

ACCOUNTING TERMINOLOGY

- **1. Accounts receivable (AR)**
- **Accounts receivable (AR) definition:** The amount of money owed by customers or clients to a business after goods or services have been delivered and/or used.
- **2. Accounting (ACCG)**
- **Accounting (ACCG) definition:** A systematic way of recording and reporting financial transactions for a business or organization.

- **3. Accounts payable (AP)**
- **Accounts payable (AP) definition:** The amount of money a company owes creditors (suppliers, etc.) in return for goods and/or services they have delivered.
- **4. Assets (fixed and current) (FA, CA)**
- **Assets (fixed and current) definition: Current assets (CA)** are those that will be converted to cash within one year. Typically, this could be cash, inventory or accounts receivable. **Fixed assets (FA)** are long-term and will likely provide benefits to a company for more than one year, such as a real estate, land or major machinery.

- **5. Asset classes**

- **Asset class definition:** An asset class is a group of securities that behaves similarly in the marketplace. The three main asset classes are equities or stocks, fixed income or bonds, and cash equivalents or money market instruments.

- **6. Balance sheet (BS)**

- **Balance sheet (BS) definition:** A financial report that summarizes a company's assets (what it owns), liabilities (what it owes) and owner or shareholder equity, at a given time.

- **7. Capital (CAP)**

- **Capital (CAP) definition:** A financial asset or the value of a financial asset, such as cash or goods. Working capital is calculated by taking your current assets subtracted from current liabilities—basically the money or assets an organization can put to work.

- **8. Cash flow (CF)**

- **Cash flow (CF) definition:** The revenue or expense expected to be generated through business activities (sales, manufacturing, etc.) over a period of time.

- **9. Certified public accountant (CPA)**
- **Certified public accountant (CPA) definition:** A designation given to an accountant who has passed a standardized **CPA exam** and met government-mandated work experience and educational requirements to **become a CPA.**
- **10. Cost of goods sold (COGS)**
- **Cost of goods sold (COGS) definition:** The direct expenses related to producing the goods sold by a business. The formula for calculating this will depend on what is being produced, but as an example this may include the cost of the raw materials (parts) and the amount of employee labor used in production.

- **11. Credit (CR)**

- **Credit (CR) definition:** An accounting entry that may either *decrease* assets or *increase* liabilities and equity on the company's balance sheet, depending on the transaction. When using the **double-entry accounting method** there will be two recorded entries for every transaction: A credit and a debit.

- **12. Debit (DR)**

- **Debit (DR) definition:** An accounting entry where there is either an *increase* in assets or a *decrease* in liabilities on a company's balance sheet.

- **15. Expenses (fixed, variable, accrued, operation)**
- **Expenses (FE, VE, AE, OE) definition:** The fixed, variable, accrued or day-to-day costs that a business may incur through its operations.
- **Fixed expenses (FE):** payments like rent that will happen in a regularly scheduled cadence.
- **Variable expenses (VE):** expenses, like labor costs, that may change in a given time period.
- **Accrued expense (AE):** an incurred expense that hasn't been paid yet.
- **Operation expenses (OE):** business expenditures not directly associated with the production of goods or services—for example, advertising costs, property taxes or insurance expenditures.

- **16. Equity and owner's equity (OE)**
- **Equity and owner's equity (OE) definition:** In the most general sense, equity is assets minus liabilities. An owner's equity is typically explained in terms of the percentage of stock a person has ownership interest in the company. The owners of the stock are known as shareholders.
- **17. Insolvency**
- **Insolvency definition:** A state where an individual or organization can no longer meet financial obligations with lender(s) when their debts come due.

- **18. Generally accepted accounting principles (GAAP)**
- **Generally accepted accounting principles (GAAP) definition:** A set of rules and guidelines developed by the accounting industry for companies to follow when reporting financial data. Following these rules is especially critical for all publicly traded companies.
- **19. General ledger (GL)**
- **General ledger (GL) definition:** A complete record of the financial transactions over the life of a company.

JOURNAL

- An accounting journal is a detailed account of all the financial transactions of a business. It's also known as the book of original entry as it's the first place where transactions are recorded. The entries in an accounting journal are used to create the general ledger which is then used to create the financial statements of a business.
- Before computerized bookkeeping and accounting, the transactions were entered manually into a journal and then posted to the general ledger. Apart from the general journal, accountants maintained various other journals including purchases and sales journal, cash receipts journal and cash disbursements journal. With accounting software, today you're likely to find only a general journal in which adjusting entries and unique financial transactions are entered.

LEDGER

- An accounting ledger is an account or record used to store bookkeeping entries for balance-sheet and income-statement transactions. Accounting ledger journal entries can include accounts like cash, accounts receivable, investments, inventory, accounts payable, accrued expenses, and customer deposits. Accounting ledgers are maintained for all types of balance sheet and income statement transactions. Balance sheet ledgers include asset ledgers such as cash or accounts receivable. Income statement ledgers include ledgers such as revenue and expenses.
- The accounting ledger – sometimes called the general ledger (GL) – provides a centralized repository to collect all account data rolled up from subledgers or modules, making it the backbone of any corporate financial system.

Trial Balance

- A trial balance is a list of credit entries and debit entries that businesses use to internally audit their double-entry accounting systems. The goal is to confirm that the sum of all debits equals the sum of all credits and identify whether any entries have been recorded in the wrong account.
- In double-entry accounting, a credit to any account must be offset by a debit to another account. While general ledgers will list individual credit entries and debit entries for each transaction, a trial balance sums the credit balances and debit balances by account, calculating the total credit balance and debit balance at the bottom. If your general ledger is accurate, the debit balance will equal the credit balance.

