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Sub : Financial Accounting

Q1) Ans)

Financial Statement Analysis :-

"Financial Statement analysis is the process of analyzing a company's financial statements for decision-making purposes".

External stakeholders use it to understand the overall health of an organization as well as to evaluate financial performance and business value.

Internal constituents use it as a monitoring tool for managing the finances.

Tools of Financial Analysis :-

Financial statements are prepared to have complete information regarding assets,

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liabilities, equity, reserves, expenses and profit and loss of an enterprise.

To analyze and interpret the financial statements, commonly used tools are :

1) Comparative statements,
2) Common size statements,
3) Trend analysis,
4) Ratio analysis,
5) Cash Flow Analysis,
6) Average Analysis,
7) Statement of changes in working capital
8) Fund Flow Analysis
9) Cost Volume Profit Analysis

Comparative statements :-

It is also known as "**horizontal analysis**". These are statements showing financial position and profitability at different periods of time. These statements give an idea of the enterprise financial position of two or more periods. Comparison of financial statements is possible only when same accounting principles are used in preparing these statements.

Comparative Balance Sheet:

The progress of the company can be seen by observing the different assets and liabilities of the firm on different dates to make

the comparison of balances from one date to another. To understand the compar-ative balance sheet, it must have two columns for the data of original balance sheets. A third column is used to show increase/decrease in figures. The fourth column gives percentages of increases or decreases.

By comparing the balance sheets of different dates, one can observe the following aspects

Current financial position and Liquidity position
Long-term financial position
Profitability of the concern

Comparative Income Statement:

It is traditionally known as trading and profit and loss A/c. Net sales, cost of goods sold, selling expenses, office expenses etc are important components of an income statement. To compare the profitability, particulars of profit and loss are compared with the corresponding figures of previous years individually. To analyze the profitability of the business, the changes in money value and percentage is determined.

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By comparing the profits of different dates, one can observe the following aspects:

The increase/decrease in gross profit
The study of operational profits
The increase or decrease in net profit
Study of the overall profitability of the business.

Common Size Statements :-

Common size statements are also known as 'Vertical analysis' Financial statements, when read with absolute figures can be misleading. Therefore, a vertical analysis of financial information is done by considering the percentage form. The balance sheet items are compared:

- to the total incomes in terms of percentage by taking the total incomes as 100.
- to the total expenses in terms of percentage by taking the total expenses as 100.

Therefore the whole Profit and loss account is converted into percentage form. And such converted profit and loss account is known as Common-Size Profit and Loss account. As the members are brought

to a common base, the percentage can be easily compared with the results of corresponding percentages of the previous year or of some other firm.

Trend Analysis :-

Also known as the Pyramid Method. Studying the operational results and financial position over a series of years is trend analysis. Calculations of ratios of different items for various periods is done and then compared under this analysis. Whether the enterprise is trending upward or backward, the analysis of the ratios over a period of year is done. By observing this analysis, the sign of good or poor management is detected.

Ratio Analysis :-

Quantitative analysis of information contained in a company's financial statements is ratio analysis. It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. To assess the profitability, solvency, and efficiency of a business, management

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can go through the technique of ratio analysis. It is an attempt at developing a meaningful relationship between individual items in the balance sheet or profit and loss account.

Cash Flow Analysis :-

The actual movement of cash into and out of a business is cash flow analysis. The flow of cash into the business is called the **cash inflow**. Similarly, the flow of cash out of the firm is called **cash outflow**. The difference between the inflow and outflow of cash is the **net cash flow**.

Cash flow statement is prepared to project the manner in which the cash has been received and has been utilized during an accounting year. It is an important analytical tool. Analysis of cash flow explains the reason for a change in cash. It helps in assessing the liquidity of the enterprise and in evaluating the operating, investment and financing decisions.

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Average Analysis:

Whenever, the trend ratio are calculated for a business concern, such ratios are compared with industry average. These both trends can be presented on the graph paper also in the shape of curves. This presentation of facts in the shape pictures makes the analysis and comparison more comprehensive and impressive.

Statement of Changes in Working Capital:

The extent of increase or decrease of working capital is identified by preparing the statement of changes in working capital. The amount of net working capital is calculated by subtracting the sum of current liabilities from the sum of current ~~tibilities from the sum of current~~ assets. It does not detail the reasons for changes in working capital.

