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BLOCK-2 UNDERSTANDING AND ANALYSIS OF FINANCIAL STATEMENTS

Sample Preview of the Solved Sample Question Papers

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QUESTION PAPER

June – 2024

(Solved)

ACCOUNTANCY AND FINANCIAL MANAGEMENT

MCS-225

Time: 3 Hours] *[Maximum Marks : 100*

Note: *: Attempt any **five** questions. All questions carry equal marks.*

Q. 1. M/s. Pankaj and Sons present you the following:

Balance Sheet as at 31st March, 2023

		₹
Equity Share Capital		**20,00,000**
10% Preference Share Capital		**4,00,000**
Reserve Fund		**16,00,000**
9% Debentures		**8,00,000**
Sundry Creditors		**12,00,000**
Profit and Loss A/c :		
2021-22	**40,000**	
2022-23	**8,00,000**	
		8,40,000
	Total	**68,40,000**

	₹
Fixed Assets	**35,00,000**
Investments	**10,00,000**
Stock	**12,00,000**
Sundry Debtors	**5,40,000**
Bank Balance	**2,80,000**
Preliminary Expenses	**3,20,000**
Total	**68,40,000**

The directors intend to transfer a sum of ₹ 2,00,000 out of the current year profits to provision for tax. You are required to calculate the following :

(i) **Current Ratio**

(ii) **Ratio of Fixed Assets to Net Worth**

(iii) **Ratio of Debt to Equity capital**

(iv) **Return on owner's Equity**

(v) **Return on Total Assets**

Ans. Data Provided

Balance Sheet as of 31st March, 2023

Liabilities:

- Equity Share Capital = ₹20,00,000
- 10% Preference Share Capital = ₹4,00,000
- Reserve Fund = ₹16,00,000
- 9% Debentures = ₹8,00,000
- Sundry Creditors = ₹12,00,000
- Profit and Loss Account (2021-22 + 2022-23) = ₹8,40,000
- Total Liabilities = ₹68,40,000

Assets:

- Fixed Assets = ₹35,00,000
- Investments = ₹10,00,000
- Stock = ₹12,00,000
- Sundry Debtors = ₹5,40,000
- Bank Balance = ₹2,80,000
- Preliminary Expenses = ₹3,20,000
- Total Assets = ₹68,40,000

Additional Information:

- Transfer to Provision for Tax = ₹2,00,000

(i) **Current Ratio**

Formula:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets:

Stock + Sundry Debtors + Bank Balance = ₹12,00,000 + ₹15,40,000 + ₹2,80,000 + ₹20,20,000

Current Liabilities:

Sundry Creditors = ₹12,00,000

$$\text{Current Ratio} = \frac{\text{₹}20,20,000}{\text{₹}12,00,000} = 1.68:1$$

(ii) **Ratio of Fixed Assets to Net Worth**

Formula:

$$\text{Fixed Assets to Net Worth Ratio} = \frac{\text{Fixed Assets}}{\text{Net Worth}}$$

Net Worth:

Equity Share Capital + Reserve Fund + P&L Account (2022-23) = ₹20,00,000 + ₹16,00,000 + ₹8,00,000 = ₹44,00,000

$$\text{Fixed Assets to Net Worth Ratio} = \frac{\text{₹}35,00,000}{\text{₹}44,00,000}$$

= 0.80:1

***(iii)* Ratio of Debt to Equity Capital**

Formula:

$$\text{Debt to Equity Capital Ratio} = \frac{\text{Total Debt}}{\text{Equity Share Capital}}$$

Total Debt:

9% Debentures + Sundry Creditors = ₹8,00,000 + ₹12,00,000 = ₹20,00,000

Equity Share Capital = ₹20,00,000

$$\text{Debt to Equity Capital Ratio} = \frac{20,00,000}{20,00,000} = 1:1$$

(iv) Return on Owner's Equity

Formula:

Return on Owner's Equity

$$= \frac{\text{Net Profit after Tax}}{\text{Owner's Equity}} \times 100$$

Net Profit after Tax:

P&L Account (2022-23) – Provision for Tax = ₹8,00,000 – ₹2,00,000 = ₹6,00,000

Owner's Equity (Net Worth):

₹ 44,00,000

Return on Owner's Equity

$$= \frac{₹\,6,00,000}{₹\,44,00,000} \times 100 = 1364\%$$

***(v)* Return on Total Assets**

Formula:

Return on Total Assets

$$= \frac{\text{Net Profit after Tax}}{\text{Total Assets}} \times 100$$

Total Assets:

₹68,40,000

$$\textbf{Return on Total Assets} = \frac{₹6,00,000}{₹68,40,000} \times 100$$

= 8.77%.

