



23BAT605-FINANCIAL STATEMENT ANALYSIS

Accounting-Overview

Over the centuries, accounting has remained confined to the financial record-keeping functions of the accountant. But, today's rapidly changing business environment has forced the accountants to reassess their roles and functions both within the organisation and the society. The role of an accountant has now shifted from that of a mere recorder of transactions to that of the member providing relevant information to the decision-making team. Broadly speaking, accounting today is much more than just bookkeeping and the preparation of financial reports. Accountants are now capable of working in exciting new growth areas such as: forensic accounting (solving crimes such as computer hacking and the theft of large amounts of money on the internet); ecommerce (designing web-based payment system); financial planning, environmental accounting, etc. This realisation came due to the fact that accounting is capable of providing the kind of information that managers and other interested persons need in order to make better decisions. This aspect of accounting gradually assumed so much importance that it has now been raised to the level of an information system. As an information system, it collects data and communicates economic information about the organisation to a wide variety of users whose decisions and actions are related to its performance. This introductory chapter therefore, deals with the nature, need and scope of accounting in this context.

Need and Importance of Accounting

When a person starts a business, whether large or small, his main aim is to earn profit. He receives money from certain sources like sale of goods, interest on bank deposits etc. He has to spend money on certain items like purchase of goods, salary, rent, etc. These activities take place during the normal course of his business. He would naturally be anxious at the year end, to know the progress of his business. Business transactions are numerous, that it is not possible to recall his memory as to how the money had been earned and spent. At the same time, if he had noted down his incomes and expenditures, he can readily get the required information. Hence, the details of the business transactions have to be recorded in a clear and systematic manner to get answers easily and accurately for the following questions at any time he likes.

- i. What has happened to his investment?
- ii. What is the result of the business transactions?
- iii. What are the earnings and expenses?
- iv. How much amount is receivable from customers to whom goods have been sold on credit?
- v. How much amount is payable to suppliers on account of credit purchases?
- vi. What are the nature and value of assets possessed by the business concern?
- vii. What are the nature and value of liabilities of the business concern?

Meaning

Accounting is a means of communicating the results of business operations to various parties interested in or connected with the business viz., the owners, creditors, investors, banks and financial institutions, Government and other agencies. Hence, it is rightly called as the language of business.

Definition

The American Institute of Certified Public Accountants has defined accounting as “the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are, in part at least, of financial character, and interpreting the results thereof.”

Objectives of accounting

The main objectives of accounting are

- i. to maintain accounting records.
- ii. to calculate the result of operations.
- iii. to ascertain the financial position.
- iv. to communicate the information to users.

Process

The process of accounting as per the above definition is given below:

In order to accomplish its main objective of communicating information to the users, accounting embraces the following functions.

- i. **Identifying:** Identifying the business transactions from the source documents.
- ii. **Recording:** The next function of accounting is to keep a systematic record of all business transactions, which are identified in an orderly manner, soon after their occurrence in the journal or subsidiary books.
- iii. **Classifying:** This is concerned with the classification of the recorded business transactions so as to group the transactions of similar type at one place. i.e., in ledger accounts. In order to verify the arithmetical accuracy of the accounts, trial balance is prepared.
- iv. **Summarising :** The classified information available from the trial balance are used to prepare profit and loss account and balance sheet in a manner useful to the users of accounting information.
- v. **Analysing:** It establishes the relationship between the items of the profit and loss account and the balance sheet. The purpose of analysing is to identify the financial strength and weakness of the business. It provides the basis for interpretation.
- vi. **Interpreting:** It is concerned with explaining the meaning and significance of the relationship so established by the analysis. Interpretation should be useful to the users, so as to enable them to take correct decisions.

vii. Communicating: The results obtained from the summarised, analysed and interpreted information are communicated to the interested parties

Users of Accounting Information

The basic objective of accounting is to provide information which is useful for persons and groups inside and outside the organization.

I. Internal users: Internal users are those individuals or groups who are within the organisation like owners, management, employees and trade unions.

- Owners: To know the profitability and financial soundness of the business.
- Management: To take prompt decisions to manage the business efficiently.
- Employees and Trade unions: To form judgement about the earning capacity of the business since their remuneration and bonus depend on it.

II. External users: External users are those individuals or groups who are outside the organisation like creditors, investors, banks and other lending institutions, present and potential investors, Government, tax authorities, regulatory agencies and researchers.

- Creditors, banks and other: To determine whether the principal and lending institutions the interest thereof will be paid in when due.
- Present investors: To know the position, progress and prosperity of the business in order to ensure the safety of their investment.
- Potential investors: To decide whether to invest in the business or not.
- Government and Tax :To know the earnings in order to assess authorities the tax liabilities of the business.
- Regulatory agencies: To evaluate the business operation under the regulatory legislation.
- Researchers: To use in their research work.

