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Unit 1: Introduction to Accounting

Learning Objectives

1. Learners will be able to define the importance of accounting in business along with the role of accounting in decision-making.

2. Learners will understand accounting cycles and financial statements.

3. Learners will learn about users of accounting information and accounting principles.

4. Learners will study accounting ethics and standards along with types of accounting.

Content

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1.0 Introductory Caselet

Financial Decision-Making at TechNova Solutions

TechNova Solutions is an midsized software development shop that has had a huge amount of growth for the last 5 years. The firm focuses on the development of cloud-based enterprise solutions, and its customer base has extended worldwide. But as it expands, TechNova is experiencing funding woes that might threaten its long term

survival. The company recently introduced a new software-as-a-service subscription option, with annual and multi-year contracts.

But its accounting for the income which TechNova recognises has drawn questions from investors and auditors. It records the full contract amount when the agreement is inked, rather than recognizing revenue as it's earned over time. A big factor in the bottoms-up accounting is exaggerated top line revenue numbers that make the financial statements look better than they are.

Further, TechNova's research and development (R&D) expenses also jumped resulting in higher operating costs. They are challenged with finding the right balance between innovation and the bottom line. The company's margins are being hit even as its sales grow. Via an imminent investor presentation, TechNova's CFO Priya Mehta must deal with such accounting issues, ensure that accounting is in line with financials and adhere to accounting standards like the accrual principle and revenue recognition rules (IFRS 15/GAAP). The board of directors is very focused on having a capitalization plan of growth but remains solid and able to command respect from the investment community.

Critical Question

What should TechNova do to adapt its accounting procedures and satisfy broad revenue recognition principles in order to maintain the trust and transparency that investors demand?

1.1 Introduction to Accounting and Accounting Concepts

Accountancy (profession) Accountancy is the process of communicating financial information about a business entity to users such as shareholders and managers. With accounting firms, businesses have a better perspective of their fiscal health and continue to stay compliant with the law so that they can make educated decisions which will result in budgeting and planning. It allows businesses to trace their income, expenses, assets and liabilities. Accounting is important for the financial health of a company's operations. It is usually divided into such areas as financial accounting, managerial accounting, tax accounting and auditing etc., all of which are useful to some extent in an organization.

1.1.1 Definition of Accounting

There have been many definitions of accounting proposed by prominent writers and various professional bodies. Some of the numerous popular definitions are given below:

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

As per the American Accounting Association (AAA):

"Accounting is a service activity designed to collect, process and communicate the information required for planning, control, and decision making within an organisation and certification."

Accounting is the function of business that processes it as the 'language of business. It jots down financial figures, afterwards arranges them and reallocates this data to comprehendible statements for interpretation. The process links up companies with a comprehensive method and lets managers choose a strategy in order to examine the financial results at multi-level of the company.

It is reality that accounting is meant to generate a clear and accurate report of financial information which sums up in its reliability. Banks and corporations create the soundness of their finances by documenting accurate records, (to provide) stakeholders including investors, regulators and management with an accurate financial picture based on commonly-agreed accounting standards. The use of accounting standards in conjunction with a theoretical framework, brings about consistency and promotes uniformity that fosters an industry wide adherence to the accounting standards, and like terms for financial disclosures thereby enhancing stakeholder confidence.

1.1.2 The Role of Accounting in Decision-Making

Accounting is a traditional information system for meausring company performance, financial rationnales and managing resources efficiently and making vital decisions at organizational level. Firms save profitability benchmarks via accurate financials data for performance and cost structure monitoring, as well as regulatory filing purposes. Business profit is largely a matter of accounting in this key.

Performance Review: Measurement of the financial well-being takes place by way of quantitative tools on predefined periods in business. Assessing business segments and products/services by key financial ratio analysis enables management to drill down into business review. The insight generated allows businesses to discover their core territories and address business issues helping them build sustainable business growth.

● Budgeting and Forecasting: Preparing a budget and making financial forecasts are only based on past market and financial data. Proactive organizational financial planning leverages historical revenues, expenses and cash flows to develop accurate

estimates that drive business decisions. Adapting budgeting using forecasting techniques ensures that resources are distributed reasonably and uncertainties are minimized while creating secure financial conditions within volatile markets.

λ Price analysis: Companies require concrete estimates of the cost of goods and services in order to determine prices and assess profit levels. The account information used by the Society is reliable since it aid the society to form production cost calculation on its cost system for pricing strategy making. The Cost Benefit Analysis assists companies in making informed decisions about product lines while controlling costs and implementing process improvements that lead to better financial performance.

● Tax Planning: A strong accounting system also makes preparing to file taxes a lot more manageable as it maintains good records, which are used in the proper taxation of revenues and expenses and liabilities. Companies are able to spend for taxes smartly since they go through the previous' monetary records in search of ways to cut costs.Among the things they may do is manage paying files and challenge tax deductions while engaged in a few programs based upon legal requirements. Tax planning in advance will help companies remain in compliance while maximizing financial status.

Accounting is not just record keeping; it's an essential support tool for organizations and this value of an organization's ability to monitor, evaluate its performance and make sounder financial decisions, operating effectively that keeps regulatory in line.

1.1.3 Objectives of Accounting

Accounting financial management is important because it helps to ensure the recording, analysis and reporting of the financial transactions in a proper and systematic manner.

Fig. 1.1 Objectives of Accounting

Orderly Record Keeping: Accounting helps in the orderly recording of transactions. Accounting systemizes monetary transactions. No integrated system, business could struggle to monitor their financials and end up making mistake or be inefficient. The Advantages of Accounting Services Human mind is really something, and if it does not have to struggle by remembering all these things then so much the better.

Example: Assume a retail store, which deal with hundreds of sales in a day. There wouldn't be any reliable way to record sales, returns or expenses without up-to-date accounting. A

full reporting of income and stock helps the shop owner tracking how many Earn on sales that are made over time.

Protecting Business Assets: Proper accounting systems can defend business assets from fraud and misuse. By communicating certain important financial data to businesses or organizations managers, accounting gives vehicles to companies in which they can track:

a. The owner's investment in the business.

b. The liabilities of the business which need to be paid.

c. Accounts receivable from customers.

d. The assets of the company – as for example, the value of buildings and used in business at balance sheet date; cash on hand, bank balances and inventory (raw materials, WIP materials, finished goods) etc.

Access to this information will ensure that resources are only used effectively, avoiding situations where funds remain idle or are misapplied.

Example: A manufacturing firm wants to keep tabs on its machines and raw materials. Accounting reports assist in knowing whether the machines are working effectively and there is no more slippage on raw materials so that all resources can be well utilized or not.

Profit and Loss Determination: One of the important purposes for which the accounting is done is to ascertain the profit or loss of a business during a certain period. Through meticulous tracking of all income and expenses, companies can know whether they have made a profit or experienced a loss. This is done by the Profit and Loss Account i.e., income and expenses. If expenses are greater than revenue, the company generates a loss; otherwise, the business realizes income. These kinds of information are beneficial to facilitate stakeholders (e.g. management, investors and creditors) assess company profit and make the necessary corrections if needed.

Example: A restaurant tracks its monthly income from selling food and subtracts characteristics like rent, salaries and raw materials. The profit and loss account analysis makes it possible for the owner to know whether business is profitable or not and if there is need in order to make adjustments.

Evaluating financial position: While the Profit & Loss Account is a measure of business performance, it does not give us a complete picture of its financial standing. Balance Sheet (also known as Position Statement) is prepared to reveal the financial position of the business on a particular date. It

sets forth the company's assets and liabilities to assist business proprietors, show the financial strength, solvency and economic state of affairs.

Example: An IT firm that wishes to grow can assess TM its balance sheet to ascertain if it has the necessary assets and capital in order to fund the expansion project, or whether or not it will require external financing.

Assisting Informed Decisions: Modern accountancy is not just for the purpose of bookkeeping, but also operates at a strategic level to assist organizations with decision-making. Anticipation that accounting information is timely and providing analytical intelligence from accounting assists the managers in taking informed decisions regarding investment, cost management, pricing strategies, resource allocation etc. The global accounting bodies such as International Accounting Standards Committee (IASC) have developed principles for standardization of financial reporting so that decision making becomes consistent and reliable.

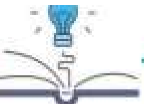
Example: A business that has recorded its accounting data and is planning to launch a new product uses the data to have knowledge of how much it will cost to produce such products, potential profit margins and likely demand, so as to make an informed decision on entering into the market.

Serving as a System of Information: Accounting provides accounting information to aid business operations and strategy formulation. Accounting gives companies actionable financial information that they can use to make better decisions, be more transparent and ensure compliance with laws. More and more, business is driven by data, so accounting plays a greater and greater role in its management.

Example: Accounting software which may be used by a multi-national company to generate the financial reports of its different countries. The stats help corporate professionals to plan budgets and growths.

By the way, and I don't know how, accounting not only promotes financial truthfulness but also allow a business to grow in the long term - sustained growth.

Did You Know?



"The global accounting services market is valued at over $600 billion in 2023. The "Big Four" accounting firms (Deloitte, PwC, EY, and KPMG) make up a significant portion of this, with Deloitte alone generating approximately $70 billion in revenue in 2023."

1.1.4 Phases of the Accounting Cycle

It refers to a sequence of proper steps that is used to record, calculate and process the accounting data. The major steps of this cycle are summarized above (Fig. 1.4):

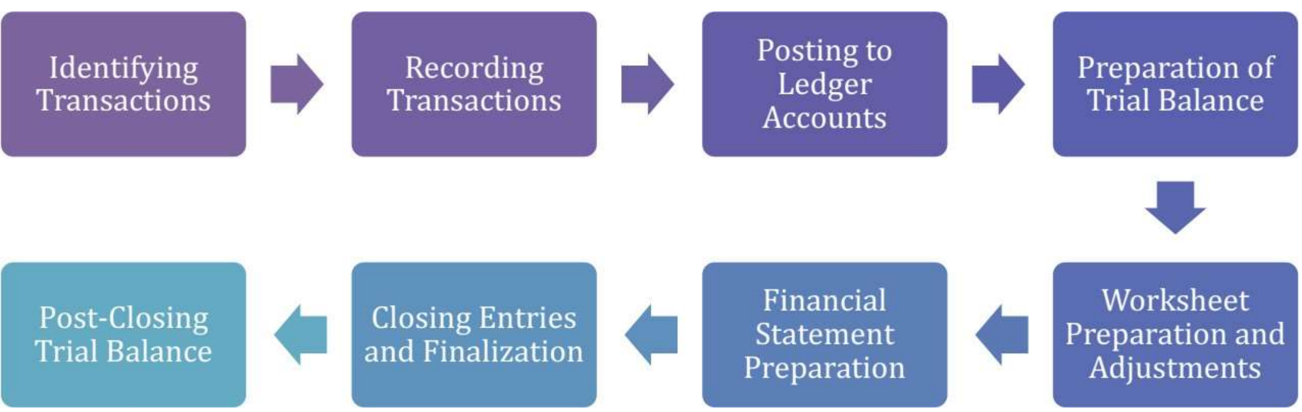


Fig 1.2 Phases of Accounting Cycle

Transaction Identification: The process begins by identifying transactions that have an impact on the company's financial position. They can be sales, purchases, payments or receipts transactions. It is also done to make the accounts stable and consistent, Only ascertained revenue earned in cash is considered.

Transaction Recording: As and when transactions are recognized, they get recorded in the journal, i.e., chronologically. Each record indicates affected accounts and the change made to them. This is the double-entry bookkeeping system, which requires that for every transaction there be an entry in two different accounts guaranteeing that the accounting equation remains in balance.

Ledger Posting: The second step in the accounting cycle is to post journal entries into the ledger accounts. A defined classification system allows a

chronological perspective on account balances so that financial modelling and reconciliation is feasible.

Preparation of Ledger: a) Ledger is prepared after the posting of transactions has been completed and then b) Trial balance ensures by making sure that Debit balances equals with credit balances. The books remain balanced through this step and error detection is also occurs to inhibit further progression past subsequent stages.

Worksheet Preparation and Adjusting An internal worksheet is used to collect account information for making adjusting entries prior to financial statements being prepared. The company makes adjusting entries to process accruals and deferrals, as well as depreciation and other adjustments that depicts a true picture of the financial position.

Financial Statement Preparation

The statements are prepared after the adjustments have been entered into the system. These include:

a. Income Statement – A statement on the profit and loss for a period of time.

2 b. Balance Sheet – It is a financial statement that represents the financial position of an entity at a certain date.

c. Cash Flow Statement : Overview of cash effect in the business.

17 Closing Entries and Reporting: Closing entries are needed at the end of the period in order to zero-out (empty) account balances in temporary accounts (revenues, expenses, dividends paid) and transfer amounts from these temporary accounts into retained earnings, which is a permanent account. The accounting period is a new beginning with an empty ledger for each post-closing trial balance. 7

Post-Closing Trial Balance the post-closing trial balance is used to prove the equality of the permanent accounts' balances and demonstrates that all temporary account have been closed. The integrity of the financial record is protected in this process that establishes a solid foundation for the new accounting cycle.

Organized process enables financial accuracy in addition to compliance and transparency proving beneficial for decision-making at all levels of the organization.

Did You Know?

Apple's headquarters in Cupertino, California, known as Apple Park, was purchased for $5 billion in 2017, though its current market value has increased due to demand and location, yet it remains on Apple's books at the original cost. The going concern assumption assumes a business will continue operations indefinitely. In 2020, J.C. Penney filed for bankruptcy, which revealed how this assumption can mask financial instability. Despite reporting positive revenues for years, the company's $5 billion debt made it impossible to stay afloat.

1.2 Types of Accounting

Three principle distinct branches of accounting can be delineated:

Financial Accounting

Cost Accounting

Management Accounting

1.2.1 Financial Accounting

It is an organized way of recording business transactions and interpreting accounting reports in accordance with pre-designed financial principles. The standardized financial performance report provides potential stakeholders with an objective benchmark for decision-making purposes about an entity's financial position. Key Features of Financial Accounting

Monetary Transactions as Events Only -Financial accounting considers only transactions that can be measured monetarily and such does not record non-quantifiable events like how employees feel or the value of your brand, values can't be recorded in financial accounts.

Historical Based – It is designed to keep track of past financial transactions and to preserve a history of business transctions.

Regulatory Compliance – Financial accounting helps in complying with regulations and laws as companies are required to operate in accordance with prescribed accounting standards like IFRS (International Financial Reporting Standard) or GAAP (Generally Accepted Accounting Principles), etc. for the purpose of uniformity and transparency.

External Users Orientation – Since ordinary users (so called internal) of accounting information are not directly related to the business operations, attention is given only to

that portion of the financial statements which establishes relationship with external users.

a. Clients and owners (to measure cost-effectiveness and risk)

b. Lenders and financial institutions (to verify a credit decision)

c. Vendor (for assessing financial stability)

d. Tax, Compliance and Regulatory authorities

Preparation of Financial Statements – Primary responsibility of financial accounting is to prepare uniform and consistent reports like:

a. Income Statement (Profit & Loss Account) : Represents revenues, expenses and profits.

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b.) Balance Sheet : It is the statement summarising assets, liabilities and equity at a certain point of time.

c. Cash Flow Statement: Explains the money rolling in and out for a certain time-frame.

Dual-Aspect Principle -} Financialaccounting is based on the principle that every financial transaction has at least two aspects. } This means that each and every business/financial transaction affects two or more items of the accounting system so as to keep the Balance Sheet equation in balance: Assets = Liabilities + Owners Equity

Objective and Trustworthy Information – The information contained in the reports are sourced from data that can be validated, guaranteeing accuracy and trustworthiness for users.

Summarization and Periodic Reporting – A company's existence is split into distinct time periods for accounting purposes (often months, quarters or years). These periodic financial statements are issued so that an investor can have an up-to-date idea of how the company is doing.

Decision-Making Purpose – Although external users are the main focus of financial accounting, internal decision makers can also use it for awareness about many aspects like performance and resources utilization.

1.2.2 Cost Accounting

Cost accounting was developed as a specialized branch of accounting to serve the needs of management. Its focus is on managing the expense of product, service or operation. The aim is to study actual incurred costs and to predict future ones for making informed decisions.

Cost accounting is also an important aid to management with the help of the techniques such as marginal costing in profit planning and standard costing in cost

control. As a stragic planning tool, it analyzes historic and current data in order to help managers make informed decisions.

Key Features of Cost Accounting

Three Elements of Cost Accounting:

- Cost determination.48 - Appraising the total and unit cost of production or service at the point of manufacture or rendering, including shipping costs; may include inspection, training costs or other related costs in appropriate cases.
- Cost Report – Communicating cost information to the multiple layers of management for decisions.
- Cost Control - Predicting the cost of production in relation to revenues, and managing that to stay within predetermined limits using budgets, standard costing, and variance analysis.

Detailed Analysis at Different Levels

- Considers an organization not only as a whole, but from the perspective of departments, jobs and processes.
- Aids in finding out the profitable and unprofitable products.

Internal Stakeholder Focus: Targeted at internal stakeholders -management, head of production staff and employees- instead of external stake holders.

It is not exactitude (Financial Accounting) In financial accounting, precision is essential and a company would only use exactly precise numbers to prepare its financial statements while in cost accounting one uses estimates and estimates are rarely ever anticipated to be exact.

Cost Reduction-Efficiency Focus: Striving to reduce production and operating costs through efficiency improvements and optimising resource utilisation.

1.2.3 Management Accounting

Management Accounting is concerned with the analysis and interpretation of financial and cost accounting data to enable management to take informed decisions.

Definition:

According to the Institute of Chartered Accountants of England and Wales, "Management accounting is concerned with the provision of information to management which will enable them to be more effective in: holding their organisation's activities where such information would make a difference."

Management accountancy combines accounting with other information (from both first and third entities) as well as present and potential data to generate reports and manage business decisions. It enables managers in varying hierarchical roles to address specific problems and consider alternatives for decision-making.

For example, a management accountant may work with the finance manager to develop financing plans or help the sales manager determine suitable pricing for a new product based on financial data.

Key Functions of Management Accounting:

Management: Oversight of financial performance and intervention when appropriate.

Coordination Integration of financial and operating activities.

Staff role Activities: - Planning - Helping management to establish objectives and strategic plans.

A major tool play a very important role in the management accounting is marginal costing that makes the analysis of financial data to help decisions at all levels done easily.

Every form of accounting has a unique function that is related to its overall use in financial management, and each one is essential for the efficient and long-term success of an organisation.

1.2.4 Other Branches of Accounting

Auditing: The process of systematically checking the accuracy and validity of accounting records and ensuring compliance with legal, tax, and administrative requirements. Audits may be internal or external, and may be conducted by an organization's employees or by independent auditors. The objective is to validate financial information.

Features:

- An audit tests the adequacy of a company's internal controls.
- Internal audits can help a business identify its financial risks.
- Independent audits would help expose and eliminate corrupt financial practices.
- Audits assure the stakeholders as to the authenticity and credibility of the financial statements.

Example:

For example, let's say the IRS believes that Company XYZ has not reported its income correctly -- or even worse, that it has deliberately underreported its income and owes an

additional $250,000 in taxes. The IRS deploys auditors to scrutinize the company's financial records and tax returns. Once completing a thorough review, auditors determine whether the reported income is in line with what it ought to be, and so whether the company has complied.

Fiduciary Accounting: Fiduciary accounting refers to the management of financial accounts relevant to trusts, estates and receiverships. It follows and reports on the cash receipts/reimbursements; disbursement of funds for appropriateness. This department operates on a cash basis accounting system and only records income or expenditure when cash is actually received or paid.

Features:

Trusts, estates and receiverships also require periodic financial reports filed with fiduciary accounting.

Trusts rely on fiduciary accounting to shield trustees from potential liabilities.

Example:

Adam establish a trust fund for his daughter's college education and designates ABC Bank to serve as the trustee. The bank holds, administers and invests the trust assets such as real estate, stocks and bonds and keeps records of all transactions involving the trust. Fiduciary accounting by ABC Bank: We all benefits from proper reporting and allocation of funds.

forensic accounting: specifically aims at examining financial discrepancies, fraud, mismanagement and resolving disputes. It is an essential part of litigation, and fraud identification and financial crime prevention. Forensic accounting is also utilized by governmental agencies, insurance companies and other financial institutions.

Features:

- Forensic accounting aids in financial fraud investigations.

Financial reports surrounding of forensic accountants are attacked in trials.

- This division research financial damages in product liability, intellectual property and contract disputes.

Example:

Sam, the owner of ABC Company sees a wacked purchase ratio, and throttled inventory levels. Noticing possible fraud, he gets forensic accountants to take a look. After a dive deep into the analysis, they discovered an employee participating in a scam by setting up false vendor accounts to route company money. The information that is collected results in legal action being taken against these criminals.

International Accounting: Because of the phenomenon that is globalization, international accounting is a now crucial part of any corporation which has business in more than one country. As opposed to financial accounting, which is governed by GAAP, international accounting has applied universally accepted principles that enables to maintain ethical procedures of conducting business and it also manages proper corporate governance.

Features:

● International accounting is employed by businesses to translate financial information into a standardized reporting currency.

• Global specific accountants join forces with tax experts to maximize worldwide tax planning.

● Companies turn to global accounting for cross-border mergers and financial statements.

Example:

DBC Corporation is a worldwide enterprise that operates across in ten counties. Its global accounting team combines financial statements across the various subsidiaries, translates currency values, and prepares consolidated reports. These reports are designed for all stakeholder to compare operating performance of the company at global level.

Tax Accounting: It refers to the aspects related to computation and assessment of taxes from individuals as well as businesses, tax compliance and filing. The firm reviews the tax implications for businesses and offers counsel on how to minimize taxes. How a company's liabilities are calculated depends on its tax structure.

Features:

● Business take advantage of tax accounting to minimize theirtax obligation legitimately.

This division also supports the conduct of tax audits and litigation.

● Tax Accountants assist companies in identifying and using tax benefits effectively.

Companies use tax accounting for those transactions to make sure they comply with the law in crossing borders.

Example:

Tax return preparation outsourced to ABC Group, a multi-national Geegaw corporation that maintains on staff tax professionals knowledgeable of foreign and domestic tax laws. This group also works to maintain the company’s tax compliance by referring and

filing taxes in other regions and optimizing tax structure to reduce your liabilities ethically.

Managerial Accounting: Managerial accounting provides internal finan cial information for use in running a company. Between financial accounting, which records historical financial data, and this process is managerial accounting – reporting on how money in the firm is used. It's for internal use, and therefore it doesn't have to follow GAAP.

Features:

- For budgeting and expense control, businesses rely on managerial accounting.
- Companies study past trends in order to forecast their finances.
- Companies also use this accounting division for tactical planning and evaluating department performance.

Example:

ABC Company, a producer of t-shirts, uses managerial accounting to determine the profitability of its different retail locations. It can use this to analyze its opex, find which stores are most profitable and what areas need improving, so the business can make better decisions.

Integrated Report and BRSR Report

1

An Integrated Report (IR) is a report on the performance of an organization that demonstrates the links between an organization's strategy, governance and financial performance and the social, environmental and economic context within which it operates. It goes beyond conventional financial reporting to include environmental, social and governance (ESG) factors that can be important to stakeholders but are not directly controlled by the company, a way for stakeholders to understand how the company generates long-term value.

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Features:

- Value-orientation over time
- Financial and non-financial information combined
- Increased transparency and accountability
- Insights into risk, opportunities and strategy

Example:

A company operating on a multinational level might issue an Integrated Report to highlight not only financial return but also highlight sustainability, corporate social responsibility (CSR) and risk management.

Business Responsibility and Sustainability Reporting (BRSR)

The Business Responsibility and Sustainability Report (BRSR) is a reporting requirement introduced by the Securities and Exchange Board of India (SEBI) for top 1000 listed entities in India. It is an advanced Business Responsibility Report (BRR) and complies with global sustainability reporting standards. The BRSR guidance asks companies to report ESG performance, risks and impact on stakeholders.

Features:

- Includes the criteria related to Environmental, Social and Governance (ESG)
- Aids investors in assessing sustainability risks and opportunities
- Maps to world-wide sustainability standards (GRI, SDGs)
- Policy action and quantitative results-oriented.

Example:

An Indian IT major can publish its carbon footprint reduction, employee welfare programmes and corporate governance policies under the BRSR framework.

Integrated Reports and BRSR Both integrated reports and BRSR are important to increase corporate transparency and sustainability accountability in businesses.

1.2.5 Comparison between Financial Accounting, Cost Accounting and Management Accounting

Criteria

Financial Accounting

Cost Accounting

Management Accounting

Definition

The collecting, summarizing and reporting of financial transactions.

Monitoring and analyzing costs for production, services, and overall company cost.

Interpreting financial and cost information for efficient business decisions.

Primary Objective

To be able to represent a company in all its financial aspect for external entities.

To ascertain the real cost of production and to aid in control of cost.

To give a good finance perspective to decision making at all levels, strategic and operational.

Regulatory Compliance

Be required to follow laws and reg u lations generally accepted accounting principles (GAAP)}_{IFRS}.

other legal standards.

Not legally binding intern use, not mandatory reference.

Not Made by Legal Standard, For Internal Management.

Time Orientation

Past transactions and historical records.

Both backwards and forwards looking (in terms of estimating costs).

Good for some historical time series and future-focused.

Financial Statements

There may be certain financial statements you'd like to look at: Income Statement, Balance Sheet, Cash Flow Statement.

Cost sheets and variance reports.

Tailored reports such as budgeting, forecasting and financial analysis.

Decision-Making Role

Assists external stakeholders in investment and credit decisions.

Aids top management in cost supervision and efficiency enhancement.

Supports decision making on strategy development and performance assessment at the internal level.

Focus

Financial Condition of a Business as a Whole.

Charges for products, services and processes.

Business decision- making and planning.

1.3 Users of Accounting Information

The purpose of accounting is to provide users (those within the organization as well as those outside) with meaningful information that can be used for a range of reasons. Accounting is an organized way of recording financial data for the purpose of analysis and reporting, which ultimately helps resource management and good judgment.

I. External Users of Accounting Information: 1.External users include anyone outside of the organization that uses financial information in any way. The primary external users to whom entities furnish financial information are comprised of the: a. governments and their agencies; b. public holders and other investment holding groups; c. creditors, employees, customers… based on stakeholders (see SEC fauna).

Investors: Business investors require financial information because they want to know if the business is stable with a promising future. These users review financial statements, calculate past performance results and predict future business potential when making their investing decisions. financial statements enable investors to judge both the profitability and financial position of a business in order to assess the safety of their current and prospective investments.

Credit suppliers and banks (banks as creditors): Stability of the organization finance is considered by suppliers and banks along with lenders in extending credit or loans. The firm needs the financial survivability to satisfy its debts as they come due. The liquidity situation of the organization is made visible in its financial statements through current assets and quick assets versus liabilities which aids creditors for analyzing its capacity to pay.

NON-PROFIT Workers of Non-Profit Organizations: Financial details about their fund distributions are needed by non-profit supporters of educational establishments, hospitals and charitable institutions. Financial statements give the interested parties such as shareholders/ potential investors a basis on which they can decide whether to continue supporting the company, given its current financial standing. Non-profit organisations are all about how effective they are at providing their services, not the profits which business enterprises seek to achieve.

Government: Business income assessment and tax liability determination compliance both require accounting records that are used by government organizations to achieve these objectives. Tax returns are prepared using financial accounts so that regulators can audit for compliance. National Income statistics and monitoring the performance of industries are done through agencies set-ups at Government levels using accounting datum.

Customers-The advantages of accounting information to customers include; improved control of costs enhanced by appropriate pricing for the goods. Financial stats help the government authorities to set prices that protect manufacturers while not allowing for

unfair profit exploitation, but also give fair earning prospects. Such a system enables price transparency to the public as well as consumer protection.

Rearch Scholars: Research scholars and professors study business records to assess financial performance along with operational efficiency. Financial statement analysis help researchers not just to investigate the important business operation information and economic trend development, cost management level of detail but also for research on economic growth of enterprises.

II. Internal Users of Accounting Information

The users of the organization are its employees who utilize accounting information to control their strategic and operating decisions. Key internal users include:

OWNERS: Owners provide the money it takes to establish a business (entrepreneurs may also be considered business owners) and in the form of investment or loans, they need financial information to determine how their funds are being used in the business. The proprietors require financial statements to know how profitable their business is and if they are doing anything wrong. Financial information is distributed on a regular basis, which allows for informed business-development and resource-management decisions to be made by owners.

Management: There is the need for accounting information in running a business and management uses such information to plan, monitor and control activities. Through financial

performance evaluation managers compare actual costs to budget and take appropriate action. The development of the budget and cost strategy and, subsequently pricing decisions, use financial information in order that organizations may make a profit and remain competitive.

Workers: Workers, particularly those with performance-based bonus incentives are among the closest to their company's financial well-being. Employees, through their examination of accounting records can analyse compensation equity as well as job security. The transparency of financial information, employees are trustful of their work more and have a higher motivation; and so the stability of organization increase.

The importance of accounting information serving company internal workers as well as external stockholders issues, in company’s financial decisions and regulatory requirements and organizational survival.

1.4 Summary

❖ Accounting in business is crucial as it records the success of businesses systematically, analyses and interprets financial information fairly which allows well informed decision making and helps to carry out matters with transparency. It is the "language of business" in financial reporting, compliance and strategic planning. Objectives of accounting: The objectives of accounting are maintaining system based records, protection and safeguarding the properties, calculation of profit or loss for a specific period, finding out financial position and to help in decision making.

❖ Recording of effective financial accounts is a must and management decision which works on this system, external communication that depends on these Financial statements and legal liability compliances for which such requirement can be easily achieved. The system is used by company insiders and outside users such as owners, managers, employees and potential investors, creditors, government agencies and customers' groups.

❖ Means of homogeneity in the financial statement based on accounting principles such as accrual concept, going concern Consistency and prudence revenues advertiser.

❖ The accounting cycle operates as a systematic process that begins with the recognition of transactions. The accounting cycle itself involves journalizing posted transactions, ledger posting simultaneous with the recording of transaction by altering entries in ledgers followed by preparation of trial balance and adjusting work culminating into production of financial statements namely P&L a/c and Balance Sheet and Cash Flow Statement. They are indicators for the health of a company and help stakeholders to make decisions.

❖ The three major accounting domains are Financial Accounting for external reporting and transaction recording, Management Accounting for internal cost management and strategic planning. The organization keeps its operations going and it keeps the books by these branches working together.

❖ The basic concepts of trusted monetary reporting like matching principle and dual aspect also as historical cost and entity notion. The development of accounting from early Mesopotamia to today's enterprise financial reporting is testament to its relevance. Accounting is a $BILLION global industry and Deloitte, along with PwC EY KPMG are the market leaders.

❖ 3.1 Accounting for business is a basic necessity to retain financial accountability, resource utilization performance appraisal or assess regulatory requirements. Through its

structured ways businesses can stay on top of complicated financial facets to support business growth over the long run.

1.5 Key Terms

Accounting: A methodical approach of recording, categorizing, summarizing, and interpreting a company's financial transactions to provide relevant information for decision-making.

Financial Statements: Documents such as the income statement, balance sheet, and cash flow statement that provide a glimpse of an organization's financial status at any given time.

Double entry accounting: A basic accounting principle, it states that each transaction affects at least two accounts.

Cost Accounting: Concentrates on recording, analyzing and controlling costs in an organization to increase overall operations efficiency and profitability.

Management Accounting: the application of accounting techniques in order to give information and assistance to everyone within the organization.Management accounting involves using financial and non-financial data for planning businesses' strategies, designing those strategies, and controlling their practical contexts.

Trial Balance: A report of the balances in all accounts designed to confirm that the total debits equal the total credits and that the ones used during recording are accurate.

Budgeting and Forecasting – Based on historical financial information, makes estimates of future revenues, expenses and needs for both strategic planning purposes.

Profit and Loss Account: A financial statement that shows income and outgo over a period.

to determine a business's profitability.

Balance Sheet: A financial statement that portrays a company's assets, liabilities and equity position at one point in time.

Liquidity: How readily a company can convert its assets to cash is being used in meeting the corporation's obligations for short term. This liquidity measure is of interest to firms, as they monitor potential for their operating bloatedness in absence before running into liquidity constraints.

Ratios: Benchmarks used to evaluate the performance of companies in terms of profitability, liquidity and solvency.

Compliance and Legal Regulations: Helps businesses to be compliant with financial rules and regulations, such as GAAP or IFRS, in order to be transparent and minimize legal challenges.

Tax Planning: It refers to the transferring assets, income and goods from one generation of family to another with due consideration to tax laws at a minimum expense.

Business Operations: Financial transactions that are conducted, such as sales and purchases or investments, that impact the financial position of an entity.

Financial Reporting: The act of providing the financial statements, enabling stakeholders to take decisions for transparency purposes.

1.6 Descriptive Questions

What is the main purpose of accounting? Illustrate how these goals are advantageous to businesses.

Identify and describe at least four important reasons for the importance of accounting in a business.

Explain how accounting aids decision making by management. Give an example of a practical business decision and explain how accounting data are included in that decision.

What are the steps in the accounting cycle? Explain each step briefly.

Distinguish financial, cost and management accounting. Give an example of each as it would be applied to a business.

C) Discuss the accrual concept in accounting, giving an appropriate example. How is it different from the cash basis of accounting?

What are internal and external users of accounting information? Give three examples of each and how they rely on accounting information.

What is the accounting matching concept? What is its significance in financial reports?

Explain the objectives of a balance sheet and discuss its elements. How does it assist in evaluating the financial health of a company?

Percent Why is it important for businesses to comply with accounting standards such as GAAP or IFRS? Please give an example of a company whose behavior was punished for its failure to comply.

What is analysis of costs in accounting? How does it assist organizations in making pricing and profitability decisions?

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1.8 Case Study

TechNova's Financial Turnaround – Aligning Growth withREDENTIALS: Fulfilled several senior level positions including that of Finance Manager companies/career-highlights/tech-nova-commendation for impressive achievements and Compliance Manager Resume Result Aggregator Page1 Punjab School Education Board division in 2015.

After the red flags in Case Study 1 about revenues and financial visibility were brought to its attention, under the CFO Priya Mehta, TechNova Solutions launched an extensive financial transformation program. Realizing the need to restore investor confidence, and position itself with accounting practices that were in line with the world, the motion picture giant rapidly took action to clean up its books and steady its financial ship.

Key Strategic Actions Taken

IFRS 15 Revenue Recognition Policy The Effect of the adoption of IFRS 16 Collateral MonitoringLanguage: Initial margin Reinvestment Amount and Change in Investment Language: Adoption Entering into Parity with IAS 19 Quest for Cash Equity Method Income StatementOperating lease expenseExpense Recognition approachThe effect of initial application on Lease Expense)\Supplemental Disclosures The Impact on Financial Statements or PerformanceDisclosure ApproachSEGMENT REPORTING SmartLand[Member]Financial Instrument Derivatives

TechNova revisited its revenue recognition policy and switched from upfront booking of revenues to performance based model. Under the new policy:

Annual and multi-year contract revenues is now being recognised over the life of the service.

The accounting complies with the accrual basis. (Revenue is shown on the income statement and deferred revenue is shown as a liability)

Restatement of Financial Statements

The finance function had restated the financial statements of its last two years, in co-ordination with the external auditors, to adjust for their revenue recognition mistakes.

Although this depressed reported earnings, it painted a more accurate picture of the financial health of that firm.

Investor Relations and Communication Strategy

8) Priya Mehta gave a clear investor presentation on what has happened and why it happened. The presentation:

Underlined the firm's dedication to proper financial conduct.

Emphasized the virtues of accurate recognition of revenue over the long term. Delivered a downgraded but realistic projection of future expansion.

Operation Cost Controllability: Detailed review of R&D budget resulted in: - Prioritising high impact projects.

Introducing innovative cross-functional teams to minimise replication of effort. Performance-based funding for research initiatives.

Establishment of a Financial Audit Committee

The Board of Directors created a Financial Governance and Risk Oversight Committee, which is responsible for:

Monitoring adherence to GAAP/IFRS principles. Reviewing quarterly financial practices.

Complying with constantly changing regulations on time.

Outcomes and Impact

Investor trust gradually restored as more shareholders participated in the following quarter meeting.

Analysts lauded the company's transparency, and TechNova was accorded a "High Transparency" rating by an independent financial watchdog.

(the adjusted for short term downward in the revised Revenue however was increased) although future earning potential long term did improve.

The finance team found increased budgeting and forecasting transparency on the inside to support strategic planning.

Key Learnings

Publicly accountable entities need transparent financial reporting so they can grow in a sustainable way.

Both local and international laws require revenue recognition and compliance, IFRS 15 is not only for compliance but also means ethical governance.

This openness to admitting and rectifying errors can boost a company’s credibility AND}}">

market reputation.

Conclusion

The TechNova’s transition from financial fudging to an open, principle-based accounting have underscored the salience of aligning growth with the culture and values of good governance. The company steered in the right direction by adopting global best practices like IFRS 15 and being transparent with stakeholders. This helped regain investor confidence and a sense of internal discipline within the firm. This case highlights that in the new age of business financial stewardship and a vision for growth are not only compliance regulations, but two critical cornerstones to continued success.

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Unit 2: Introduction to Financial Accounting

Learning Objectives

1. Learners will be able to explain the significance of financial accounting in business and its essential role in informed decision-making.

2. Learners will understand the major financial statements (Balance Sheet, Income Statement, and Cash Flow Statement) and their importance in financial reporting.

3. Learners will learn about Generally Accepted Accounting Principles (GAAP) and their role in ensuring consistency, transparency, and reliability in financial reporting.

4. Learners will understand the difference between GAAP, IFRS (International Financial Reporting Standards), and other regulatory frameworks governing financial reporting.

Content

2.0 Introductory Caselet

2.1 Introduction to Financial Accounting

2.2 GAAP (Generally Accepted Accounting Principles)

2.3 Summary

2.4 Key terms

2.5 Descriptive Questions

2.6 References

2.7 Case Study

2.0 Introductory Caselet

“Financial Distress at Stellar Solutions Pvt. Ltd.”

Stellar Solutions Pvt. Ltd, a fast growing IT services provider has seen its revenue growing by 35% in the last one year. Yet despite its expansion, the Company's financials tell a troubling story—falling profits margins combined with higher operating costs and cash burning.

A detailed financial review underscores some of the key challenges:

Much of the revenue is from long-term contracts with payment that may come over time. Its operating expenses, including employee salaries and marketing costs, have soared. Massive bet on technology and infrastructure have burned cash holdings.

Now the management team has a difficult choice to make: how it can continue to grow, but at a rate that doesn't destroy what's special here.

financial stability.

Expansion and Financial Wellness must be balanced by Stellar Solutions. One solution could be to have shift long term contracts from being lumpy LSTK payments into milestone-based structures, with a defined more predictable cashflow profile. In addition, cost can be extracted from operational processes and excess costs evaluated for elimination. While you would want to look for medium to long term financing options such as VC debt or short-term credit lines, it can still be possible to bridge the demand-supply gap with potentially less dilution passed on an entrepreneur. Better still; high margin service offering gets top priority and even raising pricing strategies involving data analytics that ultimately lead to improving overall profitability. Stellar Solutions, mission-driven since its inception, can take it's strategic and deliberate approach to position itself for mature financial strength.

Critical Thinking Question:

In your opintion as a finacial advisor what strategic number shows impact of carrying $X on till and in general what should Stellar Solutions do to improve its cash flow.

2.1 Introduction to Financial Accounting

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."American Institute of Certified Public Accountants (AICPA), Accounting is the language of business.

Accounting process starts with determining the transactions which need to be recorded for preparing financial statement. Only transactions which are of financial nature are taken. Take for example a business man talking to his prospect about the products he's selling, you can't record those kinds of talks. These proposed arrangements are potential transactions which do not constitute accounting treatment unless and until an agreement is reached.

Next comes the systematic recording of financial transactions which is based on Golden Rules of Accounting. Like transactions are sorted together, such as sales, buys

and cash. Knowing the nature of a transaction and using the appropriate accounting standards leads to accurate record-keeping.

But when the volume of transactions is large, in order to check records one by one to discover fiscal behavior becomes difficult. Accounting therefore includes a summarization process since it structures the financial information in a neat and methodical way in order for it to be analyzed more easily. This process has been streamlined by advances in computing. Summarization helps organizations and stakeholders clearly understand financial operations.

In the end, accounting results in the creation of financial statements answering two questions:

Has the business made money or lost money?

What is the status of those assets and liabilities?

Although accounting is sometimes considered an art because those who practice it use reasoned judgments in making decisions,7 accounting also has aspects of science to it. Accounting is not exact and portions of the financial data can be interpreted in different ways.

Did You Know?

- Accountants have been responsible for counting the ballots for the Academy Awards since 1935, ensuring the integrity of the Oscar results.
- The term "bean counter" is a colloquial term for accountants, highlighting their role in meticulously tracking financial details.
- The Financial Reporting Council (FRC) in the UK is investigating audit fees for small and medium-sized enterprises to ensure they are not overcharged for unnecessary work.

2.1.1 Financial Statement Overview

Key aspects of a company's business can be gleaned from financial statements. They are crucial for stakeholders -- such as investors, creditors, and management -- because they not only enable decision making through an understanding of a company's current

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financial health but also future potential. The Balance Sheet, Income Statement, Cash Flow Statement and Statement of Retained Earnings are the four most important financial presentations. Financial statements serve the unique reporting responsibilities of displaying both a period-to-time results and an accumulated time amounts.

Income Statement	Cash Flow Statement	Balance Sheet	Statement of Retained Earnings
• Revenue • COGS • Gross Profit • Operating Expenses • Net Income	• Operating Activities • Investing Activities • Financing Activities	• Assets • Liabilities • Equity	• Opening Retained Earnings • Net Income • Dividends • Closing Retained Earnings

Fig 2.1 Financial Statement

For a certain moment of time, the Balance Sheet provides a useful financial picture for current from a company's periodicperformance.

composition. There it shows the company's assets, liabilities and equity in accordance with the basic accounting equation:

Assets = Liabilities + Equity

Financial resources are measured based on the means of financing underlying them, explicitly liabilities or equity.

● Assets: Firms manage and possess as sets that ultimately contribute monetary gains. Business assets generally can be classified in two types, e.g. current asset, that could be converted into cash (or are already in the form of cash) within an year in the normal course of business and non-current asset which generates benefits over an extended period like property plant and equipment.

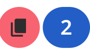
A firm's current asset structure includes both cash and accounts receivable, as well as inventory and marketable securities.

A company's assets include long-term investments that it has made in a building, or piece of equipment like property, plant and equipment as well intangibles such as patented technology and goodwill.

● Legally binding responsibilities of a company to pay at the end of an accounting

period. Current liabilities in payment terms are 1 year, and non-current liabilities must be paid more than 1 year.

Current liabilities consist of accounts payable together with short-term borrowings and various accruals such as those for wages and taxes.



Non-current liabilities include long-term debt, bonds payable and pension obligations on the balance sheet.

● The owners' investment in the business– What's left over after paying liabilities is your equity. Under the traditional definition, equity is placed between net assets and shareholders' equity. Fundamental income line items contained in equity are shares or common stock combined with retained earning and any additional paid in capital.

The financial condition, liquidity and capital structure of an enterprise is made known to concern parties by appropriately designed balance sheet informations. This demonstrates the investments and liabilities of owners in comparison to an owner's assets.

Statement of Income (Profit and Loss Statement)

The income statement Profit & Loss Statement is also a popular report in business that shows the revenues compared to the expenses and the profits or loses over a period of time, usually broken into sections like quarterly or yearly. At that point, the financial statement assesses the impact of business operations on both earnings and performance for the firm.

Major parts of an income statement include the following:

● Revenue (Sales): The company's revenue is sole derived from their primary operating business, the sale of goods and/or services. organisations can include interest or rental income as well as revenues in place.

● Cost of Goods Sold (COGS) : A business records the Production expenses as direct expenditures which are include in the costs attributable to products sold. Costs in this field consist of the cost of materials used in production and workers' wages combined with factory overhead.

● Gross Profit: Your revenue less the cost to make products is how you calculate your gross profit. A company's profit can be determined before operating expenses are deducted.

● Non-Operating expenses: These are not directly related to the production of physical products, these accounts pertain to the acts that help facilitate it. The basic costs of operation in a business are selling and general and administrative expenses (SG&A) such as wages and marketing charges plus the rent bill in addition to utilities fees and office supplies bills.

● Operating Income(The company's profit which is generated from its main business under construction business segment): The profit of the company's chief operating activity, calculated as gross profit less operating expenses.

● Other Income and Expenses: Financial analysis is influenced by core business operations in combination with items not classified as operating activities, including interest transactions and items of both income and expense such as gains or losses on investment.

● Net Income: Organizational profit After deducting expenses, interest cost and taxes / non-operating items towards valued of end revenues of company. A business computes its profit or loss from business activities by calculating net income if total revenue is greater than total expenses, and it reveals a net loss when total expenses are greater than total revenues.