Q. 2. What do you mean by 'Funds Flow Statement'? Explain its importance to the management. Discuss in detail the procedure for construction of funds flow analysis.

Ans. Ref.: See Chapter-5, Page No. 62-63, 'SCFP–(Working Capital Basis): Fund Flow Statement' and 'Construction of Funds Flow Statement' and Page No. 65-66, 'Construction of Cash Flow Statement, Uses or Objects of Cash Flow Analysis'.

Q. 3. What is Balance Sheet? Explain the main contents of balance sheet and give its proforma.

Ans. Ref.: See Chapter-4, Page No. 48-49, 'Balance Sheet' and 'Constructing a Balance Sheet', Page No. 55, Q. No. 6.

Q. 4. What is the need for analysis and interpretation of financial statements? Who are the main users of such analysis and interpretation? Also state its limitations.

Ans. Need for Analysis and Interpretation of Financial Statements

Analysis and interpretation of financial statements are essential to evaluate an organization's financial health, operational efficiency, and long-term sustainability. Here's why it is needed:

- **Performance Evaluation:** To assess the profitability, liquidity, solvency, and efficiency of a business over a specific period.
- **Decision-Making:** Helps stakeholders make informed decisions regarding investments, lending, and management strategies.
- **Trend Analysis:** Identifies trends over time to predict future performance and plan accordingly.
- **Compliance and Governance:** Ensures the business is adhering to legal, regulatory, and accounting standards.
- **Risk Assessment:** Evaluates potential financial risks and vulnerabilities to mitigate potential setbacks.
- **Comparison:** Facilitates comparisons with industry benchmarks or competitors to determine relative performance.
- **Resource Allocation:** Aids in efficient allocation of resources based on the organization's needs and financial status.

Main Users of Financial Statement Analysis

- **Investors and Shareholders:** To assess the profitability and growth potential of the business for making investment decisions.
- **Creditors and Lenders:** To evaluate the company's creditworthiness and ability to repay loans.
- **Management:** To strategize business operations, optimize costs, and improve efficiency.
- **Employees and Unions:** To understand the financial stability of the company for wage negotiations and job security.
- **Government and Regulators:** To ensure compliance with tax laws and regulations.
- **Suppliers:** To evaluate the company's financial health before extending credit or entering into contracts.
- **Customers:** To assess the long-term viability of the company as a reliable supplier or service provider.

Limitations of Financial Statement Analysis

- **Historical Nature:** Financial statements provide past data, which may not always reflect current or future conditions.
- **Lack of Qualitative Information:** They focus on quantitative data and often overlook qualitative factors like brand value, customer satisfaction, or market trends.

Sample Preview
of
The Chapter

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ACCOUNTANCY AND FINANCIAL MANAGEMENT

Accounting and Its Functions

1

INTRODUCTION

Accounting is frequently referred to as the business language. Any language's primary purpose is to facilitate communication. The goal of accounting in this situation is to convey, or report, the outcomes of business operations and all of its varied facets. Although there are many different ways to define accounting. Accounting is the art of recording, classifying, and summarizing in a meaningful way and in terms of money, transactions, and occurrences that are, at least in part, of a financial character, and evaluating the outcomes thereof, according to one generally accepted definition.

