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RAS MAINS

Rajasthan Public Service Commission (RPSC)

Volume – 3

Accounting & Auditing and Law

SIERRA INNOVATIONS

INDEX

Accounting & Auditing is **Part C of Unit 3** in GS Paper 1 of the RAS Mains exam. Unit 3 also includes **Sociology (Part A)** and **Management (Part B)**. The entire unit carries **70 marks**, comprising **14 questions of 5 marks each**, as per the updated syllabus.

1	**Part C- Accounting & Auditing**
	➢ Theory Base of Accounting: Generally Accepted Accounting Principles (GAAPs) and Accounting Concepts. ➢ Accounting Standards: Basic Knowledge of Accounting Standards ➢ Financial Statement of a Company; Techniques of analysis of Financial Statements; Cash Flow Statement; Basic knowledge of Responsibility and Social Accounting. ➢ Computerised Accounting: Features and Software Packages ➢ Basic Knowledge of Goods and Services Tax ➢ Meaning & Objectives of Auditing, Audit Programme, Basic Knowledge of Social, Performance and Efficiency Audit; Elementary knowledge of Government Audit.

Previous Years Questions:

Year	Question	Marks
2024	Write any two objectives of Government Audit.	2
2024	Mention three basic elements of performance audit with reference to the public sector.	2
2024	What are the different stages of accounting as per Double Entry System of Accounting?	2
2024	Calculate Capital of the business from the following information : (i) Fixed Assets: 4,00,000 (ii) Current Liabilities: 85,000 (iii) Stock, Sundry Debtors and Cash: ₹90,000	2
2024	Give any four approaches to Social Accounting.	2
2024	The following information has been taken from the books of ABC Ltd. : Cash and Bank Balance 30,000 Trade Payables 45,000 Trade Receivables 75,000 Inventory 30,000 Sales (All credit) 4,50,000 Cost of Goods Sold 3,15,000 Calculate: (i) Current Ratio; (ii) Quick Ratio; (iii) Receivables Turnover Ratio; (iv) Inventory Turnover Ratio; (v) Gross Profit Ratio	5
2024	Is the agreement of trial balance a conclusive proof of accuracy of books of accounts? If not, which different types of errors may remain even after agreement of trial balance ?	5

Year	Question	Marks
2023	Give any four objectives of Auditing.	2
2023	Write down any four duties of Comptroller and Auditor General of India.	2
2023	Write down elements of Auditing as per definition given by International Auditing & Assurance Standards Board (IAASB).	2
2023	Write down any four essential features of Zero Based Budgeting.	2
2023	Write any two objectives of performance budgeting as recommended by the Administrative Reforms Commission.	2
2023	Write down any five techniques of financial statements-analysis.	5
2023	Give journal entries for the following transactions without narration: .(1) Goods sold to B for 20,000 in cash and 10,000 on credit. (2) Goods returned by B for ₹ 5,000. (3) Withdrew goods of 5,000 for personal use. (4) Furniture purchased for office purposes worth 30,000. (5) Goods worth 5,000 burnt by fire.	5

Year	Question	Marks
2021	What are compound journal entries?	2
2021	Name any two methods of Trend analysis.	2
2021	Mention four types of responsibility centres with reference to Responsibility Accounting.	2
2021	What is the designation of a person having highest authority in a Government Audit?	2
2021	Why Zero Base Budgeting adopted by Government of India?	2
2021	Explain Dual-aspect concept in context of Double Entry System of Accounting with suitable examples.	5
2021	"Performance Budgeting is useful for Government and Public sector undertakings." Why?	5

2 CHAPTER Accounting

Accounting is the art of properly recording, classifying, summarizing, analyzing and interpreting business transactions and communicating business results to users.

