Objectives of Accounting

i. To find out the net profit or net loss or surplus or deficit.

ii. To find out the positions of assets and liabilities on a particular date.

iii. To check the frauds and misappropriations of money.

iv. To confirm about the arithmetical accuracy of the books of accounts.

v. To help the management formulate policies for controlling cost, preparation of quotation.

vi. To furnish information regarding Purchases and Sales, both Cash and Credit.

vii.

Nature of Accounting

i. Accounting is a process.

ii. Accounting is an art.

iii. Accounting is means and not an end.

iv. Accounting deals with financial information and transactions.

v. Accounting is an information system.

vi.

Functions of Accounting

1. Recording.
2. Classifying.
3. Summarizing.
4. Analysis and Interprets.
5. Reporting/Communicate.

- **Accountant:** a person concerned with the maintenance of books of accounts.
- **Accountancy:** Profession or practice of an accountant.
- **Business Transaction:** any event that affects the financial position of an organization and requires recording.
- **Assets**: These are resources owned by a business which benefit its future operations and are convertible to cash.

  Examples:

  - Land& buildings
  - Equipment
  - cash in bank
  - Cash in hand
  - Investments and accounts receivable.
  - Goodwill, patent

- **Liabilities: Obligations** of a company or organization. Any type of borrowing from persons or banks.

  Examples:

  - Bank loans
  - Creditors
  - Bank overdraft
  - Dividends payable
  - Income tax payables

- **Financial Statements:** or **financial report** is a formal record of the financial activities and position of a business, person, or other entity.
- Managers and investors can learn about the financial position and prospects of an organization from its financial statements

Types of financial statement :

i. Income statement : Profit and Loss report. It is a summary of firm's revenue and expense over a period of time ending with Net Income/Loss.

ii. Position Statement : Balance sheet on a company's assets, liabilities, and ownership equity at a given point in time.

iii. **Statement of changes in Equity** :Equity **statement or statement of retained earnings,** reports on the changes in retained earnings of the company during the stated period.

iv. **Statement of Cash flows** : reports on a company's cash flow activities, particularly its operating, investing and financing activities.

<u>**LEDGER**</u>

- **It may be defined as " A summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect".**
- **Principal book of accounting.**
- **Net result of all transactions in respect of a particular account on a given date can be ascertained only from ledger.**
- **Posting : Transferring the Debit and Credit items from the Journal to their respective accounts in the Ledger.**
- **It can be done :**

  A. **Take a particular side and complete postings of that side(either Debit or Credit).**

  B. **Take a particular account and post all Debits and Credits relating to that account.**

  C. **Complete posting of each journal entry and then proceed with next entry.**

Its advisable to follow the last method.

- It also disclose the proprietary interest of owner.
- It helps in calculation of various ratios which help in better management of business.
- It helps in comparison of assets and liabilities of business on two dates to ascertain the progress being made by business.
- It helps to ascertain the amount of capital employed in business.

Types of Balance sheet

- Horizontal Balance sheet : A horizontal balance sheet presents assets on one side and liabilities and owners equity on the another side of the page.
- Vertical balance sheet : is one in which the balance sheet presentation format is a single column of numbers, beginning with asset line items, followed by liability line items, and ending with shareholders' equity line items.

ADJUSTMENTS FINAL ACCOUNTS

- An accounting adjustment is a business transaction that has not yet been included in the accounting records of a business as of a specific date.
- Adjusting entries are usually made on the last day of an accounting period (year, quarter, month) so that the financial statements reflect the revenues that have been earned and the expenses that were incurred during the accounting period.
- An adjusting journal entry is typically made just prior to issuing a company's **financial statements**.

Adjusting entry is needed because:

- revenue has been earned, but it has not yet been recorded:
- an expense may have been incurred, but it hasn't yet been recorded.

Closing stock A/c Dr

To Trading A/c

If its only in Trial balance:

- It will be shown only on the Asset side of balance sheet.

2.Outstanding expenses(Pending)

- It refers to those expenses which have become due during the accounting period for which Final accounts prepared, but not yet been paid.
- **2fold-effect if its in adjustment:**

1. Outstanding expense will be shown in debit side of Trading or P&L A/c by way of addition to the expense.
2. The same amount will be shown in the Liability side of Balance sheet.

Adjustment entry:

Expenses A/c Dr

To Outstanding Expenses A/c

If its only in Trial balance:

O/S expense will be shown in Liability side only.