Cash Flow Statement

The Cash Flow Statement shows how a business actually spends it cash and bring in cash as the business runs in that particular time frame. Although the income statement does take some non-cash entries like deprecation, but the cash flow statement only refers to transaction with real cash movement. The filing reveals key details about how the company is managing its liquidity and cash.

The cash flow statement is composed of three sections:

● Operating Activities: The operating portion shows the money that has been generated from producing products or delivering services. Cash flows from operating activities represent the movement of cash resulting from customer receipts and payments to suppliers, employees, tax authorities and interest. Its concentration lies in determining the extent on which the company's operating activities generate sufficient cash flow to maintain its operations as well as meet debt service requirements.

● Investing Activities: Long-term acquisitions or sales of assets create flows that go through this section. Selling investments or assets is an example of when a company experiences financial inflows, while buying those things is representative of a time in which it experiences financial outflows.

● Financing Activities: A category in this section provides details on operating activities that change the capital structure of the entity. (The financing activities report display cash from issuances of stock and financial obligations, minus payments to debt holders and stockholders' dividends.

Companies look to the cash flow statement because it shows them how well they are at generating cash from normal operations and whether money is being used for purposes like pay down debt or invest.

Statement of Retained Earnings

The Statement of Retained Earnings explains how the shareholder equity in retained earnings changes over a period of time. Companies do not pay all accumulated earnings in dividends but rather invest the money back into their operations.

Key Components of the Statement

● Opening Retained Earnings: This shows the opening balance for retained earnings at the beginning of the accounting period. It is made up of retained, undistributed earnings from prior periods.

Example: If a company began the year with, say ₹5 million in retained earnings that would be its first retained earnings.

as the opening balance brought forward for the new period.

● Net Income: The net income you made is added to retained earnings, as reflected on the income statement. Net income indirectly affects retained earnings because it changes the amount of money a business has leftover after paying expenses and their debts. For example, if a firm has a net profit of ₹2 million for the year, and there are no dividends paid during the year, it would add the entire amount to retained earnings on the balance sheet.

● Dividends: These are payments made to shareholders from retained earnings. Dividends are decreases in returned earnings, since some of the profits are distributed, not reinvested.

Illustration: If a company declares ₹1, 00, 000 as dividends the same would be deducted from retained profits.

earnings, decreasing the balance.

● Final Retained Earnings ending balance of retained earnings after adjusting for net income and dividends. It is the balance to be carried forward for the next period and it shows the retained earnings which are available for reinvestment.

Example: If company starts with 5M, earns 2M in the period and pays out ₹1M as dividends, the closing RE balance will be ₹6 Million (₹5 +₹2 -₹1).

Corporate retained earnings reporting is a way for firms to display the transformation of their retained profits, revealing decisions by the firm about what percentage of profit will be allocated towards internal reinvestment and what percent shareholder payout.

Did You Know?

- The first known accounting records date back over 7,000 years to Mesopotamian civilizations, where clay tablets were used to record transactions.
- Luca Pacioli, an Italian mathematician, is considered the "Father of Accounting" because he introduced the double-entry bookkeeping system in his book Summa de Arithmetica in 1494.
- The Cash Flow Statement only records actual cash movements—unlike the Income Statement, which includes non-cash items like depreciation and amortization.

2.1.2 Importance of Financial Statement in Financial Reporting

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Financial statements give a true and fair view of the state of affairs. Managers, investors, creditors and regulators depend on these periodic assessments to understand how an organization is performing financially and to decide upon future action. Here are key reasons why financial statements are important as well as examples:

Fig. 2.2 Importance of Financial Statement in Financial Reporting

Decision-Making for Management

When are Financial Statements used by the business leaders? The Income Statement and Cash Flow Statement are all about profitability, whereas the Balance Sheet is into liquidity and solvency. Management can apply the content to implement strategies for investments, cost containment and operational enhancements by reviewing this data.

Example: A owner of a retail business will look over their financial statements when she notices an decrease in the bottom line, net profit. Management opts to cut wasteful costs as well as reform some aspects of supply chain practices.

Building Investor Confidence

Investors rely on financial statements to gauge a company's stability and future potential for growth. These reports address critical questions including managing the business, the ability to handle economic conditions and long term growth potential. Such strong and transparent financial statements will increase investor confidence which make it easier for companies to attract funding.

Example: A startup is vetted for its financials by a venture capital firm before investment. It the company has consistent revenue growth and strong cash on hand, then this decreases the investor’s risk and he is willing to invest.

Ensuring Regulatory Compliance

Nearly all companies are required by law to issue financial statements in compliance with accounting standards such as GAAP or IFRS. In this manner, the financial statements will be portraying the true position of the company n terms of finance, keeping them transparent and safeguarding stakeholders too.

For example: A publicly held company regularly submits quarterly financial statements to the Securities and Exchange Commission (SEC) in order to remain compliant with certain regulations and avoid penalties.

Assessing Creditworthiness for Lenders

HomeAbout debt and lending Read more You don't have access to this page yet Banks / financial providers look at a company's financial statement before offering them loans/ credit to be able to repay such borrowings. A company with clean financial statements can borrow more cheaply.

Example: A manufacturing firm requests a commercial loan. The bank reviews the company's financial statements. The bank observes a well operated cash flow and low debt-to-equity ratio, loans at lower interest.

Benchmarking and Performance Evaluation

Firms compare their numbers with industry norms and rivals to find out where they are strong and weak. Advantages of Financial Ratios Profitability, efficiency and liquidity ratios help a company to measure its performance and change its business tactics.

Example: A Telecommunication company tracks its profitability to the industry leaders and discovers that operational expenses are on the higher side. It then reshapes its pricing model to stay on the cutting edge.

Tax Planning and Compliance

Tax Planning Tax planning is one of the most important aspect of Finance where clear statements about the income, expenditures, and liabilities can guide a large part of financial action in any organization. Adequate documentation is not only a requirement for an organization, but can also pinpoint potential tax credits.

Example: A technology startup realizes through its P&L that it would be able to compute research and development costs as deductions so as to lower tax incidence on itself.

Businesses and their stakeholders rely on financial statements for transparency, data-informed decision-making, compliance with regulations and the ability to plan financially. By dissecting these reports, companies have a way to buoy - and guide - their financial health as they steer toward lasting success.

Knowledge Check 1

Fill in the Blanks:

1. The Balance Sheet follows the fundamental accounting equation: Assets = __________ + __________.
2. The Cash Flow Statement consists of three main sections: Operating Activities, __________ Activities, and __________ Activities.
3. Investors rely on financial statements to assess a company's __________ and __________ potential before making investment decisions.
4. Before approving loans, banks review a company's financial statements to assess its __________ and ensure its ability to repay debts.

2.2 Generally Accepted Accounting Principles (GAAP)

This text is done based on Indian Accounting Standards (Ind AS), which is also similar to the International Financial Reporting Standards (IFRS). The Institute of Chartered Accountants of India (ICAI) is instrumental in the making of these financial reporting standards, which leads to a consistent and transparent presentation of financial statements among companies for different periods.

GAAP in the UK and Ireland is not a single source of accounting standards but rather is composed of several sets of standards issued by various authoritative bodies. However, GAAP does not vary internationally as local accounting limits the development of universal accounting standards (Indian GAAP, UK GAAP). In the

United States[edit] GAAP in U.S. is ruled by the Financial Accounting Standards Board (FASB) and it's vital to differentiate one standard from another when calling a country's set of standards "GAAP" (e.g.Standard plus GAAP doesn't equal US-GAAP).

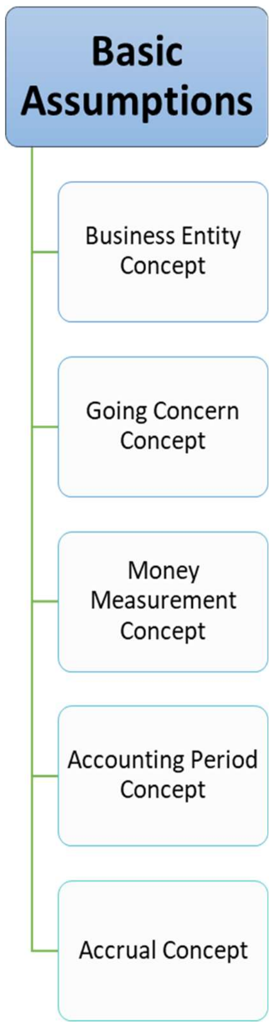


Fig. 2.3 Generally Accepted Accounting Principles

Basic Assumptions

Accounting concepts and conventions: The foundations of accounting Summary Basic assumptions __ They form the basis on which financial statements are prepared.

(a) Business Entity Concept: It treats business as separate from its proprietor and keeps the personal transaction of business and proprietor separate. This idea keeps the transparency, checks financial manipulation and brings accountability in the business operations.

Example: When the owner takes money out of the business for personal reasons, it is considered a drawings transaction - when you take money out to buy groceries etc. (a non-business purchase) and not recorded as a business expense.

(b) Money Measurement Concept: Financial statements include only such transactions and events whose value can be expressed in monetary currency. Non-financial factors such as worker productivity or public relations are also omitted, even if they do indeed have a financial effect.

Illustration: A firm's goodwill may be a factor in value but unless acquired it is not recognized on the books.

(c) Business Entity Concept: Business to be treated as a going concern unless proved otherwise. This idea permits assets and liabilities to be accounted for on their long-term use, rather than immediately liquidation value and yields smoother accounting.

Example: A business that buys equipment lists it as an asset, not as an expense, because the tool is intended for long- term use.

(d) Accounting period concept: Financial statements are prepared for a specific period (monthly, quarterly and annually) to review the operations of business systematically. This enables businesses to be able to compare financial information over reporting periods and for compliance with governmental regulations.

Exemplaire : Companies file financial reports at the end of its financial year (April to March in India and January to december in most other countries).

17

(e) All transactions are recorded when they take place, rather than when the cash is received or paid. This is done so that the financial statements present true net income and obligations and consequently helps companies to keep track of their financial status.

Example: A company with revenue in December and payment in January records the amount as a December receivable, under the accrual method.

Fundamentals: These are the fundamentals which provides a systematic way of recording business transactions to maintain reliability and comparison.

11

(a) Revenue Recognition Concept: Revenue is recognised when it is earned and not when it is received in cash. This principle guarantees that the financial statements depict the true performance of an entity assisting investors and management in making sound decisions.

For example, A sells goods on credit in March and receives the payment in April. The sales are booked in March as well.

(b) Dual Aspect Concept: All transactions have two aspect that is recorded in such a way, the accounting equation (Assets = Liabilities + Equity) remains in balance. This principle is the basis of double entry bookkeeping.

Example: A company buys equipment for ₹50,000 Increases assets (equipment) and decreases

moola (or more debt if bought on the suit)

(c)Matching Concept: Expense should reflect in the same period as that of revenue generation. This principle preserves the proper determination of profit and loss and prevents misleading reports by associating costs with revenues earned.

Illustration: When, for example, a firm spends money on advertising in December to generate January sales, the expenditure should be charged against revenue earned in January.

(d) Full Disclosure Principle: Financial statements must be capable of giving stakeholders prompt, full and apparent details about the items that affect their decisions. This principle requires material facts, such as risk and uncertainties to be disclosed in footnotes or notes to account.

Illustration: Contingent liabilities (probable future losses) are disclosed in notes to accounts, even though they are not yet realized as a loss.

(e) Materiality Concept: All entries and transactions are recorded based on source documents such as invoices, sales contracts, or receipts. This means a more accurate and reliable billing system, with less chance of fraud or mistakes.

For example, a sale transaction is posted only if there is an authorized sales invoice.

(f) Historical Cost Concept: Assets are reported at their purchase price and not their market value. This maintains uniformity and avoids arbitrary differences in financial reporting merely based on changing market conditions.

Example: Even if the market value of land, acquired for ₹5 lakh, appreciates to ₹8 lakh but that is not a revenue gain as it remains at that old value in the financial statement.

(g) Balance Sheet Equation Principle: The basic accounting equation is preserved to

those activities which dryaiffer each side of a balance sheet (i.e., Assets = Liabilities + Owner's Equity). There should be at least two entries for every financial transaction.

Example If a company takes a loan of ₹1 lakh, the entry will be on both asset side and liability side i.e. cash by bank (asset) Loan payable (liability).

keeping the equation balanced.

Modifying Principles

These are key tools to move forward the application of fundamental concepts and principles in the quest for better financial reporting.

(a) Consistency Principle: It requires that accounting procedure and practices should be unchanged from one period to another and it is not be changed without sufficient reason for the purpose of achieving uniformity comparability of financial statements. Change to the procedures should be disclosed and justified.

Example: A company has no right to change from the straight-line basis of depreciation to reducing balance method which is entirely at their whim.

b) Materiality: The materiality concept provides guidance on what information should be presented – it is based on the principle that only those items that in some way are significant to users decision making process need be disclosed. Small-potatoes stuff can lumped under a bigger heading or two. Immateriality is a function of materiality: what does not matter to the large corporation may matter to its smaller colleagues. This also enables a more compact balance sheet, as it does not require to be stretched.

Example: A big company wouldn't account for a ₹10 purchase of office stationery as an individual line item, such expense is put under "Miscellaneous Expenses" as the amount is trivial and doesn't make any sense to take financial decisions based on it. Even so, an amount that small could be considered material for a tiny company relative to its overall financial situation.

(c) Conservatism Concept (Prudence Concept): Financial statements ought to be prepared with prudence having in mind posible losses but not probable profits. This method deters businesses from over-reporting its profits and assets.

Example: If a company is anticipating that some customers may default then even though the customer has not defaulted on them they still will make a provision for bad debts and these provisions are also known as "provisions for doubtful debts".

(d) Timeliness Principle : Financial information should be communicated early enough so that it will affect the decision making process of information users. Late reporting may cause decision-makers to act on obsolete or irrelevant information.

Example: A company needs to file its financials annually, in time for the regulator deadline so that investors get updated information.

(e) Industry Practice Theory: While preparing financial statements, different industries may have specific methods of accounting that are customary to the nature of their 23 business. This is to ensure that the financial reports are automatically generated in a relevant and accurate manner with respect to industry based requirements.

Illustration: In the property sector, revenue is measured at stages of completion, whereas in retail revenue is recognized on making a sale.

Key Features of GAAP:

● Rules-Based System: For its part, the rules-based system under GAAP incorporates specific directives for how to treat common accounting scenarios. The model helps companies report very detailed transactions while providing a lot of additional detail in reporting them.

● Pervasive Guidance: Illustrated among the GAAP guidelines would be Weapons accounting treatments for selected assets;b liabilities; and c statement of earning recognition supplemented with expense allocation methods.

● Endurance for Consistency: The consistency makes the standardized reporting amongst periods to be repeated that underlies dependability more swiftly than relied upon between business and economic periods with stakeholder.

2.2.1 International Financial Reporting Standards (IFRS)

The International Accounting Standards Board generates accounting standards in the form of International Financial Reporting Standards that new processes are based on. Both U.S. and European leaders are also committed to convergence with the goal that investors around the world will be able to use the same financial information for making investment and credit decisions regardless of jurisdiction.

Key Features of IFRS:

 Substance rather than Form: The IFRS pay attention to what substances are of transactions that financial report should apply, regardless of legal form. It describes IFRS's mandates to reveal financial transaction details that could contradict legislation and executed contracts.

● Principles-Based vs. Rules Based: IFRS is principles-based and GAAP istreats for exceptions and flexibility based on industry, country, etc., as its most basic design differing point. The IFRS accounting guidelines do give overall basis approaches as well as direction by the company for separate transaction reporting.

● Worldwide Compatibility: Over 140 countries have converged with IFRS standards including Australia, Canada and the European Union. IFS offers a common financial langauge for global enterprises, which synchronises economy and regulatories across the globe.

Key Principles of IFRS:

● Accrual Accounting: IFRS uses accrual accounting and entities are required to record transactions as they occur, not only when they pay cash. Revenue has to be boked when the service is offered or products delivered even if money comes in at various points.

● Fair Value Measurement: Valuing assets based on prevailing market values supersedes historic cost valuations in numerous IFRS financial reporting protocols. You have to be presented with stocks and bonds as fair value on the balance sheet in IFRS while you can only show them by historical or even amortized cost (in case of debt securities) in GAAP.

● Property Approach: In a component approach manner It allows the depreciation of separate parts of a single asset having different useful lives. IFRS guidelines allow a company to allocate cost towards their building structure and roof components while depreciating them over separate useful lives.

Differences Between GAAP and IFRS

Financial reporting is in need of guidance from GAAP and IFRS despite the two frameworks showing considerable discrepancies in their architecture concerning both content and form, as well as with respect to precise accounting regulations. The following are a few major inconsistencies between GAAP and IFRS:

a) Revenue Recognition

● GAAP: GAAP specifies a set of detailed revenue recognition rules that are categorized into separate industry-specific guidance. Software and construction companies need special rules for revenue recognition, as both of these industry groups have their own rules governing when a company can record incoming revenue.

Illustration: The contractor uses percentage-of-completion method to recognized revenue–as following the development of the project, income continues to flow.

• IFRS: The customer obtaining control of the goods or services is a broader principle that underlies revenue recognition in IFRS 15. Revenue recognition in IFRS relies on control switching instead of focusing on the change in ownership as both systems adhere to the same basic principles.

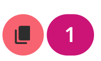
Example: A revenue recognition event takes place when customers get possession of company products; and that can happen months after the company received payment, instead of weeks.

b) Lease Accounting

70 ● GAAP: The guidance in GAAP creates two categories of lease by using the classification operating leases similar to operating leases under GAAP and capital leases classified as financing leases. Operating lease transactions are not listed on a company's balance sheet, they can only register payments as expenses.

Examples include: If an entity elects the operating model for lease contracts relating to their office premises, then it doesn't recognize any rights deriving from its right-of-use asset or any financial obligation.

● IFRS: Follows IFRS 16 that all leases are treated for accounting purposes on the



balance sheet. Regardless of classification, operating and finance leases are accounted for on balance sheets as right-of-use assets and corresponding liabilities.

Example: When a company leases office space for use as shops (e.g., rental shop) IFRS

requires that, at the inception of the lease, a right-of-use-asset and a lease-liability are recognized representing an estimate of the present-value of future payments.

c) A ssets and Liabilities Measurement

● GAAP: Most assets and liabilities are measured at historical cost under GAAP, but financial instruments and debt securities can be valued at fair value. In other words, financial statements under these circumstances, do not necessarily represent current market valuation of assets and liabilities. Example: Under GAAP accounting, a company also has value the machine at its Rs. 100,000 (purchase price) even if is market worth fluctuates over time.

● IFRS: Some assets and liabilities measured at fair value in accordance with IFRS. For IFRS,‡ investment instruments such as equities or bonds derive their value through the fair value measurement that is affected by market conditions.

Example: Under IFRS, a firm that carries available-for-sale stocks reports the fair market value of those stocks on its balance sheet.

d) Inventory Valuation

GAAP: In the U.S. Generally Accepted Accounting Principles allow financial companies to use LIFO (Last in First Out) approach for valuing their inventories. LIFO Transfer pricing works under the logic that "what we bought last is what we should sell first." During times of rising prices, it lets businesses reduce their taxable incomes by linking higher purchase prices and revenue.

Example: In a hypothetical situation with LIFO inventory accounting, if a company has purchased 1,000 units at Rs.5 each when the markets were low and then bought additional units at Rs.6 each, they could claim Rs.6 for each sold type of unit.

5 IFRS: Under IFRS, inventory valuation does not allow LIFO methods. companies must decide on FIFO or weighted average cost method for their inventory valuation-method.

32

Example: An entity that reports under IFRS and has selected FIFO as its accounting method will include first-in, first-out cost of goods sold (i.e., determine the cost of goods sold based on the units in the oldest purchase batch) (the determination after which method would tend to shift net income between periods results in an increasing taxable amount between periods in markets with rising prices).

e) Treatment of Goodwill

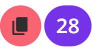
15

Goodwill: A look back period not less than one year is prescribed to test goodwill under GAAP. Companies must write off an impairment loss when the carrying value of goodwill exceeds its fair value.

Illustration:- An impairment of Rs. 200,000 shall be imposed in this case is because annual tests show that the fair value amounts to Rs. 800,000 when goodwill has been calculated at Rs. 1 million

2.3 Summary

❖ Accounting means recording, classifying, summarizing and interpreting money transactions. This is where only material financial transactions that affect a company's financial status are documented, and developed discussions or potential deals are excluded until concluded. Transactions are systematically recorded in accordance with the principles of accountancy and they are classified and summarized under appropriate heads for analysis.



❖– Financial reports gi ve a picture of a company's financial condition and include: BS, IS, CF S and Statement of Retained Earnings. The Balance Sheet lists a company's assets and liabilities, ie asset side = liability side at any balance sheet date. Current assets (liquid enough to be converted into cash in a year) and non-current assets are thus sub-grouped within the asset recourse. There are current liabilities(due within a year) and non-current liabilities(long-term debt).

❖ The Income Statement shows revenues, costs and the resulting profit of a firm over time. It has sales, cost of goods sold, gross profit, expenses and earnings. In the Cash Flow Statement, you are concerned with inflows and outflows of cash in 3 sections:

operating, investing, and financing activities. The Statement of Retained Earnings also called the retained earnings statement, that shows how retained earnings have changed from one accounting period to the next.

❖ Financial reports are important for making business decisions, for investor confidence, for the purposes of regulation, in establishing and reviewing ranges in creditworthiness, and planning for taxation. Several conventions, including the business entity convention, the going-concern assumption, the money measurement convention and the accounting period convention, that underpin GAAP provide a framework to ensure consistency of financial reporting. These are the basics for accounting practices to make financial data reliable and comparable.

❖ International Financial Reporting Standards (IFRS) represent widely accepted accounting standard to ensure a principle-based approach. Unlike GAAP, which is rule-based, IFRS emphasizes substance over form and the measurement based on fair value. For those companies that use IFRS, the recognition of a transaction depends on when control of the goods or services transfers, rather than changes in legal ownership.

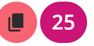
❖ GAAP and IFRS vary in aspects including the one relating to recognition of revenues, accounting for leases, measurement of assets and liabilities, the value at which inventory is held and that assigned to goodwill. GAAP provides industry-dependent standards related to revenue recognition, IFRS uses a principle based method. It is allowed under GAAP to use LIFO when the company evaluates its inventory, whereas it is not permissible under IFRS. Under GAAP, goodwill is tested for impairment annually; however IFRS has stricter requirements and allows a “reversal” in certain circumstances.

2.4 Key Terms

19 Accounting – or bookkeeping is the systematic recording, reporting, and analysis of financial transactions of a business and its effects on the enterprise itself/owners are interested users.

16 4 Financial Statements – Financial statements such as reports on the company's financial position and performance, balance sheet, income statement, cash flow statement and statement of retained earnings.

Balance Sheet – A statement of a company's assets, liabilities and equity on any given date. It is a snapshot, because it is derived based on the equation Assets = Liabilities + Equity.



25 Income Statement – A company's statement of income and expenses and the resulting net profit or loss for a specific accounting period. It is often thought of as a snapshot of a firm's performance.

Cash Flow Statement – A table showing a firm’s inflows and outflows of cash for the accounting period, under three main heads: operating, investing and financing.

- Retained earning: the net profit of your company - over a period of years, plus an amount (Previous Year) that is ploughed into the business when you are thinking about distribution pay to shareholders, that Previous year.

GAAP (Generally Accepted Accounting Principles) – Standardized principles and guidelines used in the U.S to prepare and maintain financial accounts that will instruct the company in maintaining standard for accuracy, consistency and presentation of an entity's reported financial position.

IFRS (International Financial Reporting Standards) – A global set of standards emphasizing principles and fair value measurement for financial reporting.

Revenue Recognition — A rule that governs the timing of revenue recorded, dependent on whether or not goods or services have been provisioned to a customer.

1 Accrual Basis of Accounting – A system in which revenues and expenses are recognized when they are incurred (not necessarily paid or received).

Assets – The economic resources of a company that have the future benefit to company, recording them in (a) Types- Current Assets Non-current / Fixed Asset.

31 Current assets (short-term) and non-current assets (long-term).

Liabilities - Company's financial writing off towards, divided into and long-term obligations.

26 Equity – The interest remaining in the assets of an entity after subtracting liabilities (the book value).

intangible portion of the per share ownership value, consisting of common stock and retained earnings.

Going Concern Assumption – Presumption of continuous entity existence unless evidence to the contrary exists; affects the recording of assets and liabilities.

Matching Principle – It states that costs are reported in the period when they help produce revenues, ensuring faithful representation of the financial results.

Historical Cost Principle - The idea that assets should be valued based on their original purchase price, as opposed to current market value, which provides conservative valuations for financial statements.

utting Edge Contractor Software and an Outstanding Service! The accounting rule that requires recognition of a possible loss immediately, but deferral of an expected gain until realization, entailing financial constraint.

LIFO (Last-In, First-Out)_ A method for valuing the cost of inventory sold that assumes the most recently purchased items are sold first—allowed under U.S. GAPP but not allowed IFRS.

FIFO (First-In, First-Out) – A method of valuing inventory for financial statement purposes by assuming that the first goods acquired are the first goods sold, which tends to result in better matching of costs and is acceptable under IFRS.

Goodwill - The difference between the amount paid for a company and its net worth, an intangible asset that must be tested for impairment under GAAP and IFRS.

2.5 Descriptive Questions

What is accounting? And why is the study of it often referred to as both an art and a science?

What financial events are included in accounting and those not included?

Quantify the ways in which accounting assists decision making and planning for businesses.

What are the main financial statements and what does each one tell you?

why is the accounting equation (Assets = Liabilities + Equity) balanced?

What is a current asset vs. a non-current asset? Provide examples.

What is liability and how it differs from equity in the balance sheet?

Income Statement How it reflects the Profitability? What does income statement consists of?

How does COGS affect the gross profit for a company?

What are operating expenses and how do they relate to COGS?

What are the three major parts of a cash flow statement and what does each section show?

In what ways can financial statements help investors evaluate the stability and growth prospects of a company?

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Answers to Knowledge Check

Knowledge Check 1

1. Liabilities + Equity
2. operating, investing, financing
3. financial health and growth
4. creditworthiness

2.7 Case Study

Analysis of the Financial Statements of Zenith Electronics Ltd.

Company Profile Zenith Electronics Ltd. Based in Britonwood at 0071 west Illife Street 110, this medium-sized consumer electronics firm has seen its top line grow over the last three years. But the company now has major financial problems, with decreasing profitability, liquidity problems and high leverage. This article presents and discusses these issues, an analytical study, and proposed solutions to strengthen the financial structure of the company.

Background

Zenith Electronics Ltd, established in 2015 with a focus on smart home appliances. The firm has a powerful market presence but has faced growing competition and higher production costs.

Financial Highlights for 2022-2023:

Revenue went up from ₹150 crore to ₹180 crore.

Net margins, however, slid to 8% from 12%. Operating cash flow became negative (-₹5 crore).

The debt to equity ratio rose from 1.2:1 to 2:1 which has led concern about the company's financial risk.

The management of EGEMAC is worried about this trend and it wants to take corrective actions for the purpose of having continuous growth.

Problem 1: Profitability Is Going Down and Revenue Up

Zenith Electronics Ltd.'s net profit margin decreased from 12% in 2022 to 8% in 2023, despite an increase in revenue of 20%.

Analysis:

Our COGS increased considerably, driven by increasing costs of raw materials. The company's operating expenses, including those for marketing and administration, also soared.

The cost of interest on new long-term loans rose.

Solution:

13p Optimize production scope -� Negotiate better rates with suppliers, and consider cost--sharing. S ub o p ti m iz e r ecord 15p U se of al te rn ative Ideas Become more creative and flexible in offering alternative materials and design specifications to minimize costs & variety assumptions with a high probability to misuse resources Source: Sakrellidou K., et.all (2015) Tab.

efficient manufacturing processes.

Cut down inessential overhead costs, including marketing and administrative fees. Refinance more expensive loans for lower interest costs and enhanced profitability.

Issue 2: Liquidity Issues - Adverse Operating Cash Flow A company has to carry out a number of investments in its business to pay bills, buy stock, purchase equipment and machinery; show visibly inadequate operating cash inflow.

The company had profit after tax of ₹20 crores as on 2023 but had an operating cash flow of -₹5.

crore, raising liquidity concerns. Analysis:

Solution:

A lot of the cash is tied up in inventory and accounts receivable. Extended payment terms have delayed receipt of cash.

Higher cap ex continued to deplete the treasury.

Optimize inventory to prevent overstocking and free up cash on hand. Improve terms to better collect on customers information policies Equipments will be bought on lease to cut down immediate cash out-flows.

Problem 3: High Debt-to-Equity Ratio

The D/E ratio went from 1.2 to 2.0, which led the company to a higher level of Debt financing and further expose its financial risk.

Analysis:

Solution:

The firm chose to borrow new money to pay for growth, rather than sell more stock. High leverage leads to higher interest expenses, which impacts the profitability.

High debt ratio hinders the future borrowing ability.

Diversify financing with equity and not depending only on debt. Put early debt repayment at the top of the priority list to minimize financial risk.

And build up retained earnings by recycling profits rather than borrowing from the outside.

Reflective Questions

Why does rising sales not always lead to higher profits?

What are the available methods for a company to lower its Cost of Goods Sold (COGS) without affecting product quality?

If a company is profitable, why is negative operating cash flow worrisome? How can businesses optimize cash flow management?

What is meant by companies with a high financial leverage (Debt-to-Equity Ratio) have an effect on long-term sustainability?

What is the danger of over-reliance on debt capital?

How can firms find the right mix of debt and equity financing for growth? How does inventory management contribute to financial stability?

Howdofinancialstatementshelpinvestorsandlendersassessacompany'sfinancialhealth? How does refinancing high

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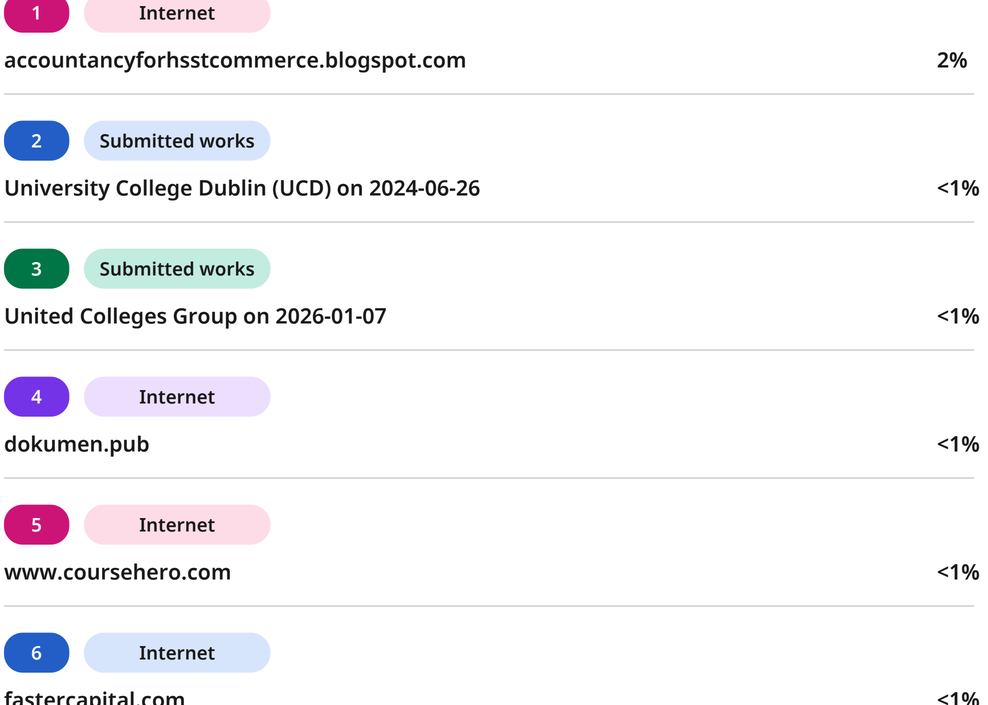

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Unit 3: Methods of Depreciation and Inventory Valuation

Learning Objectives

1. Learners will be able to define the concept and significance of depreciation in financial accounting
2. Learners will identify and apply different methods of depreciation (Straight-Line Method, Declining Balance Method, Units of Production Method, etc.).
3. Learners will learn about the importance of inventory valuation in financial reporting.
4. Learners will understand the principles of double-entry accounting and journalizing transactions.

Content

3.0 Introductory Caselet
3.1 Introduction to Depreciation
3.2 Inventory Valuation
3.3 Accounting Mechanics
3.4 Financial Statement
3.5 Summary
3.6 Key Terms
3.7 Descriptive Questions
3.8 References
3.9 Case Study

3.0 Introductory Caselet

"Titan Manufacturing Ltd: Balancing Depreciation and Inventory Cost"

Titan Manufacturing Ltd., a middle-sized manufacturer of industrial equipment, recently took over new machine costing ₹20,00,000 on which loans were contracted. There is also a good amount of inventory that the company holds, in terms of raw materials, work-in-progress and finished goods. As the year-end financial statements are being prepared by the finance department two decisions arise which stand out.

Choice of Depreciation Method – Whether new machinery should be depreciated under the Straight-Line Method (SLM) or the Written Down Value (WDV) Method depends upon the discretion of the management. Though, SLM is regular AD method but WDV produces more depreciation in initially years (it is advantageous from tax point of view).

Selection of an Inventory Valuation Method – The company is evaluating inventory valuation methods. Because companies in India cannot use LIFO (Last-In, First-Out), they are concentrating on FIFO (First-In, First-Out). Although FIFO resulted in higher profits in an inflationary environment (because the cost of goods sold was calculated based on older, lower-priced inventory, and that inflated profit margins), this made no economic sense.

Understanding the effect on financial results, tax planning and compliance implications will force management to decide what procurement strategies should be used ... profit maximization or faithful reflection of economic reality?

Critical Thinking Question:

As a financial advisor, please advise Titan Manufacturing Ltd. as to how they should choose its depreciation and inventory costing method in order to achieve an equilibrium between profit maximization, tax minimization and accuracy of barsancesheet representation. What are the factors that should impact their decision?

3.1 Introduction to Depreciation

Machinery, equipment and buildings are assets that businesses must have to function. These assets depreciate over time because of aging, wear and tear, use, or technological change. This decrease in worth is called depreciation. Depreciation also needs to be considered because it allows for correct financial statements, tax planning and investment choices. Depreciation provides for the orderly allocation of a business asset's cost over its useful life by matching expenses with revenues produced by that asset. It is a non-cash expense that lowers taxable income and represents the amount of an asset’s value used up during the period.

3.1.1 Meaning of Depreciation

Depreciation is the process of allocating the cost of an asset over its useful life. It is the loss in the worth of an asset as a result of wear and tear, use, or going out of fashion. More than any other kind of cost that can be incurred, depreciation is non-cash; there's no cash movement for its "cost" at all.

For instance, if a firm buys machine for ₹10,00,000 and thinks that the machine would be helpful to generate revenue for the next 10 years the.

cost is to be spread over such period and should not be regarded as immediately deductible.

Through depreciation, company's income statements will not overestimate the amount of its profit when spreading the cost of assets is for a number of years; it supports matched principles in accounting.

3.1.2 Definition of Depreciation

Depreciation has been described by several accounting and financial authorities as:

- Institute of Chartered Accountants of India (ICAI):

"Depreciation is a physical condition wherein the value of property has declined due to wear and tear, technological or usage obsolescence and accrues over time."

- American Institute of Certified Public Accountants (AICPA) (b):

"Depreciation accounting is a method of accounting designed to spread the cost of tangible capital asset, less estimated salvage value (if any), over its life in an orderly and systematic manner."

- AS-6 Depreciation accounting - (India):

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The original purchase cost of an asset is used for calculating depreciation together with its alternative cost yet reduced by its residual value.

3.1.3 Features of Depreciation

Depreciation is a fundamental accounting concepts that allows firms to 'spread' the cost of tangible assets over their useful lives. This feature can aid to companies to right accounting redports using its effect etcrr shows value of asset overtime. Asset value decreases over time when the asset ages and by natural wear and tear and regular usage. The benefits of efficient and tax business assets management Financial stability, depreciation and features actually rely for understanding.

Reduction in Asset Value

The value of an asset diminishes slowly over the years. The value's decline is primarily due to assets being used up and physical wear and tear or depreciation of technology.

For instance, the use value of a manufacturing machine is not maintainable as superior and modern equipment hits the markets.

Non-Cash Expense

Depreciation is an accounting-allocating method, not a valuation method, and it is unlike ordinary business expenses in that no cash expenditure has occurred. Depreciation is a non-cash item but it reduces net income and has an impact on the balance sheet of the company.

Gradual Allocation

Depreciation doesn't show up as one large expense, it's spread across a number of accounting periods. The cost allocation concept of depreciation permitted companies to spread the costs associated with assets over time, and this in turn enabled them to avoid burdensome income statement charges.

Applicable Only to Fixed Assets

Only physical fixed assets such as buildings, equipment and vehicles are allowed for depreciation treatment due to their longer useful life. It does not stick to current assets such as inventory, which is consumed or sold within the near term. Intangible assets (such as patents and copyrights) also depreciate through the process of amortization.

Affects Financial Statements

It also lowers the book value of assets as reported on your balance sheet — and is reported as an expense in relation to that asset on your income statement. The business operation is less lucrative, because net income falls as the value of depreciation increases. An enterprise ignoring depreciation will not be properly stating its assets and earnings, and it portrays erroneous financial data.

Different Methods Available

Income tax rules in India allow the WDV method for calculating depreciation. Governments give businesses permission to choose methods of depreciation producing accelerated deductions diminishing taxes during the first years assets are acquired. Different depreciation approaches can be used to estimate the value decrease of assets. For example, straight-line depreciation spreads a uniform amount of the cost over each year, while declining balance expense is weighted more heavily during the early years. The method to be used for financial and tax reporting is a function of the type of business and required by governing regulations.

Impact on Taxation

Depreciation is a hidden tax shield for businesses because the expense lowers taxable income. Enterprises are authorized by governments to choose methods of depreciation

which give an accelerated deduction to reduce their taxes during the initial period in which they have acquired the assets.

Regulated by Accounting Standards

There are several accounting principles and guidelines imposed upon you that will determine how such a depreciation is calculated. The depreciation rules in India are laid down by Accounting Standard AS-10

(PP&E) and the Companies Act, 2013. The US IRS (Internal Revenue Service) with GAAP (Generally Accepted Accounting Principles) sets the depreciation standards in the U.S. Regulatory standards, in aggregate, seem beneficial to financial reporting given that they promote consistent reporting transparency and results.

The characteristics of depreciation emphasize its place in financial reporting, asset measurement and allocation of expenses. Businesses may also reduce taxable income through depreciation as a non-cash expense it is deducted from accounting records without affecting cash balances.

3.1.4 Significance of Depreciation

Depreciation is also one of the cornerstone principles in accounting and finance as it is an important tool to assist organizations with stewardship and serve as a measure to reduce taxes. The cost of physical assets is assigned to periods (depreciation) with a rational basis so as to present an artificial match between costs and revenues on the financial statements. The following perhaps answers why depreciation is important:

Accurate Financial Reporting

Depreciation is used in business accounting to display fair updated financial statements as it lessens the value of the assets that are recorded over their useful life. The PS system allows catching profit Merchandising Imbalances and association expenses to the generating activity of revenue.

Compliance with Accounting Standards

The rules for depreciation also conform to the generally accepted accounting criteria AS-10 as India, GAAP in US and IFRS (International Financial Reporting Standards). Proper recording of depreciation is crucial for keeping companies in compliance with legal requirements and for adhering to financial statement disclosure guidelines.

Helps in Tax Savings

Depreciation is regulationally viewed as a non-cash expense that reduces the organization's taxable income. The depreciation deduction provides businesses with a way to lower their taxable profit and thus decrease their corporate tax burden, increasing the amount of cash they have on hand. The government provides

accelerated depreciation benefits to specific sectors as tax sops to encourage investment activities.

Asset Valuation and Replacement Planning

Depreciation also lets the balance sheet value of an asset continue to reflect its useful life, as it's marked down over time. The depreciation process allows for planning of replacement of older assets as funds are available during a period when the asset is losing utility.

Matching Principle in Accounting

The matching principle requires that expenses are recorded in the period in which the related revenue is earned. The Matching Principle is enhanced by depreciation because it spreads out asset costs over a number of years.

Cost Allocation for Decision-Making

Allocating the costs of assets over their useful lives helps business prepare budgets and set prices. A company can determine the exact cost of production and hence its product and services prices for survival.

Prevents Overstatement of Assets

Failure to devalue assets acquired at cost results in misstatements regarding the company's true capital. Depreciation makes the balance sheet accurate as it represents actual worth of asset in order to avoid deception of financial statement.

Enhances Business Sustainability

Enterprises can take advantage of scheduled depreciation because it allows them to plan for upcoming purchases and budgets without dealing with surprise expenditures. This method enables an environmentally friendly operation as well as operational stability.

The strategic depreciation of tools fundamentally influences not only a company's financial structure, but also has an impact on accounting, taxes and abilities to manage assets as well as to make business decisions. Tax Benefits businesses reporting depreciation based on financial statements clearly stand to save taxes and make better capital planning decisions. Firms that employ sound depreciation plans would

achieve stronger financial stability and progress towards sustainable growth.

3.1.5 Methods of Depreciation

Depreciation calculation operates using several approaches that are suitable for specific business requirements along with types of assets combined with accounting policies. The business it is, as depreciation methods chosen by the business drive not

only how financial reports appear but also tax and decision making! The most popular methods of depreciation are listed as under (in Fig. 3. 1):

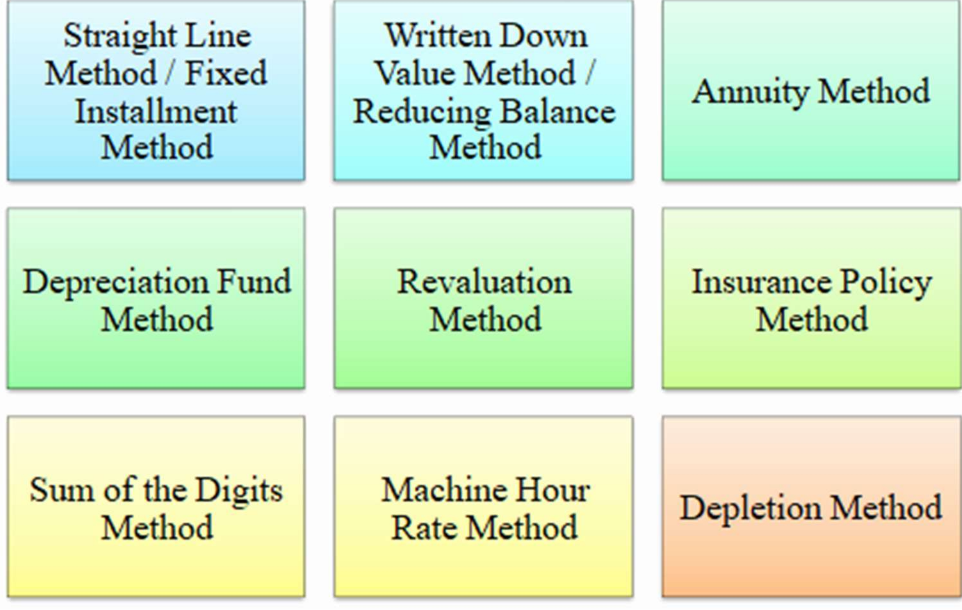

Fig. 3.1 Methods of Depreciation

A. Straight Line Method:

The SLM is the most elementary method and its use still continues increasing among all depreciation techniques. This method allocates the cost of an asset equally over its useful life so that depreciation expense is the same each year. This treatment is appropriate for assets that tend to have relatively consistent usage over their lives and very little depreciation in the early years of the asset's life, such as a building or office furniture and equipment.

$$\text{Annual Depreciation} = \frac{\text{Cost of Asset} - \text{Salvage Value}}{\text{Useful Life}}$$

Where:

● Asset price = Purchase of the asset

● Scrap Value = Estimated future net proceeds from the sale of an asset at the end of its useful life

● Useful Life = Projected number of years the asset will be used

Illustration: A machine is acquired by a company at ₹10,00,000 and its salvage value has been assessed at ₹1,00,000 with its estimated useful life being 5 years. The straight-line depreciation expense is computed as follows:

(1000000 − 100000) / 5 = 180000 per annum

This implies that the book value of the asset will be reduced by ₹1,80,000 as depreciation every year.

Journal Entry for Depreciation:

At the end of each period for counting depreciation we shall make an accounting entry something like this in our books- Depreciation Expense A/c Dr. ₹1,80,000

To Accumulated Depreciation A/c ₹1,80,000

Advantages of Straight-Line Method:

Simple to Compute & Apply – Depreciation is the same formula for the entire life of an asset, which reduces complexity when determining how much to depreciate and record on accounts.