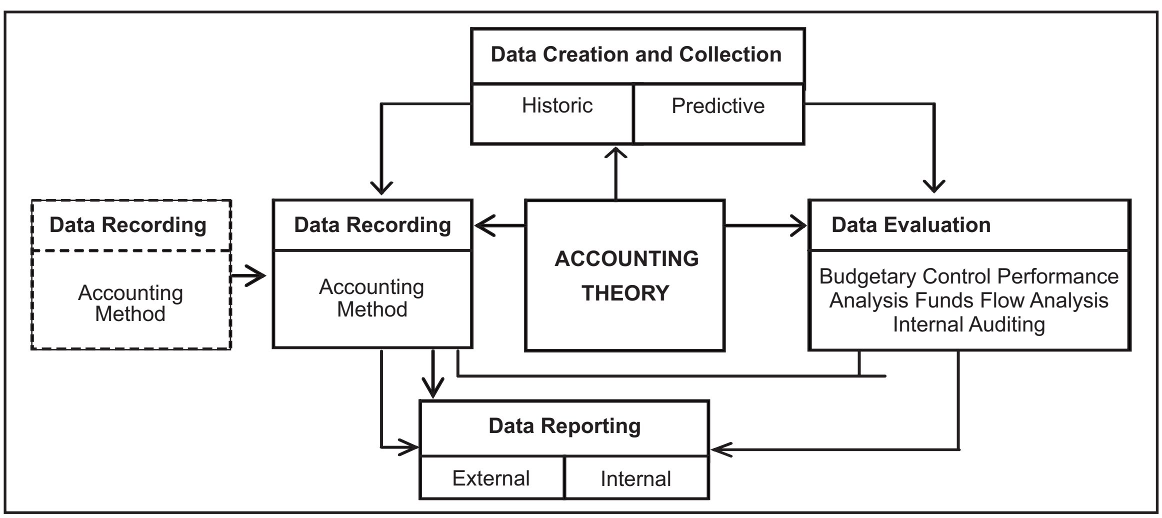
CHAPTER AT A GLANCE

THE SCOPE OF ACCOUNTING

A diagrammatic representation of the accounting industry's reach is possible, as seen in the diagram.

Data Creation and Collection: The area that supplies the necessary inputs for the accounting system is data creation and collecting. The data is 'historic' in the sense that it refers to transactions that have already happened and is related to economic and financial transactions. Earlier, accounting tended to focus more on what had already happened rather than attempting to foresee and plan for the future.

The historical data is recorded in line with generally accepted accounting theory after being gathered and connected to distinct transactions. All transactions and occurrences must be recorded in the original entry books (journals) and ledgers in accordance with the predetermined classification scheme. A significant portion of all accounting work is often devoted to recording and processing data. In accounting, this type of work may be referred to as recordative.



Scope of Accounting

Data Evaluation: These days, data evaluation is thought to be the most crucial accounting task. Analysis of data includes analyzing accounting information for decision-making purposes by selecting between alternative courses of action, evaluating business performance, analyzing the flow of funds, and controlling business activities with the help of budgets and standard costs (budgetary control).

Accounting's Analytical and Interpreting: Its work can range from quick fixes to sophisticated reports created after thorough investigation, and it can be done for internal or external purposes. Research-based reports are frequently produced as a result of capital project analysis, financial predictions, budgetary estimates, and analysis for reorganization, takeover, or merger.

Data Reporting: There are two components to data reporting: internal and external. The term "external reporting" refers to the dissemination of financial information (i.e., earnings, financial situation, and funds position) about a company to third parties, such as shareholders, governmental organizations, and regulatory bodies. Internal reporting is the process of communicating to management for decision-making the findings of financial analysis and review.

THE EMERGING ROLE OF ACCOUNTING

The evolution of accounting over time may be seen in its history as a result of shifting socioeconomic situations and expanding applications of accounting.

Four distinct stages in the development of accounting can be identified in the current setting.

Forensic Accounting: Investigating accounting records, financial statements, and other relevant financial records is the practice of forensic accounting. The investigation's findings are mostly used in court and to settle disputes. Technical expertise in accounting, investigation, and law are needed for this position. The probe includes a variety of topics, including fraud, criminal activity, insurance claims, and shareholder issues. The following steps are included in forensic accounting:

(i) **Investigation:** If there are existing allegations of fraud, forensic accountants will normally launch an inquiry and gather evidence. As a result, when conducting an investigation, they seek for information that may contain red flags and disparities that suggest fraud has occurred.

(ii) **Reporting:** Professionals in forensic accounting deliver a summary of their findings to the required persons after gathering information and data and building a case.

(iii) **Litigation:** Participation as an expert witness in the legal proceeding arising from the occurrence is the last stage of a forensic accountant's process. The expert testifies against the criminals and provides their conclusions as evidence in court.

Carbon Accounting: Making measurements of GHG emissions that can be independently verified and supported by science is known as carbon accounting. An major factor in the global carbon balance is forests. A crucial first step towards a more accurate representation of forests in climate change policy at the regional, national, and global levels is to account for the carbon contained in forest ecosystems and changes in carbon stocks brought on by human activity.

Stewardship Accounting

Rich individuals used to hire 'stewards' to look after their property in earlier periods of history. Periodically, these stewards provided their owners with a report of their stewardship. This idea is still at the heart of financial reporting today, which essentially entails the meticulous documenting of commercial transactions, or "book-keeping." Indeed, the practises used by merchants in Italy throughout the 15th century are where the principles and practises of accounting that are used today for the methodical recording of economic transactions originated. During the 19th century, several European nations adopted the Italian system, which especially became known as "double entry book-keeping."

Financial Accounting

The emergence of the joint stock company and the growth of large-scale commerce are responsible for the development of financial accounting. This type of business allows the general public to contribute capital in exchange for shares of the company's assets and profits. With this type of corporate structure, a member's responsibility is restricted to the nominal value of their shares. This means that a shareholder's liability for the financial obligations of the firm is constrained to the price he agreed to pay for the shares he purchased. Financial accounting statements are significant because society needs to mobilize savings and direct them towards productive ventures.