Trading Account

- Trading account is used to determine the gross profit or gross loss of a business which results from trading activities. Trading activities are mostly related to the buying and selling activities involved in a business. Trading account is useful for businesses that are dealing in the trading business. This account helps them to easily determine the overall gross profit or gross loss of the business. The amount thus determined is an indicator of the efficiency of the business in buying and selling.
- The formulae for calculating gross profit is as follows:
- **Gross profit = Net sales – Cost of goods sold**
- Where
- **Net sales = Gross sales of the business minus sales returns, discounts and allowances.**

- The trading account considers only the direct expenses and direct revenues while calculating gross profit. This account is mainly prepared to understand the profit earned by the business on the purchase of goods.
- Items that are seen in the debit side include purchases, opening stock and direct expenses while credit side includes closing stock and sales.
- Closing entries for Gross Loss or Gross Profit
- The following entries are passed
- **In case of Gross Loss**
- Profit and Loss A/c Dr.
- To Trading A/c
- **In case of Gross Profit**
- Trading A/c Dr.
- To Profit and Loss A/c

Profit and Loss Account

A profit and loss statement (P&L), or income statement or statement of operations, is a financial report that provides a summary of a company's revenues, expenses, and profits/losses over a given period of time. The P&L statement shows a company's ability to generate sales, manage expenses, and create profits. It is prepared based on accounting principles that include revenue recognition, matching, and accruals, which makes it different from the cash flow statement.

- **Structure of the Profit and Loss Statement**

- A company's statement of profit and loss is portrayed over a period of time, typically a month, quarter, or fiscal year.
- The main categories that can be found on the P&L include:
 - Revenue (or Sales)
 - Cost of Goods Sold (or Cost of Sales)
 - Selling, General & Administrative (SG&A) Expenses
 - Marketing and Advertising
 - Technology/Research & Development
 - Interest Expense
 - Taxes
 - Net Income

BALANCE SHEET

- The balance sheet is one of the three fundamental financial statements and is key to both financial modeling and accounting. The balance sheet displays the company's total assets and how the assets are financed, either through either debt or equity. It can also be referred to as a statement of net worth or a statement of financial position. The balance sheet is based on the fundamental equation: **Assets = Liabilities + Equity.**



UNIT-5

Financial Analysis Through Ratios

Financial Analysis

- Assessment of the firm's past, present and future financial conditions
 - Done to find firm's financial strengths and weaknesses
 - Primary Tools:
 - Financial Statements
 - Comparison of financial ratios to past, industry, sector and all firms
-

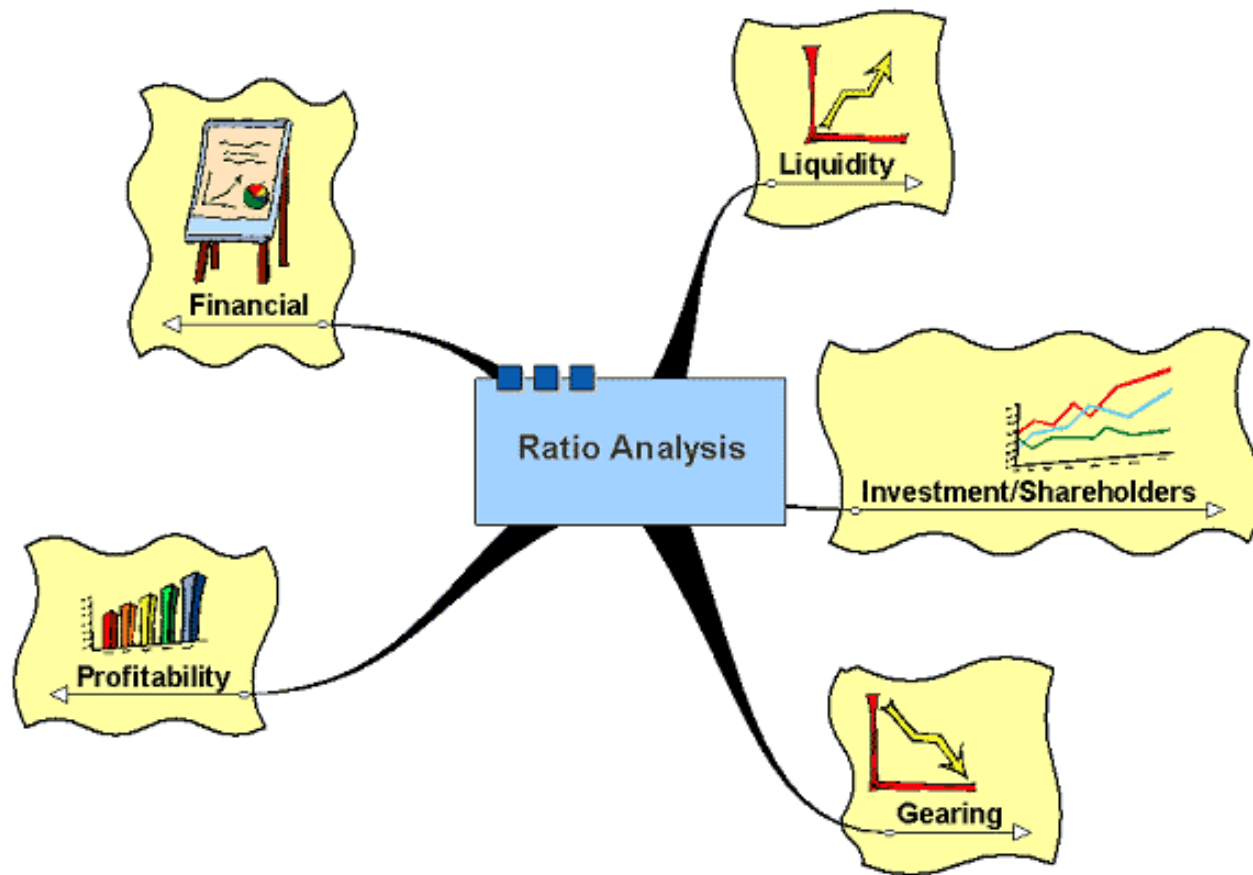
Financial Statements

- Balance Sheet
 - Income Statement
 - Cashflow Statement
 - Statement of Retained Earnings
-

Objectives of Ratio Analysis

- Standardize financial information for comparisons
 - Evaluate current operations
 - Compare performance with past performance
 - Compare performance against other firms or industry standards
 - Study the efficiency of operations
 - Study the risk of operations
-