Uniform Expense Allocation – Because the apportionment of depreciation is uniform over the asset's life,

PLAN AND BUDGET FINANCIALS MORE PREDICTABLY With Better Online sales software, businesses can plan their financials more predictably thereby enabling budgeting and profit analysis stability.

Suitable for Longer-life Assets – This is useful especially for assets which wear and tear consistently, like office buildings or furniture as their usage pattern tallies with theEven depreciation.

Disadvantages of Straight-Line Method:

Does Not Represent Actual Usage – A large number of assets (such as machinery or vehicles) experience more wear and tear in the early years than in later years, still SLM does not cater for this which can results in a disconnect between recognitions of expense when compared to actual usage of an asset.

Overlooks Technological Obsolescence – Fast-paced technological advancements could lead to assets such as computers, industrial machines becoming obsolete before its supposed life span is over, which would he ignores this high cost of replacement.

Estimate Salvage Value Risk – The approach assumes an appropriate forecasted salvage value for the asset, if this estimate is wrong it may lead to error in computing depreciation expense, misleading the financial reporting.

B. Written Down Value Method

The Written Down Value (WDV) Method {also called the Declining Balance Method(DBM)} applies a constant rate of depreciation to the book (written down) value of an asset, beginning with the first year of installation. Whereas the SLM method applies a uniform depreciation per annum, this is higher at the initial stages and lower at the later years.

Assets that depreciate more when they are new, such as machinery, vehicles and computers which go through a high amount of wear and tear in the early years.

Formula:

Depreciation Expense = Book Value at the Start of the Year × Depreciation Rate

Where:

- Book Value = How much the Asset is worth at the beginning of the accounting period (after deductions from prior Periods)

depreciation)

- Depreciation Rate-: The percent charged according to the useful life of the asset.

Calculation of Net Book Value:

Net Book Value at End of Year=Cost of Asset – Accumulated Depreciation (till end of that year)

This technique served not only to associate the cost with actual use of the asset, but also permitted income tax benefits in, for example India where there is a rule permitting accelerated depreciation for tax return purposes.

Calculation of Depreciation Rate:

salvage(orresidual)value(v_esti) is anticipated at the end of useful life of the asset:

$$\text{Depreciation Rate} = 1 - \left(\frac{\text{Salvage Value}}{\text{Cost of the Asset}}\right)^{\frac{1}{\text{Useful Life}}}$$

That way the asset's book value is down to only its salvage at the end of that useful life. If there is no salvage worth then the method could involve a predetermined rate, but typically some value for the salvage is estimated to communicate what the asset will be worth at its life termination.

Example depreciation rate calculation method:

Suppose an asset has:

● Total cost of the Asset: Rs. 100,000

● Expected Scrap Value Rs. 10,000

● Useful Life: 5 years

Substitute these values into the equation:

RATE OF DEPRECIATION = 1 − (10,000 / 100,000)1/5 = 1−(0.1)0.2 Further calculations:

0.1) 0.2 ≈ 0.631(approximately)

Depr Rate ≈ 1−0.631 = 0.369 or 36.9 %

For example, a company purchases a machine for ₹10,00,000 with 20% depreciation rate using WDV.

method. This depreciation is computed as follows:-

● Year 1: (10,00,000 × 20 % =) 2,00,000

New book value: ₹8,00,000

● Year 2: 8,00,000 × 20 % = 1,60,000

New book value: ₹6,40,000

● Year 3: 6,40,000 × 20 % = 1,28,000 etc., pubs to piecework (Tables 3.5 and Table 3.6).

New book value: ₹5,12,000

Journal Entry for Depreciation:

Depreciation is entered at the close of each accounting year as follows:

PARTICULARSDEBITCREDITDR DEPRECIATION EXPENSE A/cDr. ₹XXTo ACCUMULATED DEPRECIATION A/c ₹XX

When the asset is sold, its depreciation to date may be taken into account.

Benefits of the Written Down Value Method:

Front-Loaded Depreciation – This depreciation approach reflects the reality that assets tend to be used heavily when they are first put in service, allowing for an accurate distribution of expenses based on actual usage.

[Up to Date Asset Value] Through using a declining balance technique, the WDV method also reflects depreciation in the utility & effectiveness of assets over time which more closely represents an actual deterioration of non current assets and thus is closer to ‘asset reality’.

Tax Benefits – Because business can deduct more depreciation in the early years, it reduces taxable income which means tax savings upfront and better cash flow planning.

Broad Adoption for Taxation – A number of tax authorities, including the Indian Income Tax Act, 1961 have provisioned the WDV approach which makes it an ideal method to be used for computation and compliance purposes.

Limitations of Written Down Value Method:

Book Value Never Touches Zero – Under Straight-Line Method, there is a complete depreciation of an asset by the time it completes its useful life but WDV keeps on reducing the book value without bringing it down to zero and hence demands manual intervention for disposal.

Complicated computation – Another issue is, “Depreciation figured at a different amount each year” in fixed depreciation, increased workload on accounting records and tedious computational activity unlike the calculations for a fixed depreciation.

Complex for Asset Planning – Because of the declining depreciation cost each year, businesses may have difficulty planning how to fund new asset purchases as a result of an inconsistent expense that does not allocate uniform costs over the years.

Difference between slm and wdv method

Basis of Comparison

Straight-Line Method (SLM)

Written Down Value Method (WDV)

Definition

Depreciation is recorded throughout the useful life of an asset on a straight-line basis.

The asset's book value is depreciated and becomes lower year after year.

Calculation Formula

Depreciation Expense = (Costs of Asset – Residual Value) ÷ Useful Life

Depreciation Expense = Book Value * Depreciation Rate

Depreciation Amount

Remains constant every year.

Rising in the early years, falling off in subsequent years.

Financial Summarization at the End of Life useful Value Book :

The asset has been depreciated down to its salvage value.

(Its value never actually gets down to zero, because of the depreciation on reducing balance.)

Suitability

Applicable to interests with common usage, like buildings, office furniture and leasehold property.

Appropriate for those assets that depreciate quicker in the earlier years, like vehicles & industrial equipments or computers.

Impact on Profitability

The profits are constant as long as the depreciation is linear.

Profits are lower in the initial years as depreciation rises, and higher in the later years as depreciation falls.

Ease of Calculation

Simple and easy to calculate.

Trickier since you will apply depreciation to a new book value each year.

Effect on Taxation

Slower tax savings in the first few years since the depreciation is uniform.

More of tax benefits in the first three years for accelerated depreciation.

Method Accepted by Tax Authorities

3 Reference to taxes are less common.

It is extensively used in the issues of tax under Indian Income Tax Act, 1961 and other International taxation laws.

Accounting Standard

Permitted under AS-10 (Property, Plant & Equipment) and IFRS.

Diluted under Income Tax Act for tax depreciation but also allowable under AS- 10 & IFRS.

Did You Know

Real estate investors use depreciation as a major tax advantage! Even though real estate often appreciates in value, owners can still deduct depreciation expenses on buildings (but not land) over 27.5 years (residential) or 39 years (commercial).

In the U.S., racehorses can be depreciated! The IRS allows racehorses to be

depreciated over 3 or 7 years, depending on when they were placed in service

3.2 Inventory Valuation

Inventory valuation is an important accounting process that calculates the worth of a business' inventory at the end of an accounting period. It is used to enable companies in evaluating their cost of good sold (COGS), profitability and position in the finance. Exper8s Good inventory valuation is key to the reliable representation of financial statements, tax calculation and decision-making.

Meaning of Inventory Valuation

Inventory Valuation Inventory valuation is the calculation of cost for unsold inventory. Asset Valuation on the Balance Sheet The valuation of a company's inventory will have an effect on end-of-year balance sheets for businesses involved in manufacturing. Financial health as well as taxable income and gross profits vary with the valuation method chosen.

3.2.1 Objectives of Inventory Valuation

The monetary value of stock held by business relies on inventory valuation methods as practical applications that are essential to accounting systems. Purpose of valuation of inventory generally include the following:

Financial reporting An accurate representation of inventory is found on the balance sheet as an important asset. Proper valuation method allows entities to reflect their actual financial position on their statements and help them in avoiding the mistakes at the time of profit computation and assets valuation.

Impact of Inventory Valuation on Financial Statements: Impact on COGS and Gross Profit - the inventory value has a direct effect on both COGS and gross profit, which then indirectly affects net income. Proper valuation methods tie business expenditures to specific earning streams in order to preserve sound accounting.

Effect on Profitability & Tax Liabilities: The company's margin and taxes in subsequent years are impacted by FIFO, LIFO or Weighted Average method chosen to value inventories. FIFO results in higher profit during inflationary times but LIFO can reduce taxable income (through decreasing COGS) to be bene for tax purposes.

Good business decision-making: firms need accurate inventory valuation to develop a correct pricing strategy, set restocking levels, and manage overstocked or out of stock situations. Efficient operations are also the results of supply chain management as well as control systems for cost.

Facilitating Internal & External Audits

Transparent reporting of the financial status is possible with a fair-valued inventory, making it easier for auditors by increasing their reliance. Investors and auditors use inventory valuation analysis to evaluate the financial condition and solvency of a company as well.

Valuation of inventory is a key factor in financial management to get accurate financials and to comply with regulations, as well motives for taking cues strategically. A reliable inventory valuation system is beneficial for the companies in making the best use of its profits, managing stocks and ensuring financial accounting transparency, which ultimately leads to long-term stability and growth of company.

3.2.2 Methods of Inventory Valuation

Financial accounting relies on inventory valuation in determining the value of inventory merchandise that will be reported in financial statements. The choice of cost flow methods directly results in the effect on COGS while in some extent net income and tax costs. The choice of inventory cost flow assumptions serves its industry type and is consistent with the nature of its business concern. The other techniques involved in the inventory valuation are (Fig. 3. 2):

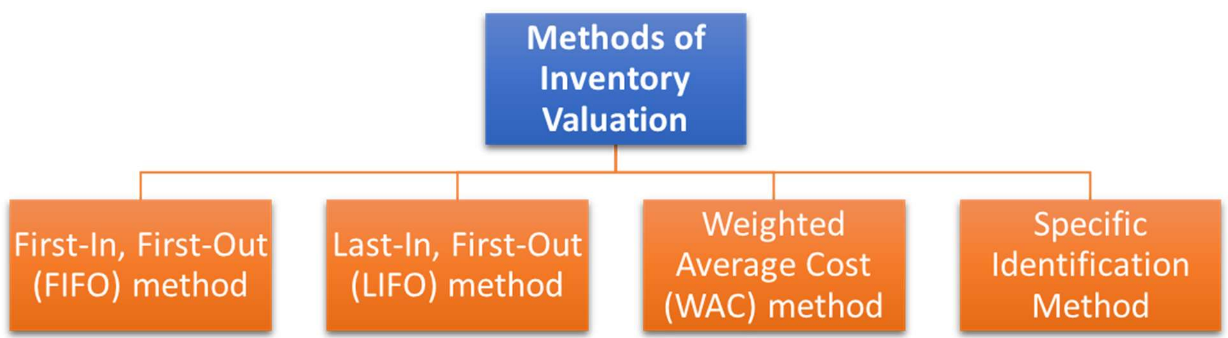

Fig. 3.2 Methods of Inventory Valuation

First-In, First-Out (FIFO) method

Under a FIFO valuation method the entire stock will be new purchases as it sells in a first-in-first-out system. The perishable good industry – and the pharmaceuticals and fashion industries are examples of this – use such inventory management as it increases the efficiency of stock rotation. The FIFO method yields lower COGS and higher profits with a rising price even though it produces greater taxable income.

Example:

A company buys 100 units of product: 50 @ ₹10 each 50 @ ₹12 each If 60 are sold under FIFO: (50 × 10) + (10 × 12) = ₹620

Balance stock : 40 pcs @₹12 per pc

Last-In, First-Out (LIFO) method

With LIFO inventory control, the most recently purchased goods are sold first and old stock remains behind. The tactic works in favor of companies dealing with inflation because it results in higher COGS, and lower taxable profits. LIFO serves as a popular

manufacturing and retail companies holding only As their inventory costs slant to rise in time series. LIFO valuation of inventory is not allowed under the IFRS (International Financial Reporting standards) & Ind AS (Indian Accounting standards). It is allowed under US GAAP.

Example:

Apply the same purchase situation: Sell 60 units If a book Camera rate is based on percentage then.

under LIFO: (50 × 12) + (10 × 10) = ₹700

Units left in stock: 40 @ ₹10::_('each')

Weighted Average Cost (WAC) method

With the WWeighed Avw Cost (WAC) approac inventory value results from averaging all available item costs across a period. The WAC formula removes price fluctuations and is advantageous for corporations that purchase in large quantities (e.g. bulk chemicals, raw materials and oil products). For all inventory using the same valuation method, these effects on revenue and COGS are equal at a given amount of inventories, so financial statement values will not change.

Example:

Total inventory cost = (50 x 10) + (50 x 12) = ₹1,100 Total number of units = 100 Average cost per unit = total inventory cost / total units = ₹1,100 / 100 = ₹11

Sold 60 units: 60 × 11 = ₹660

Unsold balance 40 units @ ₹11 each

Specific Identification Method

The Specific Identification Method assigns separate costs to each individual unit of inventory, and therefore it can provide a highly-correct valuation by recognising the purchase price. A strategy for firms that sell high-end cars as well as jewellery and real estate in particular, could benefit from this approach due to its specificities. The said inventory valuation method provides the highest accuracy; however, it leads to tasks for entities involved in business operations to manage information on details of each inventory item so that complex work processes and more time are required.

Example: A company that creates personalized jewelry prices their merchandise by specific purchase price to ensure precise cost pricing for each piece.

Businesses' financial and operational needs direct from GAAP and IFRS help determine which of these methods a company should use to inventory valuation. Inventory valuation is very important because it provides accurate financial statements and better cost control, while maximizing tax benefits of the business.

Activity: Last-In, First-Out (LIFO)

As a financial analyst for a retail company, analyze the impact of using the Last-In, First-Out (LIFO) inventory valuation method during inflation. Prepare a short report (200–300 words) comparing how LIFO affects cost of goods sold (COGS), net income, and tax liabilities compared to the First-

In, First-Out (FIFO) method. Provide recommendations on when LIFO would be most

beneficial for the company.

3.3 Accounting Mechanics

The order in which transactions are performed to obtain an overview of financial data via accounting mechanics, results in reporting the information with reliability. They are capable of financial precision and legal compliance with the decision-making freedom provided by their bookkeeping system.

The guide covers all the "basics" of accounting principles, concepts, and applications, in addition to perfecting key accounting mechanics.

3.3.1 Double Entry System

The accounting equation is the foundation upon which all transferred data go:

Assets = Liabilities + Capital Assets in the balance sheet equation – what a company owns are called assets, instruments for realizing its objectives (Michell, 2014).

Key Components:

Assets: Items that provide future economic benefits and can be measured in dollars, such as cash, accounts receivable, inventory or equipment of a company.

Debt: Debt refers to financial loans or other obligations that represent the money owed by a company to third parties, such as accounts payable, notes payable, and payroll.

Owner’s Equity The remaining interest in the assets of the business (if any) that are available to owners after liabilities have been subtracted. It

consists of capital plus retained earnings minus owner’s withdrawals.

Transactions are debits / credits applied to accounts, since the equation must always balance that means a transaction will have at least 2 account impacts.

Example: If a firm takes Rs.10,000 loan from a bank:

- Add: Cash A/c —— Assets (Increase) Rs.10,000.
- The Liabilities (Loan Payable) increase by Rs.10,000.
- The equation is still in balance.

3.3.2 Journal Entry

To keep debits and credits equal, a journal entry is posted to the accounting books using the double-entry system of recording a financial transaction. The date, the names of the accounts, a credit and debit amount to each and a brief description are all given. Each transaction affects at least two accounts, one account is credited and the other account is debited.

Standard Format

A journal entry includes:

Valse – The date the exchange was made.

Titles – The titles of accounts being affected by the transaction.

Debit & Credit Sides – Maintains balance of the books.

Narration: Short comment on the transaction.

Date

Particulars

J.No.

Dr. Amount

Cr. Amount

yyyy/mm/dd

Dr £ Cr £ Amount debited Amount credited

(Narration)

xx

XXXX

XXXX

3.3.3 Ledger

A ledger is a comprehensive account of each one of the company's financial transactions for an specific account. This ledger is also called the "Book of Final Entry." and it is a follow up step from the book of original entries.

Standard Format:

In general, the ledger will have a T-account appearance with debits on the left and credits on the right.

Ledger A/C

Dr 1st Cr.

Date

Particular

R.

No

Amount

Date

Particular

R.

No

Amount

And left side → Always good things (assets & expenses) go up.

Right Side (Cr.) → Liabilities, Equity & Revenue goes up

3.3.4 Trial Balance

A trial balance is a accounting report that lists the balances of all general ledger accounts at a certain date. It aids in checking the accuracy of financial records before generating a set of financial statements, by matching the total debits and credits.

Format of a Trial Balance

A trial balance consists of three columns:

● Account Name--Lists all Accounts (Assets, Liabilities, Equity, Revenue, Expenses).

Accounts can be: • Debit Balance – Accounts with a debit balance (Assets &Expenses).

● Credit Balance – Accounts with the normal credit balance (Liabilities, Owners Equity & Revenue).

Example of a Trial Balance

Account Name

Amount (Dr.)

Amount (Cr.)

Cash

25,000

Account Receivable

10,000

Owner’s Capital

18,000

Revenue (Sales)

17,000

Total

35,000

35,000

3.3.5 Final Accounts

Final accounts are the financial statements prepared at the end of an accounting period to ascertain the profit or loss and the financial position of a business. They distill a company’s transactions and enable stakeholders to make informed decisions.

Final accounts typically include:

Trading Account – Gross Profit or Gross Loss From the following details, draw up a Trading account of Messrs Rakesh Mohan & Co for the year ended 31st March 2011: (i) 1st April, 2010 Stock: Rs.

Profit&LossAccount–DeterminesNetProfitorNetLoss.

Balance Sheet – Indicates the financial health of the company.

Did You Know?

The Statue of Liberty was depreciated for tax purposes! The American Committee for the Statue of Liberty claimed depreciation on the statue in the 1920s, treating it as a business asset for

advertising purposes.

3.4 Financial Statement

Financial statements are formal records of the financial activities and position of a business, person, or other entity. They are useful to parties interested in evaluating the business's profitability, liquidity and solvency including investors, creditors, and management.

The fundamental financial statements are:

Income Statement– This reflects profit or loss of the company.

Balance Sheet – Shows how much money the company has.

Cash Flow Statement - It shows money going in and out of the company.

3.4.1 Income Statement

Income Statement - This is a company's revenues, expenses and net income or loss over time (monthly, quarterly or yearly). It serves to measure profitability by revealing the amount of profit remaining after all expenses have been paid.

Formula:

Net Profit = Total Revenue – Total Costs

Proforma of Income Statement

Particulars

Amount (Rs.)

Revenue (Sales)

XXXXX

(-) Cost of Goods Sold (COGS)

(XXXXX)

Gross Profit

XXXXX

(-) Operating Expenses:

Rent

(XXXXX)

Salaries & Wages

(XXXXX)

Utilities

(XXXXX)

Depreciation

(XXXXX)

Total Operating Expenses

(XXXXX)

Operating Profit (EBIT)

XXXXX

(-) Interest Expense

(XXXXX)

Profit Before Tax (PBT)

XXXXX

(-) Taxes

(XXXXX)

Net Profit (PAT)

XXXXX

3.4.2 Balance Sheet

The Balance Sheet shows an organization's financial position at a point in time. It describes Assets, Liabilities and Equity, by which company abides with the basic accounting equation:

Assets = Liabilities + Equity

Balance Sheet Format (Schedule III of the Companies Act, 2013)

1 Balance Sheet It showed as on 31.03.20....

Particulars

Note No.

Figure towards close at the end of Current reporting period

Figure as the end at the end of Previous reporting period

I. EQUITY AND LIABILITIES

1) Shareholder's Funds

(a) Share Capital

(b) Reserves and Surplus

(c) Proceeds from share warrants accepted

2) Advance/disclosure of Share Application money yet to be allotted 3)Non-current liabilities

(a) Long term borrowings

(b)Deferred Tax Liabilities (Net of Deferrals)

c) Other long term liabilities

(d) Long term provisions

4) Current Liabilities

(a) Short-term borrowings

(b) Trade payables

(c) Other current liabilities

(d) Short-term provisions

Total

II. ASSETS

1) Non-Current Assets

(a) Fixed assets

(i) Tangible assets

(ii) Intangible assets

(iii) Capital work-in- progress

(iv) In-development intangible assets

(b) Non-current Investments

(c) Net deferred tax assets

(d) Loans and advances repayable after one year

(e) Other non-current assets

2) Current Assets

(a) Current investments

(b) Inventories

(c) Trade receivables

(d) Cash and cash equivalents Short-term investments available for sale consisted of the following: Future Estimated Amortized Fair Net Loss Interest Extraordinary Value Cost Unrealized Gains or In Millions Maturity Dates maturities(a)(b) Securities.

(e) Short-term loans and advance

(f) Other current assets

Total

3.4.3 Cash Flow Statement

The Statement of Cash Flows reflects how cash comes in and goes out of a company. It helps assess the company's

As compared with the same period last year, a reduction in liquidity was the ability to generate cash, meet debts and finance operations.

Formula:

Net Cash Flow = Operating Cash Flow + Investing Cash Flow + Financing Cash Flow (Where,式)

Operating Cash Flow = The amount of cash that a company is able to generate from its regular business operations. It measures whether a business generates sufficient cash from its main operations to support itself without needing outside financing.

Investing Cash Flow = Investing Cash Flow is the cash that was spent on purchasing and selling long term assets like property, equipment or securities. It is representative of a company's CapEx and strategy for investment.

Financing Cash Flow = Financing Cash Flow is cash transactions associated with financial sources such as borrowings, debt repayments, issuance of shares and dividends paid.

Proforma of Cash Flow Statement

Particulars

Amount (Rs.)

Cash Flow from Operating Activities

Net Profit Before Tax (PBT)

XXXXX

(+) Depreciation

XXXXX

(+) Loss on Sale of Assets

XXXXX

(-) Increase in Accounts Receivable

(XXXXX)

(-) Increase in Inventory

(XXXXX)

(-) Decrease in Accounts Payable

(XXXXX)

Net cash used in operating activities

XXXXX

Cash Flow from Investing Activities

(-) Purchase of Fixed Assets

(XXXXX)

(+) Sale of Fixed Assets

XXXXX

(-) Investment in Securities

(XXXXX)

Net investment cash flow

XXXXX

Cash Flow from Financing Activities

(+) Proceeds from Issuing Shares

XXXXX

(+) Proceeds from Borrowings

XXXXX

(-) Repayment of Loans

(XXXXX)

(-) Dividend Paid

(XXXXX)

Net cash provided by financing activities

XXXXX

Net Increase/Decrease in Cash

XXXXX

(+) Opening Cash Balance

XXXXX

Closing Cash Balance

XXXXX

Knowledge Check 1

Choose the correct option:

What does the Cash Flow Statement primarily help assess?

The company's profitability

The company's ability to generate cash and fund operations The company's market share

2.2. Which component of the Cash Flow Statement includes cash transactions related to borrowing, debt repayment, and issuing shares?

Operating Cash Flow

3.5 Summary

❖ Depreciation is the allocation to income of an assets cost over its useful life because of damage, wear and tear, consumption or obsolescence. It is a non-cash cost that helps adjust financial statements to what the state of things actually are, assists in tax planning, and prevents incomes from getting exaggerated. Depreciation also

correlates with the matching principle in accounting, and allows for costs of assets to be spread out over time instead of recorded as a one-time expense.

❖ Depreciation is a decrease in the value of a company's asset to reflect their age and use. Depreciation decreases both net and taxable income and serves to follow the essential accounting rules. Different companies have different accounting and tax needs, and there are various ways to compute depreciation.

❖ Depreciation importance comes from its uses i.e., financial accounting requirements, saving of revenues and capital asset pricing. Without it, you're not in a position to accurately measure profitability, make investment decisions, or prevent the exaggeration of assets. This allows the organisation to cost up accordingly, plan a replacement or acquisition of assets, and also balance their budget. It finds its relevance in the loan request, firm survival and conformance to accounting norms.

❖ There are alternatives to calculate depreciation, with two most commonly used being the straight-line and written-down value method – where in every year a consistent percentage of book value is applied by way of depreciation but higher amounts (when compared to SLN) are deducted in the first few years. Straight Line Method is easy and preferable for the assets with continuous use, but WDV method is best for those assets that are fast depreciating like machinery and vehicles. Each approach leads to variations in taxation, profitability and financial reporting.

❖ The valuation of inventory determines how much a business holds in its stock and this has an effect on the COGS, profitably and detail to be shown in financial statements. Important techniques of the inventory valuation consist of which is used in calculation is FIFO i.e. when company would be selling the oldest stock realizing as low COGS during inflation. Or the LIFO way which results in a higher COGS and lower taxable profits. The WAC (Weighted Average Cost) removes the volatility of pricing. Method 2: Specific identification method Expensive inventory items are identifiable by actual cost hence this is applicable in case of high cost articles.

❖ To keep the balance of the accounting equation, accounting mechanics follow the double- entry system that says each transaction affects a minimum of two accounts: Assets = Liabilities + Owner's Equity. The journal is a record of financial transactions, and it captures everything and all things, and these entries are then "posted" into the ledger snowball which is a doubling of detail on each account. The trial balance ensures that the sum of debits and credits is in agreement, so that the financial records are accurate prior to summarizing in the financial statements.

❖ The two final accounts are - the Income Statement (which arrives at net profit by deducting expenses from income) and the Balance Sheet (a perspective of a company's financial status presenting assets, liabilities, and equity). Companies can assess how

financially sound they are by utilizing the Cash Flow Statement, which compares cash generated from financing, investing and operating activities. These statements provide accurate reporting, help businesses stay in compliance with regulations, and work to ensure the right decisions are made.

3.6 Key Terms

Depreciation – Depreciation is systematic allocation of the depreciable amount of an asset over its useful life, which is based on depreciation methods (straight line method) and its residual value due to wear & tear or usage & obsolescence. Since depreciation is not a cash expense, it lowers the amount of taxable income and provides better matching (within the time frame of a year) in order to present a true and fair presentation.

Depreciation Add-back: Non-Cash Expense on assets which are concurrently paying themselves – Depreciation is a real and not actual cash expense and has tax benefit for accounting purpose as expenses without deduction of taxes.

Matching Principle – A fundamental accounting concept that requires expenses to be “matched” with the revenues they help to generate. The concept here is the same, which sees depreciation as a means of letting you write off the cost of an asset over several years.

Straight-Line Method (SLM) -Depreciation in which the cost of an asset is allocated equally over its useful life. It’s straightforward, easy to use and well-suited for assets that are uniformly used such as office furniture and structures.

Written Down Value Method (WDV) – Depreciation technique that involves applying a constant percentage to the book value of an asset, resulting in higher depreciation charged in initial years. This technique applies to assets that are rapidly depreciating, such as machines and an auto.

Accumulated Depreciation – The total amount of the depreciation expense that has been taken on an asset up to the end of a fiscal period. It is also a contra asset account on the balance sheet that decreases the book value of an asset.

Valuation of Assets- It is the process in which an asset value is estimated as of a given date. Depreciation ensures

that the book value of an asset represents its true market status.

Financial Statements – Documents that reflect the financial status of a company such as the Income Statement, Balance Sheet and Cash Flow Statement. Depreciation impacts these statements by decreasing both profits and value of an asset.

Inventory Valuation — Calculation of cost of unsold inventory remaining at the end of a specified accounting period. It reflects on the balance sheet, cost of goods sold (COGS) and financial performance.

FIFO (First-In, First-Out) – An inventory costing method which assumes that the first units purchased are sold before newer units. It drives down COGS and causes higher profits during inflation.

Last-In, First-Out (LIFO) – Inventory valuation method in which the most recently acquired inventory is presumed to be sold first. And it hikes COGS and reduces taxable income when inflation rears its head.

Weighted Average Cost(WAC) Method -- A method of valuing inventory that averages all the costs incurred to accomplish the materials available for use during a specific period. It evens out price volatility and allows for reasonable profit margins.

Double-Entry –A double-entry system of accounting preserves the equation: Assets = Liabilities + Equity.

Owner's Equity, so that every transaction effects two accounts.

Journal Entry – It is the pure accounting from where the Financial Entries having debits and credits are mixed to be taken/generate on this stage which means there are without taking debit or credit side of financial statement that affect To maintain accuracy, each entry follows the double-entry principle.

Ledger -A book which contains all financial accounts of a business in order by classification and summary. It can help you keep track of income, expenses, assets and liabilities.

Trial Balance – A trial balance is a financial statement that illustrates the balances of all accounts as of a specific date and proves all debits equal credits. It is used to verified recorded figures in the books.

Income Statement -A report that shows a company's revenue, cost and whether the firm made a profit or loss during period. Depreciation is a deduction of taxable income, because you get to report that expenditure as a loss.

Balance Sheet – Financial statement showing a company's assets, liabilities and equity at a point in time

date. Depreciation decreases the book value of property in that statement.

Cash Flow Statement – A statement of cash inflows and outflows from operating, investing, and financing activities. Depreciation flows into the operating section as a cash flow adjusting item.

Tax Relief – Equipment Depreciation decreases business taxable income, which can reduce tax liability. Tax authorities frequently provide accelerated depreciation rules to promote investment in physical plant.

3.7 Descriptive Questions

What is depreciation and why it has become so important in accounting?

How Is Depreciation Reflected In The Financial Statement And Why Is It Considered A Non-Cash Expense?

Describe the importance of depreciation in tax planning and asset value.

Distinguish between the Straight Line Method (SLM) and Written Down Value Method (WDV) of charging depreciation. Which is better for tax-saving?

What is depreciation, and how does the concept assist firms in effective management of their assets?

Why is only tangible fixed assets subject to deprecation? What is the accounting treatment on amortization of intangible assets?

Q6How does depreciation help in complying with the accounting standards like AS,—10, GAAP and the IFRS?

Discuss the impact of inventory costing on the financial statement presentation of a company? Discuss the importance of selecting the proper inventory valuation method.

Explain the FIFO, LIFO and WAC methods of valuing inventory. Which of the following approaches would be most appropriate to a business in an inflationary economy?

Discuss the double-entry accounting system and how depreciation is accounted for with entries.

How does a trial balance help us verify that the financial statements are correct and what is the point of a trial balance?

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Answers to Knowledge Check

Knowledge Check 1

1: b) The company's ability to generate cash and fund

operations 2: c) Financing Cash Flow

3.9 Case Study

Depreciation, Inventory Valuation and Financial Concepts

ABC Manufacturing Ltd. manufactures heavy industrial machinery and is a mid-sized company. The following items also describe the company: recently purchased new manufacturing equipment, different methods to value inventory and reports financial statements. The ABC Manufacturing Ltd. finance team is responsible for all aspects of accounting compliance and financial reporting efficiency at the company.

Problem 1: Choosing the Appropriate Depreciation Type

ABC Manufacturing Ltd. bought machinery worth ₹10,00,000 on 1st January, 2023. Its estimated useful life is 5 years, and its expected residual value is ₹1,00,000. The finance team does not know which method of depreciation of 20% to adopt either Straight Line Method (SLM) or Writte man Down Value Method (WDV).

Solution:

Using Straight-Line Method (SLM):

Depreciation Factor (Cost – Salvage value) / Years of useful life.

= (₹10,00,000 - ₹1,00,000) / 5

= ₹1,80,000 per year

Yearly journal entry:

Depreciation Expense A/c Dr. 1,80,000

By being transferred to Accumulated Depreciation A/c ₹1,80,000

On Written Down Value (WDV) Method 20%:

Journal Entry:

Depreciation Expense A/c Dr. ₹XX

To Accumulated Depreciation A/c ₹XX

Conclusion: ABC Ltd Should Use SLM If ABC Ltd wants uniform expenses, they should go for the formula of SLM. If they want more depreciation in earlier years (tax benefits), then they should opt for WDV.

Issue 2: What is the Right Method to Valuate Inventories ABC Ltd. has made purchases as under:

50 u @ ₹500 50 u @ ₹600 50 u @ ₹700

Number of units in the beginning inventory: 150 Number of units sold during the period. The cost of goods sold (COGS) and closing inventory value under FIFO and LIFO is to be worked out by the sales division. Solution:

FIFO (First-In, First-Out) Method:

COGS Calculation:

50 units @ ₹500 = ₹25,000

COGS for the second transaction In: Product B Transaction 2 - Same situation - Same Expiry 30 units @ ₹ 600 = ₹18,000 Total COGS = ₹43,000

Closing Inventory:

20 units @ ₹600 = ₹12,000

50 units @ ₹700 = ₹35,000 Total Closing Inventory = ₹47,000

LIFO (Last-In, First-Out) Method:

COGS Calculation:

50 units @ ₹700 = ₹35,000

30units@ ₹600=₹18,000 TotalCOGS

Closing Inventory:

20 units @ ₹600 = ₹12,000

50 units @ ₹500 = ₹25,000 Total closing Stock = ₹37,000 DEBUG: Post Views: 8 What are you looking for?

Analysis: If ABC Ltd. desires lower taxable income, then it should opt LIFO, but if they aim to report higher profits for investors FIFO is the more suitable option.

Question: Problem 3: Statements And Analysis Of Financial Q1.

ABC Ltd. has drawn up financial statements using the First-In-First-Out method for valuating stock and Straight-Line Method (SLM) for depreciation. But the finance department observes that there is a net loss in the company because of high depreciation. They must consider different deprecation or inventory valuation processes to reflect higher profitability and better financial performance. Solution:

Income Statement (Partial Using FIFO & SLM):

Alternate Situation under WDV Depreciation: Had the company adopted WDV method for depreciation, expropriation in first year would be ₹2,00,000/Hence reported loss is higher. Yet depreciation would fall in subsequent years and profitability increase over time.

It concluded that the company must reconsider their depreciation and inventory valuation policies. FIFO can serve to increase profit during inflation, when upscheduling the cost does so, and help decrease taxable income from the reverse. If these were to continue, changing the method of depreciation could also help to even out financial performance.

Reflective Questions

What are the main differences between the Straight-Line Method of and Written Down Value Method of depreciation?

How does the selection of an inventory valuation method affect a firm's net income and taxes?

liabilities?

What are some advantages of depreciation in financial planning and asset replacement?

What are the pros and cons of FIFO versus LIFO for inventory valuation?

What are the reasons that companies adopt accelerated depreciation for tax purposes?

What issues can arise in estimating the useful life and salvage value of a long-lived asset?

What impact does depreciation have on the Balance Sheet and Income Statement?

What would be the optimal choice of depreciation method for a company with seasonal sales?

How will companies benefit by maximizing depreciation and inventory valuation for good financial decision- making?

Whatfactorsshouldbeconsideredwhen

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Financial Statement Analysis_MBA_1

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Unit 4: Process of Accounting and Preparation of Multi-Step Profit and Loss Statement

Learning Objectives

1. Learners will be able to understand the steps in the accounting cycle, from recording transactions to preparing financial statements.

2. Learners will understand the structure and importance of a multi-step profit and loss statement.

3. Learners will be able to identify and distinguish between operating and non-operating revenues and expenses.

4. Learners will be able to interpret financial results from a multi-step income statement.

5. Learners can analyze the profit levels, effective operational performance of the company, and the comprehensive health of a firm's finance by using financial ratios.

Content

4.0 Introductory Caselet

4.1 Process of Accounting

4.2 Multi-step profit and loss statement

4.3 Summary

4.4 Key Terms

4.5 Descriptive Questions

4.6 References

4.7 Case Study

4.0 Introductory Caselet

Financial Analysis for Strategic Decision-Making”

ABC Manufacturing Ltd, a medium-sized consumer electronics firm, has had erratic profits in recent years. The management wants to scan its financial progress through a study of major additional financial statements. the finance team is able to complete the gap analysis of trial balance, gross profit and operating income are analysed and also considers how non-operating income and taxes affects the net profit. With the aid of a

structured financial analysis, they are able to then make decisions with respect to cost reduction, productivity increase and profitability improvement.

Unfortunately, the finance team runs into a big problem while analyzing data: The unadjusted trial balance doesn't balance because there are potential accounting mistakes. Also, although gross profit seems healthy, they're worried about operating costs and the resulting hit to net income. The company must also evaluate how non-operating income and taxes impact the final financial outcomes.

Critical Question:

In view of the errors in the trial balance and the positioning of operating expenses with respect to profit generation, what actions should ABC Ltd take in order to: (a) increase financial accuracy; and (b) improve profitability over an extended period?

4.1 Process of Accounting

Accounting Cycle: A systematic process of recording and reporting accounting transactions. Accounting cycle is the process of financial data processing into useful format from raw documents that was collected from company transactions.Financial data must be reliable, complete, and in conformity with accounting standards such as GAAP or IFRS.

The accounting cycle in most cases does have an ultimate of about eight significant steps and begins with transactions identification which precedes the closing entries preparation at the end so that a complete process can be followed after each conclusion of an accounting period inform month, four months or even year end.

Fig. 4.1 Process of Accounting

1. Identifying and Recording Transactions

A count of transactions that affect a company's financial position The first step in the accounting process is to discern and analyze those events or transactions that have an effect on the financial condition of the business. Not all transactions are included in accounting records—only those with dollar amounts are recorded.

Key Considerations:

- Transactions must be quantifiable (monetary).
- The outflow of non-financial flows (e.g., a new employee) is missed.
- There must be at least two accounts to promote a transaction, as per the double-entry system.

Example: The purchase of raw materials on credit, Rs.5,000 by a firm would affect:

Inventory (Asset) increases → Debit

Increase in Accounts Payable (Liability) → Credit

Journal Entry:

Raw Material Inventory (Dr) Rs.5,000 Accounts Payable (Cr) Rs.5,000

It is also called the book of original entry because transactions are recorded in order.

Posting to Ledger Accounts

Secondly, the transactions are recorded in journal and these are transmitted to ledger accounts. These accounts are you always find in groups such as: Assets, Liabilities, Equity, Revenues and Expenses Example.

Importance of Ledger Accounts:

- Sorts transactions by account categories.
- Helps in determining account balances.
- Referred in Financial Reporting.

Example: If we use the same transaction as above, but this time add an invoice entry for $2,000, you would have a set of ledgers like these:

Accounts Payable Ledger

Date Particulars Debit (Rs.) Credit (Rs.) Balance (Rs.)

Jan 10 Purchase of Raw Materials 5,000 5,000

Inventory Ledger

Date Particulars Debit (Rs.) Credit (Rs.) Balance (Rs.)

Jan 10 Purchased Materials 5,000 5,000

This ensures that it is possible to monitor the individual account balances.

Preparing an Unadjusted Trial Balance

A trial balance is created at the end of an accounting period to verify that debits and credits are equal. This is important for revealing any errors (in the computation) that has resulted before going to the next step.

Procedure for Preparation of the Trial Balance:

Prepare a list of all the ledger accounts and note whether they need debiting or crediting.

Add the amount in all debits, and add the amount in all credits.

Be sure that the debit-cumulative is equal to your credit-cumulative.

Sample Unadjusted Trial Balance:

Account Debit (Rs.) Credit (Rs.)

Cash 10,000

Accounts Receivable 5,000

Supplies 2,000

Equipment 15,000

Accounts Payable 4,000

Stock 20,000

Service Revenue 8,000

Salaries Expense 3,000

Total 35,000 35,000

The difference, if any, between the totals could represent errors such as missing transactions, posting to wrong accounts or arithmetical inaccuracies. For instance, in the case under consideration, to agree the debit and credit balances of trial balance a credit transfer of Rs. 3,000 needs to be recorded therein. That could be an undisclosed liability, new equity or even sales.

Making Adjusting Entries

At the close of a fiscal period, all financial information is adjusted to ensure it accurately represents your company's financial position. The adjusting entries are based on the accrual accounting principle; for example, revenue earned in the financial period has to be recognized in the same period.

Types of Adjusting Entries:

Earned Revenues – Revenue recorded but which has not yet been received.

Accruals – Expenses that have been accrued but not yet paid.

Prepaid Expenses – Amounts paid out as expenses in advance.

Depreciation Adjustments – Spreading costs of assets over time.

Adjusting Entry:

The adjustments are as follows:

1.3 Supplies used: by for Goods – ₹500 → The new balance of Supplies should be ₹1,000.

Depreciation of Machinery: ₹1,000 → Will have to create a new account for this.

Accumulated Depreciation.

Salaries due: ₹300 → We must create a liability called Salaries Payable.

This modification ensures that only the portion of the rent pertaining to this payment is expensed.

Preparing the Adjusted Trial Balance

Once adjustments have been made, a set of adjusted trial balance is generated. This forms the foundation of financial statement preparation.

Sample Adjusted Trial Balance:

Account Debit (Rs.) Credit (Rs.)

Cash 10,000

Accounts Receivable 5,000

Supplies 1,500

Equipment 15,000

Accumulated Depreciation 1,000

Accounts Payable 4,000

Stock 20,000

Service Revenue 8,000

Salaries Expense 3,300

Salaries Payable 300

Total 34,800 34,800

Preparing Financial Statements

From the adjusted trial balance, each of the 3 main financial statements are prepared as follows:

Income Statement – Indicates net income or loss from transactions of revenues and expenses.

Balance Sheet – Illustrates the financial situation of the company (Assets = Liabilities + Equity).

Statement of Cash Flows – Presents the sources and uses of cash in operating, investing, financing activities.

Illustration: If a company's income is Rs.50,000 and the expenses are Rs.30,000 then (Net Profit = Income - Expenses), that will be reported as 20,00 in profit by the firm in its Income Statement.

Complete and accumulating Closing Entries / Exercise Preparing a Post-Closing Trial Balance

Temporary accounts (revenues, expenses, and withdrawals) are closed to retained earnings at the end of the accounting period. This is closing in the sense that user accounts balances are reset for the next period.

Closing Entries Process:

You may Close Revenue accounts to Income Summary

Credit the Expense accounts to Income Summary.

Move Net Income/Loss to Retained Earnings

Close Dividends to Retained Earnings

Example of a Closing Entry:

Revenue (Dr) Rs.50,000 Expenses (Cr) Rs.30,000

Retained Earnings (Cr) Rs.20,000

once the accounts are closed, a post-closing trial balance is created to verify that only permanent (balance sheet) accounts remain open.

Did You Know?

The earliest financial records date back to ancient Mesopotamia (around 3,000 BC), where clay tablets were used to document transactions of goods and services. These records are considered precursors to modern financial statements. Unlike single-step income statements, multi-step income statements separate operating and non-

operating activities, offering a more detailed analysis of a company's financial performance. This format aids in understanding core

business profitability and operational efficiency.

4.2 Multi Step Profit and Loss Statement

A multi-step income statement (otherwise known as a profit and loss account) is an itemized financial report that provides key information about a company's financial performance across several categories. It distinguishes operating activities from non-operating activities, thereby facilitating an analysis of the financial health.

Unlike a single- step income statement, which calculates total expenses from total revenues by only one subtraction, the multi- step income statement dedicates several sections to categorizing revenues and expenses to give a clearer picture of the profitability of organizations.

Revenue (Net Sales)

Revenue is the amount of money that a company actually receives from its stakeholders in exchange for any and all goods or services sold during a given time. But companies frequently have deductions like sales returns, allowances and discounts that they need to remove from total sales in order to calculate Net Sales.

Key Considerations:

- Here included is only other income traffic / sale.
- Record sales discount and returns to find the actual revenue.
- And it does not involve interest income or other non operating revenue.

Formula for Net Sales:

Net Sales = Gross Sales − (Sales Returns + Allowances + Discounts)

Example:

- Total Sales: Rs.520,000
- Sales Returns & Discounts: Rs.20,000
- Net Sales = Rs.500,000

This is the real money left to the company after returns and allowances.

Cost of Goods Sold (COGS)

COGS is the direct expense attributable to the production or purchase of things sold by a company. These expenses consist of raw product, labor, and manufacturing unit overhead.

Key Considerations:

- COGS can only be used in manufacturer, stores companies.
- It does not account for operating costs, such as salaries, rent or advertising.
- It provides the basis for calculating gross profit, a critical indicator of company efficiency.

Formula for COGS:

Raw Material Consumed-COGS = Opening Stock + Net Purchase (–) Closing Stock the part of COGS. COGS as) Raw Material Consumed + Direct Labour + Manufacturing Overheads.