3.Pre-Paid expenses(Unexpired)

- These expenses which have been paid in advance during the accounting period, but they relate only to next period.
- The benefit will be available in future.
- **2fold-effect if its in adjustment:**

1. It will be shown in Debit side of P&L A/c, deduct from the concerned expense.
2. The same deducted amount will be shown in Asset side of balance sheet.

Adjustment entry:

Prepaid expense A/c Dr

To Expense A/c

If its only in Trial balance:

- Prepaid expense will be shown only in Asset side of Balance sheet.

4.Accrued Income

- Income earned in the current financial year but not received in liquid cash.

- **2fold-effect if its in adjustment:**

1. It is credited in Profit & Loss A/c in the way of addition with concerned income.
2. It is shown on the asset side of the balance sheet.

Adjustment entry:

Accrued Income A/c Dr

To Income A/c

If its in Trial balance only: Taken in Asset side.

5.Income received in Advance(Unearned)

- Income received but not yet earned during the accounting year.
- Sometime the whole amount is not belong to current period.

- **2fold-effect if its in adjustment:**

1. It will be shown in Credit side of P &L A/c by way of deduction from the income.
2. It is shown in Liabilities side of balance sheet.

Adjustment entry:

Income A/c Dr

To income received in advance

If its in trial balance only: its shown in Liability side.

<u>Discounts</u>

Deductions allowed either on selling price or on the amount due. Following are types of discounts :

<u>1.Cash discount :</u>

Cash discount is an allowance for prompt payment and is based on the Net Value.

An allowance given to Customers is known as **Discount Allowed** and

An allowance made by creditors off the amount owing is called **Discount Received**.

<u>2.Trade Discount :</u>

Deduction allowed by the manufacturer to wholesaler on the list of price of goods.

Its a certain percentage a manufacturer is willing to reduce its list price for wholesalers or retailers.

The discount/allowance given is meant for higher/bulk purchase of goods and services.

- EXAMPLE: a retailer might only order 100 t-shirts from a manufacturer and receive a 5%trade discount.
- A wholesaler, on the other hand, might order 1,000 t-shirts at a time and could receive a 12%discount.

EXAMPLES:

1. <u>Purchased goods worth Rs.5000 from Mohan at a trade discount of 10%</u>

- Entry : ***Purchase A/c Dr 4500***

To Mohan A/c 4500

(trade discount of 500 deducted & balance shown in books)

2. <u>Received cash from Annie Rs.3850 and allowed discount of Rs.150.</u>

- ***Compound Entry : Cash A/c Dr 3850***

Discount A/c Dr 150

To Annie A/c 4000

Example

- On 31st March 2013, books of Nancy showed the following balances :
    - Cash in Hand – 600
    - Cash at bank – 2800
    - Sundry debtors- 3000(Bindhu-1500, Sindhu-500 & Indu- 1000)
    - Sundry creditors – 1500(Mini-800 & Cini- 700)
    - Stock – 2000
    - Furniture- 1500

Give journal entry to record the above transactions on 1st April 2013

Entries

- Cash A/c Dr 600
- Bank A/c Dr 2800
- Bindhu A/c Dr 1500
- Sindhu A/c Dr 500
- Indu A/c Dr 1000
- Stock A/c Dr 2000
- Furniture A/c Dr 1500

To Mini A/c 800

To Cini A/c 700

To Capital 8400(balancing figure)

Total Assets	=	Total Liabilities + Capital	
Cash	56,000	Capital	1,00,000
Bank	15,000	Ram	1,000
Furniture	25,000		
Goods	2,000		
Shyam	3,000		
	Rs.1,01,000		Rs.1,01,000

Ratio Analysis

Analysis of financial statements

- It is the process of systematic and careful examination of accounting information given in the financial statements with specific purposes.
- According to John N.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 study of the trend of these factors as shown in a series of statements".
- The first task of the financial analyst is to select the information relevant to the decision under consideration from the total information contained in the financial statement.
- 2nd step involved in financial analysis is to arrange the information in a way to highlight significant relationships.
- The final step is interpretation and drawing of inferences and conclusions. In brief, financial analysis is the process of selection, relation, and evaluation.

