of time. They tend to change due to various economic, social or political factors. Changes in the price levels cause two types of economic conditions, inflation and deflation. Inflation may be defined as a period of general increase in the prices of factors of production whereas deflation means fall in the general price level. These changes in the price levels lead to inaccurate presentation of financial statements which otherwise are prepared to present a true and fair view of the company's financial health. This is so because the financial statements are prepared on historical costs on the assumption that the unit of account, i.e. rupees in case of India, has static value. But the assumption is not valid because the value of the unit of account, i.e. the purchasing power of the rupee, has been changing ever since the beginning of this century.

Financial Statements and Price Level Changes

The term 'financial statement' refers to two statements, i.e., the balance sheet or statement of financial position that reflects assets, liabilities and capital on a particular date and profit and loss account or income statement that shows the operating results achieved during a particular period. The primary function of accounting is the preparation of financial statements in such a manner so as to give a true and fair view of the financial and operating position of the company.

Financial statements are usually based on actual or historical cost concept. They reveal the impact of various transactions involved in the accounting period on the operating and financial health of the company. But various transactions include:

- (1) Current assets acquired and current liabilities incurred at different points of time in the accounting period.
- (2) Various expenses incurred and incomes earned at different points of time in the accounting period.
- (3) Various assets acquired at different points of time.
- (4) Various Liabilities incurred at different points of time.

Hence, it is clear that the measurement unit of various transactions, i.e. money, relates to different points of time. But the value of money does not remain the same over a period of time, it has different values at different points of time due to changes in the price levels. So, we are comparing two unlike things, say bricks with vegetables; obviously, the profit or loss arrived at from these transactions will not reveal a true picture. It is generally said that profit as arrived from the profit and loss account on the basis of historical cost has a tendency to be overstated in times of rise in prices.

This is so because during inflation the selling prices would indicate the value realized in terms of the increased prices but the costs which pertain to the earlier periods would show lower values.

The profit, arrived at by deducting from the revenues at current values, the costs which are not on current values, cannot state the true picture. The causes of overstatement of profits during inflation are primarily two in number. One is the writing off depreciation on fixed assets at a lower rate than it would have been and the other is the over-valuation of stock in trade.

The effect of inflation on fixed assets is still worse because low provisions for depreciation on the assets valued at historical costs not only show higher profits but also result in non-availability of sufficient funds for replacement of fixed assets. Fixed assets, maintained on historical cost concept, have a tendency to inflate book profit thereby increasing the tax liability and payments of dividends out of capital.

Thus, accounting based on historical cost concept inflates book profits, increases tax liability and erodes equity capital. In recent past, there have been cases where dividend and taxes have been paid out of the real capital due to the effect of price level changes (Inflation) on financial statements. Thus, there is every need to adjust the conventional accounting in the light of price level changes or to adopt the price level accounting i.e., inflation Accounting.

Price level accounting is a technique of accounting by which the transactions are recorded at current values and the impact of changes in the prices on the accounting transactions is neutralized or atleast such impact is pointed out along with transactions recorded on historical cost concept. Price level accounting is also known as 'inflation accounting', for the reason that prices are usually changing on the higher side.

To sum up, the reasons for the emergence of price level accounting are as follows:

1. Inaccurate presentation of financial statements during the changes in the price levels.
2. Unrealistic, imaginary and inflated book profits in times of rise in prices due to overvaluation of stock in trade and writing off depreciation on fixed assets at a lower rate.
3. Payment of dividends and taxes, much more than warranted by the real profits, out of the equity capital resulting in the erosion of capital.

4. Difficulties in replacement of fixed assets during inflation.
5. Inadequacy of working capital arising out of increasing price levels.
6. Losses arising such as a result of holding monetary current assets such as cash and receivable and gains accruing from holding current liabilities as sundry creditors.

METHODS OR TECHNIQUES OF PRICELEVEL ACCOUNTING / INFLATION ACCOUNTING

1. Current Purchasing Power Technique(CPP)
2. Replacement Cost Accounting Technique(RCA)
3. Current Value Accounting Technique(CVA)
4. Current Cost Accounting(CCA)

1. Current Purchasing Power Technique (CPP)

Current Purchasing Power Technique of accounting requires the companies to keep their records and present the financial statements on conventional historical cost basis but it further requires presentation of supplementary statements in terms of current purchasing power of currency at the end of the accounting period. In this method, the various items of financial statements, i.e. balance sheet and profit and loss account are adjusted with the help of recognized general price index. The consumer price index or the wholesale price index prepared by the Reserve Bank of India can be taken for conversion of historical costs.

The main objective of this method is to take into consideration the changes in the value of money as a result of changes in the general price levels. It helps in presenting the financial statements in terms of a unit of measurement of constant value when both cost and revenue have been changing due to changes in the price levels.

This technique of price level accounting has been followed by a number of companies in Germany, Australia and U.S.A. but although this method is simple, it may be considered as only a first step towards inflationary accounting. The major weaknesses of this technique are as follows:

- i. As it takes into account the general price index, it does not account for changes in the individual assets of the company. Sometimes it is possible that there may be increase in the general price index, but there may not be any

increase (rather there might be a decrease) in the value of particular asset of a certain company.

- ii. The technique seems to be more of theoretical nature than of any practical utility.
- iii. In a country like India, even the price indices may not be correct and it may further cause inaccurate presentation of the financial statement.