Example:

- Opening Inventory: Rs.50,000
- Purchases: Rs.270,000
- Closing Inventory: Rs.20,000

$$\text{Raw Materials Consumed} = \text{Opening Inventory} + \text{Purchases} - \text{Closing Inventory}$$

$$= ₹50,000 + ₹2,70,000 - ₹20,000 = ₹3,00,000$$

Let's begin by computing Raw Materials Consumed:

Now assuming Direct Labour and Manufacturing Overheads are not provided and you wish to find;

COGS (When Raw Materials Consumed is to be considered) COGS based on RM used, if so:

Such costs represent the aggregate direct charges involved in an organization's goods production The costof the "goods" (i.e., inventory) associated with a manufacturer's or merchandiser's products. sold during aparticular time period: it will be deducted from sales revenues to determine grossprofits. 2 For purposes of related entries,manufacturers' inventories can follow one of several different costing methods based on flow assumptions,such as LIFO and FIFO; see these entries for more information.)

Gross Profit

Gross Profit is a metric that quantifies the sustainable profit in company's core business. It is a measure of how well a company keeps its production costs in check.

Formula for Gross Profit:

Gross Profit = Net Sales - Cost of Goods Sold

Example:

500,000 – 300,000 = 200,000

Why is Gross Profit Important?

● It helps determine pricing strategies.

● A diminishing gross profit could refer to higher production costs.

● It is applied to evaluate the performance of a firm in producing goods.

Operating Expenses

Operating expenses are the expense a business needs to meet to do its core work. These are necessary costs to keep the business in operation and expanding, but they don't directly produce goods.

Types of Operating Expenses:

➔ Selling Costs – The expenses incurred in selling and delivering to customers.

◆ Advertising & Marketing

◆ Sales Commissions

◆ Delivery & Shipping Costs

◆ Store Rent

➔ Operating Expenses – Overheads associated with the general running of a business.

◆ Salaries of Admin Staff

◆ Office Rent & Utilities

◆ Insurance

◆ Legal and Professional Fees

What are Operating Expenses Types of Operating Expenses Formula for Total Operating Expenses:

Total Operating Expenses = Selling And General Administrative Expenses

Example:

● Selling Expenses: Rs.30,000

● Overhead Costs: Rs.30,000 ● Administrative Overheads = 20,000 Total Operating Expense = 30,000 + 20,000 ≡ Rs.50,000

Operating Income

It is computed after deducting operating expenses from gross profit.

Formula for Operating Income:

Operating Income = Gross Margin − Operating Expenses

Example: 200,000 – 50,000 = 150,000

Why is Operating Income Important?

● Demonstrates how much the company has earned on its core operations

● Non-GAAP adjustments exclude non-operating items such as interest income and gains/losses on asset sales

● Helpful in measuring the operational efficiency between different companies

Non-Operating Income and Expenses

● Non-Operating Income: includes items such as interest income (related to investments) and gains on sales of assets — not related to primary operations.

● Non-Operating Expense: Losses resulting from sales of assets, penalties etc.

These are deducted from Operating Income and presented after EBITDA/EBIT in financial reports.

EBITDA Earnings Before Interest, Taxes, Depreciation and Amortization

● EBITDA is a primary indicator of the company's ability to generate profit from operational activities and manage those earnings among other financial factors.

Formula: EBITDA = Operating Income + Depreciation + Amortization Data Description: The company's operating income is the amount of money it makes after accounting for variable costs and fixed costs.

Earnings before interest and tax (EBIT)

EBIT is how a company’s profit is defined, including all costs except interest and

taxes. It shows operational performance in a way EBITDA doesn’t.

EBIT = EBITDA – Depreciation – Amortization Note: It can be written with more details as :

Summary:

Operating Income = Gross Profit - Operating Expenses

EBITDA = Profit from operations + Depreciation + Amortization

EBIT = EBITDA − Depreciation − Amortization Also Keep it in Mind The above equation is important for your retention of this knowledge.

EBT (Earnings Before Tax) = EBIT - Interest Expense

Note: Interest Income and Expense are below EBIT, not part of operating but the proper consideration must be given for these items.

Finance Cost / Interest Expense

- Finance Costs or Interest Expense: cost of borrowing money (interest payments on loans/bonds)
- These charges are deducted from EBIT to calculate the Income Before Taxes.

Net Income Before Taxes

This is the net profit before tax. Net Profit Before Income Tax Formula:

Net Income Before Taxes = Operating Income + Non-Operating Income −

Non-Operating Expenses

or

D. Income Before Taxes=EBIT−InterestExpense Example: 150,000 − (10,000) = 140,000

Income Tax

Income tax is a percentage of taxable income.

Income Tax Formula: Income Tax = Net Income Before Taxes × Tax Rate Example of an income tax calculation:

Rate = 21% 140,000 × 21% =30,000

Net Income

Net profit is the amount left over after subtracting all expenses and taxes.

Formula for Net Income:

Net Income = Net Income Before Taxes - Percentage Tax

Example:

140,000 − 30,000 = 1,10,000

This is the ultimate income for reinvestment or distribute to shareholders.

Summary of the Financial Flow:

Operating income: Earnings from normal operations of a business.

Other Income: Any other source of revenue.

Non-operating Expenses: Other costs, unrelated to core business.

= EBITDA: Earnings before interest, taxes, depreciation and amortization.

– Depreciation & Amortization: Non-cash expenses.

= EBIT: Earnings before interest and taxes.

– Finance Costs / Interest Expense: What your interest costs are if you took out a loan.

= Earnings Before Tax: Earnings before tax and related expenses.

Final Multi-Step Income Statement Example

Particulars Amount (Rs.) Amount (Rs.)

Revenue

Net Sales 500,000

Less: Cost of Goods Sold (COGS) (300,000)

Gross Profit 200,000

Operating Expenses

Selling Expenses (30,000)

Administrative Expenses (20,000)

Total Operating Expenses (50,000)

Operating Income 150,000

Non-Operating Income and Expenses

Interest Income 5,000

Interest Expense (10,000)

Loss on Sale of Assets (5,000)

Total Non-Operating Income (Expense) (10,000)

Net Income Before Taxes 140,000

Less: Income Tax (21%) (30,000)

Net Income 110,000

For the sake of this, let’s assume that you manage to depreciate ₹20,000 and amortize ₹10,000. EBITDA= Operating Profit + Depreciation + Amortization EBITDA = 150,000 + 20,000+10,000 = ₹180,000.

EBIT is Operating Income but less interest and taxes.

Now, as we are determining EBIT from the operational side of things, EBIT = Operating Income, considering income before interest and taxes are adjusted here.

EBIT = Operating Profit = ₹150,000

Activity: Adjusting Entries for Financial Accuracy

As a financial analyst for XYZ Corp., you discover that certain expenses and revenues have not been recorded accurately before preparing the final financial statements. Your task is to identify and prepare the necessary adjusting entries for accrued expenses, prepaid expenses, unearned revenues, and depreciation. Assess the effect of each on the income statement and balance sheet, and

offer a short report on the changes and how they enhance financial precision and decision-making.

4.2 The Role of the Multi-Step Profit and Loss Statement 4.2.1 Significance

A multistep income statement distinguishes between those revenue and expenses that relate to the operating category and those that do not, enabling a better indication of profitability. It also separates out gross profit, operating income and net income, so you can see the most profitable aspects of the business. This breakdown allows companies to assess the cost of production, pricing policy and financial health. Then, investors are able to see whether a company is making money by running its business or not.

Helps in Identifying Cost Structures

The multi-step income statement is used to help businesses make sure they know their cost structure so that they can break up the cost of goods sold (COGS) from operating expenses. COGS would be materials and labor, and operating expenses would comprise rent, salaries and marketing. This division will allow businesses to determine whether the cost increases are due to production inefficiencies or an excess in operational spending. It provides effective control over the costs, and better decision making for maximizing profits.

Enhances Financial Decision-Making

Multi-step income statement is useful in that it groups financial information. This would permit a business to do strategic planning as one could clearly visualize the gross and operating margins. Managers can therefore up the price, cut costs or become more efficient. Investors and creditors can also utilize this statement to determine if the company is financially sound, and to predict its future performance. A company with steady growth in operating incomes is perceived to be financially stable.

Improves Transparency and Comparability

multi-step income statement an enhanced version of the *income statement that enables firms to provide a clear, well-organised report on theirDoperations. That makes it easier for investors, regulators and other interested parties to compare companies in the same business. The expenses/revenue breakdown improves the exposure of income and expense bringing it uses to into compliance with IFRS or GAAP. Given this format is standardised, companies can also benchmark themselves against their peers and the market.

Helps with Tax and Compliance Reporting

The categorization of financial data means that a multiple step income statement can assist with tax reporting and compliance. It allows a business to know quickly what it can write off and what its taxable income will be, avoiding errors. Structured financial reporting also is beneficial for creating audit reports, and in meeting some legal requirements. The LOLA is intended to emphasize, and help ensure that reports of financial information remain transparent around the origin of this information within the company.

Supports More Profound Internal Analysis and Forecasting

The income statement is designed to assist firms in tracking financial trends. It improves the ability to forecast and budget Further, management can now forecast future financial performance by studying gross profit margins, operating margins and net profits movements. That helps companies prepare to defend against potential threats, and for future expansion, and helps them identify investment opportunities. It also allows for a better allocation of resources, and strategic planning.

The multi-step income statement is an extensive and organized calculation of the business. It drives and encourages including effective cost control, better financial decision-making and governance so that organisations can show they are on a straight path when it comes to compliance. This format is utilized for internal planning, investor analysis and regulatory reporting so it is also identified as the most valuable utility.

4.2.2 Importance of Multi-step P&L Account for Business Decision Making

Multi-step income statement categories revenues, expenses and profits in to various subsections that present a more detailed account of the financial details than single-

step statements. It divides income into operating and non-operating segments, making it easier for companies to analyze profitability and efficiency. Such a model could be an important tool for decision support, cost containment and investment planning.

Multi-Step Income Statement Components: A mulitis-step income statement can be broken down into four components (gross profit, operating income, non-operating items, and net income). Production efficiency one measured by net sales less COGS = GROSS PROFIT. Operating income is determined by deducting operating expenses and non operating items are such as interest. gains or losses. The latter of these is the net, which represents bottom-line net income.

Contribution to Business Decisions: Using a multi-step income statement, companies can better understand their financial performance and where they are earning the gains. Because of that disaggregation, it allows you to manage costs, price and invest correctly. The companies use it to track profits trend and make smart strategic decisions.

Don’t measure efficiency with enterprise or volume: Gross profit over income from operation helps to break down the gross profits of companies, and gives you a way to look under the hood at potential cost inefficiencies in production / operations. A falling gross profit margin is indicative of high costs or that overheads are too expensive if operating income is low. These are the sections where efficiency and profit margins are enhanced.

Pricing and Cost Management: The multistep income statement provides the businesses with the ability to understand how a company arrives at its pricing strategy and cost management. And conversely, a high GP margin is a confirmation of good pricing and a high aggregated COGS may require budget cuts. Managing operating costsIf you want to ensure your business is on steady financial ground, it’s up to you to look out for expenses.

Investment and Expansion Decisions: A kind of businesses uses this statement to time potential expansion and assess financial integrity. Operating income is high so you're in a position for some growth, or acquisition to make new investments. The continuous increase in net income per share garners the trust of investors and is one of the most frequent manipulations by a company with improved profitability.

facilitates funding.

financialriskassessmentdataset#47 \ nFinancial Risk Assessment Operations Reviews Track E-Mail – This process is used by companies serving for their financial risk assessment, using the other synthétique extracts with respect to multi-step income statement of profit and loss. High debt reliance or non-operating income instability

indicate high degree of risk in financial situation. This article will seek to delve further into these risks for purposes of financial planning.

Tax Planning and Compliance: The notice intends to describe what constitutes a taxpayer's taxable income so that businesses can make sound economic decisions about when deductions, credits, and expense deferrals will be available. With an accurate tax prediction, business can stay on top of shifting tax laws and reduce unexpected liabilities, which amounts to savings.

Benchmarking: Determine what areas you can work on by comparing your gross profit margin, operating income and net profit with industry benchmarks. If a company has low profit margins, then perhaps the cost structures or pricing strategies need adjusting. Benchmarking keeps one competitive.

The complete mnemonic income statement is an extremely hard-nosed indicator of performance, cost control and risk.

Knowledge Check 1

Choose the correct option:

1. What is the primary advantage of using a multi-step income statement over a single-step income statement?

A) It provides a simplified view of financial performance.

B) It breaks down revenues, expenses, and profits into detailed sections.

C) It eliminates the need for cost control.

2. Which of the following is not a key component of a multi-step income statement?

A) Gross profit

B) Net income

C) Cash flow

3. How does a multi-step income statement help businesses in investment and expansion decisions?

A) By identifying tax liabilities.

B) By determining financial stability and growth potential.

C) By listing all non-operating expenses.

4.3 Summary

❖ The accounting cycle is the eight-step process – in which accounting is done, to get records of transactions based on LEAA 2016. It includes recording transactions and ends with the financial statement preparation and closing entries to keep financial information up-to-date and in compliance with GAAP or IFRS. Only cash transactions are entered, and each entry has to impact at least two accounts under this system. Journal entries serve as the book of original entry for when transactions are recorded prior to posting to ledgers that organize such accounts as assets, liabilities, and equity in order try to make the balance sheet and income statement fit together.

❖ You prepare a trial balance to ensure that your total debits equal your total credits, so you can catch mistakes before going ahead. These entries – accruals, prepaid expenses and depreciation – help to ensure that financial statements are reported on the correct period because they match efforts and costs of transaction with revenues. With an adjusted trial balance as the basis, financial statements could be prepared; the income statement is to inform of revenues and expenses, the balance sheet shows the company's financial situation while cash flow statement categorizes streams of cash into those from operating activities, investing activities and finally financing activities.

❖ Temporary accounts (revenues, expenses and dividends) are closed to retained earnings at the end of the accounting period - they are zeroed out for the next accounting period. The post-closing trial balance proves that only permanent accounts are still open. Businesses, for a more comprehensive analysis of financial performance, prepare a multi-step income statement that illustrates in detail all revenues, expenses and net incomes. It strips out operating activities, like gross profit and earnings before taxes, from non-operating items – interest income, sales of assets and taxes.

❖ The gross profit is the net sales less cost of goods sold and is disclosed for production efficiency and pricing effectiveness. Operating income is the profit of the company after deduction of operating expenses from gross profit which can be disclosed for management share by FINANCIAL ACCOUNTING. They will end up having an impact on the net income figure in these other operating income lines (interest expense, sale of assets) and directly in the line for taxes (taxes), which is highly important for a companyí nancial forecasting or compliance purposes.

❖ In the previous case of ABC Ltd., errors in trial balance were revised to ensure attaining financial accuracy. The following discussion discusses the company's gross profit, operating income and other key performance indicators as management uses these measures to assess the profitability of its principal business. The company also took into account its non- operating income and expenses (which would ultimately

determine net income), and decided whether to engage in the transaction on an informed business basis.

4.4 Key Terms

Accounting Cycle – A sequence of eight steps that businesses use to record and report their financial transactions. Invoices accuracy in financial statements and adhere to standards such as GAAP or IFRS. At the identification end are transactions and at the other are closing entries.

Double-Entry System: A fundamental accounting principle that requires in every transaction at least two accounts be affected, so total debits are equal to total credits. This mechanism promotes financial punctuality and error elimination, as well as the credibility of the financial report.

Journal: A journal, in which the following explanations may occur: First or preliminary; books of original entry (before they are entered into ledger accounts). It applies a system of double-entry to keep all its economic records complete, current and in order.

Ledger Accounts: Ledger is a set of all accounts, namely asset, liability, equity, revenue and expense. They assist companies manage their financial health and give correct reports in order to prepare financial statements.

Balance Sheet (BS) Trial Balance: A list of all the ledger account balances at the end of an accounting period, making sure that total debits equal total credits. That helps to detect errors before issue financial statements.

Adjusting Entries: Synonymous with adjusting entries are ADJUSTMENTS, which are accounting entries made to modifyaccount balances at the END of a fiscal period. Entries are necessary to make the financial statements show the true financial status of a business.

Financial statements: Important documents which offer an overview of a company's financial performance and profile. These statements are the income statement (profit and loss), the balance sheet (assets, liabilities and equity) and the cash flow statement.

Multi-Step Income Statement: A statement which separates operating and non-operating activities and provides a more detailed presentation of revenues, expenses, gain or loss, etc. It provides a better look at the financial status of an organization than a one-step statement.

Gross Profit : The profit derived from a business after deducting cost of goods sold, but before other operational expenses. It shows whether the pricing and production are working.

Operating income: The profit that remains after a company has paid the cost of doing business, but before paying interest or taxes. It is useful in finding out cost effectiveness and revenue productivity of a company.

4.5 Descriptive Questions

The following information is available for a firm:

- Net Sales: ₹1,200,000
- Opening Inventory: ₹150,000
- Purchases: ₹500,000
- Closing Inventory: ₹200,000
- Selling Expenses: ₹100,000
- Administrative Expenses: ₹80,000

What is the Gross Profit and Operating Income (+ explain what these figures mean for their finances)?

How would a firm have the ability to legally manage its earnings on its cash flow statements (all within GAAP) and what ethical dilemmas should financial managers be cognizant of when doing so?

Discuss how IFRS and GAAP are similar and how they differ with respect to the accounting treatment of revenue recognition. What are the considerations for multinationals in making a choice between them so that their account becomes better?

A firm shows the prepaid rent in its financial statements, unlike an asset. How will this impact its statements of financial position, and what reclassification is necessary at the end of a period?

How does the presentation of the multi-step income statement differ from that of a single-step income statement?

A company has 40% gross margin but the net margin is falling over the past three years. What financial and operational initiatives to be adopted in the wake of this?

If a trial balance before adjustment shows that the total of debits exceeds the total of credits, what are some possible causes to this overstating; how should an accountant avoid or correct them?

A firm's non-operating earnings are becoming more apparent in the financial statements. What is the long-term impact of this, and what can management do to mitigate risk?

What effect does the separation between operating and non-operating expenses have on managerial decision-making and investment decisions?

WHY GROSS PROFIT MARGINS FLUCTUATE If gross profit margins are unstable, what could be reasons for this and how should management address this?

An organization inadvertently forgets to record an adjusting entry for a liability. How does the exclusion of these costs affect its financial statements, and what would be the effect on net income?

What are the advantages and disadvantages of using accrual basis accounting instead of cash basis for financial reporting?

There is a high receivables-to-sales ratio for a business. How do finance Soda managers evaluate the effect of this on liquidity, and what should they do?

What is the importance of a post-closing trial balance, and what can it tell us about the financial condition of an entity?

QuestionDescription"1- Discuss the effect of depreciation as an adjusting entry on financial reporting. What factors might a company consider when deciding which depreciation method to use?"

A company's trial balance is not necessarily correct, but that differs from saying the company's financial statements are wrong. Why does not it work out and how you can do same?

What are some operational inefficiencies of a company if the gross profit is high and operating income is low, what should management do to address these efficiencies?

How Does COGS Help Businesses In Their Pricing Decisions And What Are The Strategies To Optimize It?

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4.7 Case Study

Financial Statements Analysis in Business Decision Making

XYZ Electronics is a medium-sized enterprise engaged in the manufacture of consumer electronics such as smartphones, smartwatches and accessories. The company has had volatile revenue and uneven margins over the last three years. Even as it introduced new products and added to an online presence, XYZ Electronics had found cost control and pricing methods difficult. Now that the company leadership has been cleared of scandal it is turning its attention to improving its financial stability and to make smarter choices for increased profitability and growth.

Introduction

Financial reports: Indispensable part of decision making process for business. They offer information on a company's financial position enabling users to evaluate profitability, liquidity and operational efficiency. One of the main obstacles for companies such as XYZ Electronics is understanding financial statements well enough to make appropriate pricing, investment and expansion choices. This research examines how financial statement analysis could help XYZ Electronics to face its challenges and to make the most of their financial statements.

Problem Statement

XYZ Electronics has the following finance-related issues to be addressed on an urgent basis:

.● Reduced Profitability: The gross profit margin is on the decline due to rising COS percentage.

● Elevated Operating Costs: Overhead factors such as marketing and administrative costs continue to weigh heavily on net income.

● -- Mixed Cash Flow: erratic cash flow mgt and loss of receivable due to episodes involving income variations.

● Weak Pricing – The Company lacks a data driven pricing that would allow it to compete in the market.

Without this elementary knowledge, i.e., financial statements and performance measures, XYZ Electronics is doomed to failure both in profit generation and its potential for growth.

Statement financial for decision making business of analysis thics ject: Dynamics Of Financial Statement Analysis And Strategic Decision Making

Seeking to address these issues, XYZ Electronics adopted a structured approach to financial analysis by employing the multistep income statement, balance sheet and cash flow statement.

● Gross Profit Margin Review: Detailed analysis of COGS and supplier contracts by the Company. After renegotiating contracts with suppliers and improving inventory management, XYZ Electronics reduced the costs of manufacturing by 10%, which boosted gross margins.

● Expenditure optimization: Full audit of operational expenses led to budget re-allocation.

● Discretionary spend which includes overspending on marketing activities was cut by 15%, but investments in R&D were not compromised.

○ Cash Flow: Stricter credit policies were established in finance and collection efficiency ratio of day sales outstanding (DSO) from 60 days to 45. This enhanced cash flow stability.

● Price Strategy Improvement: Developed market-based pricing strategy supported by competitive price analysis and customer price elasticity. Revenue increased overall by 12% due to dynamic price modifiers.

Conclusion

With the help of financial statement analysis, XYZ Electronics managed to come back on track and realize profitability. The company was helped by its improved gross profit margins, lower operating expenses and better cash flow management. This case highlights the importance of financial statement analysis in taking business decision which could help to maintain a competitive and financial stability of the firms like XYZ Electronics. 'These trends can be reversed with continued financial vigilance, punctuated by strategic adjustments at some point.

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Unit 5: Understanding a Corporate Balance Sheet & Cash Flow Statement

Learning Objectives

1. Learners will know how a balance sheet provides an instant snapshot of a company's financial position at a given point in time.

2. Learners will be able to differentiate between assets, liabilities, and shareholders' equity.

3. Learners will be able to distinguish between current and noncurrent assets and liabilities and also financial and non-financial assets and liabilities.

4. Learners will be able to understand how it tracks a company's cash inflows and outflows over a period.

5. Learners will be able to understand how investors, creditors, and management use cash flow information to make informed decisions.

Content

5.0 Introductory Caselet

5.1 Corporate balance sheet

5.2 Corporate cash flow statement

5.3 Summary

5.4 Key Terms

5.5 Descriptive Questions

5.6 References

5.7 Case Study

5.0 Introductory Caselet

Financial Dilemma at Zenith Ltd.

Zenith Ltd, a mid-range manufacturer has been on a rapid chilled growth pattern over the last few years. The group recently double-sized its production facility with a significant investment in new equipment and premises. Yet despite announcing a

surge in revenue in its most recent financial statement, Zenith Ltd. has encountered a shocking problem – it is running precariously low on cash/assets.

Reviewing the corporate balance sheet and cash flow statement of the company, the CFO, Mr. Arjun Sharma, observed that although accounts receivable and inventory had gone up; the liquidity position of the company was languishing. Suppliers were demanding to be paid, and the company was not able to meet short-term financial commitments.

Its more vertically integrated peer, Zenith Ltd., on the other hand reported increased profits, and left many investors scratching their heads. The company's new board is now asking "how can the business be growing and at the same time so starved for cash?".

Critical Thinking Question:

In light of Zenith Ltd.'s financial condition, what are some recommended actions that the company could take in order to achieve an optimal liquidity/profitability trade off? Whether to improve operating cash flow, seek external funding or change its investment strategy? Explain your response using economic logic.

5.1 Corporate Balance Sheet

A company balance sheet is a snapshot of its financial position at a point in time. It presents a structured report listing the firm's assets, liabilities, and shareholders' equity in order to ensure that the accounting equation (Assets = Liabilities + Shareholders Equity) holds.

Resources = Creditors' Claim + Owners' Claims (i.e. what the person who runs the business has invested and retained)

It allows interested parties to evaluate the company's overall financial health, liquidity, solvency and investment quality. The balance sheet is a key element of the financial statements and is used for regulatory reporting, investment analysis, corporate accounting system and strategic planning.

5.1.1 Definition of Corporate Balance Sheet

A company's Balance Sheet (Schedule III of the Companies act, 2013) is a depiction of what it owns and owes as on any particular date by categorizing assets, liabilities and equity in categories like current and non-current. It would also be in compliance with the Accounting Standards (AS) or Indian Accounting Standards (Ind AS), as an applicable.

Balance Sheet Format (As per Schedule III of the Companies Act, 2013)

as at 31st March, 20......

Particulars Note No Figure as at the end of Current reporting period Figure as at the end of Previous reporting period

I. EQUITY AND LIABILITIES

1) Shareholder's Funds

(a) Share Capital

(b) Reserves and Surplus

(c) Money received against share warrants

2) Share Application money pending allotment

3) Non-current Liabilities

(a) Long term borrowings

(b) Deferred tax liabilities (net)

(c) Other long term liabilities

(d) Long term provisions

4) Current Liabilities

(a) Short-term borrowings

(b) Trade payables

(c) Other current liabilities

(d) Short-term provisions

Total

II. ASSETS

1) Non-Current Assets

(a) Fixed assets

(i) Tangible assets

(ii) Intangible assets

(iii) Capital work-in-progress

(iv) Intangible assets under development

(b) Non-current investments

(c) Deferred tax assets (net)

(d) Long-term loans and advances

(e) Other non-current assets

2) Current Assets

(a) Current investments

(b) Inventories

(c) Trade receivables

(d) Cash and cash equivalents

(e) Short term loans and advances

(f) Other current assets

Total

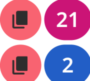
5.1.2 Key Requirements under Companies Act, 2013

Mandatory Format:

The balance sheets prepared by companies have to be drafted in accordance with the requirements of Schedule III (Companies Act, 2013), thus facilitating preparation of a standardised set of financial statements for comparative analysis across different entities.

Classification of Assets and Liabilities:

a. Assets:



a.i. Current Assets: Current assets include the assets that can be converted into cash or are expected to be sold, or consumed in the normal operating cycle of a business (or 12 months if not working).

ii. Non-Current Assets: These are assets which will give economic advantages to the entity for more than 12 months or reporting period. They are generally put to use in the operation of a business over the long term.

iii. Financial Assets: These consist of assets representing contractual entitlements to receive cash or another financial instrument.

iv. Non-Financial Assets: Physical and non-physical resources that do not represent contractual claim to cash or a financial instrument.

b. Liabilities:

Liabilities are current commitments of the entity as a result of past events that distributions may leave to an outflow of resources (such as cash).

i. Short-term Liabilities: This refers to all debts or responsibilities of the business that its management will be able to get rid of with 1 year from reporting date, or within the operating cycle if i...

ii. Non-Current Liabilities: These represent liabilities, which are not payable within 12 months from the reporting date. They tend to be about financing or long-term commitments.

iii. Financial Liabilities: These stem from contractual obligations to provide cash or some other financial asset.

iv. Non-Monetary Liabilities: This represent an obligation that is not based on a contract to pay cash and yet impose economic burden.

c. Disclosure of Notes to Accounts:

Firms need to provide a robust explanation of each line aggregated in notes, discussing policy, contingencies and other material financial items to ensure transparency of what's going on.

d. Compliance with Accounting Standards:

The financial statements are required follow the Indian accounting standards (Ind AS) or Accounting Standards (AS) as applicable to make it consistent with those used by regulators for supervision, and other regulatory requirements.

e. Comparative Figures:

The Companies Act requires that last year's numbers are also reported together with this years figures.

to enable users to compare financial results and trends across different periods.

f. Audit Requirement:

The balance sheet must be audited and also signed by the authorized directors & auditor before sending the same. It guarantees the accuracy, conformity and accuracy of financial information.

g. Filing with ROC:

The balance sheet of companies must be filed as part of the annual financial filings (AOC-4) with the Registrar of Companies (ROC) to comply with regulations and disclosure requirements.

Did You Know?

Despite high revenue, Tesla struggled with cash flow in its early years. It had to raise billions in funding before it became profitable."
"Apple's cash reserves are so large that if it were a country, it would be richer than many small nations! In 2023, Apple had over $166 billion in cash and marketable securities.

5.1.3 Importance of Corporate Balance Sheet

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" Pursuant to the Companies Act, 2013 the Balance Sheets have been prepared in accordance with accounting principles generally accepted in India. It, in turn has implications on financial transparency, and subsequently regulatory compliances and stakeholder trust as well as sustainable business decisions and the very existence of the business.

Ensures Transparency	Regulatory Compliance	Investor Confidence
Creditworthiness Assessment	Facilitates Taxation & Auditing	

Fig 5.1 Importance of Corporate Balance Sheet

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Ensures Transparency – The balance sheet provides a clear and detailed summary of a company's assets, liabilities, and shareholders' equity. It enables its stakeholders to measure progress, prospects and value through the visibility for shareholders and regulators resulting in minimal room of repainting numbers.

Regulatory Compliance – All registered companies will have to prepare and present their balance sheet in accordance with the accounting standards mandated. This kind of regulatory compliance prevents anomalous financial reporting and frauds and is in

line with corporate governance principles under the MCA (Ministry of Corporate Affairs) issued guidelines to be followed by companies.

Investor Confidence – Investors look to the balance sheet to determine how financially healthy a company is, as well as estimate its profitability and long-term growth. A clean balance sheet inspires confidence for more investors to join, and it helps clearly finance though either equity or debt.

Credit Worthiness of a Company – Banks and other financial institutions assess the balance sheet of a company's before lending capital or offering credits. It also helps to measure liquidity, solvency and debt-income capacity (which determines interest rates and lending decisions).

Aids Taxation & Auditing – In order to certify the accuracy of the figures, to the tax assessors and auditors a balance sheet is a very important thing. It is useful for calculating taxes, verifying tax compliances etc and also for auditors who can identify mismatching, fraud or financial mismanagements in statutory audits.

The company's balance sheets are not just numbers – they also serve as key solutions for the corporation to be more transparent, to comply with regulations and instill investors' confidence. It is the measure of a company's financial condition and can guide stakeholders in investment decisions, credit-granting and business operations. Companies Act, 2013 underpins the credibility and trust that companies command, facilitating the development of a robust corporate governance ecosystem in India.

5.1.4 Important Terms used in Corporate Balance Sheet

I. Equity and Liabilities

This section indicate the origin of funds for the company including shareholders' equity and other liabilities.

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1) Financial Liabilities

Financial liabilities Financial liabilities are obligations to pay cash or other financial asset that place the entity in a position of disadvantage.

Example: Loans And Trade Payables.

25

2) Non-Financial Liabilities

Definition of non financial liabilities Non-financial liabilities are the obligations that are not related to contractual form of financial instruments, such as Tax Provision, Deferred Revenue and Legal Claim.

3) Shareholders' Funds

These are the paid up capital raised from shareholders.

a. Share Capital – Total funds that are raised by the issue of share or preference shares. It comprises authorized, issued, subscribed, and paid-up capital that represents the owners' interest in the firm.

b. Reserves and Surplus – Accumulated profits and reserves kept as an expansion fund or against contingencies. These are retained earnings, general reserves and securities premium reserves.

c) Money Received on Account of Share Warrants – Payment's received in advance from the subscribers against share warrants whereby they have the option to purchase shares at a specific price at future date. This sum is accounted for separately until it is converted.

4) Share Application Money Pending Allotment

Monies subscribed by investors in respect of shares not yet actually allotted. If the shares are not allocated, money should be returned, making it a current liability.

5) Non-Current Liabilities

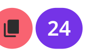
These are financial debts on which payment is due more than one year from the date on the balance sheet.

a. Long-term Borrowings – Debentures, loans and bonds the company is required to repay in the long term, normally for capital investment purposes.

b. Deferred Tax Liabilities (Net) - Represents the future tax obligations resulted from temporary differences between taxable amounts and accounting amounts.

c. Other long-term liabilities - Consist of lease liabilities,deferred revenue, and financial liabilities which are payable after one year from the balance sheet date.

d. Ultimate or Ultimate, Ultimate Provisions – Funds reserved for prospective liabilities like employee gratuity, pensions and legal actions.



6) Current Liabilities

These are short-term debts that must be repaid within a year.

a. Borrowings – Loans, bank overdrafts and credit facilities with terms of 12 months or less.

b. Trade Payables - Amount due for goods and services received from suppliers, vendors not paid yet.

c. Other Current Liabilities – are composed of outstanding expenses, statutory dues, advances received from customers and unclaimed dividends.

d. Current Liabilities – Short-term Provisions: These represent liabilities that are to be discharged in the near future-groups of tax provisions, employee benefits and dividends payable etc.

II. Assets

This segment is the company's assets that will generate future economic benefits.

1) Financial Assets: Financial assets are those assets which represent a contractual claim for cash or financial asset, which also can be settled on the net, and they give rise to cash inflows.

Examples: Cash, bank accounts, investments (e.g., shares, bonds), trade receivables, loans granted.

2) Non-Financial: Non-financial assets are real or non-real resources that have no obvious money claim but which contribute to the firm operation and value generation.

Sample: Land, Buildings, Machinery (fixed assets), Patents, trademarks, goodwill (Intangible assets) and Inventories.

3) Non-Current Assets

These are long-term assets they're not 'designed to sell.

(a) Fixed Assets – Tangible or intangible items used in the operation of the business.

a. Fixed Assets – Material or physical assets such as land, buildings, plants/factories/machinery and vehicles used for business production over the long-term.

b. Intangibles – Assets that are not physical in nature (e.g., patents, trademarks, copyrights and goodwill), that give a firm an advantage over its competitors.

c. Capital Work-in-Progress – This includes expenses on projects that are under construction like buildings etc., which are not yet ready to be used.

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d.Intangible Assets Under Development – costs incurred in the development of intangible assets such as software programs, or patents not yet ready for their intended use.

(b) Investments – Non-current investments in shares, debentures, securities of government or joint ventures with a view to long term investment and strategic growth.

(c) Deferred Tax Assets (Net)-Tax benefit on account of the difference between taxable income and accounting income, which is expected to be recovered in future.

(d) Long-term Loans and Advances – Advances to staff, subsidiaries, others are recoverable beyond a period of one year.

(e) Other Non-Current Assets – Deposits, advances, long-term receivables not classified elsewhere.

4) Current Assets

Such assets as are reasonably expected to be realized in cash or sold or consumed during the next 12 months.

a. Current Investments – These include investments in equities, debt or mutual funds that are held for trading / liquidity purposes.

b. Stock – Raw materials, W.I.P., finished goods to be sold or manufactured.

c. Trade receivable – Accounts due from customers regarding goods sold on credit or services rendered.

d.Cash and Equivalent – All liquid balances held by the company for day to day operations.

e. Short-Term loans and advances – All loans or advances given by company to employees, suppliers or any other party which are recoverable within one year.

f. Other Current Assets - Prepaid charges, income accumulated and tax reimbursements expected within a short time-frame.

The various components of the balance sheet reflect the financial health and future prospects of a company.

Did You Know?

- When big companies like Apple or Reliance release their balance sheets and cash flow statements, investors react—causing stock prices to rise or fall.
- "Companies with constant negative cash flow from operations often struggle to survive. That's why cash flow is one of the first things creditors and investors check!

5.2 Cash Flow Statement

A cash flow statement, which is also known as CFS, is a financial document that shows exactly how much money has been flowing in and out of your business for a specific period. This helps investors, creditors and other stakeholders in management to understand how the company creates cash flow and puts it to work to gain insight into its liquidity, financial flexibility and overall health.

While the income statement operates on accrual accounting, recording when and how servings are earned, the cash flow statement slashes through all that BS to report pure cash transactions – which is an important data point to decide if they're able to service things like short-term liabilities, investing in their operation or paying out money back to investors.

5.2.1 Objectives of Cash Flow Statement

Fig 5.2 Objectives of Cash Flow Statement

Cash Flow Statement(CFS) It is very important financial statement which explain the movement of cash in and out of organization during time. It shows business leaders, investors and lenders how cash is being generated and what the company is doing with it, enabling good financial health and making informed decisions. The main aims of cash flow statement are as follows:

Assessing Liquidity and Solvency

One of the primary objectives of preparing a cash flow statement is to know about the liquidity position of the company, i.e. its ability to pay-off their short term obligations. Businesses need cash to pay its suppliers, employees and creditors quickly. Having sufficient cash also keeps operations running and ensures a company does not find itself in a financial bind. Management can be alerted to potential liquidity deficiencies, enabling them to take action before the company is too illiquid to continue operating.

Understanding Cash Inflows and Outflows

The cash flow statement is the itemized list showing how and from where the company collects its cash, as well as how and what it does with that collected cash. That kind of transparency will keep management and investors aware of where cash is coming from

— product sales, or investment, or financing — and how it's getting spent on expenses, paying back a loan or making capital investments. In order to be able to plan well, businesses need always monitor these movements in order not to ruin cash and close down operations.

Analysing Financial Health and Stability

What is cash flow analysis vs. profit analysis? Rather than only focusing on profits, the study of cash flow provides a clearer image of a company's well-being. A company that constantly has positive cash flows from operations is typically healthy, and negative cash flows that never cease could mean trouble beneath the surface. It classifies cash functions into operating, investing and financing categories so companies can judge if they generate sufficient cash on their own or rely overly much on external sources of funds.

Supporting Decision-Making for Management

Management considers the cash flow statement a diagnostic device before making key financial decisions such as expansion or new investments, or eliminating extraneous spending. If a company sees an unbroken line of excess cash, it's probably going to invest in new technology or pay down the debt, and only after that will it pay dividends. On the other hand, if cash flow is negative the management has to postpone investments, decrease present spending or look for additional financing. Good cash flow management is crucial to the survival and success of any business.

Evaluating Profitability vs. Cash Flow

The Income Statement represents net income by adding depreciation and amortization, non-cash transactions. The numbers in the financial statements can demonstrate profits on paper, even while the business continues to experience real cash flow issues. Only transactions conducted with cash will appear on the Cash Flow Statement ensuring a true picture of your company's cash position. This difference provides investors a clear sense as to whether the company is actually generating sufficient cash flow so that it can be in business.

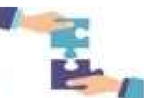
Assessing Investment and Financing Decisions

Enterprises utilize cash flow statement analysis to find out how much money the stakeholders have for expanding and outfitting their networks, to clear debts or pay dividends. The financial status of the company depends on the performance of its operational cash flow while strong cash flows indicate stability, whereas weak cash flows need external financing with financial risks. The investing and financing portions of the statement reveal whether companies grow by investing or acquire debt in doing so as they invest.

Compliance with Financial Reporting Standards

The need to prepare cash flow statements as stated in IFRS and GAAP accounting theories establishes the importance of following this regulation, because of transparency and uniformity purposes for financial reports. Banks, regulators and creditors According to financial institutions and lenders as well as regulatory agencies, businesses should disclose their cash flow statementsThese parties would like an objective judgement to be made about the prospects of the business. The Introduction of the standards will build trust among stakeholders who work to attract investment and loans.

Activity: Cash Flow Statement



Imagine you are the financial manager of a company preparing its Cash Flow Statement. Your company recently paid interest on a loan, received dividends from investments, and sold a piece of machinery at a profit. Classify these transactions under the correct cash flow activities (Operating, Investing, or Financing) as per AS-3 guidelines. Discuss your reasoning with a partner or in a group.

A fundamental decision-making instrument in the evaluation of corporate financial stability and liquidity is the cash flow statement. Companies can also enhance the sustainability of their cashflows by actively managing them.

6

5.2.2 Classification of Activities for the preparation of Cash Flow Statement

Each business unit undertakes different kinds of actions, which they bring cash in and order to purchase they have to spend on expenses. The Cash Flow Statement maps all such transactions, thereby revealing the company's liquidity and financial health. For the purposes of AS 3, these activities fall within three main categories:

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Operating Activities

Investing Activities

Financing Activities

The intent of this presentation is to report the cash effects in operational activities independent of those related to financing and investing so that financial statement users may assess their overall significance. This systematic view assists us map out the dynamics of how the various areas of business impact on the aggregate cash position and consequently how it impacts availability of funds comprising cash & cash equivalents.

Cash from Operating Activities

In other words, operating activities are the key activities that an entity engages in order to meet its underlying business objectives. These transactions include running the day-

to-day processes of the business. For example, if a firm is in the garment industry, manufacturing operations would be purchasing cloth and thread as raw materials to produce finished garments. These are the company's main sources of income and differ from investing and financing activities.

19 Operating cash flow is a measure of the company's overall financial health, as it represents the amount of money the company generates (or consumes) from normal business operations -- in other words, whether it has enough revenue to offset its cost base.

The '52-week low' of a stock is the lowest price that an investor must pay for it in the preceding 52 weeks.

Operating cash flows generally result from transactions that affect income and loss. These include:

22 Cash Inflows from Operating Activities:

- Income from sales of merchandise or services.

3 Receipts of royalties, fees, commissions, and other income.

Cash Outflows from Operating Activities:

- Payments of suppliers for goods and services.
- Employee wages and related expenses.

Payments for premiums, policy claims, annuities and policy benefits.

26 unless such tax payments are specifically related to financing or investing activities.

Net Cash Flow from Operating Activities is the end result once all cash inflows and outflows have been taken into account.

Cash from Investing Activities

Sometimes, companies are involved in the trades of securities and loans. Cash flows related to purchases and sales of securities or loans that are held for resale as a primary business activity by an enterprise are distinguished in this section. By the same token, banks which generate revenue from issuing credit card advances and loans consider these products to be operating activities because they are fundamental business operations.

10 Depending on an entity's circumstance, as per Accounting Standard (AS) 3, investing activities include purchasing and selling of long-term assets and other investments that are not considered to be cash equivalents. These transactions generally involve acquisition and disposal of fixed assets like machinery, furniture, land, buildings and other long-term investments.

Investing activities are important in assessing how much an enterprise is investing its resources to produce future income and cash flows. A distinct reporting of these transactions is vital, as it forms part of the business' investment model and future financial planning.

Illustration of Cash Flows from Investing Activities

Cash Inflows from Investing Activities:

Receipts from Sale or Disposal of Fixed Assets (Other Than Intangible Property)

● Loans and advances to third parties (excluding those granted by financing enterprises in the course of their operating activities) repaid.

● Proceeds from the sale of securities, warrants or debt instruments of other issuers, not acquired for trading purposes.

● Interest in cash on loans and advances.

● Dividends earned from investments in another companies.

Cash Outflows from Investing Activities:

● Payments to acquire property, plant and equipment, intangible assets or capitalized development costs.

● Purchases of shares, warrants or debt securities of other businesses (except for those acquired for trading purposes).

● Loans and advances to third parties, unless the operations of a financial institution include such transactions.

Investing activities give information about the strategy of growth followed by a company and how funds are being used to acquire assets and for generating income. Analyzing cash flows from investing activities Investors are able to evaluate the company's potential for eventual profitability and growth by considering cash flows from investing activities.

Cash from Financing Activities

As the name suggests, financing activities are related to funding and the structure of capital over a long term of any company. They affect such activities as raising funds by equity shares, debentures permanent long –term loans and the repayment of borrowed funds. (i) In terms of Accounting Standard (AS) 3, financing activities include the

mean dealings which affect the dimensions or the character of a company‟s share capital, of its reserves, such as dealt with by: (a) Any issuance in mixtures;

Equity Share, Pref. Share and Debentures.

A stand-alone statement of cash flows by financing activities is necessary because stakeholders need to know how the enterprise is funded and what future cash obligations will have to be met with respect to capital providers and borrowers.

Examples of financing activities несымоFrom Financing Activities 1.

Cash Inflows from Financing Activities:

● Cash received from issuance of share capital and preference shares.

● Proceeds from issuance of debentures, bonds, debts and other short-term borrowings or long-term borrowings.

Cash Outflows from Financing Activities:

● Payments of money borrowed, including loan repayments.

● Interest on debentures, long term loans and advances.

• Payments of dividends on common and preferred stock.

● Buyback of equity shares.

There are some transactions that might have cash flows of more than one type. For instance, on an asset purchased and financed in instalments the interest portion of the loan is presented as a finance activity and repayment of the loan is treated as an investing activity.

Some activities may not fit neatly into a category, and there may be other considerations that could impact how certain activities are classified depending on the type of business. For example, buying stock is an operating activity for a brokerage company, but is an investing activity for other businesses.

Through the review of financing activities, they can evaluate how a company is obtaining capital, controlling debt and paying financial obligations, thus getting a picture of its financial health, stability and insurance.

5.2.3 Treatment of Certain Special Items in Cash Flow Statement

While making a cash flow statement certain transactions are required to be treated differently as they are exceptional in nature. These include special items, interest and dividends, income and gain taxes as well as non-cash transactions. The AS 3: Cash Flow Statements has laid down the specific procedures for classification and presentation of such items to reflect a true and fair view on financial statements.

Extraordinary Items

Exceptional items are anything that are uncommon, including losses from theft, or natural disasters such as earthquakes or floods. As these are not activities in the

course of the company's ordinary business, the associated cash flows need to be separately categorized by operating, investing or financing according to their attribute. This categorization enables financial statement users to determine the effect of these activities on current and future cash flows.