Cost Accounting: The growth of accounting as a tool of industrial management was challenged by the industrial revolution in England. Costing methodologies were created to serve as a roadmap for management decisions. Cost accounting was developed as a result of business owners and industrial managers becoming more and more aware of the advantages of applying scientific management principles following the scientific management movement.

Management Accounting: The preparation and presentation of accounting and controlling information in a way that helps management formulate policies and make decisions on a variety of issues related to routine and/or non-routine business operations is the focus of management accounting. Managers receive the information they require for attaining the goals for which they are responsible through the methods of management accounting.

Social Responsibility Accounting: The emergence of social responsibility accounting, a new stage in accounting's evolution, can be attributed to the rise in social consciousness during the past 20 years or so. By taking into consideration both the social and economic implications of corporate decisions, social responsibility accounting broadens the accounting field.

Human Resource Accounting: Hermansson made the initial attempt in 1964, which eventually became known as Human Resource Accounting (HRA), to include data on human capital in the balance sheet. However, the knowledge economy's rise in the 1990s marked a significant socio-economic change towards the acknowledgement of human and intellectual capital as opposed to physical capital. A branch of accounting known as "human resource accounting" aims to highlight and disclose the significance of human resources, or informed, skilled, devoted, and committed workers, in a company's earnings process and overall assets.

Inflation Accounting: The adjustment in the value of assets (current and fixed) and of profit in light of changes in the price level is what inflation accounting is all about. In a sense, it deals with circumventing the constraints placed on financial statements by the cost assumption (recording assets at their historical or original cost) and the assumption of a stable monetary unit (both are covered in more detail in the following topic). Thus, it seeks to correct the biases in reported results brought on by changes in price level.

ACCOUNTING AS AN INFORMATION SYSTEM

Since accounting has all the characteristics of a system, it can be thought of as an information system in the context of social science. It has its raw data inputs, processes with workers and tools, and outputs with information reports. We can draw some significant conclusions if we think of accounting as an information system. The system's primary objective is to meet its users' informational needs. The nature and characteristics of the system's outputs can be specified if the needs of the users can be accurately identified. Second, the type of data chosen as inputs for conversion into information output depends on the output needs.

We will now briefly go through the information requirements of various accounting users.

Shareholders and Investors: Shareholders and other investors are interested in learning on a regular basis if the business is profitable, whether their investment is sound, and what its future growth prospects are because they have invested their money in it. Business accounting was initially created to give information to people who had invested money in commercial ventures.

Creditors: Long-term or short-term lenders can be creditors. Suppliers of supplies, products, or services are examples of short-term creditors. They are typically referred to as trade creditors. Long-term lenders are those who have extended credit for a considerable amount of time, frequently in the form of secured loans. The credit quality of the companies and their capacity to fulfill their financial commitments are the creditors' key areas of focus. They are therefore concerned with the firms' profitability, financial stability, and liquidity.

Employees: As a result of social developments, the idea that businesses exist to optimize shareholder returns has been changing. Today, the economic and social significance of management is seen from a wider perspective. There is no way to overstate the value of positive workplace interactions between management and employees.

Government: In a mixed economy, it is thought that it is the role of the government to steer economic activity in a direction that promotes the welfare of all. A mixed economy is defined by controls and regulations on how private sector businesses operate. Several government organizations gather data on numerous facets of corporate organizations' operations.

Management: Organizations may or may not exist solely for financial gain.

However, because the managerial processes, namely planning, organizing, and controlling, are the same, the information demands of the managers of both types of businesses are essentially the same. All of these roles have one thing in common: they are all involved with making decisions, each of which has unique information needs.

Consumers and Others: In order to evaluate the effectiveness and social role of the enterprises in different sectors of the economy, that is, what levels of profits and outputs are being achieved, in what way the social responsibility is being discharged, and in what manner growth is being planned by the enterprises, in accordance with the national priorities, accounting information is also of interest to consumer organizations, the media, welfare organizations, and the general public.

THE ROLE AND ACTIVITIES OF AN ACCOUNTANT

We can now define who an accountant is after talking about the scope of accounting and its evolving role. We have included some statements below that attempt to address this query:

(a) An accountant is either a person who keeps accounts or a functionary who assists in control.
(b) An accountant serves as an organization's conscience.
(c) An accountant is a specialist whose main responsibilities revolve around managing information for both internal and external use.
(d) A fiscal advisor is an accountant.
(e) An accountant creates an income statement and a balance sheet for a given accounting period and keeps track of any pertinent information that contributes to the final accounting statements, including classified data.
(f) An accountant audits, authenticates, and confirms an entity's financial statements.
(g) An accountant offers the data that managers need to make various managerial decisions.