Types of financial statement analysis

1. **On the basis of nature of analyst and material used**
2. **On the basis of objective of analysis**
3. **On the basis of Modus operandi of the analysis**

On the basis of nature of analyst and material used

- ***External analysis:*** The external analysis is done on the basis of published financial statements by those who do not have access to the accounting information, such as, stock holders, banks, creditors, and the general public.
- **Internal Analysis:** This type of analysis is done by finance and accounting department. The objective of such analysis is to provide the information to the top management, while assisting in the decision making process.

On the basis of objective of analysis

- ***Long term Analysis:*** in order to study the long term financial stability, solvency and liquidity, profitability of a business concern.

- Identification of Strength & Weakness
- Taking Remedial Measures
- Comparison of Performance

Limitations of Ratio Analysis

- Based on Historical data
- Ignores change in Real Value of money
- No standard interpretation
- Ignoring Qualitative aspects
- Difference in accounting methods make comparison difficult
- Wrong results if based on incorrect data

Classification of Ratios

A. Liquidity Ratios

B. Solvency Ratios

C. Activity Ratios

D. Profitability Ratios

E. Shareholders' Ratios

. Liquidity Ratios

- Used to study the ability of the organization in meeting short-term payments or obligations.
- Highlights the relative strength of a firm to pay its current liabilities.
- It also help to ascertain the effectiveness of the working capital.(**Working Capital** = Current Assets - Current Liabilities.)

1) Current Ratio

2) Acid Test Ratio or Quick ratio

3) Absolute liquid or super quick ratio

Current Ratio

- Fundamental measure of a company's financial condition.
- Relation between current assets and current liabilities.
- Most widely used ratio.
- **Measurement of Current Ratio**

$$\frac{CurrentAssets}{CurrentLiabilities}$$

- **Ideal Ratio = 2 : 1**

  CA should twice of the CL

Acid Test Ratio or Quick ratio

- It is the ratio between quick assets and quick liabilities
- Quick assets = CA-(stock prepaid expense)
- Quick liabilities = CL- bank overdraft
- **Ideal Ratio= 1:1**
- **Healthy indicator of cash management**

$$\frac{QuickAssets}{QuickLiabilities}$$

Absolute liquid or super quick ratio

- To get a clear idea of liquidity of a firm, both Receivables and inventory excluded.
- absolute liquidity ratio relates cash, bank and marketable securities to the current liabilities.
- Absolute Liquid Ratio = **Cash+ Bank+ marketable securities/ CL**
- **Ideal Ratio= .50:1(1:2)**
- **i.e No need for keeping more cash in liquid form**.

$$= \frac{\text{GrossProfit}}{\text{Net Sales}} X100$$

This ratio measures how profitable a company sells its inventory or merchandise. In other words, the gross profit ratio is essentially the percentage markup on merchandise from its cost. This is the pure profit from the sale of inventory that can go to paying operating expenses.

It shows how efficiently a company can produce and sell its products.

Net Profit Ratio

Net Profit is equal to total income minus total expenses during a period; *Revenue* is income earned from the principal business activities.

$$= \frac{\text{ProfitAfter Tax}}{\text{NetSales}} X100$$

A popular profitability ratio that shows relationship between net profit after tax and net sales. It is computed by dividing the net profit (after tax) by net sales.

Net Profit Margin ratio is a key performance indicator of the profitability of an enterprise. It is one of the two elements that determine the return on assets, the other element being the sales turnover ratio.

Return on Total Assets

- A profitability ratio that measures the net income produced by total assets during a period by comparing net income to the average total assets.
- ROA measures how efficiently a company can manage its assets to produce profits during a period.

$$= \frac{\text{ProfitAfter Tax}}{\text{TotalAssets}} X100$$

Return on Equity

- A profitability ratio that measures the ability of a firm to generate profits from its shareholders investments in the company.
- It is the return on equity ratio shows how much profit each dollar of common stockholders' equity generates.

$$= \frac{\text{Profit After Tax}}{\text{Shareholders' Funds}} X100$$

RETURN ON EQUITY CAPITAL:

$$= \frac{\text{Profit After Tax - Pref dividend}}{\text{Equity Funds}} X100$$

Expenses ratio

These ratios are calculated by dividing the various expenses by sales. The variants of expenses ratios are:

Material consumed ratio = $\frac{\text{Material consumed}}{\text{Net sales}} \times 100$

Manufacturing expenses ratio = $\frac{\text{manufacturing expenses}}{\text{Net sales}} \times 100$

Administration expenses ratio = $\frac{\text{administration expenses}}{\text{Net sales}} \times 100$