Interest and Dividend Treatment

Cash flows arising from interest and dividends 3.38 The presentation of cash flows arising from interest and dividends paid and received is a matter of choice if such cash flows are classified within operating activities.

➔ For Banks – For profit or not-for-profit:

◆ Interest paid, interest received and dividends received are categorised inIntervalSince_NT_LP-IV_APPENDIX-G.doc Investment_ENC-AE_TypeInfo-dlIPart_II_SEC-(G).DOCHead_nullInteres_t paid_siblingINTEREST PAID Interest received_siblingINTEREST RECEIVED Income_Entercptor_DIV (F).docGroup_OPPS_HISTORY.new.group–IIB_Seinate_VLCRIncome_Communications of ordcertain description.

activities as they represent the core activities for the company.

◆ Dividends to shareholders are classified as financing activities.

➔ For Non-Financial Enterprises:

◆ Payments of interest and dividends are financing activities because they relate to financing decisions.

◆ Interest received and dividends received are classified as investing activities because they conform with the definition of returns on investments.

Taxes on Income and Gains

There are types of tax and its connection with diverse business processes in which they can be classified. AS-3 specifies the following treatment:

● Income tax related to operating profit is presented as operating activities.

●Tax on dividends (tax paid on dividends distributed to the shareholders) is presented under financing activities, along with dividend payments.

● Capital gains tax, paid when you sell a fixed asset is categorized as investing activities because it results from disposal of assets.

Non-Cash Transactions

Some investing and financing activities do not lead to cash flows but affect the position of a company. AS-3 prescribes the exclusion of such transactions from the cash flow

statement but requires their disclosure in the financial statements as separate information, so that it becomes available to users for decision-making.

Examples of non-cash transactions include:

● Machinery purchased on acceptance of share.

● Conversion of Debenetures into Equity Shares.

Because no cash or cash equivalent is used, these transactions are not included in the cash flow statement, yet are still accounted for on the financial statements so that investors can see what has happened to revenue.

The correct treatment of these special items increases the effective-ness of the Cash Flow Statement as a financial statement, to give readers an understanding of the true health or strength of a business. Proper classification of abnormal items, interest, dividends, taxes and non-cash will enable the businesses to exhibit true picture of their cash movements and also adhere with the AS-3 norms.

5.2.4 Format of Cash Flow Statement

Statement of Cash Flows for the Year Ended [Date]

For the year ended.......

Particulars Details Amount

A. Cash Flows from Operating Activities

● Profit Before Tax and Extraordinary Items

● Net of Non-Cash and Non-Operating Adjustments:

○ Add: Depreciation and Amortization

○ Add: Loss on Disposal of Fixed Assets

○ (Profit) Loss on Sale of Fixed Assets

○ Add: Interest Expense

○ Less: Interest Income/Dividend Received

○ Add/Less Other Non-Cash Items (e.g. Provision for Doubtful Debts)

: ● Operating Profit before Changes in Working Capital

● Working Capital Adjustments:

○ Add/Less: Increase/Decrease in Trade Receivables

○ Add/Less: Increase/Decrease in Inventories

○ Add/Less: Increase/Decrease in Trade Payables

● Cash Generated from Operations

Less: Taxes Paid

A Net cash flow from operating activities

B. Cash Flow from Investing Activities.

➔Cash Outflows (Payments Made for Investments):

◆ Purchase of Fixed Assets

◆ Investment (Share, Bond etc.) Purchase Types

◆ Loans and Advances Given

➔ Cash Inflows (Receipts from Investments):

◆ Disposal of Property, Plant and Equipment

◆ Proceeds from Sale of Investments

◆ Interest Received

◆ Dividend Received

Inflow/(Outflow) of Cash as a Result of Investment Activities (B)

C. Cash Flow and Financing Activities

❖ Cash Inflows (Funds Raised):

➢ Issues for Share (Equity/Preference) Cash Received during the Year

➢ Long-Term Borrowings (Loans, Debentures, Bonds, etc.) on the Application of Funds end section.

❖ Cash Outflows (Repayments & Dividends):

➢ Repayment of Loans/Debentures

➢ Interest Paid

➢ Dividend Paid

C. Net Cash Flow from Financing Activities

Cash and Cash Equivalents at the End of the Period (A+

B + C)

E. Cash and Cash Equivalents on Beginning of Period.

F. End of Lease Term (D + E) Cash and Cash Equivalents amortised on page 71.

G. Cash Management Activities

- Short-term investments in marketable securities
- Overdrafts and short-term borrowings
- Management of cash and liquidity (cash pooling, sweep accounts)
- Idle cash balances optimization

H. Free Cash Flow to the Firm (FCFF)

I. Free Cash Flow to Equity (FCFE)

Any cash management activities, including short-term investment of excess cash or borrowing for the company's daily cash needs are not reflected on the cash flow statement. The cash flow statement is divided into three basic categories; operating activities, investing activities, and financing activities. These statements illustrate where money comes from and how it is spent in business or enterprise (operations, long-term assets or debt and equity). The decision as to when and how to maximize or transfer cash between such accounts for short-term purposes, however, are internal cash administration decisions and do not represent transactions that would be shown in this financial statement.

With respect to free cash flow measures, FCFF and FCFE are used to evaluate the financial flexibility of a firm, but they center on different claimholders. FCFF is cash available to all capital providers (both bond and stock holders) after expenses, taxes, working capital investments, and new ideas are factored in. Its formula is:

FCFF = (EBIT)×(1 – Tax Rate) + Depreciation – capex – change in Working Capital

In contrast, FCFE is the cash that is available only to equity shareholders after all obligations are met, including payments on debt. Its formula is:

FCFE = Net income + Depreciation – CAPEX – Δ Working Capital _Worksheet:FCFE FCFE Free cash flow to equity is a measure of how much cash can be paid to the equity shareholders of a company after all expenses, reinvestment and debt are paid.

Net Borrowing

The distinctive feature is that FCFE includes debt cash flows, FCFF does not. Analysts rely on FCFF when evaluating the value of the entire firm and FCFE when considering what remains for equity shareholders.

Knowledge Check 1

Choose the correct option:

1. How should extraordinary items be classified in a Cash Flow Statement?
   a. Always under operating activities
   b. Separately under operating, investing, or financing activities based on their nature
   c. Only under financing activities
2. How are interest and dividend payments classified for financial enterprises in a Cash Flow Statement?
   a. Interest paid, interest received, and dividends received are under operating activities; dividend payments are under financing activities
   b. Interest paid and received are under financing activities; dividends paid and received are under investing activities
   c. All interest and dividend transactions are classified under investing activities
3. Where should capital gains tax be classified in a Cash Flow Statement?
   a. Operating activities
   b. Financing activities
   c. Investing activities

5.3 Summary

❖ A company's balance sheet is a snapshot of the firm at an instant in time. It preserves the basic accounting equation Assets = Liabilities + Shareholders' Equity, which enables interested parties to assess financial health, liquidity and solvency.

❖ The balance sheet in the company's schedule III to the Companies Act, 2013 is arranged so that it relates to most recent classification of previous years and classification is uniform. Indeed, preparing financial reports in compliance

with the Indian Accounting Standards or the Accounting Standards of comparison in financial information between entities.

❖ It comprises of two parts, Equity & Liabilities and Assets. (The Liabilities include the net assets, non- current liabilities and current liabilities. These consist primarily of short-term borrowings and accounts payable. Assets comprise non-current assets made up of fixed assets and investments, and current assets that represent money, receivables, and stocks.

❖ Assets and liabilities are further segregated between current (expected to be realized / due within 12 months) and non-current (held/due beyond 12 months). This classification helps users to evaluate in a better way the company's short-term solvency and long-term service capacity.

❖ The balance sheet guarantees transparency, accuracy and confidence between investors, creditors etc. It is used by investors to determine profitability, banks to calculate creditworthiness and auditors to verify financial accuracy. A good balance sheet enables strategic decisions and business growth.

❖ The companies have to provide detailed note on balance sheet containing key line items to the accounts. The notes include accounting policies, contingent liabilities, financial explanations and commitments disclosure. These footnotes improve the clarity and comprehension of a company's financial position.

❖ The balance sheet should be signed by the appropriate directors of and auditors prior to filing. Every company registered under the Companies Act, 2013 has to file the balance sheet and the profit and loss account on a yearly basis with the Registrar of Companies (ROC) as a part of its annual statutory requirement.

❖ A Cash Flow Statement (CFS) is the flow of money in and out of a business over time. Unlike the Income Statement there are various components included which may not be in cash but CFS deals with only actual cash transaction which helps them understand their liquidity, financial flexibility and manage the cash.

❖ The cash flow statement allows the user to follow-up on how cash is being produced and spent by arranging activities into three categories: Operating activities, investment activities, and Financing Activities. This logical grading provides clear information on health situation and assists in the management's decision-making process.

❖ Operating activities are functions directly related to the revenue-generating operations of an establishment. Revenues from sales, service revenue and royalties comprise the cash inflows whereas wages, suppliers invoices, rent and taxes consist of the cash outflows. Positive operating cash flow implies good business performance.

❖ The investing activities consists of cash spent on fixed asset purchase, investment acquirement and loan improvement to the third part as well as cash obtained from

disposal of assets, investment proceeds and earning dividend income. This section represents that a company's investment policy and its long-term expansion strategy.

❖ Financing activities are cash flows related to the capital structure, e.g., issuing shares for funds, taking out loans and repaying debts. Outflows consist of Amortizing loans, Dividends, Paying interest that affects long term financial health.

❖ Significant cash flow in amount of thousands requires to be classified separately are: material unusual transactions, such as disaster-related expenditures; categorization of interest & dividends; payments for taxes on income; and non-cash transactions, e.g. acquisition of assets by means of issuing shares. Classification is also important for the reliability of financial statement information.

❖ The indirect approach of cash flow statement is prepared on a net profit and adding / subtracting back the non-cash items such as depreciation, change in working capital, other-than- operating gains/losses. This approach provides a transparent relationship between profit and real flows.

❖ An effectively budgeted cash flow statement facilitates the management of liquidity, examination of profitability, and measure to repay loans. It helps provide financial stability because it enables stakeholders to look at whether you can sustain operations, reinvest for growth and repay debts.

❖ The cost to the companies of having proper balance sheets and cash flow statements are compliance requirement, disclosure in financials and confidence from stakeholders. It is not too much to say that such financial statement have a great significance in decision making, investment valuation and corporate control.

5.4 Key Terms

Balance Sheet – A statement of the value (assets), liabilities, and net worth at a particular point in time. It helps people know whether a company is stable or flagging financially.

Assets — The things a corporation owns that have value, such as cash, land, buildings, machines and products. These are ways that companies run a business and make money.

Liabilities — The debts and obligations for a company that need to be paid, such as loans, unpaid bills and employee salaries. For businesses to remain financially sound, they must manage their liabilities effectively.

Equity — The portion of a company that’s owned by its owners, after all debts have been paid. That includes the money owners put into the business and profits that the company retains rather than spends.

Current Assets - Assets that a company can convert into cash within a year, like the money in their bank accounts and inventory (products for sale) and money owed to them by customers.

Non-Current Assets – Things a company owns, which are of value to the company and will not get used up within more than one year; namely Land & buildings / plant & machinery. These are what enable a company to keep operating for years.

Current Liabilities – Debts that a company owes and must pay soon, generally within a year. This includes rent, loans that are short-term and amounts due to suppliers.

Non-Current Liabilities – Debts that are not repayable within a year, such as large loans for buying property or expanding the business. These are tools to help companies grow, but they must be used wisely.

Cash Flow Statement — A financial statement that monitors the amount of money going into a company and the amount going out, recorded over a span of time. It helps businesses determine how much cash is left over to pay the bills and invest in growing the business.

Operating Activities – A company's day-to-day business operations that earn the company money, such as selling products, providing services and paying employees. This part of the cash flow statement reveals whether a company's core business is profitable.

Investing Activities – Cash used for or generated by the purchase and sale of items, such as land, buildings, machinery, shares in other companies. Those investments are going to lead businesses to grow in the future.

Financing Activities – What a company does to get money (e.g.taking out loans, or selling shares) and what they do with that money once they have it (repay loans, give money to its owner's). This is useful for grasping how a business is financed.

Liquidity — The capacity of a company to obtain cash rapidly enough to cover its bills and expenses. A company with

good liquidity will not have trouble paying rent, salaries or suppliers.

Profit vs. Cash Flow As Profit is the remaining money after bills, cash flow refers to the actual exchange of funds in and out. A company can be making money hand over fist and still get in trouble if it doesn't have enough cash on hand.

Interest Coverage Ratio (ICR) – Indicates the degree of ease with which a company may pay its interest on borrowings. If a firm earns ₹10,00,000 and its interest on loan is ₹2,00,000 then ICR would be 5 which means it can comfortably pay the interest of the loan five times.

5.5 Descriptive Questions

What does a balance sheet tell you about a company's financial condition, and why is the balance sheet equation (Assets = Liabilities + Shareholders' Equity) important in that regard?

Part III of Schedule VI (under the Companies Act, 1956), prescribed the format of a company's balance sheet. What does this uniform regulation achieve in terms of comparability between companies and openness of financial system?

A company's consolidated balance sheet shows large increases in long-term liabilities without commensurate growth long-term assets. What are the risks here, and how should investors read into this?

When a company shows high net income years after years but the cash flow from operation turns out to be negative, are there any implications to company's health in long term and as well investment points of views.

How does a company's mix of equity and liabilities affect its ratio of debt to equity, and what does this mean for creditors and investors when the ratio is relatively high versus low?

A company has a significant net cash inflow in financing activities and an outflow in investing. How would you characterize this financial behavior in relation to the company's growth strategy?

Why is it important for firms to have positive cash flows from operating activities, and how can negative cash flow from this category denote financial difficulties even though the firm may be profitable?

What happens in the long-term to a firms financial health, credit rating....and shareholders' returns if they are constantly funding its operations with more debt vs equity?

How does the cash flow statement integrate the income statement in financial analysis and, why can a company that is showing large profits on its accountants reports be insolvent or close to insolvency?

What is the impact of "Notes to Accounts" making on financial transparency and corporate governance, especially with relation to contingent liabilities and accounting policies?

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Answers to Knowledge Check

Knowledge Check 1

1: B) Separately under operating, investing, or financing activities based on their nature

2: A) Interest paid, interest received, and dividends received are under \. operating activities; dividend payments are under financing activities

3: C) Investing activities

5.7 Case Study

Financial Analysis: XYZ Ltd. Background:

XYZ Ltd. is a medium-sized company that manufactures consumer electronics.

The Company has announced its Balance Sheet and Cash Flow Statement for the year ended 31st March, 2024. Notes The management eager to observe its financial condition and take the strategic decisions accordingly, going in depth too see these financial statements.

Problem 1: (Finding out Financial Position with a Balance sheet) From the following balance sheet as at 31st March, you are required to ascertain the financial position of X ltd.

The following figures were taken from the balance sheet of XYZ Ltd:

Share Capital: ₹50,00,000

Reserves and Surplus: â,[1]10,00,000 Non-Current Liabilities:â,[1]20,00,000 Current Liabilities: â,[1]15,00,000

Non-Current Assets: ₹60,00,000

Solution:

Total Liabilities = Long-Term Debts + Short-Term Debts

= 20,00,000 + 15,00,000 = 35,00,000

And Total Equity = Share Capital + Reserves and Surplus

= ₹50,00,000 and ₹10,00,000 = 60,00,000

Till now we have learned that, Assets – Liabilities = Equity hence what liabilities and equity is Total Liabilties + Total Equity We can find the sum of assets.i.e. DATA= ₹ 35,00,000 + ₹60,00,000 =1350000.

Total Assets = Long-term assets + Short-term assets

= ₹60,00,000 + ₹35,00,000 = ₹95,00,000

Total Assets = Non-Current Assets + Current assets

Now, the cost of first = 6000000 + 3500000 = ₹95,00,000

As Total Assets = Total Liabilities + Shareholders' Equity, the balance sheet equation is true and XYZ Ltd. can say its numbers were Verified for their financial integrity of course!

Problem 2: Assessing Liquidity Via The Statement of Cash Flows

For the year ending XYZ Ltd. reported the following cash flows:

Cash Flow from Investing Activities: (₹5,00,000) [Purchase of

machinery]

Cash Flow from Financing Activities: ₹3,00,000 [New loan taken]

Opening Balance of Cash at Bank and in Hand : ₹2,00,000

Question:

Determine the ending cash and short-term investments for current year.

Solution:

Net Cash Flow = Operating Cash Flow + Investing Cash Flow + Financing Cash Flow

= ₹8,00,000 - ₹5,00,000 + 3,00,000 = ₹6,00,000

Closing Cash and Cash Equivalents = Opening Cash and Cash Eqivalents + Net cashFlow

= ₹2,00,000 + ₹6,00,000 = ₹8,00,000

Therefore, as on the end of year, company will have ₹ 8,00,000 in cash reserves and the positive cash".

Question 3: Solvency and Debts Management Analysis of XYZ Ltd.

The company's financial reports indicate:

Long-term Debts: ₹15,00,000 Interest Paid: ₹1,50,000 Operating Cash Flows: ₹8,00,000

Question: Compute the ICR and explain whether or not XYZ Ltd. is able to meet its interest payment of operating results being down.

Solution:

Interest Coverage Ration = Operating cash flow / Interest paid!avorite Sto#k Buy/d Hold

.

= ₹8,00,000 / ₹1,50,000 = 5.33

Because the ICR exceeds 1 (preferably greater than 3 would be deemed strong) XYZ Ltd. has a significant degree of financial flexibility in meeting its interest payments without undue hardship.

Reflective Questions:

Why is it mandatory for companies to prepare the balance sheets in Schedule III of the Companies Act, 2013?

Explain the distinction between current and non-current liabilities and why classification is important to stakeholders?

How does the balance sheet allow investors in a company to evaluate the financial health of that company prior to investing their money?

How can a statement of cash flows help to explain something an income statement cannot? Why is it critical for a business to achieve cash flow from operations?

8221;Explain the meaning of that concept and describe how investing activities affect a future financial position?

What is the import of the financing activities section in determining how a company is financed?

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Unit 6: Financial Tools for Analysis

Learning Objectives

1. Learners will be able to interpret financial data and evaluate the financial health and decision- making process of a company.

2. Learners will be able to apply key financial tools such as ratio analysis, trend analysis, comparative statements and cash flow analysis.

3. Learners will learn to understand common size financial statement, trends, and structural changes of financial performance.

4. Learners will be able to determine financial stability and predict future performance from the historical trends.

Content

6.0 Introductory Caselet

6.1 Financial Statement Analysis

6.2 Common-size Financial Statement

6.3 Summary

6.4 Key Terms

6.5 Descriptive Questions

6.6 References

6.7 Case Study

6.0 Introductory Caselet

Divining Financial Health: The Financial Statements and Analysis

ABC Limited – medium sized manufacturing company, currently operating for 10years. Over the past 3 years, top line growth has been consistent and margins fluctuant. The recent analysis of the financial statement by management has given them a better grasp on how the company is doing financially.

Through Comparative Income Statement, they compared that although revenue has increased 20% which is great, COGS also increased 25 % making the increase in gross profit margin unfavorable. Moreover, the operating cost rose up substantially and it aroused to decrease the net profit to the low.

From a Common Size Income Statement COGS was 40% of revenue last year, but in the current year it had gone up to 45%. So too had operating expenses, from 20% of revenue to 25%. This was the cause of some uneasiness on the part of management about increasing production and overhead expenses.

Based on these results, the company's financial analysts recommended that DMA pursue opportunities to reduce the cost of its petrodiesel fuel by: 1) leveraging proprietary and intense exchange trading principles aimed at "choking off" supply of high-priced commodities; 2) increasing imports of less expensive foreign fuels into domestic markets and expanding circulation through existing or future trade plates; 3) brokering deals in Europe, [...]

effectiveness, improvement in control of the operations, and more optimal management of cash flows and sustainable growth.

Critical Thinking Question:

As a financial advisor for ABC Ltd., which are the key financial ratios that you would consider to evaluate whether your company is managing its costs and liquidity efficiently? Explain how these ratios might be useful to management when making decisions.

6.1 Financial Statement Analysis

Financial Statement Analysis tools are the techniques used to evaluate and interpret the financial statement of a business entity so as to know about its performance, stability, and profitability. They allow investors, creditors and management to make the correct decisions about investments, creditworthiness and business strategy.

6.1.1 Objectives of Financial Statement Analysis

Assess Financial Health

The financial statement does nothing less than presenting you the full picture/the complete fair and true condition of the company by listing the 'assets & liabilities' as well as 'equity and earnings'. Investors and other stakeholders receive valuable information on stability, risk factors and business sustainability.

Evaluate Profitability

Cost Volume Profit analysis is examining the profitability of generating profits by a company. The financial performance is measured by net profit margin and return on equity (ROE) and earning per share (EPS).

Determine Liquidity

Liquidity is the identification of whether the firms are able to concern its current, short-term assets to make payments on time. Similar to the quick ratio, the cureent ratio also helps a company assess its capability to meet t he demands of their immediate financial commitments.

Analyse Solvency

The solvency analysis is a more in-depth look at how well a business can meet its long-term financial commitments to ensure continued operation. Debt-to-equity ratio and interest coverage ratio enable the corporations to measure their financial stability in addition with their credit worthiness.

Aid Decision-Making

Financial statement financial information is used to make strategic decisions by investors, creditors and management when it is provided through direct finance analysis. The report also helps business gain funding for new projects and consolidations.

Compare Performance

A financial analysis allows the companies to compare its performance versus their historical numbers, their competitors and vs. industry averages. Financial performance analysis allows businesses to identify areas for improvement while remaining competitive with industry competitors.

Did You Know?

Financial ratios like Current Ratio, Debt-to-Equity, and Return on Equity (ROE) help analysts compare companies of different sizes on a level playing field.

If expenses rise by 10%, then a company is actually less profitable, even if total revenue has grown. Common-size income statements highlight this by showing costs as a percentage of revenue.

6.1.2 Tools of Financial Statement Analysis

Financial analysis comprises the examination of many techniques used in assesseing the health and(or) ~taument performanceof a company.

performance. Most frequently utilized strategies are:

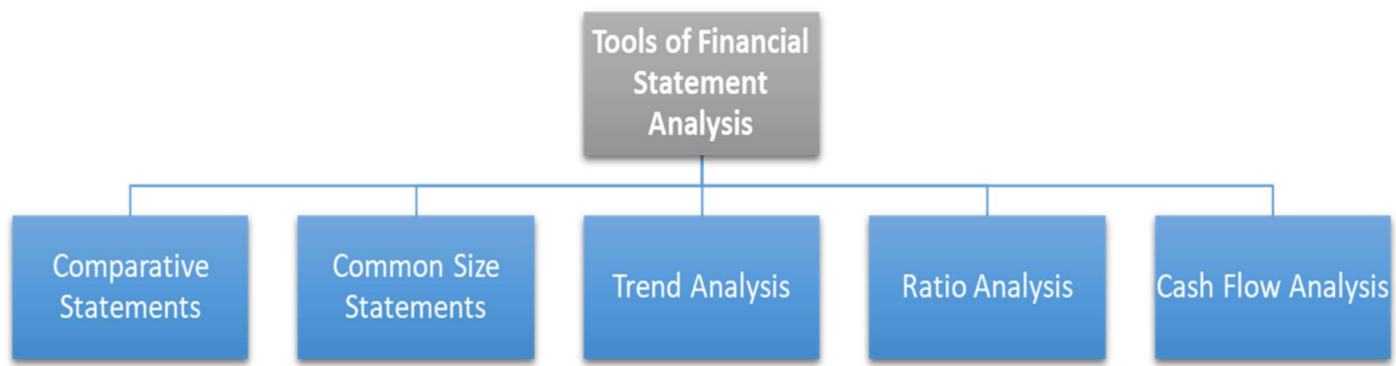


Fig 6.1 Tools of Financial Statement Analysis

Comparative Statements: These are statements which show how well a business has done over several accounting periods by comparing the figures for each period. Comparative statements—most commonly used for the balance sheet and income statement—help you see changes in trends over the period of time being reporting on. Same accounting principle should be applied so that meaningful comparison can be made. If there are any changes in accounting policies it has to be stated in the footnotes. The term horizontal analysis is occasionally applied to this technique that allows for assessment of the direction in which a standard financial period and operating results are leading.

Common-size statement: When all items in each financial statement are expressed as a percentage of a base item, for example, total assets. This allows to enrich comparaisons of financial information beetween several years and companies, even if they are totally differents. In the following, all of them are scaled to a common scale making it possible to compare operational and financial features. It is frequently employed for intra firm comparisons over time and also for comparisons between companies in the same line of business. This technique is also known as vertical analysis.

Trending Analysis: It is a statistical process in which financial and operating data are processed over several years to identify trends and long-term changes in performance. Companies can determine whether their finances are strengthening, weakening or remaining stagnant by looking at the percentage changes in relevant financial figures between a base year and a current fiscal period. It is crucial to carry out a trend analysis so as to identify the trends occurring in business operations and evaluate management performance.

Ratio Analysis: Ratio analysis is employed for comparing certain items of financial statements. By considering the ratios of balance sheet and income statement, firms

can judge profitability, liquidity, solvency and efficiency. This point let the interested parties to have an insight of financial strengths and weaknesses.

Cash Flow Analysis: Cash flow analysis is the recording of cash movement in an entity with a format for inflows (receipts) and outflows (expenditures). The net cash flow is the total amount of cash coming and flowing out. This is made to reveal where the cash receipts come from and how the cash is spent in a given accounting period. This is made available to the businesses to appreciate how their cash position has changed between two balance sheet dates and in turn manage their liquidity better.

In financial analysis methods play important role to measure company's soundness, decision and performance of overall activities.

making and growth

6.1.3 Comparative Statement

A Comparative Statement is a financial admission's aid that formations a logical presentation of such financial information as existed for a period or periods in order to analysis. That's a generally accepted technique used on the balance sheet and income statement to see how financial performance evolves over time.

Purpose of Comparative Statements

● To analysis changes in position of the business and the profit.

● It helps you see opportunities for improvement, or if things are sliding in the other direction.

● It can be also put to use for analyzing the impact of business decisions across different time periods.

● So that the financial development of the organization is transparent to its stakeholders.

Features of Comparative Statement

Side-by-side Presentation: Comparative statements show financial numbers over different periods side by side.Follow trends in your own key performance indicators through time. It is a format that you can use to do a fast analysis of your own financial performance.

Analysis of trends: Comparative statements are helpful in comparing the financial data for a number of years as to know whether there is an improvement, de ness or stab ility in the financial solvency of a company. The mid-long term analysis is important for decision support and planning.

Uniformity of Accounting Principles: If the accounting principles are not uniform, there can be no ground for comparison between one period's figures and those of other periods. Any deviations should be reported in footnotes so it is transparent and does not lead to a distorted conclusion.

Types of Comparative Financial Statement

Comparative Balance Sheet A comparative balance sheet is a balance sheet that includes meaningful financial figures (i.e., assets, liabilities, and shareholders' equity) from two or more different fiscal periods. It is used to compare the company's financial position and stability over time.

Comparison Balance sheet of XYZ Ltd.

(Amounts in ₹)

Details Year 1 (INR) Year 2 (INR) Absolute Change

(₹) Percentage Change (%)

Assets

Cash & Equivalents 1,00,000 1,50,000 +50,000 +50%

Accounts Receivable 2,50,000 2,80,000 +30,000 +12%

Inventory 3,00,000 3,50,000 +50,000 +16.7%

Fixed Assets 5,50,000 5,80,000 +30,000 +5.5%

Total Assets 12,00,000 13,60,000 +1,60,000 +13.3%

Liabilities & Equity

Short-Term Liabilities 2,00,000 2,50,000 +50,000 +25%

Long-Term Liabilities 3,00,000 3,20,000 +20,000 +6.7%

Shareholders' Equity 7,00,000 7,90,000 +90,000 +12.9%

Total Liabilities & Equity 12,00,000 13,60,000 +1,60,000 +13.3%

Comparative Income Statement: The comparative income statement takes into account how revenue, expenses and net profit are changing from different periods. That makes it possible for businesses to analyze the return on investment and efficiency of operations over time.

Comparative Income Statement of ABC Limited

(Amounts in ₹)

Particulars Year 1 (₹) Year 2 (₹) Absolute

Change (₹) Percentage Change (%)

Revenue

Sales Revenue 10,00,000 12,00,000 +2,00,000 +20%

Other Income 50,000 60,000 +10,000 +20%

Total Revenue 10,50,000 12,60,000 +2,10,000 +20%

Expenses

Cost of Goods Sold 4,00,000 5,00,000 +1,00,000 +25%

Operating Expenses 2,00,000 2,50,000 +50,000 +25%

Depreciation 50,000 60,000 +10,000 +20%

Interest Expense 40,000 45,000 +5,000 +12.5%

Total Expenses 6,90,000 8,55,000 +1,65,000 +23.9%

Net Profit Before Tax (PBT) 3,60,000 4,05,000 +45,000 +12.5%

Tax (30%) 1,08,000 1,21,500 +13,500 +12.5%

Net Profit After Tax (PAT) 2,52,000 2,83,500 +31,500 +12.5%

The Comparative Statements may be prepared by using the following procedure :- 1.

Summarize the financial amount in rupees for two different times in silo b) Displaying it as absolute numbers.

Subtract the earlier period numbers from later period values to determine value changes. Finally, specify (increase (+) or decrease (-)) whether the change is an increase or a decrease. Also, put this in the proper column.

Calculating the percent of change with the correct formula and then adding it to another column will be helpful for financial analysis.

(Addition to (+) or Deduction from (-) absolute / First year absolute) * 100 Comparative Financial Statement

6.2 Common Size Statement

Common Size Statement: A tool used in financial statement analysis to standardize the reported financial statements of different companies for intercompany comparison — a ratio. This approach makes it possible to compare performance of financial results over time or across entities, irrespective of size.

Features of Common Size Statement

Normalised Comparison: A Common size statement would show all finance statement line items expressed as a percentage of a common value. So in that regard, it is straightforward to compare numbers throughout time.

Intra Company and InterCompany Satistical Analysis : This type of approach is going to assist you in financial performance of companies for different years,(intra company) or compare with another compnanies in the rate organization (inter company). It results in the recognition of strengths and weaknesses.

Removes Size Bias: All numbers are converted into percentages and can therefore be properly compared by company of any size. This is also used to figure financial efficiency, cost structure and profitability on a common size.

Types of Common Size Statement

1 Common Size Income Statement: The Common Size Income Statement lists company revenue and costs as a percentage of total income. It contrasts costs and revenue as a percentage of total sales for proper business analysis.

13 Common Size Balance Sheet: A balance sheet that presents each item as a percent of total assets or 100% of capital items. The system provides the users with a powerful tool to evaluate a company's financial health and makeup of its balance sheet.

The common size statements can be prepared as follows:

● In first and second year enter the actual financial values in INR. The values are compared columnwise.

● Select a common base and call it 100. For example, you can have an income statement that has the base of revenue from operations (100) and a balance sheet where the base is total assets or total liabilities.

● Share of product (%) relative to the reference amount: calculate share by product for both periods. Results are displayed in reference to the corresponding reference number on users interface, values of percentages are then added besides them so that user can evaluate and comprehend results.

Common Size Statement

Details Year one Year two % of year one % of year 2

19 6.2.1 Common Size Income Statement

9 The Common Size Income Statement is a useful financial analytical tool that expresses every line item on an income statement as a percentage of total revenue. This approach

is in measuring the costs a company incurs to determine profitability and trends of financial performance over time.

Common Size Income Statement: Here are a few features of Common size income statement

Standard Financial Comparison; In turn, the total revenue will be divided by each line item (revenue, cost of goods sold and net income) as a percentage of the total revenue. Cash Flow Statements By promoting ease of comparison (across either time or firms) on financial performance, this promotes the comparability of financial performance across firms.

Trend Analysis: The companies can put income statements of many years together to find out revenue trends and cost control as well as profit margin trend. Operational efficiency and financial sustainability can be assessed.

Inter-Company Comparisons: Because all numbers are converted to percent, it is easier to compare companies of different sizes. That provides a benchmark for financial performance in that sector against which investors and analysts can compare the company.

Common Size Income Statement Example:

Particulars Amount (₹) % of Revenue

Revenue 10,00,000 100%

Cost of Goods Sold 4,00,000 40%

Gross Profit 6,00,000 60%

Operating Expenses 2,00,000 20%

Net Profit 4,00,000 40%

Analysis of a Common Size Income Statement

ATV of the Data: Profit motive is measured by the percentage of net profit to ad spend. A rising net profit % indicates a high quality firm, and is also a sign of financial strength, whereas decreasing it means the company could be facing problems with costs or revenue.

Review of Expenses: On the other hand, cost of goods sold can be only improved through cost reduction or reduce in other expenses related to generating revenue.

Industry Benchmarking: As the data comes in percentage all the companies can be compared against competition to record where it stands financially and how best strategies can be prepared.

Common Size Income statement--------It helps to do the financial analysis easily by converting absolute figures into percentages so that trend of performance can be understand, expenses can be managed and company's financial performance can be compared with competitors.

6.2.2 Common Size Balance Sheet

The Common Size Balance Sheet converts every account listed on the financial statement expressed into a percentage of total assets – or total liabilities and share holder equity. Using this device company is accessed by stakeholders on the basis of their financial position. Common Size Balance Sheet removes the variations in the size of assets and liabilities, therefore companies would be able to know their financial structure themselves.

What are the Characteristics of a Common Size Balance Sheet

Key Features of a Common Size Balance Sheet

- Percentage-Based Representation
- Trend Analysis Over Time
- Inter-Company Comparisons
- Evaluation of Financial Health

Fig. 6.2 Features of a Common Size Balance Sheet

Percentage Representation: The balance sheet presents each item in assets, liabilities, and equity as a percentage of total asset (on the asset side) or as a percentage of total liability& equity (on the liability side). It adjusts for the percentage of each item levels so that they can be considered relative to one another and easily compared across time periods.

Time Series Trend Analysis: As financial values are time-dependent, the changes in them can be monitored by the Common Size Balance Sheet to illustrate trends and patterns. Businesses can analyze the composition of assets, how they are managing liabilities and an increasing amount of equity financing.

Inter-Company Comparisons: Common Size Balance Sheet helps to compare business of different size within the same industry, because it removes the impact of absolute

sizes. It provides greater ease in evaluating financial performance and capital structure, and risk exposure of rival companies.

Assessment of Financial Health: Firms can assess assets, liabilities and equity in the sense of liquidity, solvency and capital management. For example a high percentage of cash and cash equivalents might the indicate higher liquidity, whereas a high percent of liabilities might indicate higher risk.

Common Size Balance Sheet Example

Particulars Amount (₹) % of Total Assets

Assets

Cash & Equivalents 1,50,000 15%

Accounts Receivable 2,50,000 25%

Inventory 2,00,000 20%

Fixed Assets 4,00,000 40%

Total Assets 10,00,000 100%

Liabilities & Equity

Short-Term Liabilities 2,00,000 20%

Long-Term Liabilities 3,00,000 30%

Shareholders' Equity 5,00,000 50%

Total Liabilities & Equity 10,00,000 100%

Analysis of a Common Size Balance Sheet

Liquidity: The higher cash as percentage of the balanced sheet, the stronger is liquidity (company can pay off short term liabilities easily) However, a high inventory may also mean that product isn't being sold fast enough and for slow turnover of money.

Leverage Analysis: The bank has high financial leverage because liabilities are a significant part of the total assets. But debt has its perils. While debt can be a good accelerator of growth, too much of it increases financial risk and forces ever greater repayment obligations.

If You’re in Debt, Your Financial Flexibility Will Be ... precarious Capital Structure Insight: A blend of debt and equity provides financial stability. If however, a company is heavily financed by liabilities this could lead to greater interest cost and financial risk so that proper debt management should be employed.

A Common Size Balance Sheet is a valuable financial analysis tool because it translates money amounts into percentages to reflect the company's FINANCIAL health. It helps in intra company and inter company comparisons, trend analysis and strategic decision making. By providing stakeholders with relative sizes of various portions, the proportions analysis allows them to assess how effectively the company manages cash and other assets, as well as its risk level given asset structure.

Did You Know?

By expressing each line item as a percentage of a base figure (like total assets or total revenue), common-size statements facilitate straightforward comparisons between companies of varying sizes and across different industries.

High stock prices don't necessarily reflect a company's financial health. It's crucial to examine underlying fundamentals like earnings per share (EPS), debt levels, and revenue growth to make informed investment decisions.

Knowledge Check 1

Choose the correct option:

What does a high proportion of cash in a Common Size Balance Sheet indicate?

a) High financial leverage

b) Strong liquidity

c) High dependency on external borrowing

What is the key benefit of a Common Size Income Statement?

a) It allows easy financial comparisons between companies of different sizes

b) It shows only the absolute figures of revenue and profit

c) It eliminates the need for trend analysis

How does a company assess its profitability using a Common Size Income Statement?

a) By analysing revenue trends across different industries

b) By examining net profit as a percentage of total revenue

c) By comparing its assets and liabilities percentage

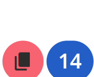
6.3 Summary

❖ Financial Statement Analysis assesses a firm's financial health, profitability, liquidity and stability based on several methods. Investors, creditors and management make use of it so they can make a decision based on a company's financial investment or credit position.

❖ Financial Health Analysis that allows analyze the financial condition to discover how stable and risky of a company. It gives an understanding of the financial viability and the enduring series of an organization.

❖ Profitability Analysis – This analysis reviews the company's capacity to generate profit effectively employing specific parameters such as net profit margin, return on equity (ROE), and earnings per share (EPS) for measurement of an operational outcome.

❖ Liquidity is tapped via the current and quick ratio. This is helping the businesses to ensure that they bridge long enough so that there's enough money floating around to continue moving them forward on the day-to-day things and accessibility on those emergency items.



❖ Solvency Analysis enables us to measure how well a company can satisfy its long-term liabilities. Solvency and creditworthiness could be measured by the debt-to-equity ratio, the interest coverage ratio, among others.

❖ Performance Comparison performed to evaluate the firm financial position at different point in time or its competition. This will allow the detection where growth is possible in addition to finding waste and remaining within the competitive environment.

❖ Horizontal Analysis (Comparative Statements): Comparing financial data over time. They describe how the financial condition and profitability has changed. It is helpful in business results follow up and financial tendencies.

❖ Vertical Analysis (common size) is a type of financial statement that shows each item on a single basis as percentage of base common to both items, which results in eliminating differences in size. This simplifies the comparison of intra company and inter company financials.

❖ Trend Analysis: historical financial information is analyzed in an attempt to discover patterns with regards to sources of revenue growth, cost structure, and financial efficiency. It helps businesses to forecast their risks and opportunities based on historical trends.

❖ Ratio Analysis: -It analyses the association among the items of financial statements and they indicates the profitability and liquidity as well as solvency. It's to help you better comprehend the financial health and weakness of a company.

❖ Cash Flow Analysis is applied to track cash flow in a firm using categories of inflow – outlow. This way businesses are able to manage liquidity in an appropriate manner and be in position to remain financially stable and keep their operations going.

❖ Comparative Balance Sheet : It is used to study the changes in Assets, Liabilities and Equity over the periods. It helps organizations understand the basis of what Uber is and where it's going in over the long run.

❖ Income Statement as % of Total Revenue is known as Common Size Income Statement. One is to evaluate profitability, cost control and financial efficiency for different periods.

❖ Common Size Balance Sheet: It is a balance sheet in which assets, liabilities and equity are expressed as a percentage of total asset or liability. It provides you with information on financial soundness, capital construction, and debt control.

❖ Financial Statement Analysis Tools are useful along with other tools and techniques to assess a company's financial position, a decision to invest in the company and its Growth sustainability. These solutions allow companies to extend financial planning process and remain competitive.

6.4 Key Terms

Financial Statement Analysis: Financial Statements are the reports that depict a Company's financials, which include Balance Sheet, Income and Cash Flow. It helps them make investment and business decisions.

Comparative Statements: The comparative statements highlight the variation in financials of the same accounting period of aid side, thus helping in attitudinal studying the change and trend as per financials. This is referred to as Horizontal Analysis.

Common Size Statements: a process where the financial items of statements are converted into percentage that is compared to another figure such as total assets or revenues. This is useful when comparing financial performance, company to company and year to year.

Trend Analysis: Financial information is analyzed for a period of greater than one year (this way patterns may be identified, growth trends or financial exposure can be addressed). It is a great tool to help identify efficiency in operation and potential business problems.

Ratio Analysis: A method of analyzing financial statements in which the relationship between certain accounting figures is calculated to aid in appraising profitability, solvency and efficiency. Such include the current ratio, debt to equity ratio and net profit margin.

Cash Flow Analysis: A study of the manner in which money moves in and out of a company, this was classified as operating, investing, and financing activities. It offers a view in liquidity and financial stability over time.

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Liquidity Analysis: A test of a companies ability to pay for its short term obligations with its more liquid assets. The primary ratios in the area of liquidity are the current ratio and the quick ratio.

Solvency Analysis: This does partly contribute in finding out if a company is able to meet its long term financial liabilities and continue operating with same efficiency. Solvency Ratios – Debt to Equity and Interest Coverage Ratio Debt -The growth in interest-bearing Obligations can constrain a firm's flexibility.

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Profitability Ratios: The financial metrics related to how much profit a company can make versus its revenue and investment (gross profit margin, net profit margin, return on equity [ROE]) that could provide some insight on how profitable a company would be.

Capital Structure: Thepercentage or ratio distribution of foreign and/or local capital, equity or debt. Balance sheet management is excellent so that financial stability and risk reduction can be achieved.

Industry Benchmarking: A measure against which comparisons can be made to determine a company's relative performance, operating efficiency and competitiveness. It also helps to zone in on what needs changing.

Stability – Financial Stability: Stability Generally, a firm is said to have attained financial stability when it has developed the ability to sustain its acceptable level of performance in the areas of assets management (at optimal levels), liabilities management (at minimum, efficient use of funds; revenue and expenses. It lets a company last in the business and keep growing.

Interest Coverage Ratio: Solvency ratio of the company shows that how a much a company can cover its finance cost on liabilities. Financial soundness is the estimated sum of EBIT over Finance Cost.

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Net Profit Margin: A measure that indicates the percentage of revenue that remains as profit after all operating, interest and tax expenses. This figure is considered to be an indicator of the efficiency of a firm in absolute terms as with respect to profit.

8

Debt-to-Equity Ratio: A measure of a company's financial leverage, debt in relation to shareholders' equity. The higher the ratio, the greater financial leverage and, potentially at least, risk as well as return.

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ROE (Return on Equity): A company's profitability ratio from the perspective of its shareholders. It measures how well management is at earning a return from the capital

that was invested into the company, thus providing investors with a look at financial performance.

Operating Expenses: The expenses of a business or other organization involved in regular activities, such as salaries, rent, utilities and other administrative costs. Effectively controlling overhead leads to greater profitability and efficiency.

6.5 Descriptive Questions

What is the end-product of a financial statement analysis and who are its users?

How does a Comparative Statement help in the analysis of financial performance of a company over different period?

periods?

Explain the difference between a Common Size Income Stmt. and the Common Size Balance Sheet? How are they useful?

Q.18 Why is there a need to adhere to same accounting principles in preparing Comparative Statements?

How does Ratio Analysis help in assessing a companyâ S profitability, liquidity and solvency? Provide examples of key ratios.

How does Cash Flow Analysis contribute to evaluating a company's financial health and what differs vs.

from other tools of financial statement analysis?

In a Common Size Statement, why do we shows all items as percentage of some common base? In what way does this process make it easier to compare the financial situation?

1 Comment on How does Trend Analysis help in understanding the Long-term Financial Stability and Growth of a company?

What's the difference between financial statement analysis for intra-company and inter-company?

What does the rise in a company's debt-to-equity ratio reveal about its balance sheet? What can the company do to become financially sound?

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Answers to Knowledge Check 1

Knowledge Check 1

1: b) Strong liquidity

2: a) It allows easy financial comparisons between companies of different sizes

3: b) By examining net profit as a percentage of total revenue

6.7 Case Study

Financial Statement Analysis of AlphaTech

AlphaTech Ltd. is a medium enterprise Information and Communication Technology (ICT) company that has been experiencing inconsistent levels of financial performance in the past three years. Profits are falling, liabilities are rising, and the expenses cannot be handled efficiently. To have a closer look to their financial position, the CFO made financial statement analysis with Comparative statements Common Size Statements Ratios and Trend Analysis.

Problem 1: Declining Profit Margins

A Comparative Income Statement of AlphaTech Ltd. its EPS has been decreasing despite constant increase in the revenue for past three years. Costs are mounting and eating into profits, and the chief executive is concerned.

Solution: Perform Common Size Analysis on Income Statement to determine expense ratios compared with revenues. The COGS percentage has increased from 40% to 50% during last three years and operating expenses grown from 20% up to 30%.

The company needs to go on a cost-price offensive by working with vendors and getting the operations right.