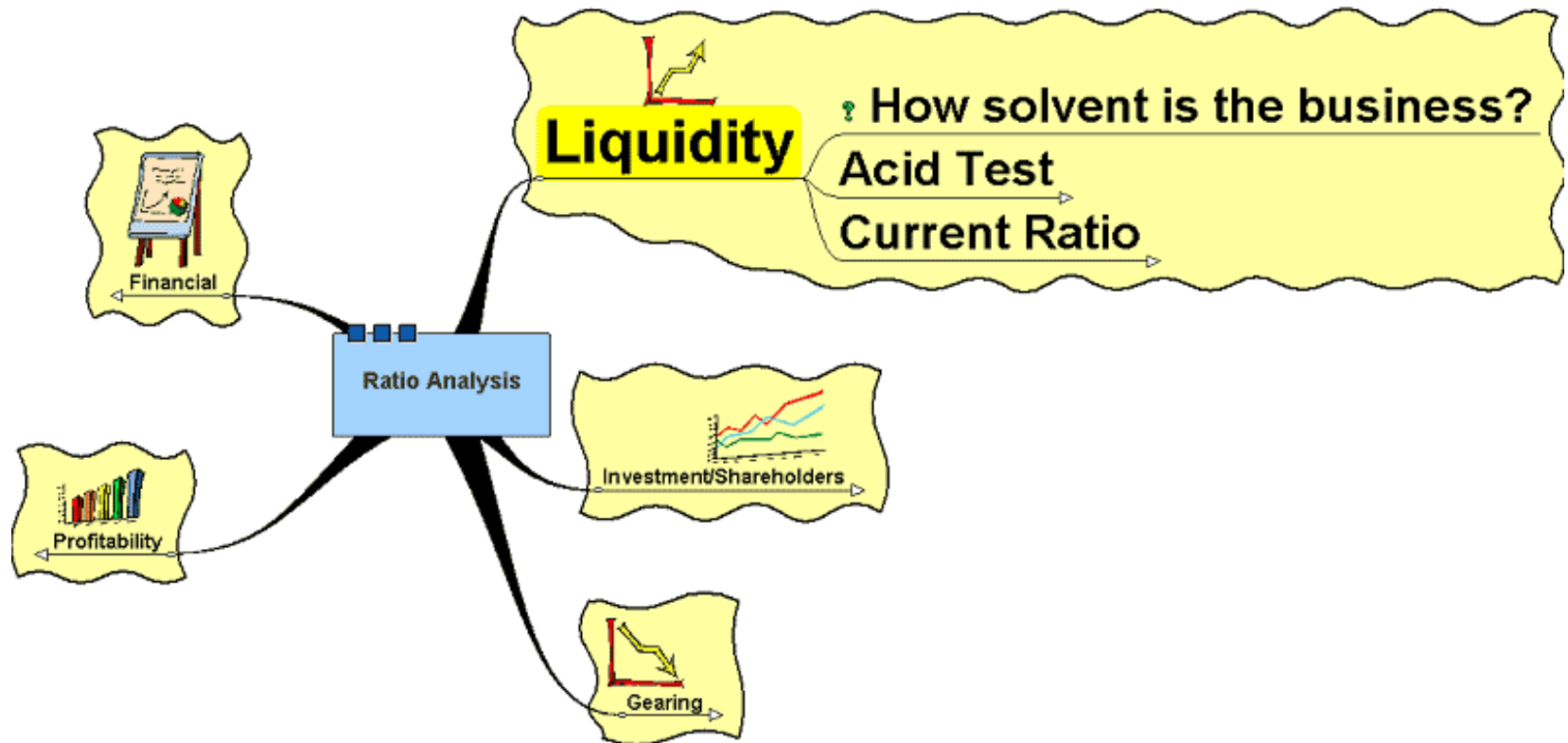
Ratio Analysis



Ratio Analysis

1. **Liquidity** – the ability of the firm to pay its way
 2. **Investment/shareholders** – information to enable decisions to be made on the extent of the risk and the earning potential of a business investment
 3. **Gearing** – information on the relationship between the exposure of the business to loans as opposed to share capital
 4. **Profitability** – how effective the firm is at generating profits given sales and or its capital assets
 5. **Financial** – the rate at which the company sells its stock and the efficiency with which it uses its assets
-