Fund Flow Analysis:

Fund flow analysis deals with detailed sources and application of funds of the business concern for a specific period.

Cost Volume Profit analysis:

It discloses the prevailing relationship among

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sales, cost and profit.

Liquidity Analysis :-

The liquidity ~~analysis~~ of a firm measured by the ability to satisfy short-term obligation as they come due- Liquidity refers to solvency of firm's overall financial position - the ease with which it can pay bills. A common precursor to financial distress and bankruptcy is low or declining liquidity, these ratios are viewed as good leading indicators of cash flow problems.

Formulae :

1) Current Ratio :-

It measures the financial strength of the company- Generally 2:1 is treated as the ideal ratio.

$$\text{Current Ratio} = \frac{\text{Current Asset}}{\text{Current liability}}$$

where current asset = stock, debtor, cash, and bank, receivables, loans etc.

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Current liability = Creditor, short-term loan, bank overdraft, outstanding expense etc.

⟹ The higher the current ratio, the more liquid the firm is considered to be.

2) Quick (Acid-Test) Ratio :

This ratio is the best measure of the liquidity in the company - This ratio is more conservative than the current ratio. The quick asset is computed by adjusting current assets to eliminate those assets which are not in cash. Generally, 1:1 is treated as an ideal ratio

$$\text{Quick Ratio} = \frac{\text{Current Asset} - \text{Inventory}}{\text{Current liabilities}}$$

The quick ratio provides better measurement of overall liquidity only when firm's inventory cannot be easily converted into cash.

Activity Ratios :-

It measures the speed with which various accounts are converted into sales or cash - inflows or outflows. Measures

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of liquidity are generally inadequate because differences in composition of a firm's current assets and current liabilities can affect its 'true' liquidity.

1) Inventory Turnover:

It commonly measures the activity or liquidity of firm's inventory.

$$\text{Inventory turnover} = \frac{\text{Cost of Goods Sold}}{\text{Inventory}}$$

A low inventory turnover ratio is a sign that inventory is moving slowly and typing up capital. A company with high inventory turnover can be moving inventory in rapid pace. However if inventory turnover is too high, it can lead to shortages and lost sales.

2) Average Collection Period:

The average collection period, or average age of account receivable, is useful in evaluating credit and collection policies.

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- Average collection period = $\frac{\text{Accounts Receivable}}{\text{Avg. sales per day}}$

$$= \frac{\text{Account Receivable}}{\frac{\text{Annual Sale}}{360}}$$

3) Average Payment Period:

The average payment period or average age of a/c payables is calculated as:

Average payment period = $\frac{\text{Account Payable}}{\text{Average purchase per day}}$

$$= \frac{\text{Accounts payable}}{\frac{\text{Annual purchase}}{360}}$$

The average payment period calculation can reveal insight about company's cashflow and credit worthiness, exposing potential concerns.

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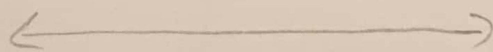
4) Total Asset Turnover :

It indicates the efficiency with which the firm uses its assets to generate sales. Total asset turnover is calculated as:

$$\text{Total asset turnover} = \frac{\text{Sales}}{\text{Total Asset}}$$

Higher the firm's total asset turnover, the more effeciently its assets have been used.



Q2) Ans

Partnership :-

The term partnership, is used to mean a business structure wherein two or more individuals, come together for undertaking a lawful business and have agreed to share the profits and losses.

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The partnership is the relation which subsists between individuals, who have decided to pool their money, to share profits and losses, in an agreed ratio. The members of a partnership are jointly called partnership firm and severally called partners.

Properties :-

Properties of partnership are :

1) Membership

At least two persons are required to begin a partnership while the maximum number of members is limited to 100. All individuals entering into partnership must be legally competent to do so, as they have to enter into a contract to become partners. Thus minors, insolvent and lunatic persons cannot become members, but a minor can be admitted to partnership, to share profits.

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2) Unlimited liability:

The members of a partnership have unlimited liability, i.e. they are collectively and individually liable for the firm's debts and obligations. So if in case business assets are not adequate to repay liabilities, personal assets of all or any partner can be claimed by the creditors to realise the outstanding amount.