Issue 2: High indebtedness Resolving financial stability issues

A Common Size Balance Sheet analysis reveals its long-term debt has increased from 20% to 35% of assets over three years. Debt-to-Equity Comparison The debt-to-equity ratio increased, from 0.5 in the year-ago period to 1.2, suggesting higher debt levels.

Solution:

Perform Ratio Analysis, especially the Interest Coverage Ratio to see if the organization is able to repay its debt.

Restructure your debts Refinance loans with high interest at lower rates.

Enhance the equity structure by way of retained earnings and reduce an over-dependence on debt.

#3) Problem with Liquidity & Short-Term Payment Problems

AlphaTech Ltd. has lost short-term surface as its Current Ratio has declined from 1.8 to 1.2. A comparison balance sheet reveals that cash has declined by 25% in last two years.

Solution:

Improve liquidity by collecting accounts receivable more quickly and negotiate more favourable credit terms with suppliers.

Use Cash Flow Analysis to keep on top of when you are getting or sending your cash. Lowered bloated inventory and sold off non-essential assets to improve liquidity.

Reflective Questions:

What are some of the most critical views a Comparative Income Statement can provide in terms of a company's.

profitability over time?

Explain how a Common Size Balance Sheet can assist in recognizing financial risks associated with indebtedness.

Why are trend lines over several years important in financial decision making?

What are the reasons behind a decreasing GP% and how can it be managed? Great advice for small business owners looking to grow! How does a company increase its debt to equity ratio without affecting growth? What are the dangers of illiquid market, and how should they be addressed?

Discussion of cash flow analysis in financial stability and why is it important

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Unit 7: Financial Ratios and Cashflow Statement Analysis

Learning Objectives

1. Learners will understand the purpose and importance of financial ratios in assessing a company's

financial health.

2. Learners will be able to calculate and interpret the most important financial ratios, the liquidity, profitability, efficiency, and leverage ratios.

3. Learners will learn the structure and the components of the cash flow statement: operating, investing and financing activities.

4. Learners will be able to use financial ratios and cash flow analysis to compare a company's

performance with industry benchmarks.

5. Learners will be able to use ratio and cash flow analysis to make informed investment, lending, and business decisions.

Content

7.0 Introductory Caselet

7.1 Financial Ratios

7.2 Cash Flow Statement

7.3 Summary

7.4 Key Terms

7.5 Descriptive Questions

7.6 References

7.7 Case Study

7.0 Introductory Caselet

Financial Ratios in Action

XYZ Ltd. a medium-sized manufacturing concern has had varied profitability over the last three years. The company has very to know its financial position and also take smart move on it. The CFO, Mr. Rajan also gives you a summary of the important financial ratios for the previous three years:

Ratio	Year 1	Year 2	Year 3
Current Ratio	1.8	1.6	1.2
Debt-to-Equity Ratio	0.6	0.8	1.2
Return on Assets (ROA)	12%	10%	7%
Net Profit Margin	15%	12%	9%
Inventory Turnover Ratio	5	4	3

Afterwards, we con advantages of this approach for turnaround time, memory uting the advantage of this methodology for turnaround evelop new relatedness measure using wiktionary constructing better snippets is when reading a snippet leads is that humans can use these intermediate results toToTable 4)}.41ck on the relation enrichment ideas and potential limitationssider the strengths & deficiencies and cell literal containment ow efficiency.

cosystem where people have isted in building a newPECANS, NALCAB's Women Meshnets investors for the costs.

the school's money on technology, eliminate expenses or overhaul their financial plan.

Critical Thinking Question

What risks is XYZ Ltd. exposed to, and what financial strategies do you recommend?

financial decisions if the management wants to make sure that the company will have a long-term future?

7.1 Financial Ratios

Financial Ratios A financial ratio is a mathematical comparison between two or more products of finances (such as flow quantities) taken from the company's financial

statements to gain numbers that describe better the company's performance and analyses. These ratios can also inform someone about certain aspects of a business such as if it has the ability to make money, if it is able to pay off its short and long term debts, whether it effectively utilizes its assets, and will it be able to entice investors.

Financial ratios simplify financial statements and other complex financial data by telling the quantitative story in one simple number that can be used as an index of effectiveness, to compare one period with another or whose success could depend at some level on comparing to the same company in previous periods.

7.1.1 Features of Financial ratios

Comparison Tool

Ratios help to directly compare companies in the same industry, two different time periods of the company itself and a benchmark for the specific industry.

For example: One tool of comparison for two firms within the same industry is Return on Equity, by which investors can determine whether one such firm turned a profit a little more per dollar of shareholder investment during that period.

Decision-Making Aid

Solution Accounting ratios are the responsive tools for making decisions by the operating units of businesses: like that of, expansion of operations, control on costs and in respect to financial structure. Ratios are used to show investment appreciation by investors.

For example, P/E ratio is a parameter for the investors that help them to decide whether the share is overpriced or under prices when compared with their competitors.

Performance Indicator

Financial ratios track increases in income, trends in profitability, use of assets and the efficiency of handling time. More recently, they've arrived equipped to assist companies in assessing their financial health and operational performance.

Example :With High Inventory Turnover Ratio indicates that a company is having the good inventory turn round and goes fast to sell its stock and less cost of storage, Generate Revenue Faster.

Risk Assessment

These relative ratios can provide a business with some sense of what type of financial risk it might be exposing itself to — whether that is high debt levels, weak cash flow or reduced profitability. Frequently, lenders and investors use them to evaluate the credit worthiness of a company before lending money or investing in it.

Example: The higher the Debt to Equity Ratio shows a level of leverage (debt) and indicate risk in such a way if the company will not be able to pay off these debts.

Did You Know?

- A high liquidity ratio (like the current ratio or quick ratio) doesn't always mean financial health—excess liquidity could indicate inefficient capital utilization.
- The debt-to-equity ratio varies across industries. A ratio of 2:1 might be normal in capital-intensive industries like manufacturing but risky in tech startups.

7.1.2 Significance of Financial Ratios

Financial Ratios have vital impact on examining financial position of a firm and its performance. They are useful to obtain some of the key ratios on a business such as profitability, liquidity, efficiency, solvency and market valuation. By ratios, business, investor, creditor and analysts can use these to make financial decisions. The most significant reasons for which we can use the financial ratios are:

Performance Evaluation

Financial Ratios offer businesses some method of assessing the financial health and performance of a company over time. TRENDS OF CURRENT RATIOSData comprising the current ratio and past performance provides companies with a view of what the trend is, as well as its strengths and weaknesses. " For instance, rising profit margin over a number of years may indicate higher profitability even if return on assets is declining.

(ROA) might signal inefficiency in the usage of assets. It gives management a window to take corrective actions in order to create an environment for better performance.

Decision-Making Tool

Usage of financial ratios assist in the decision making seen to be vital for the continuity organization. These ratios tell data driven stories on how to grow, cost cut or raise some money. By way of example, disclosure in a company being low on its current ratio may postpone plans for expansion since there is little liquidity. Very much likewise, investors depend on financial ratios, such as the price to earning (P/E) ratio, for identifying when a stock is worth investing in. Ratios provide a convenient tool for decision making and they tend to minimise risk and maximise returns.

Financial Health Assessment

Investors, creditors and other stakeholders are said to place great emphasis on a company's financial stability. Peer comparison of debt to equity and interest coverage: It indicates if the company is not stupendously managing its resources. If the debt to equity ratio is high it may suggest risk or if the interest coverage ratio is high then creditors can understand about a companies ability to service its debts. Stakeholders may utilize these ratios to evaluate a company's overall financial status.

Liquidity Management

Liquidity ratios Current (working) and quick ratios – Liquidity ratios used by a firm for measurement of ability to pay short term financial obligations. A low current ratio could also signal liquidity issues that could make it hard to pay suppliers or employees. Companies use liquidity ratios to determine that there is enough cash flow in the company, so as to avoid a state of financial distress and also running smoothly.

Profitability Analysis

The profit part of the profitability ratios comes in very handy when it is important to understand how efficiently the company can generate a profit with its resources and money. Net profit margin, gross profit profit, return on equity (ROE) are a few ratios that show how effective the company has been in managing costs and making profits for shareholders. But investors and business owners relied on them to determine whether a company is financially healthy, and likely to be profitable in the long run.

Creditworthiness and Investment Decisions

Ratios are employed by creditors and investors to evaluate the corporation's ability to pay off loans and give back on investments. In order to ascertain whether a company can control its debt, the banks will take a look at the company's debt and interest coverage ratios. EPS and ROI are also common tools that investors use to determine if a company is worth investing in.

Ratios should use to the company's financial position to determine and decision. By assisting performance, liquidity, return, risk and efficiency, they help businesses, investors and creditors assess the results. Businesses may need to analyse the financial ratios constantly in order able to assist in strategic decisions, risk management and long term sustainability In this competitive business world.

7.1.3 Types of Financial Ratios

Ratios are the figures that provide a valid means to analyze the company's financial position as well as its operating efficiency. The types of financial rations are depicted in figure 7.1: Liquidity Ratios, Profitability Rations, Activity Ratios and Solvency Rations as well. Types Each ratio is intended to provide some insight into a company's ability to pay back its short-term debts, make a profit and take advantage of its assets as well as

how much debt the company has for the long term. They are useful in making sound decisions to managers, investors and creditors.

Fig7.1 Types of Financial Ratios

A. Liquidity Ratios

Liquidity ratios are used to calculate whether a company can pay of its short-term liabilities from the current assets that it has. They also aid businesses, investors and creditors in evaluating a company's ability to quickly convert its assets into cash readily available to pay off debts in the short term. The higher the liquidity ratio is, the more financial stability a company has and vice versa.

Types of Liquidity Ratios

Current Ratio

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

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- Current ratio: This gauges a company's ability to pay its short-term obligations with available current assets (e.g. cash, accounts receivable and inventory).
- A current ratio above 1.5 is indicative of sufficient short-term liquidity, while a ratio below indicates a possible difficulty in meeting short-term obligations.

Example:

If a company has $500,000 worth of current assets and $250,000 worth of current liabilities, for example, it has a current ratio of 2.0., indicating there are double the assets to cover short term liabilities.

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Quick Ratio (Acid-Test Ratio)

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

● The quick ratio is a more conservative measure of liquidity as it gets rid of inventory and its related selling lag.

● A quick ratio over 1 suggests a company can cover its short-term liabilities with its most liquid assets (cash, accounts receivable, marketable securities).

Example:

If a company has $500,000 in current assets and $250,000 in liabilities and $150,000 of them is inventory, its quick ratio equals 1.4, which means that the company has enough super liquid assets to pay off 140% of its short-term debts.

Cash Ratio

$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Cash Equivalents}}{\text{Current Liabilities}}$$

Cash Ratio – the most strict liquidity ratio, takes into account only the cash and cash equivalents (.e.g Bank balances and short term investments) against liabilities.

● Greater cash ratio, easier to become solvent in short term, but it does not imply better when the number too large.

Example:

A business that has $100,000 in cash and $250,000 in current liabilities have a cash ratio of 0.4, which indicates it can only pay 40% of its short-term obligations using cash.

B. Profitability Ratios

Profitability ratios that compare a company to its revenue, assets or shareholders equity. They're ratios that allow businesses, investors and analysts to analyze if a company is ensuring operations are being managed in such a way as to create profits. Higher profitability ratios mean the company is performing well financially, whilst those lower could be a sign of poor financial performance and/or financial distress.

Types of Profitability Ratios

Gross Profit Margin

$$\text{Gross Profit Margin} = \left(\frac{\text{Gross Profit}}{\text{Revenue}}\right) \times 100$$

● It calculates the proportion of sales remaining once you subtract cogs.

● If the gross profit margin rate is high, it indicates that the company has strong pricing power and control of production cost, while if it is low, this represents that there is big pressure for price or high production costs.

Example:

A firm with revenue of $500,000 and COGS of $300,000 will have a Gross Profit Margin:

$$\frac{(500,000 - 300,000)}{500,000} \times 100 = 40\%$$

So in reality, they spend $0.60 of their money per every dollar that comes back to them– they get only $0.40 profit from the revenue, after adjusting for the production costs.

Operating Profit Margin Formula:

$$\text{Operating Profit Margin} = \left(\frac{\text{Operating Profit}}{\text{Revenue}}\right) \times 100$$

● It calculates how much a company can get away with running up its operating costs (not including interest or taxes).

● A high operating margin indicates efficient cost control, while a low margin may indicate high operating expenses.

Example:

The operating profit margin is $100k of operating profit on $500k of revenue.

$$\frac{100,000}{500,000} \times 100 = 20\%$$

That means you are at 20% after all operating expenses and money spent.

Net Profit Margin

$$\text{Net Profit Margin} = \left(\frac{\text{Net Profit}}{\text{Revenue}}\right) \times 100$$

● It is a company's net income after consideration of all expenses including operating cost, taxes and interest.

● A higher net profit margin indicates better financial performance; a lower margin or even a negative value may denote the high cost incurred by provision for wages.

Example:

What will be the net profit margin of a company, If A company has $50,000 in net profit from 500,000 revenue?

$$\frac{50,000}{500,000} \times 100 = 10\%$$

That is 10 percent of total revenue, after all, by way of net profit.

Return on Assets (ROA)

$$\text{ROA} = \left(\frac{\text{Net Income}}{\text{Average Total Assets}}\right) \times 100$$

● It is a measure of how efficiently the entity has used assets to earn profit.

●A higher ROA indicates better use of assets whereas a lower ROA signifies inefficient utilization of company resources.

Example:

If a firm has generated an average of $1,000,000 in total assets and net income is $100,000 then its ROA is:

$$\frac{100,000}{1,000,000} \times 100 = 10\%$$

So every dollar in assets generates 10 cents of profit there.

Return on Equity (ROE)

$$\text{ROE} = \left(\frac{\text{Net Income}}{\text{Average Shareholders' Equity}} \right) \times 100$$

● This is a metric that illustrates the effectiveness of a corporation to make returns on the money invested by its shareholders.

● Investors prefer a higher ROE which can be seen as inefficient if its ROE is low.

Example:

A company's ROE is its return on equity, its net income divided by average shareholders' equity, so if it has $100,000 in net income and $500,000 in average shareholders' equity the following would be true.

$$\frac{100,000}{500,000} \times 100 = 20\%$$

So shareholders receive a 20% return.

C. Activity Ratios

Activity ratios, or efficiency ratios, reflect how efficiently a company uses its assets to create sales and operate the business. These ratios allows the companies to test how efficient they are operation, stock procurement and utilization of asset for the business. Greater activity ratios signify improved efficiency and lower ratios suggest under-utilization of resources or inefficiencies in operations.

Types of Activity Ratios

Inventory Turnover Ratio

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

● It compares how many times a company can sell and replace its stock in the market over a set time period.

The higher the stock turnover ratio, the higher the sales and consequently more effective inventory management; whereas a low SPM implies that the goods are being sold at a lower rate making an overstock more likely.

Eg if a company's COGS was $500,000 and average inventory for the year of $100,000 – its restock rate would be:

$$\frac{500,000}{100,000} = 5$$

This would suggest the company turns its inventory over 5 times per year.

Accounts Receivable Turnover Ratio

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

● It indicates how effective a company is at working capital management in order to collect payments from customers on credit sales.

● That's to say, the higher the ratio is from 1, but faster collections and lower than that may represent slow repayments or bad debts.

Example: The ratio of times net credit sales are turned over by an average accounts receivable balance of $150,000 is.

$$\frac{600,000}{150,000} = 4$$

Accounts Payable Turnover Ratio

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

● It is percentage on the frequency of a company settles its suppliers in a particular period.

A higher ratio shows timely payments while a lower may be indicative of delayed payments that can strain supplier relationships.

Example: If a company's credit purchase was $400,000 and average accounts payable balance

$80,000then the accounts payable turnover would be:

$$\frac{400,000}{80,000} = 5$$

That is, the company has a five-time-a-year payment cycle to its suppliers.

Asset Turnover Ratio

$$\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

● Statistical method where the efficiency of a company's ability to generate revenue from assets is compared.

● High asset turnover ratio is a indicator of efficient use and lower ratio indicates inefficiencies.

1 Example: If a company has net sales of $1,000,000 and average total assets of $500,00 its asset ratio.

turnover ratio is:

$$\frac{1,000,000}{500,000} = 2$$

It says, then, that for each dollar the company has in assets it generates $2 of revenue.

Fixed Asset Turnover Ratio

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

● Indicates a company's effectiveness in turning fixed assets borne (or used) by the company into revenue.

● A high ratio may suggest effective utilization of fixed assets; an abnormally low figure, on the other hand, a possible underutilization.

6 Example If a company has net sales of $800,000 and average fixed assets of $400,000, the fixed

asset turnover ratio is:

$$\frac{800,000}{400,000} = 2$$

Put another way, the firm is capable of realizing revenue of $2 for every dollar of fixed-asset investment.

Working Capital Turnover Ratio

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

● It shows how effectively a company is using its net working capital (defined as current assets minus current liabilities) to produce revenues.

● The greater the ratio, the more efficient working capital use and low or negative ratio indicate less efficiency, or even over investment in working capital.

For Example, if a company has net sales of $900,000 and average working capital of $150,000 then.

$$\frac{900,000}{150,000} = 6$$

working capital turnover ratio will be: 13 Calculate for the client part 3 of this assignment.

That means that the company is generating $6 in sales per dollar of working capital.

D. Solvency ratios: The solvency ratios show the level of or power to meet company's long term financing obligations and ability to continue operations in long run. These also enable the investors, creditors and the business owners to evaluate if the company is strong enough financially to pay off its debt and be solvent for longer terms.

Types of Solvency Ratios

Debt-to-Equity Ratio

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Debt}}{\text{Shareholders' Equity}}$$

● the debt-to-equity ratio: This indicates the breakdown between financing that has been provided by way of debt and the financing that’s been extented via equity.

● A higher ratio indicates a greater reliance on borrowing, resulting in a greater financial risk. On the other hand, a smaller ratio indicates a stronger equity financing.

For example, if you have total debt of $500,000 and shareholders' equity in the amount of 1,000,000 your debt-to-equity ratio would be 500,000 / 1,0000 =.5. That means the company's total debt sits at a mere fifty cents for every dollar of equity.

Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

● Debt ratio represents the percentage of a company's assets that are financed by debt, reflects a firm's overall financial leverage.

● A higher ratio implies greater financial leverage and therefore increased risk; a lower ratio implies that assets are primarily being financed with equity.

Example: If the company has a total debt of 500,000 dollars and total assets of 2,000,000 dollars then its debt ratio would be calculated as follows 500,000 divided by 2,000,000 or 25 percent (the calculation is as follows: 500.00/2000.00 =.25). As a result, 25 percent of the company's assets are financed with debt.

Interest Coverage Ratio

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

● Interest coverage ratio describes the ability of a company to pay interest on outstanding debt out of operations revenue.

● The higher, the better is manament's capability to pay interest; lower ratio means financial troubles.

Example: If a company has 200,000 dollars of EBIT and 50,000 dollars of annual interest expense then EBIT divided by interest expense is 200,000/50,000 = 4. This allows the company to pay interest four times over.

Cash Flow to Debt Ratio

$$\text{Cash Flow to Debt Ratio} = \frac{\text{Operating Cash Flow}}{\text{Total Debt}}$$

● This ratio of operating cash flows to debt is used to measure how many years it will take for a company to pay off all its debt obligations using the operating cash flow.

A higher ratio provides better protection to the company from the debt perspective whereas a lower value to the liquidity concern.

Example: If a company has $300,000 in operating cash flow and a total debt of $600,000 dollars, then the ratio is 0.5 or 50 percent ($300,000 divided by $600,000). Put another way, 50 percent of the amount that it owes (debt) is in some sense covered.

E. Market Valuation Ratios

Market valuationUse in financial ratios Some financial metrics are used not only to assess profitability, but also to measure a company's level of risk and its cost of capital (we will discuss the concept of "cost of capital" later). These are used largely to determine whether a company's stock is cheap or costly in the stock market. A higher market valuation ratio tends to indicate that a company has high growth potential and, conversely, if the market valuation ratio is low it means the market does not have favourable views.

Types of Market Valuation Ratios

Price-to-Earnings (P/E) Ratio

$$\text{P/E Ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share (EPS)}}$$

● The P/E ratio reflects how much money investors are willing to pay for each dollar of a company's

earnings.

● More expected growth rate by investors, higher P/E ratio, and Lower expected growth or undervalued firm is assumed to have more opportunities of investments in the future.

Example: 50 dollars is the stock price of a corporation having earnings 5 dollars as Earning Per Share, then P/E ratio =

50 divided by 5, or 10. Investors are willing to pay 10 times the company's earnings per share.

Price-to-Book (P/B) Ratio

$$\text{P/B Ratio} = \frac{\text{Market Price per Share}}{\text{Book Value per Share}}$$

● A P/B ratio is a company's market value divided by its book (assets minus liabilities) value.

If this company is trading at X times its book value, or if you divide the stock price by its book value per share, that's how many times over it's worth more than the equity to the business.. . If it sells for less than that, it's a way of thinking in terms of how much could I get by liquidating... A lot can be learned from that sort of formula application."

Example: If for a firm, market price of share is 40 dollars and the book value per share is 20 dollars,

its P/B of 40 / 20 and 2. In other words, the company is valued at two times its book value.

Dividend Yield

$$\text{Dividend Yield} = \frac{\text{Dividend per Share}}{\text{Market Price per Share}}$$

● It is the market price of one share of stock divided by the dividends per share that a company pays to its shareholders as dividends.

● The dividend yield is better, the higher the return on investment through dividends and worse, the lower than that with the company invests retained earnings for its own growth instead of distribute them.

Example: If a company pays 4 dollars per share to shareholders, and the shares cost 80 dollars on average over a day, the dividend yield is then 4 divided by 80, or 0.05, which means an annual payout of 5% of the stock value. In this scenario, 5 percent of the value of the stock will be received by the investor in the form of dividend.

PEG Ratio

$$\text{PEG Ratio} = \frac{\text{Price-to-Earnings (P/E) Ratio}}{\text{Earnings Growth Rate}}$$

●It's a valuation ratio that takes the P/E ratio and turns it on its head by adding in expected earnings of the company.

growth.

● Investors can use it to determine if a stock is overvalued or undervalued compared to growth potential.

For example, if a company has a P/E ratio of 20 and an estimated annual earning growth rate of 10%, dividing the P/E by the earnings growth rate yields a PEG of 2. A PEG of 1 generally signals that a stock is valued, while a PEG of 2 implies that it may be overvalued due to its growth trajectory.

Market Capitalization

Method: Market Price, per Share (x)total No of Shares Outstanding.

● It simply represents total value of market and all the while is ready to take over company's total shares.

They are employed to categorize and grade companies in various "size classes", namely small-cap, midcap, or large-cap. Example In the case of a company that has 10 million shares outstanding and whose stock price is $30 per share, if the company's stock were to be repurchased at $40.00 a share, its market capitalization would rise to $40 X 10 million = $400 million. So the company is worth a total of 300 million dollars.

Knowledge Check 1

Choose the correct option:

1. What does a higher Debt-to-Equity ratio indicate about a company's financial structure?

   a) Greater reliance on equity financing

   b) Higher reliance on borrowed funds and financial risk

   c) Lower level of financial leverage

2. Which formula is used to calculate the Interest Coverage Ratio?

   a) EBIT / Interest Expense

   b) Total Debt / Total Assets

   c) Shareholders' Equity / Total Assets

3. What does a Price-to-Book (P/B) ratio less than 1 generally indicate?

   a) The company's stock may be undervalued

   b) The company is highly profitable

   c) The company has excessive debt

7.2 Cash Flow Analysis

Cash Flow Analysis is simply an analysis that tells you the amount of cash (money) coming in and going out of your business as well as what it is used for in a specific time period or how much cash there is, on any given day. This evaluation makes possible to estimate a company's liquidity and count whether it is in good or bad financial health, can generate the cash flow that will meet its basic needs: settling debts and making investments.

The income statement may look rosy, but the company is failing to generate enough cash flow to stay afloat. Meaning: If we (jump to magazine pricing debate)hold back the Foundry on price.) and look at a cash flow analysis, it provides us with a better picture of financial stability than this profit and loss by itself.

7.2.1 Importance of Cash Flow Analysis

Without the kind of healthy cash flow in operation, a business doesn't function very well. Here are some of the key reasons why cash flow analysis is required:

A. Liquidity Management: One of the reason that analysis on cash flow statement is very crucial, this is because it ensures the company has enough available resources to meets its short-term obligations such as employee salary, rent, and operation etc (Ijiri & Ittner 2003).

expenses. Cash flow management can help businesses escape the state of a liquidity crisis which leads to insolvency or financial trouble.

B. Profitability v/s Cash flows: Even if the company appears to be profitable in terms of paper shows profit, but its inflow of cash didn't equal up with the cash it outflows, and then also it would have a tough time running. In this case, the firm could have relatively large revenues, and yet be unable to meet its short-lived obligations even if it pays its bills just as they come due; sales may literally be on credit.

C. InvestmentDecisions: Decision on the cash flow will help determine how stable a company can hold an investor‟s fund invested over a long period of time and show them if it is investable or not. A business that has ongoing positive cash flow shows it will be able to operate and survive long-term, which is an attractive investment.

D. Debt Management:Cash flow analysis can enable a firm to ascertain its ability to satisfy loan repayments and interest payments. It's to make sure that companies don't borrow too much or have an unhealthy mix of debt and free cash available.This will mean that the business does not need to seek finance desperately.

E. Business Expansion and Growth: firms with cash flow reinvestment (back) opportunities can expand or make hold acquisitions into other markets. Consequently it assists businesses in the process of making strategic plans with potential future cash needs and sufficient cash for expansion without a need for heavy dependence on external financing.

7.2.2 Components of Cash Flow Analysis

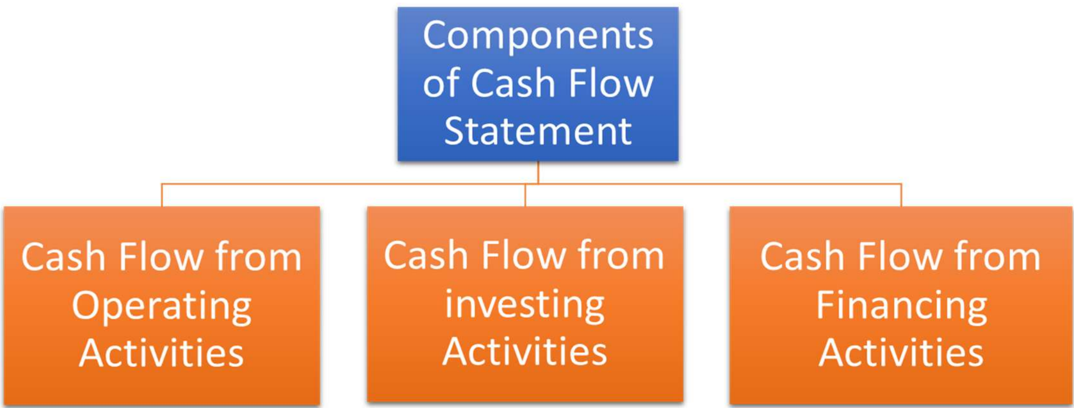

Fig 7.2 Components of Cash Flow Statement

Cash Flow from Operating Activities

Cash Flow from Operating Activities (CFO) is the amount of cash that is generated or consumed by a company's normal business operations in a specific time period. That is whether a company can make all the cash it needs to retain and grow its operations without taking on more outside financing.

CFO is one of the important financial health metrics for the company because it shows how much money a business can generate from its normal operations, such as selling goods or services, paying suppliers and controlling costs.

Elements of Cash Flow from Operations

Cash Flows (Money coming into the business) Cash InflowsApiOperation -> AssemblyProduct 1.

Exhibit 13-2 ● Revenues by Source CONTENT AREA Revenues REVENUES Sales of goods and services

’ Receipts from accounts receivable (cash collections on credit sales)

Cash Outflows (Money Used in Operations)

● Suppliers for raw materials and services

● Employee wages and salaries

● Rent, utilities and other fixed Overhead costs

● Taxes paid to the government

Ways to Calculate Operating Cash Flow

There are two possible methods for calculation of CFO:

Direct Method

This approach discloses the true amount of cash transactions in operating activities. It's a way to see quickly how cash moves, but it comes with heavy record-keeping demands.

Formula for Direct Method:

CFO = Cash Inflows from Customers _ Cash Outflows to Suppliers _ (Operating Expenses + Taxes Paid)

Example Calculation (Direct Method):

- Customer cash sales = $500,000
- Payments to suppliers = $200,000
- Employee salaries = $100,000
- Rent, utilities and other costs =$50,000
- Taxes paid = $30,000

CFO = $500,000 - ($200,000 + $100,000 + $50,000 +$30,000) = $120 4,300 3.1 Shares of Rexicom's stock cost $27.11 and the firm has a P/E multiple of 24 (rounded to nearest whole number). If the earnings per share are estimated at $.06 /share what is their expected dividend payout?

Indirect Method

This approach begins with net income and adds or subtracts non-cash and non-operating items including depreciation, amortization, other revenue and changes in working capital.

Formula for Indirect Method:

CFO = Profit - DAE + NNICTA + DWCKCPremium | Medium CFO : Wikiblame (en)CFO = Net Income + Non Cash Expenses – Non Operating Income + Change in your Working Capital.

Adjustments include:

- Adding back non-cash expenses (Depreciation, Amortization)
- Working capital (Accounts Receivable + Inventory - Accounts Payable) changes over 3 years.

Example Calculation (Indirect Method):

- Net Income = $80,000

● Depreciation = $20,000

● Accounts Receivable up = -$10,000 (net cash out)

● Rise in Accounts Payable = +$15,000 (cash flow)

● Reduction of Inventory = +$5,000 (cash in-flow)

CFO = $80,000 + $20,000 - $10,000 +$15,000+ $5,00= 1100,000 Exercise 2-23 DeJack Systems had limited cash on December 31.

Cash Flow from Investing Activities

Cash Flow from Investing Activities represents the cash that a company can generate from or use for its investments in long-term assets and certain investing "instruments". There are also transactions for property, equipment, investments and securities. This part of the cash flow statement tells us how much a company is putting into its future growth.

A negative cash flow from investing activities can signal a heavy investment in business expansion, and a positive cash flow might indicate that asset sales are transpiring or that there is little need to reinvest, potentially indicating retrenchment or warning of slower growth.

Investing Activities: What It Means and How to Use It in the Free Cash Flow Formula Components of cash flow from investing activities

Proceeds (Cash Received from Investing Activities)

● Disposal of property, plant and equipment (PP&E)

●Disposal of Investments (shares, and other securities)

● Cash received from acquisition or merger of business

● Loans to others – moneys loaned to other entities

Cash Outflows (the Money You Spend on Investments)

• Acquisition of property, plant and equipment (PP&E)

● Investments (stocks, bonds or other securities) bought

● Expenditures for research and development (if capitalized)

● Loans to other companies or individuals

● Acquisitions made

Formula Cash Flow from Investing Activities

Cash Flow from Investing Activities = Cash Received on Investments - Cash Paid for Investments

Cash Flow from Investing Activities Calculation Example

The following are transactions of a company during a year:

- Purchased machinery for $50,000
- Bought land for $80,000
- Sold old equipment for $20,000
- Sold some investments for $30,000

Cash Flow from Investing Activities = ($20,000 + $30,000) - ($50,000 + $80,000) Cash Flow from Investing Activities = $50,000 - 130,000

Cash Flow from Investing Activities = ($80,000)

The negative cash flow means the company is busy reinvesting in its assets and it might be expanding.

Cash Flow from Financing Activities

Cash Flow from Financing Activities are the cash inflows and outflows associated with obtaining or repaying capital for a company. De caption This comprises borrowing, issuing and paying off shares and dividends. It's a segment of the cash flow statement that shows how a company receives its capital and repays these funds.

Thus, when a company has positive cash flow from financing activities, this indicates that the business is selling stocks or borrowing money, and when it has negative cash flow from financing activities, this can either mean the company is repaying debt and/or interest payments, paying out dividends to shareholders, or buying up of its own shares.

Elements of Financing Activities Cash Flows

cash receipts (money received during investment activities)

- (New stock (increase) as a reason for change))
- Loan, bond or other indebtedness financing
- Cash received from the issuance of preferred shares

Cash Outflows (Word You Spend Your Money on) When the term is cash outflows then, your money going out.

- Payment of loans or repayment of bonded indebtedness

○ Payment of dividends to shareholders

○ Stock buybacks (repurchasing company shares)

○ Repurchase of lease obligations (as financing activity)

○ Interest paid on business loans

Formula of Cash Flow from Financing Activities

Cash Flow from Financing Activities = Cash Inflows for Financing - Cash Outflows from Financing

Sample Calculation of Cash Flow from Financing Activities

The financing transactions of a company are as follows for the year:

- Sold new stock and generated 100,000 in cash
- Took out a loan of $200,000 from a bank
- Repaid $150,000 of existing debt
- Declared $30,000 in dividends to shareholders

Cash Flow from Financing Activities = (100,000 + 200,000) - (150,000 + 30,000) Cash Flow from Financing Activities = $300,000 - $180,000

CFF – or cash flow from financing (obviously): $120,000

A positive cash flow from financing activities indicates that the company is raising capital, and a negative number means it is paying back debt, paying dividends or buying back stock.

7.3 Summary

❖ Ratios are derived from the partial figures contained in a company's financial statements, with which an assesment of the financial position of the company can be made. They are employed to judge profitability, efficiency, liquidity, solvency and market valuation. These ratios are useful for the businesses, investors and creditors to access the right decision.

❖ Tools to benchmark‡ a company's financial performance against industry peers, competitors or historical data. It's good for trends, strengths and weaknesses over time. Investors use this to evaluate which companies are performing well in a specific sector.

❖ Any business can nonetheless engage this guide in taking strategic decision of growth, cost control and financial structuring. Investors use financial ratios to evaluate a stock and whether a company is a good investment opportunity.

❖ Key performance indicators are also the method whereby the rate of growth in revenue, operating efficiency and asset utilisation of the company can be discerned. Inventory turnover and return on assets category of ratios give us insight about the efficiency with which a firm is utilizing its resources.

❖ It enables management to spot financial risks e.g.the raise of a high Debt level, cash flow difficulties, a declining profitability. Creditors and investors scrutinize these ratios before giving money to someone in the form of a loan or an investment to determine how stable the company is.

❖ Liquidity ratios reflect a company's ability to meet its short term obligations from current resources. The greater the liquidity ratio, the more financial stability exists; and lower the liquidity ratio, it is a signal of possible cash flow problems.

❖ Current ratio: – Short term solvency of a company is determined by current ratio and find out that whether a company would be able to pay its short term liability with the help of current assets. Healthy ratio is above 1.5; if below 1, could indicate financial distress.

❖ Ratio reduces inventory from current assets andpresentsa more accurate picture of liquidity. A number greater than 1 means a company has enough of very liquid assets to be able to settle its short-term debts.

❖ Cash ratio the most conservative of the liquidity measurements because it excludes all current assets except cash and cash equivalents. A high cash ratio represents immediate solvency but it could also suggest wasteful money.

❖ Profitability ratios are the indications of how a company can make profit in relation to various parameters such as revenue, assets or shareholders' equity. A high ratio is good news- it means the company is performing well, financially- while a low ratio could mean that the company isn't an efficient one.

❖ That is the portion of revenue remaining after paying for the cost of goods sold. This is a very important consideration of the mine's cost control and pricing, so that the higher the margin, and there are clearly better control likely better pricing in place, while when we see a mine with lower margins then they probably have more costs at its production.

❖ Operating Profit Margin - it shows the efficiency of a company operating, managing its operating cost. The higher the margin, the better it is for cost control; a lower margin could indicate high overheads.

❖ Net profit margin indicates that what percentage of the income remains after considering all the savings including taxes and interest. If the net profit margin is high, this means that the company has low costs and is financially healthy.

❖ Return on assets is a sign of how efficiently a company uses its assets to generate profit. A higher return

on asset indicates better utilisation of assets and lower return reflects underutilisation of assets.

❖ "Return on Equity" measures the return that an investment generates for all its shareholders. When the return on equity is lower, a higher return may be better for investors because it can signal poor financial management.

❖ The activity ratios determine the effectiveness with which a company manages its assets and liabilities to generate revenue. These proportions are of value to businesses in enhancing their operational efficiency and inventory management.

❖ The inventory turnover ratio is a measure which reveals how quickly an enterprise is able to sell and replace its stock. The ratio is high for an effective inventory management and low in case of slow-moving stock.

❖ The accounts receivable turnover ratio shows how efficient a business is in collecting the customer's payments. A higher ratio indicates that cash is collected faster and a lower ratio indicates slower payment or bad debts.

❖ Trade payable turnover– trade payable turnover reflects on how often company agreed to settle its suppliers. The higher the ratio, the better return on payments; and vice versa.

❖ Asset turnover is the utilization of assets in generating sales. The larger this proportion, the better you are utilizing your property, the smaller the percentage, the less.

❖ Fixed asset turnover = revenue / dollar value of fixed assets. A high ratio reveals efficient asset management while a low ratio may indicate inefficiency in asset management.

❖ Net working capital turnover ratio indicates how efficiently a firm can use its net working capital to generate sales. The larger the ratio, the more effective use of financial management; the smaller might suggest inefficient.

❖ The solvency ratios extent to which company is capable of meeting its long term financial commitments. Financial stability is associated with more solvency ratio, and vice versa, the lower the solvency ratio means greater financial distress.

❖ Debt to equity cycle is the rate of financing through debt in contrast to investment from funding types of a company

with equity. A higher proportion suggests that debt is being used more and financial risk is rising.

❖ Debt ratio is the percent of company's total assets financed by debt. Small ratio indicates that a firm is not relying much on borrowed funds.

❖ Interest coverage ratio measures how comfortably the company can pay its interest with operating income. The greater, the better the ratio of resources to service interest.

❖ The ratio is a measure of shareholders' equity against total assets. The higher the

ratio, the more it signifies a dependent financial system with increased dependence on foreign debt.

❖ Lower fixed assets to net worth ratio is proportion of the company's total net worth that are provided by owned fixed assets. A lofty ratio could indicate that investments are going to have longer shelf lives, but at the expense of financial maneuverability.

❖ Cash flow to debt ratio – Gauges cash flow capability to retire all debts. You want a high ratio, signalising strong cash generation and low one might be an indication of liquidity problems.

❖ Market valuation ratios enable investors to compare a company's market value to its income, sales and equity. These ratios can be used to value a stock.

❖ P/E or the price to earnings ratio represents the amount that an investor would be willing to pay for each dollar crated by a company in profitsNTAX. Higher ratios mean better growth expectations and that the ratio may be undervalued.

❖ Book to market ratio refers is a company's book value to its market value. A ratio above 1

aver ratio of less than 1 may imply the share being undervalued.

❖ Dividend yield is the ratio of dividends paid to stock price in percentage, which investors obtain from dividends. That is to say the higher yield corresponds to a robust dividend return.

❖ Unlike the price to earnings ratio in which the price of a stock is compared to earning, earning yield is the opposite, i.e., an inverse; it is a percentage amount in which an

investor can expect also from per dollar earning. Earning Yields implies a greater investment play.

❖ Market capitalization is the total number of outstanding shares in a company. It is useful in categorization of small cap, mid cap and large cap companies.

❖ To do a cash flow analysis is to analyze, over a period, the flow of funds from or to an organization. It

also allows us to evaluate liquidity, financial stability, the capability of financing operations and investment.

❖ Liquidity management is necessary in order to maintain a company's ability to cover short-term liabilities. The purpose of tracking the cash flow is to avoid running out of money and finding oneself in a financial difficulty.

Profitability Vs Cash flow -this contrasts the position where the Co is making profits but experiencing lack of cash. Businesses have got to make it happen, to even out the cash receipts and cash disbursements.

❖ Investment decisions to declare a company's financial status are based on the cash flow statements. Companies

with positive CFS value indicate a long term sustainability as such they are preferred by investors.

❖ The debt service coverage ratio is used to calculate the amount that a company can repay considering both principal and interest payable on debts. MPS has a strong cash flow which means it can meet its debt obligations with ease.

❖ Good cash flow is of vital good for businesses so they can flourish and expand the operation by purchasing new assets, reinvest in further operations and explore into new markets. Cash flow projections will assist with planning for sustainable growth.

❖ Operating activities cash flow refers to the cash generated from operation of the business. If your cash flow is positive, it tells you you are financially viable and if it's in the negative that means something is not going quite well.

❖ Cash flows from investing activities represent inflow or outflow of cash on account of purchase or sale of assets, investments and/or securities. A negative investing cash-flow is, in most cases, indicative of expansion and growth.

❖ Cash flow from financing activities is the series of cash flows reflecting borrowing, stock issuance and dividends. Positive financing cash flow represents a capital raising, while negative financing cash flow implies a debt repayment.

7.4 Key Terms

3.2 Financial Ratios: It is a term describing quantitative techniques used to assess the financial position and performance of an organization; including profitability, liquidity/revenue, solvency and efficiency measure calculations.

Liquidity Ratios: The ones that examine the ability of the company to fulfill short term obligations to observe if they are met or not).

operational sanity and financial stability of the firm.

Current Ratio: A measure of a company's ability to pay its short-term obligations using its.

current. such as a higher value than \(\geq 1.5\) is considered to be healthy.

Quick Ratio: This current ratio or acid test ratio is calculated after deducting the inventory from current assets.

Cash Ratio: An indicator of a company's liquidity that does not include receivables, only cash and cash equivalents, in assessing the ability to pay off near-term obligations.

Ratios Of Profitability: These ratios try to tell how a company is able to generate its profits from revenue, asset or equity.

Gross Profit Margin: is the percentage of revenue that remains after a deduction of the cost of goods sold and which

serves as a measure of efficiency in pricing and production by a firm.

Operating Profit Margin: Provides the ease that company is using its operating costs exclusive of taxes and interest.

Net Profit Margin: The proportion of revenues that are left over after all expenses and taxed have been paid.

Return on Assets (ROA): A measure of a company’s efficiency at using its assets in producing earnings, the higher the ratio, the more efficient.

ROE – Return on Equity: A ratio that indicates a company's capacity to generate profits for investors as shareholders.

Activity Ratios: They are also known as efficiency ratios that will measure the company operates of its assets and liabilities to produce income.

Inventory Turnover Ratio:A crucial measure for being able to gauge the efficiency of a company's inventory – how many times (sold and) restocked was product during some unit period.

Accounts Receivable Turnover: It is a ratio that is calculated as total collections divided by the total credit sales, with a higher ratio indicating more ease for the company to collect money received from their sales made on credit.

Funds Ratio: The ratios which measure the ability of the company to fulfill long term funding commitments.

and remain field financially.

Debt-to-Equity Ratio: This is a very popular measure for checking the long-term financial health of an institution as it reveals when a company has borrowed too much.

78 This is a free parameter which = (5) RWT FcDB Run up FcWt fD BAR Eq tDRw A represents the financial leverage.

Market Valuation Ratios: Financial ratios where the stock price of a company are compared against it earnings, sales and book value.

Price-to-Earnings (P/E) Ratio: A valuation ratio that benchmark a company's current share price to its per-share earnings.

earnings per share. It enables investors to measure potential for growth.

Cash Flow Analysis: The analysis of how much and when is the cash coming and leaving from the company and consequently to see.

liquidity, operational effectiveness and financial soundness.

Operating cash flow: A measure of the money created by core operations,

(The latter signaled the time for a company to survive without raising additional money.)

7.5 Descriptive Questions

What are financial ratios, and how do they assist you in evaluating the financial performance of a company?

What do liquidity ratios tell businesses about their short-term financial stability and what are some major types of liquidity ratios?

8) Discus the importance of current ratio. How does it show a company's short-term debt paying ability?

What is the meaning and significance of quick ratio and why it is considered a more conservative ratio than current ratio?

Explain why it may or may not be significant for profitability ratios to be similar. What do they do to find a

company’s efficiency in generating profits?

1. How is gross profit margin indicative of a company's capacity to regulate the cost of production? Give an example to explain the calculation.

Q: What is the operating profit margin, and why is it important in analyzing a company’s operations?

efficiency?

Define net profit margin. What is the difference between net profit margin and operating profit margin, and why is this important for investment decisions?

What is return on assets (ROA), and why does it matter for evaluating how well a firm can use its assets?

efficiently?

In what way does the return on equity (ROE) ratio assist investors in deciding whether to invest in a company?

What are the activity ratios, and why they matter when evaluating a company's operational performance?

Discuss with examples.

Discuss the meaning of inventory- turnover ratio. What effects will high & low turnover ratios have on a company’s ratio return on assets?

financial health?

What is the debt-to-equity ratio, and how does it show if a company is leveraged or not? How is a high debt-to-equity ratio too risky?

Explain what you would like to learn about market valuation ratios. What do they contribute to a company's stock valuation?

What is price-to-earnings (P/E) ratio, why do investors use it to assess growth opportunities of a company?