Liquidity



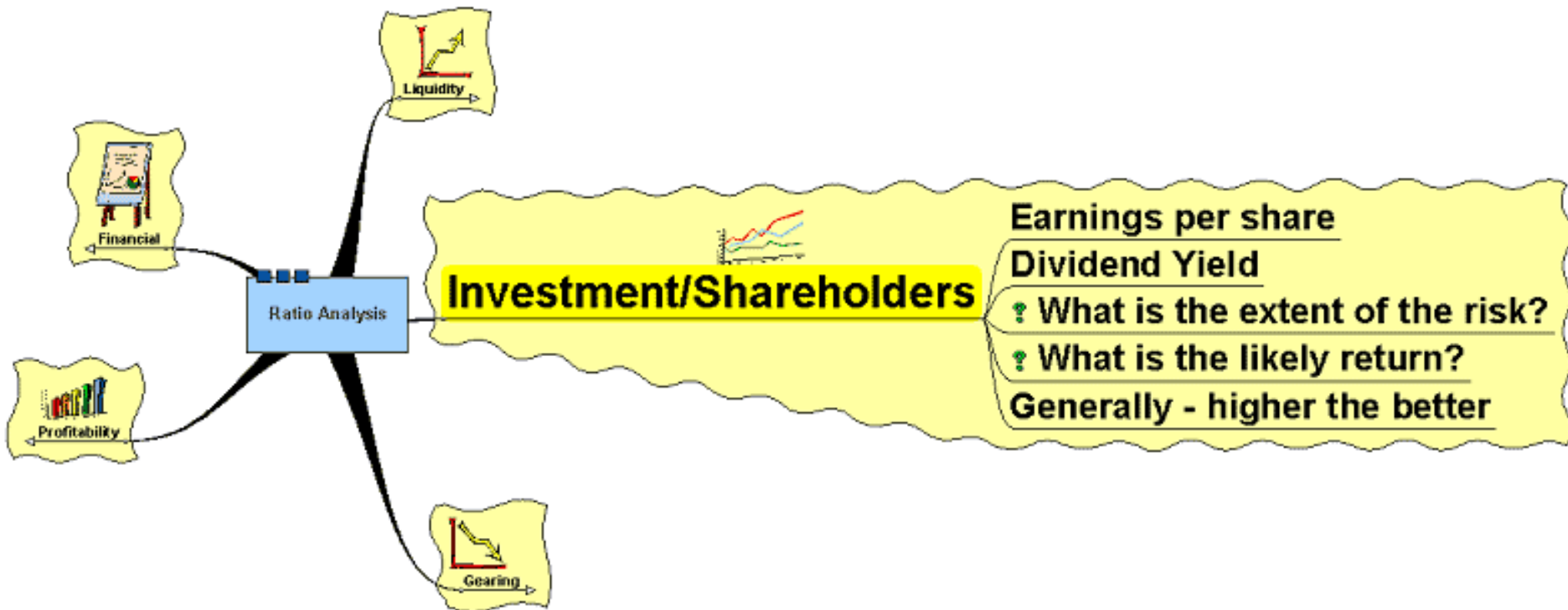
Acid Test

- Also referred to as the ‘Quick ratio’
 - **(Current assets – stock) : liabilities**
 - 1:1 seen as ideal
 - The omission of stock gives an indication of the cash the firm has in relation to its liabilities (what it owes)
 - A ratio of 3:1 therefore would suggest the firm has 3 times as much cash as it owes – very healthy!
 - A ratio of 0.5:1 would suggest the firm has twice as many liabilities as it has cash to pay for those liabilities. This ***might*** put the firm under pressure but is not in itself the end of the world!
-

Current Ratio

- Looks at the ratio between Current Assets and Current Liabilities
 - **Current Ratio = Current Assets : Current Liabilities**
 - Ideal level? – 1.5 : 1
 - A ratio of 5 : 1 would imply the firm has £5 of assets to cover every £1 in liabilities
 - A ratio of 0.75 : 1 would suggest the firm has only 75p in assets available to cover every £1 it owes
 - Too high – Might suggest that too much of its assets are tied up in unproductive activities – too much stock, for example?
 - Too low - risk of not being able to pay your way
-

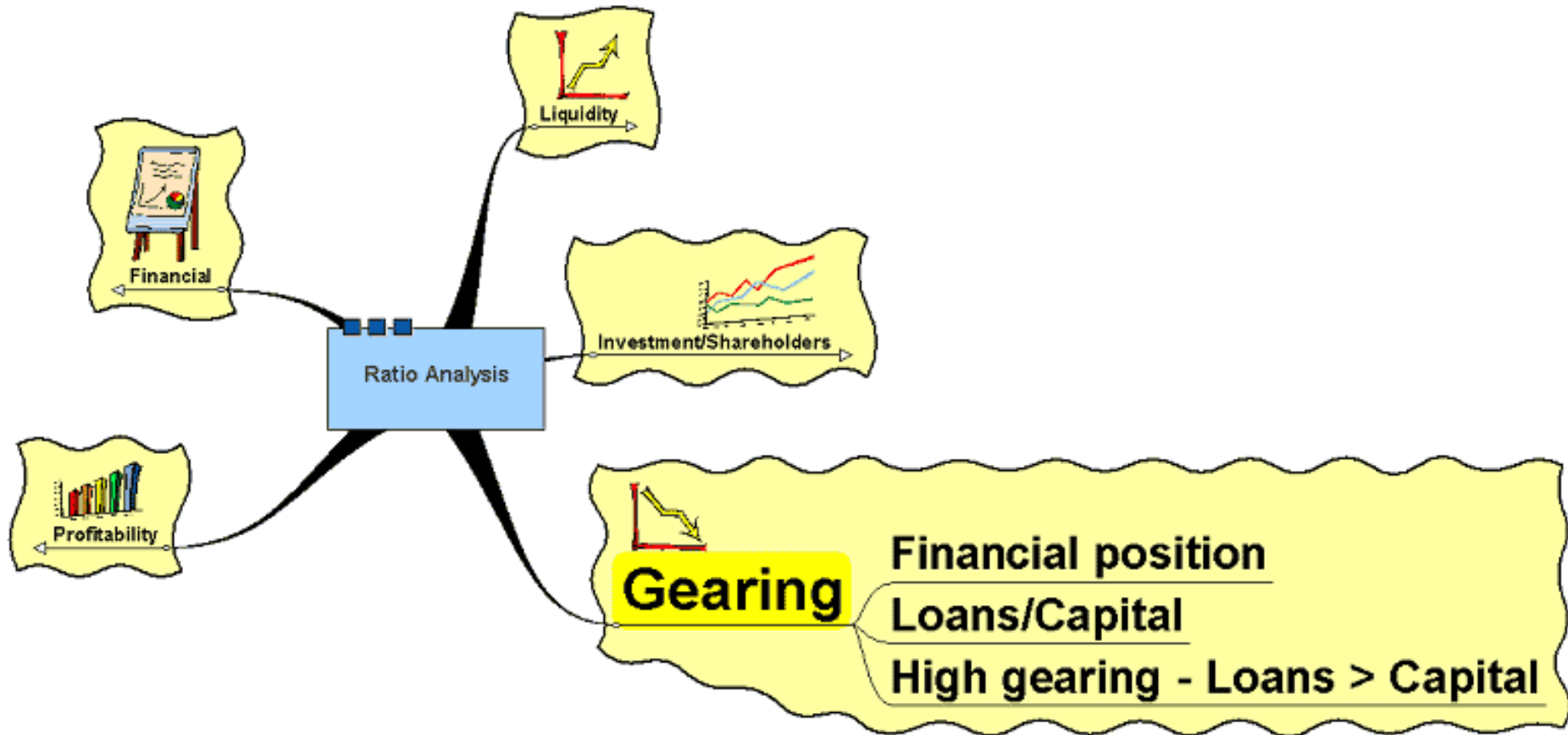
Investment/Shareholders



Investment/Shareholders

- **Earnings per share** – profit after tax / number of shares
 - **Price earnings ratio** – market price / earnings per share – the higher the better generally for company. Comparison with other firms helps to identify value placed on the market of the business.
 - **EV / EBITDA Ratio** - Enterprise Value / EBITDA ratio - the higher the better generally for company . It measures the operational performance of the firm.
 - **Dividend yield** – ordinary share dividend / market price x 100 – higher the better. Relates the return on the investment to the share price.
-