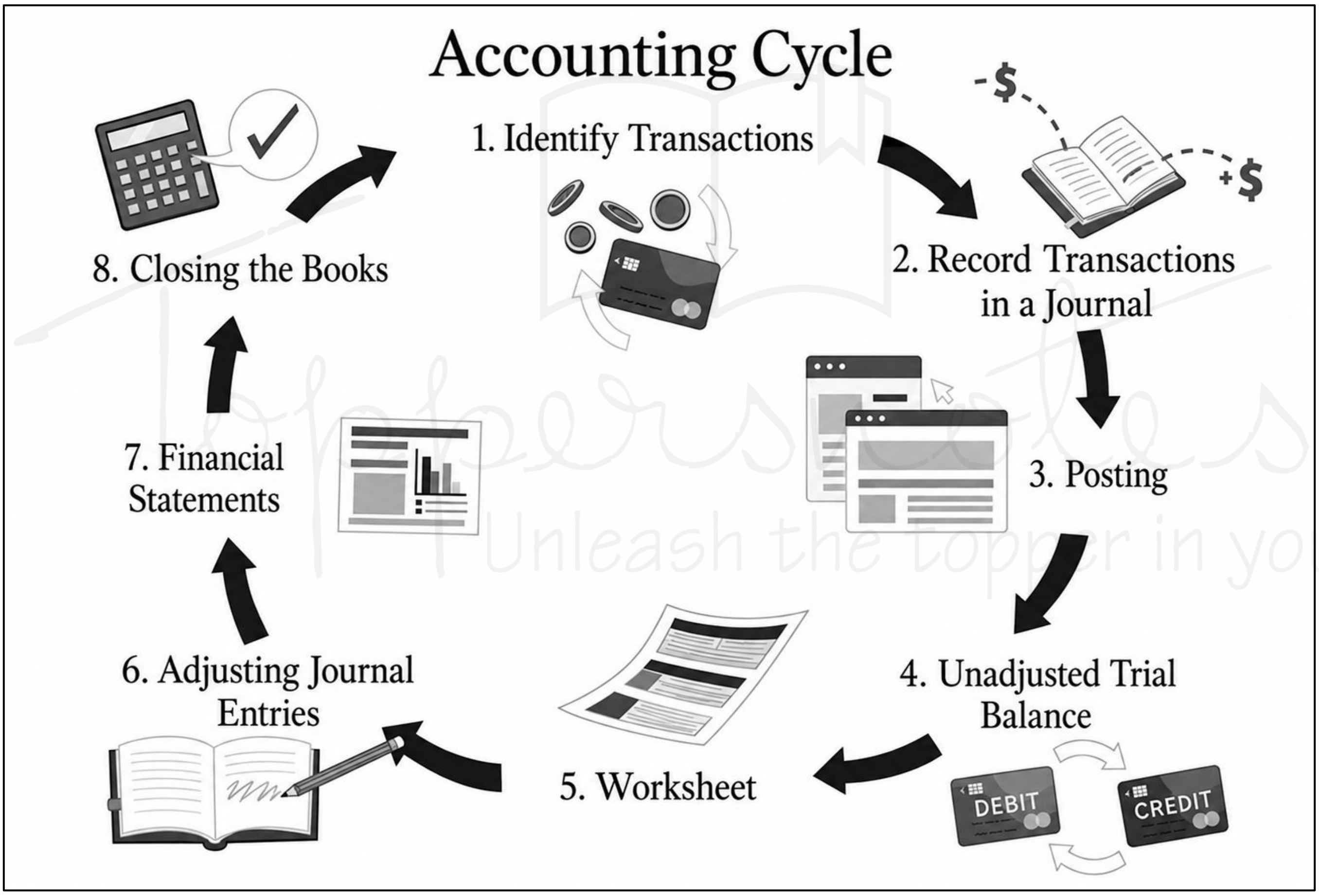
Accounting has a definite process under which the following tasks are performed: -

I. To prepare: Profit & Loss Account and Balance Sheet to know the summary of classified transactions and to find out the business results.

II. Analyzing the results, drawing conclusions and communicating the results to those individuals and institutions who are interested in these results. These are- government, society, stakeholders.

III. Preparing useful information based on known results and making it available to desired persons/institutions.

Accounting Cycle



8 Steps of Accounting Cycle

1. **Identify Transactions:** The first step is to identify all financial transactions of the business, such as purchases, sales, receipts, payments, expenses, income, assets, and liabilities. Only transactions that can be measured in money are recorded in accounting.
2. **Record Transactions in Journal:** After identification, transactions are recorded in the journal in chronological order. This step is also called journalising. Each transaction is recorded using the debit and credit rule.