Explain the meaning of ‘cash flow analysis’ and state why it’s so significant in financial decision making. How does it assist in analyzing a company's financial condition?

What are the classifications of business cash flows? Discuss how operating, investment and financing cash flows are utilized in financial analysis.

How does money flow from operating activities shed light on the core business operation of a company?

Describe the direct and indirect methods of determining it.

What is the Importance of cash flow from investing activities?

do investments impact a firm's financial position?

Discuss sources and uses of funds: cash flow from financing activities. How do borrowing, issuing shares and paying dividends

impact a company's financial stability?

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Answers to Knowledge Check 1

Knowledge Check 1

1: b) Higher reliance on borrowed funds and financial risk

2: a) EBIT / Interest Expense

3: a) The company's stock may be undervalued

7.7 Case Study

Financial Analysis of XYZ Ltd.

XYZ Ltd. is a medium-sized manufacturing company that processes in the consumer-durable segment. The Company has been in business for over 10 years and has exhibited consistent growth. But recent financial presentation has sparked concerns over liquidity position, profitability and financial stability. The firm's management has employed you, a financial analyst, to determine its overall financial health based upon key ratios and cash flow analysis.

Problem 1: Liquidity Issues

The current ratio (at 0.8 lower than the industry average of 1.5) was reported to be less than the adequate level of financial flexibility. This means the company might not be

able to pay its debt in the near future. Furthermore, the quick ratio is 0.5, indicating that when we remove inventory from calculation, Lukka doesn'thave a high enough level of liquid assets.

Solution:

Fast collection of accounts receivable means the company can boost liquidity by having more cash and reduce uncertainty in sales.

Cutting down on unnecessary inventory levels will help enhance the quick ratio.

Constantly striving for better credit terms from vendors will maintain a more healthy balance between receivables and payables.

Problem 2: Declining Profitability

The net profit margin reduced from 12% to 7%, the last two years for XYZ Ltd. The 40% gross energy margin stays consistent which demonstrates that production expenses are in check. But the company's operating profit margin has slipped as administration and marketing costs have risen.

Solution:

The company needs to further scrutinize the administrative and sales expense line items sooner rather than later, to trim any fat.

Problem 3: High Debt Levels

XYZ Ltd is leveraging itself 2.5 times against its equity as compared to the industry average of 1.2. This indicates that the company is very highly leverage and raise its financial risk. Furthermore, the interest coverage ratio is down to 2.0, suggesting trouble in covering interest payments from operating profits going forward.

Solution:

The firm need concentrate first on high interest debt, to be able to ease its financial load. They might think about looking at equity financing as well to try to balance out their debt-to-equity ratio.

Improving the interest coverage ratio and maintaining on-time debt repayment by increasing cash flow from operations.

Reflective Questions

Explain how the current ratio and quick ratio reflect a company's short-term financial position. What could be the benefits to XYZ Ltd. if these ratios are improved?

Why did the net profit margin of XYZ Ltd. decrease when the gross margin remained more or less constant?

Michael Berg, Why is it so important for a business to strike a balance between opex and revenue? How XYZ Ltd can pull this off?

Cash Flow Statement for ABC Manufacturing Ltd.

ABC Manufacturing Ltd. is a medium-sized firm engaged in the production of industrial equipment. The company has been in operation for 15 years and has continued to experience revenue growth. But all seems not well with its cash flow management, which is a worrying sign for its ability to operate efficiently and sustain profitability. The management has also hired financial analysts who conduct a thorough study of the cash flow, as well as analyze the main financial ratios.

Problem 1: Negative Operating Cash Flow Though the Firm is Making Net Income

ABC Ltd had just announced with a profit of $1.2 million for the year, however cash flow from operations was negative.

$300,000. This difference shows that earnings are not getting converted into cash, leaving a question for the company's ability to pay back its day-to-day operating expenses.

Contributing Factors:

Amount of accounts receivable is way too high, slow collections. Product too many: storing cash.

A generosity of terms extended to customers.

Solution:

Adopt more stringent credit and collection policies that result in reduction of total accounts receivable period.

receivable days.

Ensure inventory is effectively managed through use of JIT, to minimize working capital tied up in stock.

To get cash in focus on and renegotiate terms of credit with customers.

Use forecasting tools to predict and plan for liquidity requirements.

Issue 2: Excessive Capex Resulting in Cash Outflows

During year ABC Ltd. made big investment in new machinery and plant expansion, causing huge cash outflows under investing activities squeezing free cash flow. 2.

Solution:

Rank capital expenditure projects according to strategic value and projected cash flow

benefits.

Consider leasing equipment as a way to distribute your cash outflows over periods of time. Enhance project planning to have no cost-over runs and expenses.

Stagger your investments to distribute cash outflows more evenly.

Issue 3: Escalating Short-Term Debt Resulting from Cash Flow Gaps

As a result, ABC Ltd. has turned to shorter-term borrowings for cash flows and increased costs of financing and interest expense, evidenced by its greater debt-to-equity ratio of 1.8 (industry average: 1.0).

Solution:

Work on Operating Cash Flow by better working capital management. Restructure the terms of current debt to longer tenures cutting short-term pressure.

The equity participation may be considered to enhance the capital base, which in turn decreases financial risk. Use cash flow forecasts and to schedule debt repayment and avoid running out of cash.

Reflective Questions:

What effect does a negative operating cash flow and positive net income have on a company?

financial health?

Which are the main working capital elements influencing cash inflow& outflow of ABC Ltd. & how the relevant ones could be ma nag ed easily?

optimized?

Why is controlling capex useful to keep the cash flow positive?

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Unit 8: Key IND AS Standards: Principles and Applications

Learning Objectives

1. Learners will be able to learn about Accounting Standards (AS) and explain their significance in financial reporting.

2. Learners will be able to differentiate between AS, Ind AS, and IFRS based on their framework, applicability, and principles.

3. Learners will be able to understand the need for accounting standards to maintain transparency in financial statements.

4. Learners will be able to understand the global significance of IFRS and its adoption in over 140 countries.

5. Learners will be able to analyze the challenges in IFRS convergence.

Content

8.0 Introductory Caselet

8.1 Accounting Standards

8.2 Indian Accounting Standards

8.3 International Financial Reporting Standards

8.4 Summary

8.5 Key Terms

8.6 Descriptive Questions

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8.0 Introductory Caselet

The Global Accounting Dilemma

XYZ Ltd. – A Multi National Company (MNC) based in India recently opened a couple of offices abroad, one each in Europe and North America. GovernanceTo further its international growth objectives, the company needs to publicly report financial information according to International Financial Reporting Standards (IFRS) in order attract international investors. But, XYZ Ltd also has historically adopted Indian Accounting Standards (Ind AS) which are substantially converged with IFRS but still leave significant differences in revenue recognition, lease accounting and fair value measurement etc.

The CFO of the company, Ms. Mehra, has a daunting task in hand: whether or not to be involved with two financial reporting standards — Ind AS and IFRS or should XYZ Ltd. fully adopt IFRS on a standalone basis. Adoption of IFRS would bring the company to conform with global standards, at a cost of heavy investment and training to employees in addition to software upgrades and setting up regulatory apparatus. On the contrary, retaining Ind AS for domestic operations and reporting in IFRS format for international markets would result in inconsistencies and ambiguity with stakeholders.

The board must balance the cost, benefit and lasting effect of their decision while considering their next move.

Critical Thinking Question:

If you were the CFO of XYZ Ltd., how would you overcome issues related to implementation of both Ind AS and IFRS? When determining your course of action, take into account the regulatory, cost, investor sentiment and financial reporting transparency implications.

8.1 Accounting Standards

Kohler defines an accounting standard as a rule established and enforced by custom and/or law that regulate the recording of transactions, which are described in the Preparatory?recipient article. These standards facilitate in the preparation of the financials, and hence need to be followed while preparing the financials as these would ensure a consistent and uniform way of reporting.

They aim, through standardization, and with increasing clarity, to facilitate the reading of financials by an increasingly wide group of stakeholders in the easiest possible manner." Simply put, accounting standards refer to the guidelines and rules for preparing and presenting financial statements in an orderly manner so that they are common size.

8.1.1 Characteristics of Accounting Standards

Conclusion From the above discussion, it is manifest that accounting standards are normally a guide, such as a regulatory force, empower or make ease working around accounting related issues.

Directing Accountants : The accounting standards provide clear guidance to accountants: when and in what way to record the financial transaction, how much to report the transaction. Prescribed methods need to be adopted that would establish the foundation for a set of financial statements. Suppose that they mandate 'normal' valuation methods of inventories, to be used by any ent ity.

Accounting isn't subject to regulation as much in the sense that these are rules that accountants must follow whether it's to their liking or not. A great deal of staring and planning will be needed if you even want to remain within their constructs for they are sort of like rules but ones decreeing what treatment type needs to be given with essentially no room for personal discretion. There are a variety of 'standards' one has to construct and balance and in the case we so love them honor, example is the Cash Flow Statements which also you will have complete it with such format as ruled by an accounting standard.

Furnishing Logical Financial Frame: Accounting standards describe accounting concepts, explain reporting requirements (as to what information is to be reported and how), prescribe treatment of accounting transactions and specify disclosure requirements. This is because they should be authoritative guides for accountants applying industry best practices and rules.

Measurement: There should be a management concept based on the standardization and objectivity of accounting treatment, while one of the basic purposes is to eliminate arbitrary rules and apply uniform method for enterprises. They standardized

accounting policies that reduce alternative accounting practices which would ensure that the financial statements are comparable and reliable. In addition, such standards also harmonize the profession at times when controversies or questions occur in accounting treatments and when guidance needs to be provided.

Accounting National / International Accounting Standards (including Integration of accounting standards with financial reporting, Meaning, concept and features of accounting standard etc) The financial reported information are governed by accounting standards such as; accounting standards acts which guide the Financial Reporting Standard and principle.

8.1.2 Advantages of Accounting Standards

Accounting standards, financial reporting and conservative, transparency and efficiency. Here are some of the benefits brought to you by that:

Uniformity in Accounting Practices

The primary benefit of accounting standards (particularly those established by the Financial Accounting Standards Board (FASB)), is uniformity in the accounting process. The yardstick by which these current guidelines have set as what the GAAP standards businesses are supposed to adhere to so that they can avoid financial reporting discrepancies. For instance, in the absence of these guidelines, an entity could have had used different methods for inventory valuation throughout several periods within a financial year causing distortion of the reporting of financial information. By being consistent the accounting standards provide reliability to the financial information for investors and other stakeholders.

Accounting Issues and Resolution

The accounting standard plays a significant role to detect and encounter the issue of possible accounting. Businesses in the United States can find those problems and mistakes in their financial reporting early, by using FASB's same principles. Firms would report the objections to the FASB, which monitors and evaluates the existing rules and changes or revises them if there are deficiencies. For example, if a particular way of accounting for liabilities creates problems with net income computations, companies can submit complaints about that practice to FASB which will then scrutinize and revise the accounting standard.

Independent Regulatory Oversight

FASB standards have the force of law, and the board is not directly overseen by the U.S. government. This involves that in securities regulation, the Securities and Exchange Commission (SEC) has to monitor these rules and for accounting principles this is done by the Financial Accounting Standards Board (FASB). Therefore, private sector regulation by way of regulations reduces the amount of administration that government has to manage and allows for the dynamic and industry-based development of accounting standards:ournalist. Assigning the responsibility for setting accounting standards to the FASB, and giving the agency increased capacity and more expert control to make it more efficient.

Facilitating Global Financial Reporting

As worlds are becoming smaller and the need for standardization increases, having harmonized accounting standards is also crucial. FASB now cooperates with The Internationl Accounting Standards Board (IASB) and some regulatory bodies to make sure that uniform global accounting principles are formulated. This alignment has led to a convergence where financial accounting reports in world markets are relatively consistent and comparable with investors, multi-nationals and even the securities analyst able to measure and assess businesses across national borders. Uniform global accounting standard increases trust and fairness of cross-border financial statements.

Accounting Standards Accounting standards provide transparency, accuracy and reliability as a basis for all financial reporting. In so doing they help to achieve consistency, account for the challenges and problems, provide independent regulatory oversight as well as improve consistency via standardization on a global level. The enforcement of the standards confers great credibility to financial markets, enhances investor confidence and increases efficiency generally in the financial markets for the benefit of companies and other stakeholders.

8.1.3 Accounting Standards

AS 1: Disclosure of Accounting Policies AS 2: Valuation of Inventories

AS 3: Cash Flow Statements

AS 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

AS 5: Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies AS 7: Construction Contracts

AS 9: Revenue Recognition

AS 10 : Fixed Assets

AS 11: Effects of Changes in Foreign Exchange Rates AS 12: Government Grants

AS 13: Accounting for Investments AS 14: Accounting for Amalgamations AS 15: Employee Benefits

AS 16: Borrowing Costs AS 17: Operating Segments

AS 18: Related Party Disclosures AS 19: Leases

AS 20: Earnings Per Share

AS 21: Consolidated Financial Statements AS 22: Accounting for Taxes on Income

AS 23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES AS 24 : DISCONTINUING OPERATIONS

AS 25: Interim Financial Reporting AS 26: Intangible Assets

AS 27: Financial Reporting of Interests in Joint Ventures AS 28: Impairment of Assets

AS 29: Provisions, contingent liabilities and Contingent assets

Did You Know?

- As of 2023, IFRS is utilized in more than 144 countries worldwide, including major economies like Australia, Canada, India, Japan, and all member states of the European Union.
- India has developed its own set of accounting standards known as Indian Accounting Standards (Ind AS), which are largely converged with IFRS. This alignment facilitates comparability and consistency in financial reporting between Indian companies and their global counterparts.

8.1.4 Limitations of Accounting Standards

Limitations of Accounting Standards

- Rigidity in Application
- Complexity in Implementation
- Different Interpretations
- Subjectivity in Certain Areas
- Frequent Amendments and Updates
- Costly Implementation
- Lack of Consideration for Inflation
- Limited Flexibility for Unique Transactions

Fig 8.1 Limitations of Accounting Standards

Norms of accounting such as comparability and consistency are to be preserved in the process for the same reason they have some drawbacks. But these can stretch a company's financial statement to mirror its truly financial makeup.

Rigidity of Application: Since, the accounting standards are more or less rules and regulations it is not very flexible to suit every industry.The historical cost based set of accounts may not be adequate in the present day economy. Some of these benchmarks may not be relevant in some cases; for instance, when specific financial transactions applicable only to the firm are omitted explicitly.

Complexity in Implementation: Ind AS and IFRS are the much complicated accounting standard such as fair value measurement, revenue recognition," lease accounting etc. All those small and medium enterprises (SMEs) will find themselves facing a tough time to comprehend these standards as well as implement the same.

Various Interpretations: Despite general acceptance, here may be divergent interpretations among accountants, auditors and regulators regarding these accounting standards. These dynamics can lead to inconsistent financial reporting and disagreements about compliance.

Subjectivity in Specific Areas: These comprise extensive use of management estimation in the recording provisions, depreciation and near fair value. Cooking the books or a backdoor accounting for how strong your fiscal health is.

67 Reason 3: Changes in US GAAP Frequent Amendments and Updates Accounting standards evolve as the economy changes, new corporate frauds occur or new technologies come to surface. "But it's a work in progress, some business will find compliance harder, and their staff keeping up-to-date with the latest information.

Expensive Implementation: It is necessary to invest in training, software and expert advice for the Ind AS & IFRS compliance. In small business where they don't have available resources to implement the changes it is a hardship.

Absence of Reflection on Inflation According to historically dominant concept in accounting was incorporated by going concern accounting based this historical stable concept despite the indisputable influence of inflation in which makes impossible to describe accounts for influence that inflation has on need assets and liabilities. This can sometimes give a company an inflated view of its financial position.

Limited Flexibility for Specific Transactions but not for the Rest: There are some other specific industries like start-ups, fintech and digital business where accounting financially and transaction-ally does not fit into the normal accounting model. Accounting standards may also not take into account these developing business models.

Ws 1They are, however, very important as they serve the purposes of transparency and consistency and comparability in financial reporting. Still, companies must contend with these challenges through professional judgment, regulatory guidance and advancement of technology in order to faithfully depict their financial condition.

Knowledge Check 1

Choose the correct option:

1. Which of the following is a major challenge of accounting standards?
   a. They provide too much flexibility for unique financial transactions.
   b. They may be rigid and not adaptable to specific industry demands.
   c. They eliminate the need for financial reporting.
2. Why do small and medium-sized enterprises (SMEs) face difficulties in implementing accounting standards like Ind AS and IFRS?
   a. They lack financial transactions that require complex accounting.
   b. They find the standards simple and easy to implement.
   c. The complexity of certain accounting principles makes them difficult to understand and apply.

8.2 Indian Accounting Standards

The initial adoption of Ind-AS mandate preparers to comply with accounting treatment specified in Ind-AS 101 on Transition from Indian GAAP (Accounting Standards). This memorandum sets out the specific actions that organizations must execute as part of this transition to ensure successful turnover of their financial reporting obligations.

First-time adoption of the Ind-AS shall be from the commencement of reporting period when an entity makes a transition from Indian GAAP or other accounting standards to Ind-AS. The changeover is eased by the relaxation made available under Ind- AS 101. There are two separate exemptions available in Ind-AS.

So under the binding exemptions also application of Ind-AS in this period out rightly prohibited. Businesses can choose to apply, or skip certain Ind-AS requirements retrospectively.

The Ind-AS 101 provides the presentation and disclosure norms companies need to adhere to better inform stakeholders about the transition. Entitles shall explain the impact of adoption of Ind-AS on their financial statements and statements of profit and loss paragraph 4 and cash flow. All other disclosure requirements as per the Ind-ASs continue to apply.

8.2.1 Objectives of Indian Accounting Standards (Ind AS)

Objectives of Indian Accounting Standards (Ind AS)

- Uniformity and Standardization
- Global Convergence with IFRS
- Transparency and Reliability
- Better Financial Decision-Making
- Facilitation of Cross-Border Transactions

Fig 8.2 Objectives of Indian Accounting Standards (Ind AS)

Consistency and consistency :- Ind AS aims at standardizing the reporting structure across all types of industries. It does this by harmonising the accounting principles for them to be comparable, reliable and transparent in order that the stakeholders can base their decisions on them.

International Convergence with IFRS: One of the other most important objectives of Ind AS is to converge Indian accounting standards with International Financial Reporting Standards (IFRS). This convergence enhances the credibility of the financial reports, paves the way for cross border investments and places Indian companies on equal footing with global reporting standards.

Transparency and Reliability: Ind AS employs the methodology of fair value accounting with additional disclosure requirements to paint the picture of a company's financial health in a manner true and fair laid out. It contributes to increased transparency, raises investors' confidence, reduces corporate financial misstatement and promotes better governance and accountability.

Enhances financial decision-making: Ind-AS promotes the basis of investors, creditors and management to take good economic decisions as it provides a true picture of all financial information. Standardized reporting eliminates ambiguities, making it easier to evaluate a company's operations, financial health and future growth prospects.

Cross-Border Interaction: Nonetheless, by virtue of Ind AS being substantially the same as IFRS, it eases financial reporting for multi-nationals operating in India. This explains for smoother mergers, acquisitions process and therefore, sooth integration with global markets.

Did You Know?

- Research indicates that the adoption of IFRS in the European Union has been associated with a reduction in business investment and an increase in shareholder pay-outs, suggesting that accounting standards can significantly influence corporate behaviour and economic outcomes.
- The IASB has proposed new guidance to enhance the reporting of climate change impacts on financial performance. This initiative aims to ensure that climate-related uncertainties are accurately reflected in financial statements, addressing investor concerns over inconsistent climate information.

8.2.2 Scope of Indian Accounting Standards (Ind AS)

The Ind AS provide the entity with a single accounting system for preparation of its financial statements. The objective of the standards is to promote consistency in financial statements, based on transparent and comprehensive reporting approaches that can be applied with the international accounting standards known as IFRS. The Ind AS with corresponding financial reporting elements are:

Coverage of Various Types of Entities

The accounts of corporates, large entities and the listed entities as also the specified categories of banks/financial institutions to come up to international best practices under Ind AS. It has application in the following sectors:

● Listed Companies trading on stock exchanges are required to adopt Ind AS as their mandatory reporting standard.

• *Companies having Net Worth more than ₹250 Crore shall comply with Ind AS, even though they may not be listed.

any stock exchange.

● Ind AS should also be applicable for financial institutions (which include Banks and NBFCs) and Insurance Companies so that they are more transparent in financial reporting.

● Small size or private entities are allowed to adopt Ind AS as a way to improve their comparability with international standards.

Regulation of Financial Reporting

All financial transactions shall be required to adhere to the provisions of Ind AS with regard to their recognition and measurement and presentation and disclosure. The system comprises basic necessitiescomprising;

● The normal Revenue Recognition (Ind AS 115) contains provisions for determining the timing and manner of recognising revenue on account of contracts.

● Financial Instruments (Ind AS 109, 107): Addresses classification, measurement and disclosures of financial assets and liabilities.

● The financial statements accurately represent lease commitments that are based on common accounting standards, as laid out in the new standard on Leases (Ind AS 116).

Principles-Based Accounting Approach

Indian GAAP works on rule based approach and on the other hand, Ind AS is based on principle based approach. The Indian accounting system (Ind AS) enables true statements of affairs as the reporting serves to reflect real business activity, not mere forms.

Achieving comparability with IFRS and global standards

With Ind AS aligning with IFRS, Indian companies can compete on a level playing field with their counterparts globally. Cross-border investments, transnational mergers and acquisitions, and worldwide financial operations depend heavily on the standard to achieve their aims.

Industry-Specific Considerations

Ind AS is more applicable Financial Reporting Standards that vary on a requirement to require basis across various industries and it is the characteristics of the Ind AS:

manufacturing and retail sector will have to crosscheck if they can use Ind AS 2 for cost accounting and inventory valuation.

● The fair value accounting for financial instruments in accordance with Ind AS 109 is mandatory for the financial services industry.

● Technology & Startups – Share-based payments and intangible assets (Ind AS 38, 102).

Impact on Financial Decision-Making

The entities that use Ind AS provide to their investors & stakeholders and regulators financial statements, which reflects true & fair view. Both corporate governance and regulatory compliance, as well as investor confidence, are enhanced through this modus operandi.

The land of fortune: The Indian finance reporting landscape Gets its shape After Ind AS Adoption Balance while ensuring global best practices in these structured flexible framework. Good corporate governance today relies on the implementation of Ind AS as it fosters financial credibility and transparency.

8.2.3 Indian Accounting Standards

The Indian government has notified the applicability of the Ind-AS standards. The list provided below incorporates all the notified Ind-AS standards:

Ind-AS 1: Presentation of Financial Statements

Ind-AS 2: Inventories

Ind AS 7 Cash Flow Statements

'Ind-AS 8: Accounting Policies, Changes in Accounting Estimates and Errors.

Ind-AS 10: Events after the Reporting Period

Ind-AS 11: Construction Contracts

Ind-AS 12: Income Taxes

Ind-AS 16 PROPERTY, PLANT AND EQUIPMENT

Ind-AS 17: Leases

Ind-AS 18: Revenue

Ind-AS 19: Employee Benefits

Ind-AS 20Comment of Taxmann on | Ind-AS 20: Accounting for Government Grants and Disclosure of Government Assistance

Ind-AS 21: The Impact of changes in Foreign Exchange Rates

Ind-AS 23: Borrowing Costs

Ind-AS 24: Related Party Disclosures

Ind-AS 27 Consolidated and Separate Financial Statements

Ind-AS 28: Investments in Associates

Ind AS 29: Financial Reporting in a Hyper-inflationary Economy

Ind-AS 31: Interest in Joint Ventures

Ind-AS 32: Financial Instruments: Presentation

Ind-AS 33: Earnings per Share

Ind-AS 34: Interim Financial Reporting

Ind-AS 36: Impairment of Assets

Ind AS 37: Provisions, Contingent Liabilities and Contingent Assets

Ind-AS 38: Intangible Assets

Ind-AS 39: Financial Instruments – Recognition and Measurement

Ind-AS 40: Investment Property

8.3 International Financial Reporting Standards (IFRS)

Standardized accounting framework enables stakeholders, such as companies, investors and regulators, as well as other interested parties to compare the financial effects of different entities. Financial reporting standards are designed to set a uniform process for preparing financial statements and maintaining the stability of business-to-business comparisons. Public companies that are publicly traded must create financials based on these accounting standards for earnings reports and other financial reporting.

International Financial Reporting Standards (IFRS) are the accounting standards and principles used in more than 110 countries, including the European Union, Australia and Singapore. The Guidelines have been written to facilitate reference (from both advanced and emerging markets as well as developing markets) but can be used for comparisons of financial performance across listed companies internationally.

International Financial Reporting Standards (IFRS) are used, in addition to more than three-quarters of, also by the European Union and over one hundred other countries. Different international business institutions along with the security institutes again and again continue to support the IFRS scheme due to its ability in forming a common transparent global financial reporting system.

8.3.1 Need for IFRS (International Financial Reporting Standards)

International Comparability: The financial statements that are prepared under IFRS are prepared using consistent criteria to provide information, including financial results, which allow stakeholders (for e.g., investors) to compare the results with previous performance and elsewhere across the globe. Consistency allows multinationals, investors and regulators to compare businesses on a like-for-like basis.

Transparency and Dependability: Financial statements become more transparent using IFRS as it follows the fair value accounting basis and emphasizes extensive disclosure requirements. The establishment of these

measures results in fewer misstated financial statements while also strengthening investor confidence and increasing the degree of accountability for those charged with preparing them.

Encouraging foreign direct investment: Multinational companies are simplifying their financial reports by adhering to generally accepted accounting practices used by businesses across the world as they expand their international operations. Firms adopting IFRS become more able to attract international investors and consider foreign stock exchange listings, as well as global market access.

Simplification of Financial Complexity: The blending of multiple accounting policies results in financial consolidation issues across jurisdictions. The demand for IFRS allows businesses which operate in different countries to use one unified reporting format instead of having to submit reports using different standards and procedures. Simplification of IFRSs allows organizations to save costs regarding maintaining different financial records.

Regulatory Compliance and Economic Growth: Both regulators as well as government benefit from adoption of IFRS as it helps to robust the economic policies by decreasing financial instability and lessen fradulents. There is also an universally accepted reference, which enables emerging countries to connect themselves with the world's financial markets thus promoting the economic progress and international commerce.

8.3.2 Challenges in IFRS Convergence in India

Complexity and Cost of Implementation: The implementation of Ind AS requires reconfiguration of financial reporting, up-gradation of accounts software, and training of staff. In the big-company world, within a few clicks of working from home and sending out laptop docking stations, you can manage transition on your side — but if millions of small to medium sized businesses (SMES) are disrupted, it's too much to take. In addition, there is a cost to professional advice and compliance audits.

Fair Value Measurement – norms: The biggest stress in Ind AS is on Fair Value accounting especially for the assets where there is no active market and that's laundry list for real estate, intangibles. Their fair values are significantly volatile in financial statements and the benchmarking of performance is therefore impossible. Moreover, companies are forced to defer to valuation experts and drive up the subjective nature of the program and the costs for compliance.

Regulatory conflicts and Taxation Issues: In spite of the fact that Ind AS follows all the Standards, it invariably comes across conflict with the existing Indian legislations like Income tax Act, Companies Act and SEBI guidelines. For example FAIR VALUE accounting is the norm as per India AS whereas INDIAN tax laws still continue to use

to historical cost. This incompatibility creates artificial deferred tax liabilities, and thereby introduces opacity to business's

financial reporting.

Enhanced Disclosure Requirements: All Ind AS migrating companies are required to provide significant disclosures on financial instruments, revenue recognition and lease liabilities. These increasing layers of complexity are then piled upon the already high documentation and compliance demands of financial statements. Such disclosures make things clearer but require more time and skill in financial reporting.

Financial Performance and Investor Perception Effects: Volatility of earnings – this represent the changes being brought about in reporting of profits, assets and liabilities in addition to current disclosures by implementation of Ind AS as they were expected which could generate lack of confidence among investors. For example, Ind AS refers to the fact that lease liabilities must be recognised on the balance sheet and would lead investors to believe it was more indebted. Variation in these sorts of variables impacts on the credit ratings, financial ratios and stock market returns.

Nevertheless, Ind AS has improved the financial transparency and international comparability of Indian firms. However, organizations remain to overcome the obstacles of deployment through proper training services, regulatory compatibility and financial planning strategies. If transition is designed correctly, it will promote compliance without roiling the financial statement presentation

8.3.3 IFRS issued by IASB and the corresponding Ind- AS

List of IFRS issued by IASB and their equivalent Ind- AS are given below:

S. No. IFRS No. Title Corresponding Ind AS

1 IFRS 1 First-time Adoption of Indian Accounting Standards Ind AS 101

2 IFRS 2 Share-based Payment Ind AS 102

3 IFRS 3 Business Combinations Ind AS 103

4 IFRS 4 Insurance Contracts Ind AS 104

5 IFRS 5 Non-current Assets Held for Sale and Discontinued Operations Ind AS 105

6 IFRS 6 External for and Evaluation of Mineral Resources Ind AS 106

7 IFRS 7: Financial Instruments: Disclosures Ind AS 107

8 IFRS 8 Operating Segments Ind AS 108

9 IFRS 9 Financial Instruments Ind AS 109

10 IFRS 10 Consolidated Financial Statements Ind AS 110

11 IFRS 11 Joint Arrangements Ind AS 111

12 IFRS 12 Disclosure of Interests in Other Entities Ind AS 112

13IFRS 13Fair Value MeasurementInd AS 113

Comparison of Accounting Standards, Ind AS and IFRS

As a part of globalisation, our financial reporting in India has also changed significantly, transitioning from AS to Ind AS (Indian Accounting Standards which is mostly converged with IFRS). Here is a complete comparison:

Basis AS Ind AS IFRS

Issued By Institute of Chartered Accountants of India (ICAI) Ministry of Corporate Affairs (MCA)/ IFRS International Accounting Standards Board (IASB)

Applicability Indian companies (primarily SME and private entities) Listed Cos, Large Pvt Cos, certain NBFCs & Certain Banks Global Companies, listed entity in IFRS adopting countries

Approach Rule-based (Strict set of rules for accounting treatment) Principle-based (IFRS-like with some modifications) Principle-based (Focus on substance rather than form)

EC Fair Value accounting Mostly HCA-basedSome FV in some areasFVM used substantially

Revenue Recognition Transfer of risk and rewards B13044-84 -Control transfer (Ind AS 115) Control transfer (IFRS 15)

Financial Instruments No specific standard Ind AS 109 – Uses expected credit loss model IFRS 9 – Uses expected credit loss model

of Leases Classification dual finance” and operating”).dual lessee (Ind AS 116)Single lessee Similarityglobal lease model for all Accounting Standards Indian Ind AS 17 IFRS IAS 17IAS 16 IFRCARVE-IN CARVE-OUT Leases Page26\Page26 SortCARVE-IN CARVE-OUT casualty loss A Carve-out is a formal removal of the wording within the coverage or key endorsements by adding policy text to restrict it.

Preparation of Consolidated Financial Statements Not required for some enterprises Required if control exists (Ind AS 110) Required if control exists (IFRS 10)

Component Accounting NA Yes (Ind AS 16) Yes (IAS 16)

Segment Reporting Applicable not applicable for unlisted companies Not applicable for unlisted companies Required (also) for listed entities

Inventory Valuation Permits LIFO (Last In, First Out) and FIFO (First In, First Out) LIFO is not allowed (Ind AS 2) LIFO is not allowed (IAS 2)

Cash Flow Statement Not compulsory for all apply Mandatory for all the Ind AS compliant enterprises (Ind AS 7) Mandatory for all the IFRS compliant enter prises(IAS 7)

Actuarial Gain/Loss Recognition Included in PL Recognized in Oci as oci Recognized Following mech Title

Effect on Taxation Relatively less effect on tax May create needs to adjust for deferred tax liabilities IFRS 1 Deferred taxes recognised under IFRS 12

AdaptabilityMandatory and inflexibleMore flexible with global harmonizationHighly flexible & globally accepted

Adoption Countries India only India, but with convergence to IFRS Over 140 countries including the EU, and G20 countries

8.4 Summary

❖ Accounting standards are a body of principles and rules on the basis of which companies are required to make their financial statements, uniform, clear and comparable. They deliver a prescriptive framework to determine the financial position of an entity that the stakeholders, e.g. investors, regulators and others can use in reducing accounting treatment disparities.

❖ Accounting standards are a template, for the accountants, telling us how to make accounts and generate financial reports. They serve as regulating standards by providing reporting options, defining disclosure requirements, and ensuring consistency in how claims are reported from university to other universities, or from industry to industry.

❖ They enhance the consistency of accounts that is companies financial statements will be comparable. Additionally, there are several other applications for accounting. Eg they advise us on accounting issues, and ensure we comply Laws and Regulations by subcontracting our compliance to independent enforcement organizations, and track the global money in accounting from those field of practice on that globe.

❖ Meanwhile, the accounting standards also have their own benefits on the one hand, and defects in nature: inflexible in application, complicated to put into practice material changes which can be made frequently for ever including. There is a significant element of subjectivity in for example fair value measurement, for smaller businesses the costs of compliance have also been disproportionately high and rising as result of recurring new and evolving financial regulation.

❖ Ind AS had been implemented in India to converge IFRS financial report with special case of Indian regulatory environment. Pursuant to Ind AS 101, entities transitioning from Indian GAAP to Ind AS shall be required and permitted certain exceptions on transition irrespective of the exemptions allowed by law.

❖ Ind AS aims at making financial reporting amongst similar industries consistent and globally comparable. So it enhances transparency, helps in facilitating decision making across the boundaries and basically puts IFRS into local Indian economic perspective.

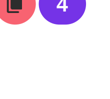
❖ Ind AS is mandatory for listed entities, big companies, banks, NBFCs and insurance companies. It offers the principles of revenue, financial instruments and lease accounting. This method adopts a principle-oriented approach to that of including in the substance the reliability and accuracy of financial statements.

❖ Some of the Indian government defined Ind AS standards include conversion calculator IFRS on Ind AS 1 (Presentation of Financial Statements), IFRS to Ind AS 7 (Statement of Cash Flows), Conversion calculator IFRS to Indian GAAP on Ind AS 16 (Property, Plant and Equipment) and Transition from IGAAP toInd As 109(Financial Instruments). Financial statement preparation applies across various sectors and the standards are enforced accordingly.

❖ The International Accounting Standards Board (IASB) created IFRS as a universally used accounting system. The harmonization is designed to enable developing and emerging economies better compare IFRS-compliant financial reporting at public entities, and increase trust in reported results.

❖ IFRS facilitates international comparability of financial statements, enhances transparency and attract the investment of MNCs into other countries. The integration of financial markets through harmonisation of reporting standards reduces complexity in financial and regulatory reporting, and contributes to economic development.

❖ India also had the associated costs for implementation, fair value measurement challenges and clashes with former tax laws while transitioning to Ind AS. But improved disclosure requirements and increased earnings volatility translated into poorer financial performance, and companies had no choice but to invest in their own planning processes to smooth compliance.



❖ Several IFRS standards have been converged into Ind AS, to meet the global requirements. Such as IFRS 1 (First Time Adoption of Ind AS 101), IFRS 9 (Financial Instruments as Ind AS 109) and IFRS 15 (Revenue from Contracts with Customers as Ind AS 115) and are consistent with international reporting standards.

❖ AS is rule based framework and damage by SMEs in India where as Ind AS is principle-based framework which provide the numbers on IFRS for application to listed

entities and big companies of India. So, Ind AS is an adapted version of the standards that meet India's regulatory requirements initially whereas IFRS is universally accepted and essentially based on fair value accounting.

8.5 Key Terms

Accounting Standards (AS): These are issued by the Institute of Chartered Accountants of India (ICAI) to make accounting practices uniform in the presentation of financial reports for different companies.

Indian Accounting Standards (Ind AS) The Indian accounting standards are local version of IFRS converged standards to reach international financial reporting standards while being compliant with the domestic economy and regulatory environment.

International Financial Reporting Standards (IFRS) The International Financial Reporting Standards (IFRS) is the common global language of practice financial reporting accountancy profession De facto international accounting standards body International Accounting Standards Board (IASB), which was formed to improve financial statement comparability and transparency in the interest of investors.

Institute of Chartered Accountants of India (ICAI): The Institute of Chartered Accountants of India ICAI is the accounting regulator in india which promulgate and regulate accounting standards AS to achieve uniformity in financial reporting.

Ministry of Corporate Affairs (MCA): It serves as an Indian government authority that enforces the Ind AS standards with corporate governance security and financial compliance drive.

IASB (International Accounting Standards Board) It is the global authority that develops and supports IFRS implementation throughout the world.

Fair Value Accounting: A method of accounting that measures asset and liability value based on current market values to increase relevance in financial reports.

Toward IFRS: Convergence with INDIAN ACCOUNTING STANDARDS (Ind AS) – enables comparison of financial reports across global boundaries.

Historical Cost Accounting is a conventional method of accounting that, despite being used for centuries, does not account for the effect of changing market values or inflation on assets.

Recognition of revenue: One should assess the recognition of revenue in such a way that companies need to be looking upon the principle under Ind AS 115 and IFRS which is IFRS 15 where control basis is taught rather that examining it whether risk and reward or not.

Financial Instruments: It means contracts that give rise to financial assets, and financial liabilities and equity instruments under the expected credit loss model in Ind AS 109 as well as IFRS 9.

Leases Accounting: It includes recording of lease transactions under which both Ind AS 116 and IFRS 16 require lessees to bring leased assets and liabilities in the financial statement.

Consolidated Financial Statements: The consolidated financial statements include a parent company along with its subsidiaries in accordance with the consolidation requirements of Ind AS 110 and IFRS 10.

Principle-Based Accounting: Ind-AS and IFRS are based on Principle-Based Accounting, which makes use of concepts that admit a wide discretion in financial reporting instead of hard and fast rules.

Rule-Based Accounting: Account Standards (AS) enforce Rule Based Accounting in terms of rigid reporting requirements and less flexibility in terms of reporting.

Expected Credit Loss (ECL) Model: This model allows organizations to assess potential losses on loans and credit under the framework of both Ind AS 109 and IFRS 9.

Deferred Tax Liabilities (DTL): The tax to be paid in future due to temporary differences (between accounting income and taxable income under the IT Act) which lead to increased taxes in future.

Disclosures: Compulsory disclosure requirements under Ind AS and IFRS, making the companies to mandatorily disclose detailed financial numbers providing a trust and confidence to investors.

Segment Reporting- Financial statement presentation by business segments, enabling users to understand the revenue generating sources as per Ind AS 108 and IFRS 8.

Cross-Border Investment: Three types of foreign investment that are positively correlated with the adoption of IFRS, and in which full international standardised financial reports enhance confidence by over seas investors and fleet market access.

Transparency in Financial Reporting: Ind AS and IFRS aims at transparent, fair and consistent presentation of financial information which would provide all stakeholders including regulators timely indication to prevent problems.

8.6 Descriptive Questions

What is accounting standard and why do we need in financial reporting?

According to Kohler, what are accounting standards doing to accountants?

How does accounting standardization promote consistency and neutrality among financial reports?

What are the primary features of accounting standards?

How do accounting standards control the practice of accounting and their presentation of financial information?

Why is it essential for businesses to comply with basic accounting concepts?

What are the significant benefits which can be earned with accounting standards in reporting practices?

What is this Ind AS 101 and how it helps in moving from Indian GAAP to Ind AS?

What are the major differences between the required and optional exemptions in terms of Ind AS 101?

What are the primary objectives of Ind AS in financial reporting?

What benefits Ind AS brings to the transparency and comparability of financial statements across borders?

Why does IFRS matter to multinational enterprises and cross-border investment?

What are the key hurdles for Indian companies in implementing IFRS?

How does IFRS promote globally comparable and transparent financial reporting?

What are the fundamental distinctions between AS, Ind AS and IFRS?

Which are the headline IFRS standards and their Ind AS equivalents?

Discuss the function of the IASB in sustaining IFRS.

What are the primary differences resulting from IFRS converge in India?

8.7 References

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Answers to Knowledge Check

Knowledge Check 1

1: b) They may be rigid and not adaptable to specific industry demands.

2: c) The complexity of certain accounting principles makes them difficult to understand and apply.

3: b) It creates challenges in compliance and requires constant staff training.

8.8 Case Study

Integration Missteps over Transition Troubles and Financial Management at

ABC Manufacturing Ltd is a medium-sized firm, which manufactures industrial equipment. The business has been in operation for 15 years and has shown year-over-year revenue growth. However, it is evident from its recent financial reports – as well as some other warning indicators in its cash management and the difficulty of adjusting to new accounting rules that could put pressure on operational performance or compliance – that release would seem premature.

Issue 1: The Aspects of AS, Ind AS and IFRS that are Needed to be Harmonied

ABC Ltd. was following SIndian AS for years and required to switch over to Ind AS in the current fiscal year. The company's finance staff was not exposed to the concept of fair value accounting and the principle-based nature of Ind AS and IFRS, leading to divergent views when preparing its financial statements.

Solution:

Trained the finance team on the differences between AS, Ind AS and IFRS. Applied Ind AS 101, with a smooth transition option (with exemptions).

A financial consultant was engaged to aid in the fair value accounting and disclosure compliances.

Issue 2: Non-repeatable canaigre production and an adverse working capital movement Proportional reserves replacement (excluding the effects of all other issues) 1 Average delivered unit-repair costs proven Work in progress $9.66/CMS $5.68 CMS=content/pulp-portion tonne Problems discovered; work in progress inventory reduced by about 75% @ period end KS Case Studies workbook v5_A4_Page_174.jpg What do you estimate was your realised margin on this paper?

ABC LtdTS posted $1.2 million in net profit, but had a negative operating cash flow of $300,000, which gave Pausezky some concerns about liquidity and sustainability.

Contributing Factors:

• Significant increase in accounts receivable.

• High inventory buildup.

• Extended customer credit terms.

Solution:

• More stringent credit policies and better collection efforts.

• Adopted just-in-time (JIT) inventory practices.

• Renegotiated customer credit terms.

• Implemented cash flow forecasting tools.

Issue 3: High Capital Costs Resulting in Cash Drain.

There was significant spending on equipment and expanding its plants this quarter, causing large cash outflows and pressure on free cash flow.

Solution:

• Identified and selected critical capital projects, based on strategic value and ROI.

• Explored leasing equipment to spread outflows.

• Better planning of projects to prevent overruns.

• Phased the investments for cash flow relief.

Reflective Questions

If a company has negative operating cash flow but positive net income, what does it tell us about the firm?

financial health?

Which working capital items directly impacts cash flows of ABC Ltd and how can they be

optimized?

Cost Of CapitalExplain the importance of managing capital expenditure to maintain positive cash flow-vesm.. 8.

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Unit 9: Key IND AS Standards: Principles and Applications

Learning Objectives

1. Learners will be able to understand the components of financial statements and the qualitative characteristics of useful financial information.
2. Learners will be able to understand the accounting treatment of inventory write-downs and disclosures in financial statements.
3. Learners will be able to analyze the accounting treatment for asset disposals and subsequent expenditures on fixed assets.
4. Learners will be able to classify financial instruments into financial assets, liabilities, and equity instruments.
5. Learners will be able to understand the disclosure requirements and presentation of investment properties in financial statements.

Content

9.0 Introductory Caselet

9.1 Ind AS 1

9.2 Ind AS 2

9.3 Ind AS 16

9.4 Ind AS 8

9.5 Ind AS 38

9.6 Ind AS 115

9.7 Ind AS 109

9.8 Ind AS 116

9.9 Ind AS 40

9.10 Summary

9.11 Key Terms

9.12 Descriptive Questions

9.13 References

9.14 Case Study

9.0 Introductory Caselet

The Financial Reporting Dilemma

ABC Ltd., a medium-sized manufacturing entity is in the process of compiling its financial statements for the year ended March 31, 2025. The Company has applied Ind AS 1, 2, 16, 8, 38, 115,109 and 116 in compliance with the Indian Accounting Standards (Ind AS).

As part of the closing process, the CFO, Mr. Rajan, faces a dilemma as stated below: Instead of sharing it with others on ur team youu should have solved Pasquale "The King" Benedetto problems at ur and get promoted as soon as possible.

• Inventory Valuation (Ind AS 2): The NRV of certain raw materials is lower than their cost on account of a decline in market prices. But the production manager wants to leave the original cost so not to show a loss on its books.

• Depreciation policy (Ind AS 16): The entity has been depreciating the assets using Straight-Line Method (SLM). But a board interviewee mentions that using the WDV (Written Down Value) method is slightly more tax-efficient.

• Revenue (Ind AS 115): ABC Ltd. has a multi-year contract signed with one their clients, but there is ambiguity on whether the revenue should be recognized flat in initial year or over the years.

• Lease Liabilities (Ind AS 116): The company has acquired an industrial warehouse on a lease of 5 years, but the finance team is confused if they should record it as the Right-of-Use (ROU) asset or leave it off – balance sheet.