Branches of Accounting

The economic development and technological advancements have resulted in an increase in the scale of operations and the advent of the company form of business organisation. This has made the management function more and more complex and increased the importance of accounting information. This gave rise to special branches of accounting. These are briefly explained below:

1. Financial accounting : The purpose of this branch of accounting is to keep a record of all financial transactions so that:

- (a) the profit earned or loss sustained by the business during an accounting period can be worked out,
- (b) the financial position of the business as at the end of the accounting period can be ascertained, and

(c) the financial information required by the management and other interested parties can be provided.

2. Cost Accounting : The purpose of cost accounting is to analyse the expenditure so as to ascertain the cost of various products manufactured by the firm and fix the prices. It also helps in controlling the costs and providing necessary costing information to management for decision-making.

3. Management Accounting : The purpose of management accounting is to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions.

CONCEPTUAL FRAME WORK OF ACCOUNTING

I. Basic Assumptions

The basic assumptions of accounting are like the foundation pillars on which the structure of accounting is based. The four basic assumptions are as follows:

i. Accounting Entity Assumption

According to this assumption, business is treated as a unit or entity apart from its owners, creditors and others. In other words, the proprietor of a business concern is always considered to be separate and distinct from the business which he controls. All the business transactions are recorded in the books of accounts from the view point of the business. Even the proprietor is treated as a creditor to the extent of his capital.

ii. Money Measurement Assumption

In accounting, only those business transactions and events which are of financial nature are recorded. For example, when Sales Manager is not on good terms with Production Manager, the business is bound to suffer. This fact will not be recorded, because it cannot be measured in terms of money.

iii. Accounting Period Assumption

The users of financial statements need periodical reports to know the operational result and the financial position of the business concern. Hence it becomes necessary to close the accounts at regular intervals. Usually a period of 365 days or 52 weeks or 1 year is considered as

the accounting period.

iv. Going Concern Assumption

As per this assumption, the business will exist for a long period and transactions are recorded from this point of view. There is neither the intention nor the necessity to wind up the business in the foreseeable future.

II. Basic Concepts of Accounting

These concepts guide how business transactions are reported. On the basis of the above four assumptions the following concepts (principles) of accounting have been developed.

i. Dual Aspect Concept

Dual aspect principle is the basis for Double Entry System of book-keeping. All business transactions recorded in accounts have two aspects - receiving benefit and giving benefit. For example, when a business acquires an asset (receiving of benefit) it must pay cash (giving of benefit).

ii. Revenue Realisation Concept

According to this concept, revenue is considered as the income earned on the date when it is realised. Unearned or unrealised revenue should not be taken into account. The realisation concept is vital for determining income pertaining to an accounting period. It avoids the possibility of inflating incomes and profits.

iii. Historical Cost Concept

Under this concept, assets are recorded at the price paid to acquire them and this cost is the basis for all subsequent accounting for the asset. For example, if a piece of land is purchased for Rs.5,00,000 and its market value is Rs.8,00,000 at the time of preparing final accounts the land value is recorded only for Rs.5,00,000. Thus, the balance sheet does not indicate the price at which the asset could be sold for.

iv. Matching Concept

Matching the revenues earned during an accounting period with the cost associated with the period to ascertain the result of the business concern is called the matching concept. It is the basis for finding accurate profit for a period which can be safely distributed to the owners.

v. Full Disclosure Concept

Accounting statements should disclose fully and completely all the significant information. Based on this, decisions can be taken by various interested parties. It involves proper classification and explanations of accounting information which are published in the financial statements.

vi. Verifiable and Objective Evidence Concept

This principle requires that each recorded business transactions in the books of accounts should have an adequate evidence to support it. For example, cash receipt for payments made. The documentary evidence of transactions should be free from any bias. As accounting records are based on documentary evidence which are capable of verification, it is universally acceptable.

III. Modifying Principles

To make the accounting information useful to various interested parties, the basic assumptions and concepts discussed earlier have been modified. These modifying principles are as under.

i. Cost Benefit Principle

This modifying principle states that the cost of applying a principle should not be more than the benefit derived from it. If the cost is more than the benefit then that principle should be modified.

ii. Materiality Principle

The materiality principle requires all relatively relevant information should be disclosed in the financial statements. Unimportant and immaterial information are either left out or merged with other items.

iii. Consistency Principle

The aim of consistency principle is to preserve the comparability of financial statements. The rules, practices, concepts and principles used in accounting should be continuously observed and applied year after year. Comparisons of financial results of the business among different accounting period can be significant and meaningful only when consistent practices were followed in ascertaining them. For example, depreciation of assets can be provided under different methods, whichever method is followed, it should be followed regularly.

iv. Prudence (Conservatism) Principle

Prudence principle takes into consideration all prospective losses but leaves all prospective profits. The essence of this principle is “anticipate no profit and provide for all possible losses”. For example, while valuing stock in trade, market price or cost price whichever is less is considered.