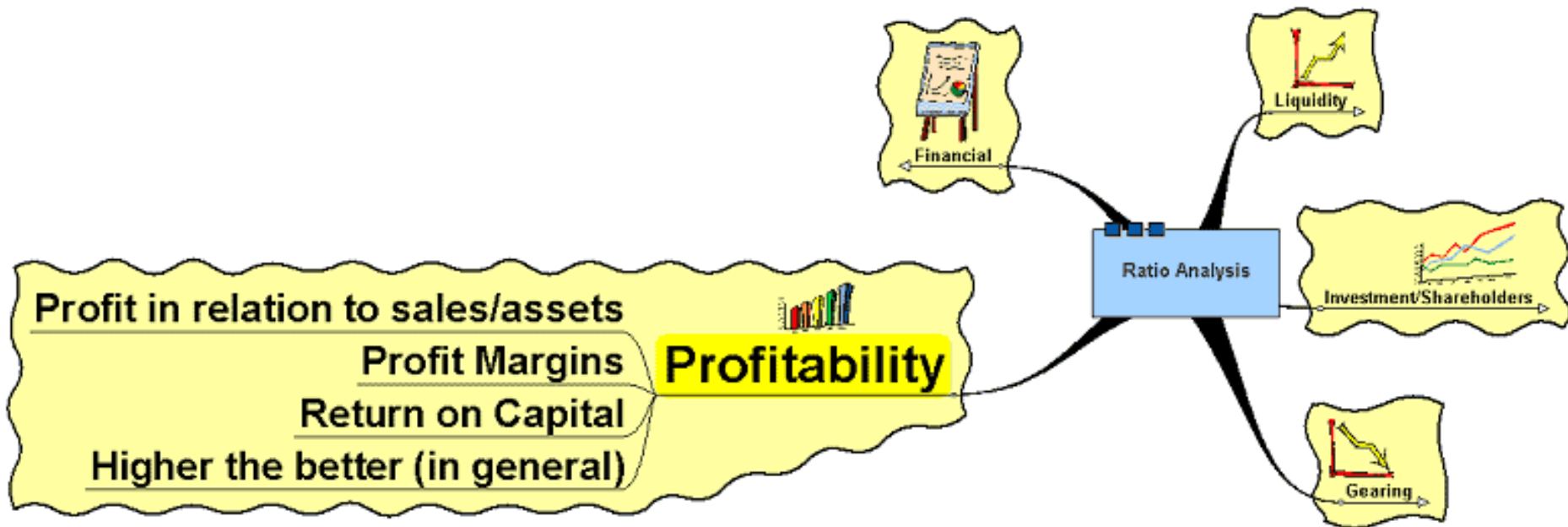
Gearing



Gearing

- **Gearing Ratio = Long term loans / Capital employed x 100**
 - The higher the ratio the more the business is exposed to interest rate fluctuations and to having to pay back interest and loans before being able to re-invest earnings
-

Profitability



Profitability

- Profitability measures look at how much profit the firm generates from sales or from its capital assets
 - Different measures of profit – gross and net
 - **Gross profit** – effectively total revenue (turnover) – variable costs (cost of sales)
 - **Net Profit** – effectively total revenue (turnover) – variable costs and fixed costs (overheads)
-

Profitability

- **Gross Profit Margin = Gross profit / turnover x 100**
 - The higher the better
 - Enables the firm to assess the impact of its sales and how much it cost to generate (produce) those sales
 - A gross profit margin of 45% means that for every £1 of sales, the firm makes 45p in gross profit
-

Profitability

- **Net Profit Margin = Net Profit / Turnover x 100**
 - Net profit takes into account the fixed costs involved in production – the overheads
 - Keeping control over fixed costs is important – could be easy to overlook for example the amount of waste - paper, stationery, lighting, heating, water, etc.
 - e.g. – leaving a photocopier on overnight uses enough electricity to make 5,300 A4 copies. (1,934,500 per year)
 - 1 ream = 500 copies. 1 ream = £5.00 (on average)
 - Total cost therefore = £19,345 per year – or 1 person's salary
-