2. Replacement of Cost Accounting Technique

Replacement Cost Accounting (RCA) technique is an improvement over current Purchasing Power Technique (CPP). One of the major weakness of current Purchasing Power technique is that it does not take into account the individual price index relate to the particular assets of a company. In the Replacement Cost Accounting technique the index used are those directly relevant to the company's particular assets and not the general price index. In this sense the replacement cost accounting technique is considered to be an improvement over current purchasing power technique. But adopting the replacement cost accounting technique will mean using a number of price indices for conversion of financial statements and it may be very difficult to find out the relevant price index to be used in a particular case. Further, the replacement cost accounting technique provides for an element of subjectivity and on this ground it has been criticized by various thinkers.

3. Current Value Accounting Technique

In the current Vale Accounting Technique of price level accounting all assets and liabilities are shown in the balance sheet at their current values. The value of the net assets at the beginning and at the end of the accounting period is ascertained and the difference in the value in the beginning and the end is termed as profit or loss, as the case may be. In this method also, like replacement cost accounting technique, it is very difficult to determine relevant current values and there is an element of subjectivity in this technique.

4. Current Cost Accounting Technique

The British Government had appointed a committee known as Sandilands Committee under the Chairmanship of Mr.Francis C.P. Sandilands to consider and recommend the accounting for price level changes. The committee presented its report in the year 1975 and recommended the

adoption of Current Cost Accounting Technique for price level changes. The crux of the current cost accounting technique is the preparation of financial statements (Balance Sheet and Profit and Loss Account) on the current values of individuals items and not on the historical or original cost. The essential characteristics of current cost accounting technique are as follows:

1. The fixed assets are shown in the balance sheet at their current values and not on historical costs.
2. The depreciation is charged on the current values of the fixed assets and not on original costs.
3. Inventories or stocks are valued in the balance sheet at their current replacement costs on the date of the balance sheet and not cost or market price whichever is lower.
4. The cost of goods sold is calculated on the basis of their replacement cost to the business and not on their original cost.
5. The surpluses arising out of revaluation are transferred to Revaluation Reserve Account and are not available for distribution as dividend to the shareholders.
6. In addition to the balance sheet and profit and loss account, an appropriation account and a statement of changes is prepared.

The current cost accounting (CCA) technique has been preferred to the current purchasing power (CPP) technique of price level accounting as it is a complete system of inflation accounting. The financial statements prepared under this technique provide more realistic information and make a distinction between profits earned from business operation and the gains arising from changes in Price levels. As depreciation under CCA is provided on current cost, the method prevents overstatement of profits and keeps the capital intact. The effect of holding monetary items in terms of gains and losses having an impact on the finance of the business is also highlighted.

However, there are many difficulties in the operation of CCA technique:

- (a) It is very difficult to determine the value of the business of a real asset.
- (b) There is an element of subjectivity in this technique.
- (c) It does not hold good during the periods of depression.

Advantages of Price Level Accounting

In the past few years of high inflation, companies have reported very high profits on the one hand but on the other they have faced real financial difficulties. This is so because in reality dividends and taxes have been paid out of capital due to overstated figures of profits arrived at by adopting historical cost concept. Thus a change from historical cost concept to price level or inflation accounting has been recommended. The major advantages of Inflation Accounting are as follows:

- (1) It enables company to present more realistic view of its profitability because current revenues are matched with current costs.
- (2) Depreciation charged on current values of assets in inflation accounting further enables a firm to show accounting profits more nearer to economic profits and replacement of these assets when required.
- (3) It enables a company to maintain its real capital by avoiding payment of dividends and taxes out of its capital due to inflated profits in historical accounting.
- (4) Balance sheet reveals a more realistic and true and fair view of the financial position of a concern because the assets are shown at current values and not on distorted values as in historical accounting.
- (5) When financial statements are presented, adjusted to the price level changes, it makes possible to compare the profitability of two concerns set up at different times.
- (6) Investors, employee and the public at large are not misled by inflated book profits because inflation accounting shows more realistic profits. Higher paper profits without adjustment for price level changes cause resentment among workers and they demand higher wages and also excessive profits attract new entrepreneurs to enter the business. Inflation accounting helps in avoiding further competition from prospective entrepreneurs.
- (7) The financial statements prepared by a company adjusted to the price level changes also improve its social image.
- (8) Inflation accounts also effects the investment market as it helps to establish a

Disadvantage of Price Level Accounting

Some people are of the opinion that inflation accounting may create more problems than solving them because of the following inherent disadvantages of the price level accounting:

- (1) Adjusting accounts to price level changes is a never-ending process. It involves constant changes and alterations in the financial statements.
- (2) Price level accounting involves many calculations and makes financial statements so complicated and confusing that it becomes very difficult for man of ordinary prudence to understand, analyze and interpret them.
- (3) The concept of price level accounting appears to have more theoretical importance than practical because adjusting the accounts to the changes in the price levels may lead to window dressing of accounts due to the element of subjectivity in it. People may adjust the accounts according to the values most suited to them, thereby, making the financial statements more inaccurate.
- (4) Depreciation charged on current values of fixed assets is not acceptable under the Income Tax Act, 1961 and hence adjusting it to price level changes does not serve any practical purpose.
- (5) During deflation, when the prices are falling, adjustments of accounts to price level changes will mean charging lesser depreciation and overstatement of profits.