• Investment Property (Ind AS 40): The company's corporate building has been used / occupied a commercial building provided by the developer for setting of to be management team for sale of underwritten project and is being remeasured at Fair Value through Profit or loss on revaluation, which results in increase in value proposed due to the final agreement with the developer. They rented it for passive income this year. The finance team is in a discussion whether to classify it as PPE (Ind AS 16) or Investment Property (Ind AS 40).

As the CFO, Mr. Rajan has to ensure that Ind AS is complied with while also giving a true and fair picture of the companys finances.

Critical Thinking Question: As Mr Rajan, what actions will you take with respect to these accounting issues and why considering ethical financial reporting and

compliance with Ind AS? Develop an orderly plan for each of your issues and explain why you chose as you did.

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9.1 Ind AS 1: Presentation of Financial Statements

IND AS 1 on Presentation of Financial Statements This standard deals with the presentation of general-purpose contra financial statements for making sure comparability, both at an intra-entity as well as inter-entity level across reports prepared at different reporting times. It describes the form and content of all financial statements prepared under IND AS as per this notification.

Objective

4

The objective of IND AS 1 The objective of IND AS 1 is to provide a world-wide standard that prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.

Scope

● This Standard applies to all statut emen ts containing general purpose financial statements, the date of authorisation for issue of which is on or after 1 April 2017.

● Does not apply to condensed interim financial statements (which are subject of IND AS 34).

● Regulatory agencies such as Companies Act, 2013 may require specific formats.

Structure of Financial Statements according to IND AS 1

Required financial statements by IND AS 1 are as follows:

8

Balance Sheet (Statement of Financial Position) 10.

Statement of Profit or Loss and Other Comprehensive Income

Statement of Changes in Equity (SOCE)

Cash Flow Statement (in terms of IND AS 7)

Notes to Financial Statements (including applicable accounting policies)

Comparative Information for prior periods

It may also show a third new balance sheet style (opening balance sheet) in specific cases of adjustments, e.g., restatements as per an accounting policy which has retrospective application.

Fundamental Principles

• True & Fair View and Compliance with IND AS: The financial statements should be a fair presentation of the financial position and performance of an entity. IND AS compliant All applicable IND AS NOT IND AS compliant providedInascompilantsness 78.

• Going Concern: Financial statements must be prepared on a going concern basis, unless management plans to liquidate the entity or cease operations.

• Accounting Basis: Except for the Statement of Cash Flows, financial statements are presented on an accrual basis.

• Materiality & Aggregation If items are immaterial to the financial statements in aggregate, they may be combined in presentation. Immaterial items may be aggregated.

• Offset: There is no offsetting of assets and liabilities, income and expenses unless allowed by IND AS.

• Comparative Information: A period of at least one year preceding the financial information included for

comparison.

• Consistency in the presentation: The presentation of financial statements shall not be changed unless a change is required by an Ind AS or will enable users to make better decisions.

Form and Content of Financial Statements

Balance Sheet (Statement of Financial Position)

➔ Presentation of assets and liabilities as current and non-current.

➔ Minimum line items include:

◆ Property, Plant, and Equipment (PPE)

◆ Intangible Assets

◆ Investments

◆ Trade Receivables & Payables

◆ Borrowings

◆ Equity (Share Capital & Reserves)

Income Statement (Including Other Comprehensive Income)

➔ Statement of Profit or Loss: Income, Expenses, Finance Costs and Tax

➔ Other Comprehensive Income (OCI): Items that are not reclassified in profit or loss, including:

◆ Remeasurement of Defined Benefit Plans

◆ Gains/Losses on Cash Flow Hedges

◆ Foreign Currency Translation Adjustments

Statement of Changes in Equity (SOCIE) .... 4 6.

● Shows how the equity portions of Share Capital, Reserves and Retained Profit for some instances of time has changed over the period.

Statement of Cash Flows

● Prepared as per IND AS 7(Direct or Indirect method).

Notes to Financial Statements

● certain accounting policies, key estimates and other explanations are included.

Disclosure Requirements

● Estimates and Judgements in applying accounting policies.

Dividends declared after the end of a period but before financial statements are produced.

● Nature & purpose of reserves in equity.

Did You Know?

- Unlike its international counterpart IAS 1, which allows entities to present profit and loss in either a single statement or two separate statements, Ind AS 1 mandates the use of a single statement approach.

- Ind AS 1 requires entities to classify expenses based on their nature (e.g., raw materials, staffing costs) rather than their function (e.g., cost of sales, administrative expenses), which is an option permitted under IAS 1.

9.2 Ind AS 2: Inventories

IND AS 2 – INVENTORIES – deals with the accounting of Inventoryto ensure it is reported at such value which will be playing a vital role in reporting true & fair financial position of the enterprise. It deals with determining the cost of inventories, its subsequent recognition as an expense and any writedowns to NRV.

Objective

The objective of IND AS 2 is to prescribe the accounting treatment for inventories and it requires that inventories are carried at the lower of cost and net realizable value (NRV). The objective is to avoid excessive inventory valuation and match costs with the revenue they helped produce.

Scope of IND AS 2

Applicable To:

➔ All inventories, including:

◆ Raw materials

◆ Work-in-progress (WIP)

◆ Finished goods

◆ Stores and spares

◆ Traded goods held for resale

➔ Exclusions (Not in the Scope of IND AS 2):

◆ Write-up of work in progress in respect of a contract Revenue and the associated costs attributable to construction Contracts (IND AS 11).

◆ Financial instruments (such as stocks, bonds, derivatives etc.) (included in IND AS 32, 107, 109).

◆ Living organisms, plants and their products (as envisaged under IND AS 41).

Definition of Inventory

As per IND AS 2 the inventories are defined as the assets which :

● Are held for sale in the ordinary course of business (e.g., finished goods).

● Are being produced for sale (e.g., work-in-progress).

● Are a material or supply that is consumed in the production or provision of a service They are held for possible future sale in the ordinary course of business.

Measurement of Inventories

The valuation of inventories should be at the LOWER of:

materials cost (purchase cost + conversion cost + other costs).

Net Realizable Value (NRV) (estimated selling price less costs to complete and sellumes)

Components of Inventory Cost

A. The cost of inventories includes:

● Acquisition price – The invoice price includes cost of delivery to the importer's premises (anything upto the customs frontier - ports, airports etc), up to arrival at your door in effect.

● Conversion cost - It includes direct labor, factory overheads and fixed manufacturing costs.

● Other costs – Consists of abnormal loss treatment, storage costs (necessary for manufacturing if any) and administrative costs (regarding inventory control).

B. EXCLUDED COSTS FROM INVENTORY VALUATION Not included in inventory value:

● Abnormal waste during production.

● Storage expenses (unless storage is a part of production).

● Selling and distribution costs.

● Administrative costs that are not related to production.

Interest and borrowing costs (otherwise than in respect of borrowings made specifically to finance inventories for a non-financial institution) ○ For a non-financial institution that are directly attributable; or ○ In other cases, interest incurred during the production phase.

Inventory Valuation Methods (Cost Formulas)

The standard IND AS 2 permits following techniques to compute cost of inventory:

‘● FIFO – First In First Out: It means placing in use the old inventory first and then using the more recent purchases.

● Average Weighted Cost (AWC) -The actual cost of inventory as an average over all purchases.

● Last-In, First-Out (LIFO) Last-In, First-Out (LIFO) is prohibited under IND AS 2 because it has the potential to distort inventory valuation and profit.

Net Realizable Value (NRV)

NRV = Selling Price Estimate - Costs to Finish - Sales Cost NRV Adjustments:

● If NRV < Cost, the inventory is devalued to NRV.

● If NRV goes up in any subsequent period, the original write down on inventory can be unwound (which was not permitted under Indian GAAP).

Example:

● A firm is having a stock-intrade valued at ₹500,000.

● Expected selling price is ₹550,000 and it will cost ₹100,000 to complete the project and sell.

● NRV = ₹550,000 – 100,000 = ₹450,000.

● Because the NRV (₹450,000) is less than cost (₹500,000), inventory should be written down to ₹450,000.

Recognition of Inventory in the Financial Statements

When inventory is sold, the cost of such sold inventory becomes reported under Cost of Goods Sold (COGS) in Statement of Profit & Loss.

● Expense is also the amount of inventory write-downs resulting from a decrease in NRV.

● Subsequent revision of a write-down reversal is recognised as income in the period of reverse.

Disclosure Requirements in Financial Statements

The following must disclose in their financial statements:

● Methodology of accounting treatment for inventory valuation.

● Split of items by inventory category (RM, WIP, Finished Goods etc.).

● The cost formulas adopted (FIFO or WAC).

● The amount of any inventory write-downs, along with the related reversals, if any.

● Reasons behind your write-downs of inventories (obsolete stocks or whatever).

9.3 Ind AS 16: Property, Plant and Equipment (PPE)

Accounting Standard (IND AS) 16 Property, Plant and Equipment The objective of this Indian Accounting Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The standard seeks to encourage consistency in reporting of PPE in financial statements, accounting for its economic benefits over time.

Objective

The objective of IND AS 16 is to prescribe the accounting treatment for property, plant and equipment.

Recognition of PPE.

● Initial recognition of the cost of PPE.

● Subsequent measurement, in particular depreciation and revaluation.

● PPE related disclosures in financial statements.

Scope

Applicable To:

The scope: applicability of IND AS 16 has relevant to physical, non-current assets, such as :

● Land and Buildings

● Machinery and Equipment

● Furniture and Fixtures

● Vehicles

● Computers and Office Equipment

● Leasehold Improvements Exclusions (Not inherited under IND AS 16):

● Properties classified as investment properties (covered by IND AS 40).

● Biological assets (applying IND AS 41).

● Mineral rights, including exploration and extraction assets (covered by IND AS 106).

Recognition of PPE

A PPE is acknowledged as an asset when:

It is likely that the economic benefits associated with the asset will accrue to the entity.

The fair value of the asset can be reasonably measured.

Cost Basis of PPE 1.

➔ PPE is initially recognized at cost, which includes:

◆ Purchase price (import duties and taxes included).

◆ Incremental costs directly attributable to the asset in preparing it for its intended use (e.g., overhead, installation, testing or site preparation).

◆ Borrowing costs (if the asset is eligible under IND AS 23).

➔ Costs Excluded from PPE Valuation:

◆ Abnormal costs incurred during construction.

◆ Costs of startup (unless the costs are for an asset to be used in the property).

◆ Administration and indirect costs (unless specifically identified).

◆ Repairs and maintenance (these are expensed as incurred).

Subsequent Measurement of PPE

PPE after first diagnosis can be described by either model:

Method Description

Cost Model PPE is stated at cost net of accumulated depreciation and impairment losses.

Revaluation Model PPE is stated at fair value, which is periodically revaluated, net of depreciation and impairment.

If an entity opts to use the revaluation method, it must also revalue all other assets within that same class at the time of adoption and record such revaluation surplus in OCI.

Depreciation of PPE

Depreciation is the process of spreading out the cost of an asset over its useful life.

Key Points:

● Depreciation begins when the asset is in the condition to be used.

Depreciation stops when the asset is derecognised or classified as held for sale. The depreciation model chosen should correspond to the pattern of consumption of economic benefits by future users.

Methods of Depreciation Permitted under IND AS 16:

● Straight-Line Method (SLM): Spread the cost of depreciation throughout the life of the asset.

Question 1: WDV and SLM Methods Case 1: Higher rate of depreciation in early years ● Written Down Value (WDV) Method More rapid decline in value.

● Units of Production Method: According to the original output or usage of asset. Life and salvaged value need to be considered at least annually – when the need exists change them.

Impairment of PPE

● When the carrying amount of the PPE exceeds its recoverable amount, an impairment loss shall be recognized.

● The recoverable amount is the greater of:

Fair value less costs to sell

Net present value (discounted future cash flows from the asset)

When the reasons for impairment no longer exist, an impairment loss may be reversed (except for goodwill).

Derecognition of PPE

● PPE is derecognised (taken off the books) if:

●Elimination of the asset (sale, discard, or transfer).

● No future economic benefits are anticipated to be received from the asset. A gain or loss on derecognition is reflected in the Profit and Loss statement.

Disclosures in Financial Statements

A company must disclose:

● Basis of measurement adopted for PPE (cost or revaluation).

● Depreciation policies and lives of assets.

● Assets, carrying amount of assets (gross and net).

● Opening and closing balances reconciliation, additions, disposals, depreciation and impairment analysis.

Details of revaluation surplus, if any.

● Title restrictions of PPE_SX(if any) (e.g., asset pledged as collateral).

9.4 Ind AS 8: Accounting Policies, Changes in Accounting Estimates, and Errors

Indian Accounting Standard (IND AS) 8, "Accounting Policies, Changes in Accounting Estimates and Errors" deals with :

● Selection and application of accounting principles.

● Treatment of accounting estimates changes.

● Fixing financial statement errors.

This standard aims at making sure that the financial statements convey reliable, consistent and comparable information over time.

Scope

IND AS 8 applies to:

● All bodies corporates which are issuing financial statements under IND AS.

● Changes in accounting policies that effect financial reporting.

● New knowledge and changes in accounting estimates.

● 1Restatement of previously issued financial statements for material errors. Exclusions:

This practice is not applicable to:

● Accounting policy changes issued by other IND AS (eg., IND AS 115 - Revenue Recognition).

● Misstatement arising out of fraudulent reporting on financials (addressed by governance laws).

Accounting Policies Definition:

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Selection of Accounting Policies

An enterprise shall apply only those accounting policies that comply with IND ASs. In case any IND AS is not specifically applicable to a transaction, management may frame the policy which states that:\" Management should determine whether an accounting standard applies to a particular item in interim financial statements.

● Provides reliable financial reports.

● Is based on comparable industry practices.

● Adhering to the Framework of Financial Reporting provided by IND AS Preference for Expertise In Financial Reporting And Taxation Skill(s) required: contributed in financial statements. Order of Preference in the Absence of a SpeciÃ¢â‚¬Âc IND AS

Use the guidance on similar issues in existing IND AS.

Refer to the IND AS Framework for Presentation of Financial Statements.

5.5 Accounting principles used in other IFRS/GAAPs, if not inconsistent with the overall IND AS framework may also be applied when consistent with that framework.

Changes in Accounting Policies

An entity is permitted to change an accounting policy only if:

● Is mandated by a new IND AS.

● It enhances the reliability and relevance of financial statements.

Example of Acceptable Change:

A firm changes from the WAC method to FIFO for reasons of financial statement representation.

Example of NOT Allowed Change:

A business changes from FIFO to LIFO only because it wants to pay less tax (LIFO is also not allowed under IND AS).

Treatment of Changes in Accounting Principles

➔ Retrospective Application:

◆ The change in accounting policy should be applied retroactively to all prior periods as if it always had been adopted.

◆ If it is not practicable to apply the new policy retrospectively, apply it from the first date that is appropriate.

◆ converted opening balance of retained earnings for the earliest period presented.

Example:

A firm that used to recognize revenue on a cash basis but changed to accrual accounting. It has to adjust historical revenue and profit figures for the new method.

Changes in Accounting Estimates

Explanation: Accounting estimates are revised amounts that reflect new information or experience. Examples of Accounting Estimates:

● Asset useful lives and residual values.

● Bad debt provisions for receivables.

● Warranty provisions.

● Fair value of financial instruments.

Accounting estimates – changes in estimates treated 48.

➔ Prospective Application:

Example:

◆ The current and future period is affected by changes in estimates only.

◆ There is no retrospecti ve adjustme nt on the fi rst fin ancial statements.

A company initially estimated that the useful life of a machine was 10 years, but after new technical evaluations modifies its estimate to 8 years. Any remaining deprecation amount will be prospec- tively adjusted with no re-statement of historical financial statements.

Correction of Errors

Errors include:

Mathematical mistakes.

Misapplication of accounting policies.

Omissions or incorrect estimates.

Fraud or manipulation.

Treatment of Material Errors

➔ Prior Period Adjustment (Retrospective Correction):

◆ Mistakes have to be fixed on a backward basis by reissuing the old financial statements.

◆ Reclassify opening balances of retained earnings into the earliest year presented.

◆ When full retrospective restatement is not possible, apply adjustments to the earliest period practicable.

Example:

A company realises in 2024 that a large contract was recorded as revenue for 2023 when it should have been recognised in the books for 2024. The company must:

Restate 2023 financial statements.

Revalue the retained earnings at the beginning of 2024.

If the error is NOT material, it may be corrected in the current period's financial statements.

than restating previous ones.

Disclosures as per IND AS 8

➔ For Changes in Accounting Policies:

◆ Nature of the change.

◆ Justification for the change.

◆ Retrospective adjustments to financial statements.

➔ For Changes in Accounting Estimates:

◆ Description of the change.

Impact on financial statements (materiality).

➔ For Correction of Errors:

◆ Nature of the error.

◆ Financial impact on prior periods.

◆ Adjustments made to retain earnings.

9.5 Ind AS 38: Accounting Policies, Changes in Accounting Estimates and Errors

IND AS 38 Intangible Assets deals with the treatment of intangibles in the books of accounts. It ensures that goodwill is correctly reported, amortized and disclosed on financial statements.

Objective

The objective of IND AS 38 is to:

What is an intangible asset and how are recognition criteria being set down?

Issue principles with respect to the initial and subsequent measurement of intangible assets.

Test for proper amortization and impairment.

Set up disclosure obligations to improve financial transparency.

Scope

Applicable to:

IND AS 38 is applicable to all intangible assets such as;

● Patents, trademarks, copyrights

● Franchises and licenses

● Software and website development costs

● Brand names and customer lists

● Research and development (R&D) costs

● Goodwill (only to the extent of impairment, if any, in accordance with IND AS 103)

Exclusions: (Outside the Scope of IND AS 38):

Financial instruments (referred to in IND AS 32, 107, 109) tailassets and dpers:

Exploration and evaluation of minerals covered under IND AS 106

Deferred tax assets covered under IND AS 12

Goodwill acquired in a business combination covered under IND AS 103

Definition of intangible assets: Intangible assets are non-monetary, identifiable assets without physical substance that is controlled by the entity as a result of past events, will generate future economic benefits, and can be measured reliably at cost. For example, if a company purchases software for ₹10lakhs, then the future economic benefits are expected. Then it records it as an intangible asset. If an asset does not meet all the three conditions, then it must be expensed immediately. Recognition of intangible assets: Firstly, an entity recognize an intangible asset only when both, probability of future economic benefits exists, and the cost of asset can be reliably measured as when the asset should not be recognized: 1. asset cannot be separated or transferred. 2. future benefits are uncertain. 3. the cost cannot be reliably measured. Example: if a pharmaceutical company spends ₹50 crores in developing a new drug. If the drug is successful and passes all clinical trials, then the drug will generate revenue. The drug can be capitalized as an intangible asset. Otherwise, it is expensive. Measurement of intangible assets 1. Initial Measurement It is measured at the cost of an intangible asset on acquisitions that include. purchase price. Directly attributable costs Eg; legal fees, registration, consulting fees. Costs for preparing the asset for use E.g. the company purchases a patent for ₹10 lakhs and pays ₹2 lakhs as legal fees. The total cost of the intangible asset is ₹12 lakhs. 2. Subsequent Measurement After initial recognition, Differentiate();

Method Description

Cost Model Asset is recorded at cost, net of amortization and impairment losses.

Revaluation model Asset is carried at fair value, adjusted for revaluations less amortization and impairment.

The Revaluation Model is permitted only when the fair value of an asset can be reliably determined.

Amortization of Intangible Assets

Finite-Life Intangible Assets

● Amortized over their useful life.

● Depreciation starts when the asset is in condition to be used.

● The residual value is presumed to be zero unless it the asset is bought by a third party.

Illustration: A firm purchases software for ₹20 lakh and it's useful life is 5 years. Annual amortization = ₹20 lakh ÷ 5 = ₹4 lakh per annum.

Indefinite-Life Intangible Assets

● Not amortized, but instead tested for impairment on an annual basis.

● Examples: Trademarks, goodwill and licenses for indefinite period.

Example: Coca-Cola's trademarks are indefinite-life and are not amortized; however, they are tested for impairment.

Impairment of Intangible Assets

● Indicator may lead to the need of performing an impairment test If there are indicators of impairment: ¾ Value is initary reduced by deteriorated circumstances; IAS36 – Impairment test Where there is any indication that an asset may be sepass in a major way.KEY INDICATORS OF IMPAIRMENT Indicators can follow below processes; ◦Evidence of Obsolescence or physical damage has occurred

declined.

● Intangible assets with indefinite lives and goodwill must be tested for impairment at least annually.

● The loss from impairment is recognised in the Statement of Profit & Loss.

Illustration: A company purchases a patent for ₹5 crore, but later finds that its competitors have launched a better technology which reduces the market value of the patent to say ₹2 crore.

Impairment loss = ₹5 crore – ₹2 crore =₹3 crore (charged to expense).

Derecognition of Intangible Assets

A non-financial asset, such as goodwill, intangible assets (if not traded in an active market), or any other long-lived asset is derecognized upon:

● It is sold or disposed of.

● It does not contribute future economic benefit.

For instance, a company sells a trademark for ₹10 lakh having fully amortized it. The amount received is

capitalised to the Profit & Loss account.

Disclosures Required in Financial Statements

A company must disclose:

Holding a certain amount of intangible assets.

Useful life and amortization method.

Impairment losses and reversals.

Details of the revaluation (where a revaluation model is used).

Information on internally generated intangible assets.

9.6 Ind AS 115: Revenue from Contracts with Customers

Indian accounting standard (IND AS 115) "REVENUE from CONTRACTS with CUSTOMER" is the best way through which revenue can be include in the statement of P&L. It supersedes existing revenue standards (IND AAS 11 & IND AAS 18) and introduces a five step model that is applied when recognising revenue.

Objective

The primary purpose of IND AS 115 is that revenue should be recognised:

● Represents the sale of goods or services to customers.

● Is the estimated sum the company believes it will receive.

● When performance obligations are satisfied, it records revenue.

Scope

Applies To:

This IND AS 115 shall apply to all contracts with customers, except for:

● Sale of goods.

● Sale of services.

● Licensing (software, IP rights).

● Construction contracts.

● Franchise arrangements. Exemptions (Not under IND AS 115):

● Lease contracts (IND AS 116).

● Insurance contracts (IND AS 104).

● Financial instruments (IND AS 109).

● Items exchanged between two or more entities of the same industry.

Five-Step Model for Revenue Recognition

IND AS 115 provides for a five-step methodology for the recognition of revenue as mentioned below:

Step 1: Identify the Contract with the Customer

There are certain conditions that a contract must fulfil, including:

● It has commercial substance.

Both sides have agreed to the accord.

● Payment terms are clearly defined.

● There is a reasonable possibility of recovery of consideration.

Example:

A company inks a contract for ₹5 crore to offer IT services over a three year period. Since all criteria are

it is regarded as a contract under IND AS 115.

Step 2: Identify Performance Obligations

Performance obligations are the promised distinct goods or services in the contract.

• A product/service is separate if the buyer can derive service from it directly.

● If several services are combined, they must be assessed separately or grouped into a single obligation.

Example:

A telecom company sells:

A mobile phone (delivered immediately).

1 year data plan (spread over 12 months).

These are two different performance obligations: the phone is sold immediately and revenue is booked; the data plan service continues over time.

Step 3: Identify the Transaction Price

The fair value is the price to be received for goods or services to be delivered.

● Fixed Consideration – Agreed amount/ price in the contract.

● Variable Consideration – Bonuses, discounts, refunds (estimated using probability-weighted approach).

● Material Financing Element – If it is not built into the price, at least interest should be added.

● Of Non-Cash Consideration – In-kind trades, securities or other assets.

Example:

A developer decides to build a shoping complex for ₹50 crore, with an incentive of ₹5 crore if the shopping malls completes in 10 months instead of 12 months.

early completion. Possible transaction price might be:

₹50 crore (guaranteed) + ₹3 crore (likely bonus) = ₹53 crore.

Step 4: Allocate the Transaction Price to the Performance Obligations

If a contract contains more than one performance obligations, the transaction price is allocated in accordance with:

● SSPs for each element.

● Appropriate consideration if SSP is not available.

Example:

A software company sells:

A software license for ₹80,000.

One-year tech support for ₹20,000.

A bundle discount (at ₹90,000 instead of per existing ₹1,00,000).

Revenue allocation:

● Software license = (₹80,000 / ₹1,00,000) × ₹90,000 = ₹72,000.

● Tech support = (₹20,000 / ₹1,00,000) × ₹90,000 = ₹18,000;

Step #5: Identify the Point in Time at Which Revenue is Recognized (i.e. When or As The Performance Obligation Is) Fulfilled

Revenue is recognized:

● Point (if cost & control is conveyed - for example product sales).

● Ongoing (if it is an ongoing service such as subscriptions, long term contracts).

Example:

● A company that sells its good to a retailer books the revenue when R&G ship product after an order is placed.

A construction company that, for two years, constructs a bridge over two years recognises the revenue as it makes progress on building the bridge.

Contract Modifications

When a contract is modified (e.g., through the addition of work), such modification is accounted for as:

● An additional contract (for new performance obligations).

● If changes are included in the original contract, then an amendment to the current agreement.

Example:

A contractor takes a contract for construction of 5 buildings on ₹ 100 crore. One user then asks for 2 additional buildings.

● If the new buildings are priced out separately at market rates, it's a new deal.

— If it is blended pricing with the existing agreement, adjustment to the original

contract.

Disclosures Required in Financial Statements

A company must disclose:

Source of revenue (goods and/or services and transfers from contracts).

Opening and closing contract balances.

Unsatisfied performance obligations.

Transaction price allocation method.

This cookie allows you to express your preference for time-based vs. straight-line recognition of revenue.

9.7 Ind AS 109: Financial Instruments

Ind AS 109, Financial Instruments: Ind AS 109 is applicable to the recognition, classification, measurement and impairment of financial instruments whether any financial asset or liability is a financial instrument.

Key Aspects of Ind AS 109:

Scope of Ind AS 109

● It applies to all financial instruments except investment in subsidiaries, associates and joint ventures reported under Ind AS 27, Ind AS 28 or Ind AS 110.

● Excludes rights and maintain obligations presenting under insurance contracts, lease liabilities and employee benefit plans.

Classification of Financial Instruments

There are three categories of financial assets, depending on the business model and cash flow characteristics:

Classification Measurement

Amortized cost When collecting contractual cash flows where there only exist principal and interest cash flows.

Fair Value through Other Comprehensive Income (FVOCI) When objective is to only collect contractual cash flows and sell financial assets.

FVTPL: Fair Value through Profit or Loss When the asset does not qualify for Amortized cost nor do you want to designate it as FVOCI.

➔ Financial liabilities are classified as:

◆ Measured at amortized cost.

◆FVTPL (either held for trading or designated as such).

9

Initial and Subsequent Measurement

➔ Initial Recognition: Financial instruments are recognised at the date when an entity becomes a party to the contractual provisions of the instrument.

➔ Subsequent Measurement:

◆ Financial assets at amortised cost: Effective Interest Rate (EIR) method.

◆ Financial assets/liabilities at FVTPL: These are measured at Fair Value through PL.

◆ Financial asset at FVOCI: Movements recognised in Other Comprehensive Income.

Impairment of Financial Assets

• Ind AS 109 replaces the incurred loss model by an Expected Credit Loss (ECL) model.

● ECL is applicable to:

Lendings, debt securities, trade receivables, loans and advances on finance leases are included in this category.

● Three-stage impairment model:

Step 1: 12-month ECL if there has not been a significant increase in credit risk.

Stage 2: Lifetime ECL when credit risk has experienced a significant increase.

Step 3: ECL recognised over lifetime with interest recognised on net carrying amount.

Hedge Accounting

● Formalizes the hedge accounting corresponded to risk management.

● Types of hedges:

Fair Value Hedge: Gains/Losses on hedging instruments taken to P&L.

Cash Flow Hedge: Effective portion of gains/losses recognized in other comprehensive income.

Net Investment Hedge: Hedges investments in foreign operations.

Ind AS 109 takes a more principles-based and risk-oriented approach to financial instruments. It increases transparency, especially in the recognition of impairment by Expected Credit Loss (ECL), thereby enhancing the resilience of the financial reporting.

9.8 Ind AS 116: Leases

##Ind AS 116, Leases The objective of Ind AS 116 is to specify the principles for recognition, measurement, presentation and disclosure of leases. It supersedes Ind AS 17 and it is consistent with IFRS 16.

Scope of Ind AS 116

➔ Applies to all leasing transactions, including subleases.

➔ Exclusions:

◆ Leases of biological assets.

◆ Contracts for exploration or exploitation of non-renewable resources.

◆ Service concession arrangements.

◆ Intellectual property rights (such as patents, films).

◆ Beneficial rights under particular license agreements (e.g. film).

Definition of a Lease

A lease is a contract that:

● Represents a right to manage the use of an identified resource over time.

● In exchange for consideration. Control exists if:

● Comprehensive benefits to be derived from the asset by the lessee.

● The leasee has the ability to guide the use of the asset.

Accounting Entry for Ind AS 116

(a) Lessor Accounting – Single Model Approach. (a) Lessee Accounting – Single Model Approach Instead of the currently existing accounting for lessees whereby certain

leases give rise to an owned asset and a lease liability, and other leases result in an operating statement charge, the Board decided that every lease would be accounted for as a financing under a single model.

No difference between the operating lease and finance lease retained in Ind AS 116 for lessee. It replaces that with a ROU asset model.

Lessee's Accounting Steps:

➔ Initial Recognition:

◆ Right of Use (ROU) Asset = Lease liability + Initial Direct Costs + Restoration Costs.

◆ Lease Liability = PV of lease payments discounted at the

lessee's incremental borrowing rate.

➔ Subsequent Measurement:

◆ ROU Asset: Amortized over the shorter of the lease term or asset's useful life.

◆ Lease Liability: It will be recognized using the EIR method and interest expense in P&L.

➔ Exemptions for Lessees:

◆ Short-term lease durations (≤ 12 months)

◆ Low-value assets (e.g., laptops, furniture).

◆ These rentals can be directly straight lined in the P&L instead of being capitalized.

(b) Lessor Accounting: Dual Model Approach 4.2.1 Measurement of Lease Receivables 144.)

The lessee continues to use finance lease and operating lease classifications as per the requirement of Ind AS 17.

Type Treatment

Finance Lease Asset is recognised and leased a receivable.

Operating Lease The lease income is recognized on a straight-line basis.

Lease Modifications

➔ A second right-of-use asset is created, if the modification adds a lease.

➔ If such modification adds or changes your obligations:

◆ Adjust lease liability.

◆ Adjust ROU assets accordingly.

Presentation and Disclosure

● Lessee: ROU asset as separate line item from other assets, lease liabilities in current and noncurrent.

Signatory, if Lessee is a corporation Name Title Schedule 1 Lessor: Leased items with their classification.

Key Disclosures:

● Maturity analysis of lease liabilities.

● Nature of leasing activities.

Variable Lease Payments and Residual Value Guarantees.

Impact of Ind AS 116

➔ For Lessees:

◆ Balance sheet impact (increased assets and liabilities).

◆ EBITDA rises (lease cost is exchanged with depreciation & interest).

◆ LeASE ExPENSEs (Front-loAdEd – BecAUse of interest cost).

➔ For Lessors:

◆ No material change in accounting treatment.

◆ Operating lease model remains.

Ind AS 116 is a game changer with respect to lessee accounting; it mandates that lease capitalisation take place on the balance sheet, affecting financial indicators. Leasing Information promotes transparency and comparability, in consistent with international IFRS 16

Did You Know?

• While international standards may allow the revaluation model for investment properties, Ind AS 40 mandates that investment properties be measured using the cost model after initial recognition, prohibiting the use of the revaluation model.

• Ind AS 16 requires entities to depreciate significant parts of an asset separately if they have different useful lives, a practice known as component accounting, ensuring a more accurate allocation of depreciation expenses.

9.9 Ind AS 40: Investment Property

Ind AS 40 prescribes the accounting treatment for investment property and related disclosure requirements.

Scope of Ind AS 40

➔ Applies to investment property, i.e., real estate held in order to:

◆ Earn rentals, or

◆ For capital appreciation, or both.

➔ Exclusions:

◆ Items of property, plant and equipment used for production or administrative purposes (Ind AS 16).

◆ Property classified as held for sale (Ind AS 105).

◆ Biological assets and mining rights.

Definition of Investment Property

Investment property includes:

● Land or a building (or part of it).

● Construction property to become an investment property. It excludes:

● Owner occupied property (owner-occupied property).

● Asset used in the routine course of business (inventory).

Recognition Criteria

An investment property is recognized when:

● Future economic benefits are likely to flow to the entity.

● The expense can be objectively quantified.

Measurement under Ind AS 40

(a) Initial Recognition

➔ Recognised at cost, comprising:

◆ Purchase price.

◆ Transaction costs (legal fees, taxes, and commissions).

◆ Expenses that can be attributed directly (professional fees and renovation costs).

(b) Subsequent Measurement

- Value/Economy Mission requirements only on select type of investments and prohibited in case of investments measured at FVTOCI or FVTPL.

- IREDA does not allow Fair Value Model unlike IAS 40 (IFRS).

Measurement Model Treatment under Ind AS 40

Cost Model (Mandatory) - Cost less accumulated depreciation & impairment.Total Additions Additions are measured at cost.

Depreciation charged to the profit or loss.

Impairment is measured at the reasonable interval after work in progress (Ind AS 36).

Note: The option to adopt fair value model is available under IFRS (IAS 40) where as under Ind AS 40 it is specifically prohibited.

Transfers of and to Investment Property

Transfer to/from investment property is made only when there's a change in use. Indications of change in use:

Change of Use Transfer

Owner-occupied → Investment property Ind AS 16 ⇨ Ind AS 40

Property held for investment → Investment property Ind AS 16 → Ind AS 40

Investment property > Inventory Ind AS 40 > Ind AS 2

- Transfers are effected at the carrying amount at the transfer date.

Derecognition of Investment Property

Investment property is derecognized on:

- Disposal (sale).

- Use--permanent cessation of use (no future economic benefits anticipated).

Gain/Loss from derecognition:

- Recognized in profit or loss.

- Calculated as:

Net proceeds on Disposal - Carrying Value

Disclosure Requirements

Disclosures include:

● Accounting policy adopted.

● Analysis of carrying amounts (opening balance, additions, disposals, depreciation and impairment).

● Depreciation and useful life methods.

● Restrictions and contractual obligations.

● Amounts taken to profit or loss (rental income, operating expenses directly incurred, depreciation)

Knowledge Check 1

Choose the correct option:

1. Under Ind AS 40, which of the following is classified as investment property?

A) Property held for administrative purposes

B) Property under construction intended to be an investment property

C) Biological assets and mining rights

2. How is investment property measured after initial recognition under Ind AS 40?

A) Fair Value Model

B) Cost Model

C) Revaluation Model

9.10 Summary

ϖ Ind AS 1 prescribes that financial statements should present true and fair viewof an entity's financial position, performance and cash flows. It requires compliance with fair presentation, continuing concern, accrual and consistency in presentation. Components of Financial Statements The financial statements are comprised of Balance Sheet, Statement of Profit & Loss, Statement of Changes in Equity, Cash Flow Statement and Notes.

ϖ The inventory valuation follows the lower of cost, and the NRV to avoid overstatement. It is relevant for raw materials, WIP and finished products, but not financial instruments or biological assets. FIFO and Weighted Average method are permitted not LIFO.

Ind AS 16 defines the accounting treatment of Property, Plant and Equipment (PPE), recognition criteria for PPE’s and subsequent depreciation and impairment. PPE is either initially measured at depreciated cost, and then under the cost or revaluation model, or is directly entered into financial statements at historical / nominal cost. Depreciation is charged over the estimated useful lives of assets, and impairment is recognized when carrying amount exceeds recoverable value.

ϖ Ind AS 8 is related to accounting policies, changes in accounting estimates and errors. Retrospective and prospective adjustments Retrospective changes in policies are performed retrospectively, whereas estimated changes are applied prospectively. Significant errors are corrected through prior period adjustments restating results so that financial information is dependable and comparable.

ϖ Ind AS 38 provides rules for recognition and measurement of intangible assets like patents, trademarks, software etc. Intangible asset has to be identifiable, controllable and measurable. Finite-life assets are amortized, and intangible indefinite-life assets are tested for impairment on an annual basis.

ϖ Ind AS 115 introduces a five-step revenue model of contract identification, performance obligations, transaction price determination, allocation and recognition of revenue. It is effective for all customer contracts except leases, insurance contracts and financial instruments.

ϖ The financial instruments are governed by Ind AS 109 with classification as amortized cost, FVOCI or FVTPL. It passes the ECL (Expected Credit Loss) model for impairments. Hedge accounting links financial reporting to an entity’s risk management activities.

ϖ Ind AS 116 removes the difference between operating and finance leases for lessee. The ROU model results in lease liabilities and corresponding ROU assets on the balance sheet. Rental expenses turn into depreciation and interest: affecting EBITDA.

ϖ Ind AS 40 applies to property (including a part of a property), land and/or building, whether it is investment property or owner-occupied property. Recognition at inception is at cost, while subsequent measurement are in accordance with the cost model. Transfer between investment property and other asset categories is made at the carrying amount.

9.11 Key Terms

Financial Elements: The coordinated data that results in a financial statement (Balance Sheet, Profit & Loss, Cash Flow Statement) SOCIE related activities and reports).

and Notes) that describe an entity’s financial position, performance, and cash flows.

Going Concern Concept: The concept that an entity will operate in the foreseeable future without the necessity or intention of liquidation or discontinuation.

Accrual Basis of Reporting: A type of accounting which recognizes revenues and expenses at the time they are earned or incurred, instead of when cash is received or paid.

Materiality Concept: Financial data is material if, in case of omission or misstatement, it would affect the economic decisions of the users.

Fair Value: The price that would be received to sell an asset or paid to transfer a liability in an (1) orderly transaction between market participants.

Amortization: The systematic writing off of a tangible asset's cost over its useful life to reflect natural wear and tear.

Amortization: The decline in value of an intangible asset over time, much like depreciation.

but is used to refer to non-physical possessions such as patents or trade marks.

Impairment of Assets: When the recoverable amount of an asset falls below its carrying value, full text

that have resulted in a significant increase in impairment

Revenue Recognition (Ind AS 115): Revenue is recognized when an entity transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Expected Credit Loss (ECL) Model (Ind AS 109): The forward looking model that is employed to recognise impairment losses on the financial assets based on the expected risk of a default occurring.

Right-of-Use (ROU) Asset (Ind AS 116): An asset used to recognise a lessee's right to use an asset for the lease term appended in class_XII_Accountancy_PART_B[52]-3.indd its balance sheet.

The period of the lease is stated on the balance sheet.

Lease Liability (Ind AS 116): A liability of a lessee that he recognizes for the lease payments payable over the lease term, at an amount equal to the present value of future lease payments.

Investment Property (Ind AS 40): All other property that is held to earn rentals or for capital appreciation rather than for use in the production or supply of goods and services or for administrative purposes.

Net Realizable Value (NRV) (Ind AS 2): the estimated selling price in the ordinary course of business, less the estimated costs to completion and the estimated costs necessary to make the sale.

Revaluation Model (Ind AS 16 & Ind AS 38): It is a model to provide upward revaluation of assets such that they are fair valued on the balance sheet as compared to their historical cost and periodic changes go through statement of Other Comprehensive Income (OCI).

9.12 Descriptive Questions

What are Ind AS and what is their significance to financial reporting ensuring comparability between entities?

Highlight the main differences between Ind AS and IFRS. How does Ind AS address the Indian regulatory needs?

What are the fundamental elements of financial statements based on Ind AS 1?

Discuss the concept of “Going Concern” and its relevance to preparation and presentation of financial statements as per Ind AS 1.

How does Ind AS 1 provides consistency in financial reporting across periods?

Describe the cost formulas in Ind AS 2 that are allowed for the valuation of inventories. Why LIFO is not permitted?

What is the Net Realizable Value (NRV) in inventory valuation and how it has been companylculated under Ind AS 2?

Explain the accounting treatment of abnormal losses and borrowing costs in the valuation of inventories as per Ind AS 2.

What is the recognition criteria of PPE in Ind AS 16?

Discuss the two post measurement mo dels for PPE under Ind AS 16. What are the implications of the revaluation model on financial statements?

How would depreciation on PPE be recorded and what are the factors that may determine the method of depreciation?

What is the difference between an accounting policy and an accounting estimate in terms of Ind AS 8? Provide an example of each.

How should en entity account for and disclose material errors found in the previous financial statements as per Ind AS 8?

What are the recognition criteria for an asset Intangible as per Ind AS 38? Give one example of asset that fulfills the requirement, and one which doesn't.

How does Ind AS 38 differentiate between finite and indefinite-life intangible assets? How do you treat them?

Discuss how impairment of intangible assets is treated as per Ind AS 38.

Explain the five step model for revenue recognition as per Ind AS 115. Give a company that could use this model as an example.

How are changes in contract accounted for under Ind AS 115?

Describe the three categories of financial assets as per Ind AS 109 and their measurement.

What is the difference between Ind AS 109's ECL model and Incurred Loss Model under previous financial reporting practices?

9.13 References

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Answers to Knowledge Check

Knowledge Check 1

1: B) Property under construction intended to be an investment property

9.14 Case Study

Ind AS Standards: Implementation and Its Challenges

XYZ Ltd. is a mid-sized manufacturing company which follows the Indian Accounting Standards for its financial statements XYZ LTD Income Statement For the year ended 2020 Particulars Amount Total revenue generated during the prior year 2,00,000 Suppose cost of goods sold (COGS) 1,20,000 Costing formula As per the questions vegetables costing are included at their standard cost means actual cost also it is

normally taken as such = Production Expense + Beginning Work in Process − Ending Work in Process Economic Order Quantity Example Let us consider you own a handmade chocolate business(unit). The company had been through a financial restructuring recently and has had several accounting issues post adoption of the various Ind-AS standards. The CFO of the company has three critical accounting issues, which need to be resolved immediately to meet Ind AS and maintain financial integrity.

Problem 1: Recognition of Revenue under Ind AS 115

XYZ Ltd signed an agreement with a customer to provide a machines and repair services for ₹10

crores. The contract includes:

Supply of machinery (₹8 crores) within 3 months. MRO maintenance (₹2 cr for 2 years).

How XYZ Ltd should account for the revenue as per Ind AS 115: Revenue from Contracts with Customers?

Solution:

2) Identify the Contract – The contract is enforceable in terms of Ind AS 115. Step 2: Identify the performance obligations – Only two obligations are present:

Delivery of machinery (Point-in-time recognition). Maintenance services (Over-time recognition).

Step 3: Calculate the Transaction Price – It is ₹10 crores Important Observation: The total transaction price may actually have Value-added Tax and Service Charges in addition to the actual agreed price of supply.

Step 4: Allocate the transaction price Machinery ₹8 crores Maintenance ₹2 crores

Step 5: Recognize revenue:

Rs 8 crore worth of machinery being handed over as revenue".

₹2 crores recognized over a 2 year period on a straight-line basis.

Question 2: Accounting for Lease under Ind AS 116

The factory is leased by XYZ Ltd. from a land owner for 10 years and pays an annual rent of ₹1 crore. The agreement

is capitalized under Ind AS 116.

What is the accounting treatment for the lease in XYZ Ltd company's financial statements?

Solution:

Recognize:

Identify Right-of-Use (ROU) Asset and Lease Liability.

Determine the INS of lease payments, applying a discount rate (for ex., 8%).

ROU Asset on the balance sheet. Lease Liability at the PV of

Amortize the ROU asset to expense over 10 years.

Interest on lease liability to be recognized in P&L.

Problem 3: Valuation of Inventory as per Ind AS 2

At the beginning of year, raw material was ₹50 lakhs for XYZ Ltd. The NRV of the inventory was reduced to Rs.

How would you account for the inventory in financial statements of XYZ Ltd.?

Solution:

*According to Ind AS 2, inventory will be measured at the lower of cost or NRV.

lakhs).

• The company needs to write this inventory off by ₹10 lakhs and expense it in?

P&L. A write-back is allowed in case if NRV increases in the future.

Reflective Questions

How does deferred service revenue work as opposed to recognized upon the execution of a contract?

Where is Ind AS 115 better and more improved in the case of revenue recognition compared to the previous standards?

Why you need to capitalise leases under Ind AS 116 and not treat them as rent expenses?

How does leverage capitalization affect EBITDA and financial metrics?

Why isn't inventory immediately written down when NRV had decrease, even if company hasn't sold the inventory yet?

Q86 How is fair valuation of inventory achieved under Ind AS 2 and how it prohibits manipulation of earnings?

What occurs if NRV rises following a write-down of inventory? Will the company be able to recover from that loss?

What are the risks for companies in selecting a discount rate for lease liabilities?

How does the classify leases as an asset/liability impact a company's financial statements?