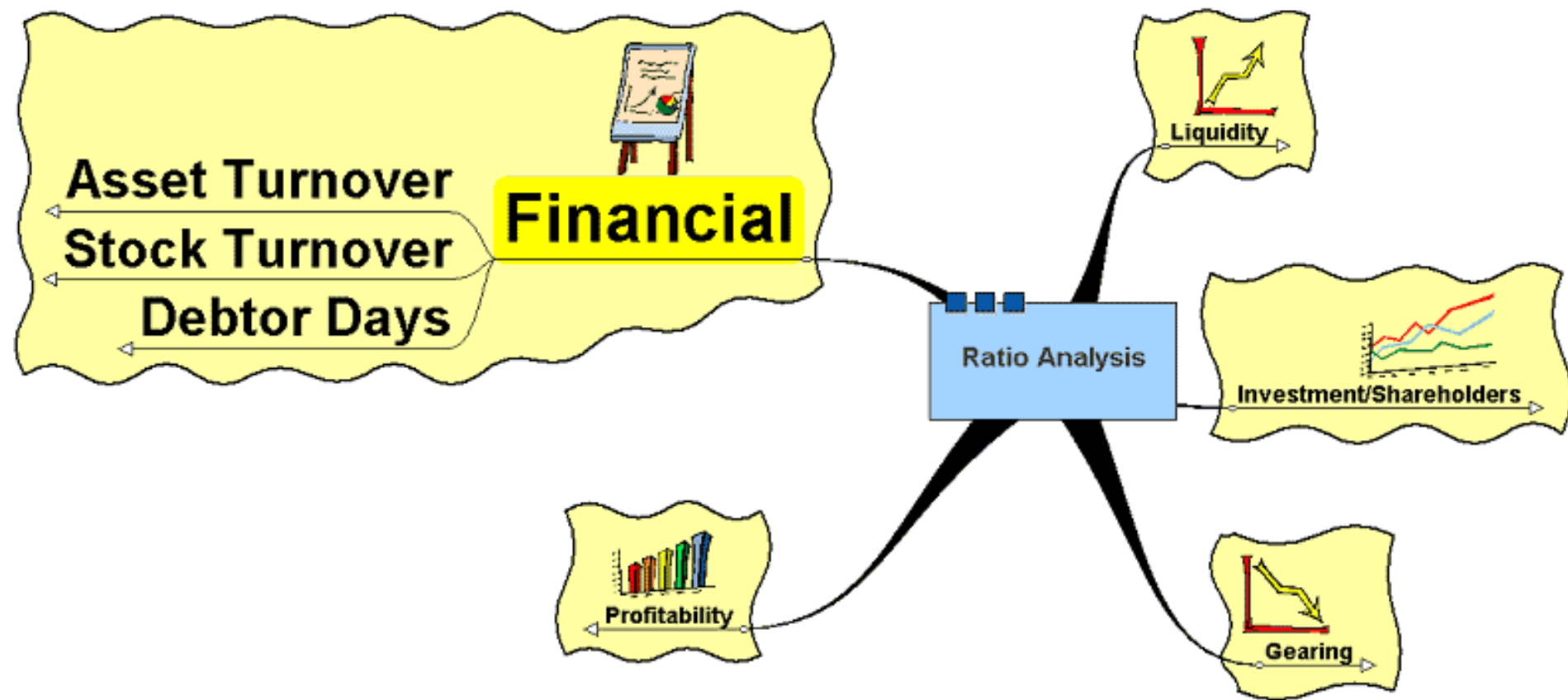
Profitability

- **Return on Capital Employed (ROCE) = Profit / capital employed x 100**
-

Profitability

- The higher the better
 - Shows how effective the firm is in using its capital to generate profit
 - A ROCE of 25% means that it uses every £1 of capital to generate 25p in profit
 - Partly a measure of efficiency in organisation and use of capital
-

Financial



Asset Turnover

- **Asset Turnover = Sales turnover / assets employed**
 - Using assets to generate profit
 - Asset turnover x net profit margin = ROCE
-

Stock Turnover

- **Stock turnover = Cost of goods sold / stock expressed as times per year**
 - The rate at which a company's stock is turned over
 - A high stock turnover might mean increased efficiency?
 - But: dependent on the type of business – supermarkets might have high stock turnover ratios whereas a shop selling high value musical instruments might have low stock turnover ratio
 - Low stock turnover could mean poor customer satisfaction if people are not buying the goods (Marks and Spencer?)
-

Debtor Days

- **Debtor Days = Debtors / sales turnover x 365**
 - Shorter the better
 - Gives a measure of how long it takes the business to recover debts
 - Can be skewed by the degree of credit facility a firm offers
-

Before looking at the ratios there are a number of **cautionary points concerning their use that need to be identified :**

- a. The dates and duration of the financial statements being compared should be the same. If not, the effects of seasonality may cause erroneous conclusions to be drawn.
 - b. The accounts to be compared should have been prepared on the same bases. Different treatment of stocks or depreciations or asset valuations will distort the results.
 - c. In order to judge the overall performance of the firm a group of ratios, as opposed to just one or two should be used. In order to identify trends at least three years of ratios are normally required.
-

SOME IMPORTANT NOTES

- Liabilities have Credit balance and Assets have Debit balance
 - Current Liabilities are those which have either become due for payment or shall fall due for payment within 12 months from the date of Balance Sheet
 - Current Assets are those which undergo change in their shape/form within 12 months. These are also called Working Capital or Gross Working Capital
 - Net Worth & Long Term Liabilities are also called **Long Term Sources of Funds**
 - Current Liabilities are known as **Short Term Sources of Funds**
 - Long Term Liabilities & Short Term Liabilities are also called **Outside Liabilities**
 - Current Assets are **Short Term Use of Funds**
-

SOME IMPORTANT NOTES

- Assets other than Current Assets are **Long Term Use of Funds**
 - Installments of Term Loan Payable in 12 months are to be taken as Current Liability only for Calculation of Current Ratio & Quick Ratio.
 - If there is **profit** it shall become part of **Net Worth** under the head Reserves and if there is **loss** it will become part of **Intangible Assets**
 - Investments in Govt. Securities to be treated **current** only if these are marketable and due. Investments in other securities are to be treated **Current** if they are quoted. Investments in allied/associate/sister units or firms to be treated as **Non-current**.
 - Bonus Shares as issued by capitalization of General reserves and as such do not affect the Net Worth. With Rights Issue, change takes place in Net Worth and Current Ratio.
-

EXERCISE 1

LIABILITES		ASSETS	
Capital	180	Net Fixed Assets	400
Reserves	20	Inventories	150
Term Loan	300	Cash	50
Bank C/C	200	Receivables	150
Trade Creditors	50	Goodwill	50
Provisions	50		
	800		800

- a. What is the Net Worth : $\text{Capital} + \text{Reserve} = 200$
- b. Tangible Net Worth is : $\text{Net Worth} - \text{Goodwill} = 150$
- c. Outside Liabilities : $\text{TL} + \text{CC} + \text{Creditors} + \text{Provisions} = 600$
- d. Net Working Capital : $\text{C A} - \text{C L} = 350 - 250 = 50$
- e. Current Ratio : $\text{C A} / \text{C L} = 350 / 300 = 1.17 : 1$
- f. Quick Ratio : $\text{Quick Assets} / \text{C L} = 200/300 = 0.66 : 1$

LIABILITIES	2005-06	2006-07	ASSETS	2005-06	2006-07
Capital	300	350	Net Fixed Assets	730	750
Reserves	140	160	Security Electricity	30	30
Bank Term Loan	320	280	Investments	110	110
Bank CC (Hyp)	490	580	Raw Materials	150	170
Unsec. Long T L	150	170	S I P	20	30
Creditors (RM)	120	70	Finished Goods	140	170
Bills Payable	40	80	Cash	30	20
Expenses Payable	20	30	Receivables	310	240
Provisions	20	40	Loans/Advances	30	190
			Goodwill	50	50
Total	1600	1760		1600	1760

1. Tangible Net Worth for 1st Year : $(300 + 140) - 50 = 390$

2. Current Ratio for 2nd Year : $(170 + 30 + 170 + 20 + 240 + 190) / (580 + 70 + 80 + 70)$
 $820 / 800 = 1.02$

3. Debt Equity Ratio for 1st Year : $320 + 150 / 390 = 1.21$

Exercise 3.

LIABILITIES		ASSETS	
Equity Capital	200	Net Fixed Assets	800
Preference Capital	100	Inventory	300
Term Loan	600	Receivables	150
Bank CC (Hyp)	400	Investment In Govt. Secu.	50
Sundry Creditors	100	Preliminary Expenses	100
Total	1400		1400

1. **Debt Equity Ratio** will be : $600 / (200+100) = 2 : 1$
2. **Tangible Net Worth** : Only equity Capital i.e. = 200
3. **Total Outside Liabilities / Total Tangible Net Worth** : $(600+400+100) / 200 = 11 : 2$
4. **Current Ratio** will be : $(300 + 150 + 50) / (400 + 100) = 1 : 1$

Exercise 4.