3) Sharing of Profit & Loss :-

The main purpose of the partnership is to share profit in the agreed ratio. However in the absence of any agreement between partners, the business profits or losses are divided equally among all the partners.

4) Mutual Agency :-

The partnership business is undertaken by all the partners or any of the partner, who acts on behalf of all the partners. So, every partner is a principal as well as an

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agent. The acts of partners bind each other as well as the firm.

5) Voluntary Registration :-

The registration of partnership is not mandatory, but it is recommended, as it offers certain benefits, eg in case of any conflict among partners, any partner can file suit against other partner or if there is any dispute between firm and outside party, then also the firm can file a case against that party.

6) Continuity :-

There is a lack of continuity in partnership, like death, bankruptcy, retirement or insanity of any partner can lead the partnership to end. Although, if the remaining partners want to continue operations, they can do so by a fresh agreement.

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7) Contractual Relationship :-

The relation subsisting between partners is due to the contract, which may be oral, written or implied.

8) Transfer of interest :-

Mutual consent of all the partners is a must for transferring the interest in the firm to any external party.

In partnership, the decision making is done with the mutual consent of all partners.

They share among themselves the decision making and control of the regular business operation.

9) Admitting new partners :

Partners can be admitted into partnership by either purchasing an interest at the firm from a current partner or contributing assets to the business.

10) Liquidating a partnership:

When a partnership liquidity, the following occurs

1) Assets are sold
2) Creditors are paid
3) Cash is distributed to partners.

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Q3) Ans)

General Journal

Date	A/C Title and Explanation	Debit $	Credit $
Jan 2, 2017	Patent	840,000	
	Cash		840,000
	To record the purchase of goodwill		
April 1, 2017	Good will	450,000	
	Cash		450,000
	To record the purchase of good will		
July 1, 2017	Prepaid Franchise	330,000	
	Cash		330,000
	To record the purchase of franchise		
Sep 1, 2017	Research and Development	210,000	
	Cash		210,000
	To record Research and Development expenditure		

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Adjusting Enteries as of Dec 31, 2017 :-

Date	A/c Title and Explanation	Debit $	Credit $
Dec, 31, 2017	Patent Amortization Expense	120,000	
	Patent		120,000
	To record amortization expense on patent		
	$840,000 \times 1/7 = 120,000$		
Dec 31, 2017	No Entry	-	-
	Goodwill is not amortized		-
	Goodwill is tested for impairment each year.		
Dec 31, 2017	Franchise Fees	16,500	
	Prepaid Franchise		16,500
	$330,000 \times \frac{1}{10} \times \frac{6}{12} = 16,500$		
	To record franchise fees for six months July-Dec 2017		
Dec 31, 2017	No Entry	-	
	Research and Development cost is not amortized. The cost is expensed immediately.		-

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Q4.) Ans

(a) Straight line for 2017

Straight line Method:

Cost = $145,000

Salvage Value = $ 25,000

Useful Life = 5 yrs

$$\text{Depreciation Expense} = \frac{\text{Cost} - \text{Salvage value}}{\text{Useful Life}}$$

$$= \frac{\$145,000 - \$25,000}{5}$$

$$= \$24,000 \text{ per year}$$

$$\text{2017 depreciation} = \$24,000 \times \frac{3}{12} \text{ oct-dec}$$

$$= \$6000$$

(b) Units of activity for 2017:

Data: machine usage 3,400 hrs

Unit of Activity Method:

$$\text{Depreciation per unit} = \frac{\text{cost} - \text{salvage value}}{\text{Total Estimated production unit}}$$

$$= \frac{\$145,000 - \$25,000}{\$20,000}$$

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= $ 6 per hour

2017 depreciation = 3,400 hrs x $6

= $ 20,400

(c) Declining balance using double of straight-line rate for 2017 and 2018.

Declining Balance Method:

Straight-line depreciation rate $= \frac{1}{\text{useful life}}$

$= \frac{1}{5 \text{ years}}$

$= 0.2 = 20\%$

Double depreciation rate $= 0.2 \times 2$

$= 0.4$

$= 40\%$

2017 Depreciation $= \$145,000 \times \frac{3}{12} \times 40\%$

$= \$14,500$

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Book value January 1, 2018 = Cost − Acc. Depreciation
= \$145,000 − \$14,500
= \$130,500

2018 Depreciation = \$130,500 × 40%
= \$52,200

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