A person who keeps accounts is defined in statement *(a)*. Statement *(f)* virtually exactly repeats the motion, but it expands his responsibility to include the creation of financial statements. These sentences imply employment that involves keeping score, and the individual doing this function is known as a financial accountant (or maintenance accountant).

The function an accountant can play in the decision-making and management control process is discussed in statement *(b)*.

Statement *(e)* emphasizes a limited, particular function of an accountant, notwithstanding its crucial importance. Due to India's significant tax incidence on business, tax planning is essential to fiscal management.

Statement *(g)* emphasizes the "audit," "watchdog," or "certification role" of the accountant who undertakes an external audit of accounts but is not an employee of a corporation.

The accountant is portrayed in Statement *(c)* as a conscience-keeper. He is seen as someone whose goal is to effectively safeguard and advance the employer's interests.

The definition of an accountant as a professional in statement *(d)* emphasizes his focus on information management for both internal and external usage (management accounting function and financial accounting function, respectively). We hope that our examination of accounting as an information system has helped you better understand this accountant's job.

ACCOUNTING PERSONNEL

Virtually every organization has an accountant on staff. The accountants can be roughly divided into two groups: those who work for the government and those who work for themselves. The public practice accountants provide their services for performing cost audits as well as financial audits. Accountants may work for different for-profit or nonprofit organizations to carry out a range of accounting and management control tasks. Higher level accountants typically belong to professional accounting bodies, although lower level accountants are not required to do so. Depending on their line of work, accounting chiefs in various organizations may also be referred to as financial officers, internal auditors, chief accounts officers, etc. In India, the title "controller" for the person in charge of accounting and finance is not often used, but it is starting to gain traction. There are controllers in a number of sizable enterprises, both in the public and commercial sectors. Let's learn more about these individuals and what they do.

Internal Auditor: In contrast to an external auditor, who is compensated for his services, an internal auditor is a member of staff in a company. A statutory audit is carried out by an external auditor, who is not an employee of the company. The internal auditor is in charge of carrying out monitoring tasks as well as other services including designing and running the internal control system, auditing the information provided to the company's directors, and supporting external auditors. Either the CEO or the audit committee of the Board of Directors receive direct reports from the head of the internal audit department.

Controller: This is the Chief Accountant's alternate moniker, and he or she typically oversees all aspects of accounting, including internal audit. He or she is ultimately in control of all tasks, including tax accounting, management accounting, cost accounting, and financial accounting. He or she has jurisdiction over both internal and external reporting accounting. Reports to regulatory and revenue-collecting government agencies, such as the Income Tax Department and the Company Law Board, are included in the external reports. He or she may also be in charge of the internal audit and control systems for the business.

The controller's duties can be listed as follows:

(a) Making financial statements and reporting
(b) Creating and running the accounting system
(c) Creating and upholding systems and practices
(d) Coordinating external audits and supervising internal audits
(e) Monitoring computer programmes
(f) Supervising cost management
(g) The creation of budgets
(h) Producing projections and reports with analysis
(i) Giving top management financial information
(j) Handling tax issues and making sure other legal requirements are met.

Treasurer: All of the company's cash and near-cash resources are held and managed by them. The treasurer oversees credit evaluations and establishes procedures for collecting receivables (debtors of the company who have purchased goods or services from the company credit). Additionally, s/he manages connections with banks and other lending or financing institutions.

Finance Officer: Business is fueled by finance. The two key components of financial management are acquiring financial resources and ensuring their wise application. Investment, financing, dividend, and working capital decisions are among the four key choices in financial management. Because it involves resource allocation, the investment decision may be the most crucial one. It is focused with the future, which is risky because it is unclear.

THE NATURE OF THE ACCOUNTING FUNCTION

A service function is accounting. The chief accounting executive, or whatever name he goes by, is a staff member, with the exception of his own department, where he is in charge. This runs counter to the functions performed by executives in production or marketing who have line authority. The accountant's job is primarily consultative in nature. He or she operates under the chief executive's authority. Line departments are not directly under the control of the accounting and/or finance department(s). The accounting executive, however, exercises what is known as the functional authority over all the accounting professionals deployed in different segments in a decentralized organization with a number of units and divisions.

The role of the accountant has two components. She serves as a watchdog for top managers while serving as a "helper" for middle and lower level