LIABILITIES		ASSETS	
Capital + Reserves	355	Net Fixed Assets	265
P & L Credit Balance	7	Cash	1
Loan From S F C	100	Receivables	125
Bank Overdraft	38	Stocks	128
Creditors	26	Prepaid Expenses	1
Provision of Tax	9	Intangible Assets	30
Proposed Dividend	15		
	550		550

Q. What is the Current Ratio ?

Ans : $(1+125 +128+1) / (38+26+9+15)$
 $: 255/88 = 2.89 : 1$

Q What is the Quick Ratio ? Ans : $(125+1)/ 88 = 1.43 : 11$

Q. What is the Debt Equity Ratio ? Ans : $\text{LTL} / \text{Tangible NW}$
 $= 100 / (362 - 30)$
 $= 100 / 332 = 0.30 : 1$

Exercise 4. contd...

LIABILITIES		ASSETS	
Capital + Reserves	355	Net Fixed Assets	265
P & L Credit Balance	7	Cash	1
Loan From S F C	100	Receivables	125
Bank Overdraft	38	Stocks	128
Creditors	26	Prepaid Expenses	1
Provision of Tax	9	Intangible Assets	30
Proposed Dividend	15		
	550		550

Q. What is the Debtors Velocity Ratio ? If the sales are Rs. 15 Lac.

$$\begin{aligned}\text{Ans : (Average Debtors / Net Sales) } \times 12 &= (125 / 1500) \times 12 \\ &= 1 \text{ month}\end{aligned}$$

Q. What is the Creditors Velocity Ratio if Purchases are Rs.10.5 Lac ?

$$\text{Ans : (Average Creditors / Purchases) } \times 12 = (26 / 1050) \times 12 = 0.3 \text{ months}$$

Exercise 5. : Profit to sales is 2% and amount of profit is say Rs.5 Lac. Then What is the amount of Sales ?

$$\begin{aligned}\text{Answer : Net Profit Ratio} &= (\text{Net Profit} / \text{Sales}) \times 100 \\ 2 &= (5 \times 100) / \text{Sales} \\ \text{Therefore Sales} &= 500/2 = \text{Rs.250 Lac}\end{aligned}$$

Exercise 6. A Company has Net Worth of Rs.5 Lac, Term Liabilities of Rs.10 Lac. Fixed Assets worth RS.16 Lac and Current Assets are Rs.25 Lac. There is no intangible Assets or other Non Current Assets. Calculate its Net Working Capital.

Answer

$$\text{Total Assets} = 16 + 25 = \text{Rs. 41 Lac}$$

$$\text{Total Liabilities} = \text{NW} + \text{LTL} + \text{CL} = 5 + 10 + \text{CL} = 41 \text{ Lac}$$

$$\text{Current Liabilities} = 41 - 15 = 26 \text{ Lac}$$

$$\begin{aligned}\text{Therefore Net Working Capital} &= \text{C. A} - \text{C.L} \\ &= 25 - 26 = (-)1 \text{ Lac}\end{aligned}$$

Exercise 7 : Current Ratio of a concern is 1 : 1. What will be the Net Working Capital ?

Answer : It suggest that the Current Assets is equal to Current Liabilities hence the NWC would be **NIL** (since $NWC = C.A - C.L$)

Exercise 8 : Suppose Current Ratio is 4 : 1. NWC is Rs.30,000/-. What is the amount of Current Assets ?

Answer : $4a - 1a = 30,000$

Therefore $a = 10,000$ i.e. Current Liabilities is Rs.10,000

Hence Current Assets would be $4a = 4 \times 10,000 = \text{Rs.}40,000/-$

Exercise 9. The amount of Term Loan installment is Rs.10000/ per month, monthly average interest on TL is Rs.5000/-. If the amount of Depreciation is Rs.30,000/- p.a. and PAT is Rs.2,70,000/-. What would be the DSCR ?

$$\begin{aligned} \text{DSCR} &= (\text{PAT} + \text{Depr} + \text{Annual Intt.}) / \text{Annual Intt} + \text{Annual Installment} \\ &= (270000 + 30000 + 60000) / 60000 + 120000 \\ &= 360000 / 180000 = 2 \end{aligned}$$

Exercise 10 : Total Liabilities of a firm is Rs.100 Lac and Current Ratio is 1.5 : 1. If Fixed Assets and Other Non Current Assets are to the tune of Rs. 70 Lac and Debt Equity Ratio being 3 : 1. What would be the Long Term Liabilities?

Ans : We can easily arrive at the amount of Current Asset being Rs. 30 Lac i.e. (Rs. 100 L - Rs. 70 L). If the Current Ratio is 1.5 : 1, then Current Liabilities works out to be Rs. 20 Lac. That means the aggregate of Net Worth and Long Term Liabilities would be Rs. 80 Lacs. If the Debt Equity Ratio is 3 : 1 then Debt works out to be Rs. 60 Lacs and equity Rs. 20 Lacs. **Therefore the Long Term Liabilities would be Rs.60 Lac.**

Exercise 11 : Current Ratio is say 1.2 : 1 . Total of balance sheet being Rs.22 Lac. The amount of Fixed Assets + Non Current Assets is Rs. 10 Lac. What would be the Current Liabilities?

Ans : When Total Assets is Rs.22 Lac then Current Assets would be $22 - 10$ i.e Rs. 12 Lac. Thus we can easily arrive at the Current Liabilities figure which should be Rs. 10 Lac

Exercise 12. From the following financial statement calculate (i) Current Ratio (ii) Acid test Ratio (iii) Inventory Turnover (iv) Average Debt Collection Period (v) Average Creditors' payment period.

Sales	1500
Cost of sales	1000
Gross profit	500

<u>C.Assets</u>	
Inventories	125
Debtors	250
Cash	225

<u>C. Liabilities</u>	
Trade Creditors	200

200

(i) Current Ratio : $600/200 = 3 : 1$

(ii) Acid Test Ratio : $\text{Debtors} + \text{Cash} / \text{Trade creditors} = 475/200 = 2.4 : 1$

(iii) Inventory Turnover Ratio : $\text{Cost of sales} / \text{Inventories} = 1000/125 = 8 \text{ times}$

(iv) Average Debt collection period : $(\text{Debtors}/\text{sales}) \times 365 = (250/1500) \times 365 = 61 \text{ days}$

(v) Average Creditors' payment period : $(\text{Trade Creditors}/\text{Cost of sales}) \times 365$
 $(200/100) \times 365 = 73 \text{ days}$

Summary of Financial Ratios

- Ratios help to:
 - Evaluate performance
 - Structure analysis
 - Show the connection between activities and performance
 - Benchmark with
 - Past for the company
 - Industry
 - Ratios adjust for size differences
-

Limitations of Ratio Analysis

- A firm's industry category is often difficult to identify
 - Published industry averages are only guidelines
 - Accounting practices differ across firms
 - Sometimes difficult to interpret deviations in ratios
 - Industry ratios may not be desirable targets
 - Seasonality affects ratios
-

Funds flow statement

- A Funds Flow Statement is a financial document that analyses a company's Balance Sheet of two years to validate the movement of funds from the previous financial year to the current year. In other words, it compares the source of inflow and outflow of funds during the concerned accounting period and analyses how it affects the working capital of an organization.
- It is an essential determiner that shows how funds are used. With the help of this statement, financial analysts can assess the fund flow of an organization in the near future.
- As this statement portrays the movement of funds among several sources and their applications, it is also known as the Application of the Funds and Statement of Sources.

- As this statement portrays the movement of funds among several sources and their applications, it is also known as the Application of the Funds and Statement of Sources.
 - Usually, the preparation of these statements is followed by a funds flow analysis. It serves as a financial parameter that helps a company to control its finance and develop a better strategy to utilize funds.
-

What is a Funds Flow Statement Analysis?

- Funds Flow Statement analysis is a comparison between various aspects of a Balance Sheet. While evaluating this statement, it is also vital to understand all the aspects.
 - Assets
 - If the asset section of a Balance Sheet experiences increment, it implies that the concerned institution has purchased assets by spending funds. These assets might thus result in the inflow of funds in the future. Here are some examples –
 - Fixed assets
 - Short-term loans
 - Long-term loans
-

Cash flow statement

- A cash flow statement summarizes the amount of cash and cash equivalents entering and leaving a company.
 - The CFS highlights a company's cash management, including how well it generates cash.
 - This financial statement complements the balance sheet and the income statement.
 - The main components of the CFS are cash from three areas: Operating activities, investing activities, and financing activities.
 - The two methods of calculating cash flow are the direct method and the indirect method.
-

- Inventory
 - Cash and cash equivalents
 - Receivables
 - Present investments
 - Contrarily, if the assets section shows a decline, it means that the company has sold some of its assets to maintain fund inflow.
 - Liabilities
 - In a Funds Flow Statement, any increase in liabilities means the organization has funds inflow which needs to be paid. Some of the examples are-
 - Lenders
 - Customers
 - Vendors
 - Employees
 - Shareholders
 -
-

- Long-term loans
- Inventory
- Cash and cash equivalents
- Receivables
- Present investments
- Contrarily, if the assets section shows a decline, it means that the company has sold some of its assets to maintain fund inflow.
- Liabilities
- In a Funds Flow Statement, any increase in liabilities means the organization has funds inflow which needs to be paid. Some of the examples are-
 - Lenders
 - Customers

How is a Funds Flow Statement Prepared?

- Preparation of Funds Flow Statement is done in the following three steps –
 - Statement depicting differences in working capital
 - According to the formula for working capital calculation,
 - $\text{Working capital} = \text{Current assets} - \text{Current liabilities}$
 - This particular statement focuses on the effects that modify working capital. Here are some reasons that are responsible for a change in the company's working capital.
 - If the company keeps investing in fixed assets or long term business avenues without accumulating any long term funds, the working capital can reduce significantly.
-

- If the company is spending most of its profit in paying dividends and not accumulating any assets.
 - Working capital can also change with an over-extension in lending.
 - Again, without any advancement of long term funds, if the firm needs to repay a long-term obligation or preferred stockholders, the concerned firm can come across working capital deficiency.
-

Cash Flow Statement

- A cash flow statement summarizes the amount of cash and cash equivalents entering and leaving a company.
 - The CFS highlights a company's cash management, including how well it generates cash.
 - This financial statement complements the balance sheet and the income statement.
 - The main components of the CFS are cash from three areas: Operating activities, investing activities, and financing activities.
 - The two methods of calculating cash flow are the direct method and the indirect method.
-

Format of a cash flow statement

- There are three sections in a cash flow statement: operating activities, investments, and financial activities.
- **Operating activities:** Operating activities are those cash flow activities that either generate revenue or record the money spent on producing a product or service. Operational business activities include inventory transactions, interest payments, tax payments, wages to employees, and payments for rent. Any other form of cash flow, such as investments, debts, and dividends are not included in this section.
- The operations section on the cash flow statement begins with recording net earnings, which are obtained from the net income field on the [company's income statement](#). This gives an estimate of the company's profitability. After this, it lists non-cash items involving

The operations section on the cash flow statement begins with recording net earnings, which are obtained from the net income field on the [company's income statement](#). This gives an estimate of the company's profitability. After this, it lists non-cash items involving operational activities and convert them into cash items. A business' cash flow statement should show adequate positive cash flow for its operational activities. If it doesn't, the business may find it difficult to manage its daily business operations.

- **Investment activities:** The second section on the cash flow statement records the gains and losses caused due to investment in assets like property, plant, or equipment (PPE) thus reflecting overall change in the cash position for a company. When analysts want to know the company's investment on PPE, they check for changes on a cash flow statement.
 - Capital expenditure (CapEx) is another important line item under investment activities. CapEx is the money which a business invests on fixed assets like buildings, vehicles or land. An increase in CapEx means the company is investing on future operations. However, it also shows that there is a decrease in company cash flow.
-

Financial activities

The third section on the cash flow statement records the cash flow between the company and its owners and creditors. Financial activities include transactions involving debt, equity, and dividends. In these transactions, incoming cash is recorded when capital is raised (such as from investors or banks), and outgoing cash is recorded when dividends are paid.