3. **Ledger Posting:** In this step, journal entries are transferred to their respective ledger accounts. For example, cash transactions are posted to the cash account, sales transactions to the sales account, and purchase transactions to the purchase account.
4. **Prepare Unadjusted Trial Balance:** After posting, an unadjusted trial balance is prepared to check whether total debits are equal to total credits. It helps in checking the arithmetical accuracy of ledger accounts before adjustments.
5. **Prepare Worksheet:** A worksheet is prepared to organize accounting data and identify necessary adjustments. It helps accountants arrange trial balance, adjustments, adjusted balances, and financial statement information in one place.
6. **Record Adjusting Journal Entries:** Adjusting entries are made for items such as outstanding expenses, prepaid expenses, accrued income, depreciation, bad debts, and closing stock. These adjustments ensure that income and expenses are recorded in the correct accounting period.
7. **Prepare Financial Statements:** After adjustments, financial statements are prepared. These include the trading account, profit and loss account, balance sheet, and cash flow statement where required. They show the profitability and financial position of the business.
8. **Closing the Books:** At the end of the accounting period, temporary accounts such as income, expenses, gains, and losses are closed. Their balances are transferred to the profit and loss account or capital account so that the next accounting period can begin with fresh records.

   The accounting cycle is a complete step-by-step process through which business transactions are identified, recorded, posted, adjusted, summarized, reported, and closed for a particular accounting period.

Functions of Accounting

The main functions of accounting are as follows:

1. **Measurement:** Accounting measures past performance of the business entity and depicts its current financial position.
2. **Forecasting:** Accounting helps in forecasting future performance and financial position of the enterprise using past data and analysing trends.
3. **Decision-making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
4. **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.
5. **Control:** Accounting also identifies weaknesses of the operational system and provides feedback regarding effectiveness of measures adopted to check such weaknesses.
6. **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

Book-Keeping

- Book-keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers procedural aspects of accounting work and embraces record keeping function.
- These procedures are governed by the end product, the financial statements. The term ‘financial statements’ means Profit and Loss Account, Balance Sheet and cash flow statements including Schedules and Notes forming part of Accounts.

Distinction Between Book-Keeping and Accounting

Basis	Book-Keeping	Accounting
Meaning	Book-keeping is the process of recording financial transactions in a systematic manner.	Accounting is the process of summarising, analysing, interpreting, and communicating financial information.
Nature	It is mainly concerned with recording transactions.	It is concerned with recording as well as interpreting financial data.
Objective	Its main objective is to maintain complete and accurate records of transactions.	Its main objective is to determine profit or loss and show the financial position of the business.
Scope	Scope is limited to recording transactions in journals and ledgers.	Scope is wider and includes preparation of financial statements, analysis, and interpretation.
Stage	It is the primary stage of accounting.	It is the secondary stage that begins where book-keeping ends.
Skill Requirement	It requires clerical and routine skills.	It requires analytical, technical, and decision-making skills.
Financial Statements	Book-keeping does not prepare financial statements directly.	Accounting prepares trading accounts, profit and loss accounts, and balance sheets.
Decision-Making	It does not help directly in decision-making.	It provides useful information for managerial and financial decisions.
Users	Mainly used by book-keepers and clerical staff.	Used by management, investors, creditors, government, and other stakeholders.
Result	It provides recorded financial data.	It provides meaningful financial information and reports.

Sub-Fields of Accounting

The various sub-fields of accounting are:

1. **Financial Accounting –** It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already occurred. The final step of financial accounting is the preparation of a Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.

2. **Management Accounting –** It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision- making, the management needs a variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control.

3. **Cost Accounting –** The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as: "the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs."

4. **Social Responsibility Accounting –** The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. Social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created at the expense of society.

5. **Human Resource Accounting –** Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

Double Entry System

The origin of the double-entry system is formally considered to be from **1494 AD.** When the Italian scholar **Lucas Pacioli** mentioned this system in his book **"Particularis de Computis et Scripturis".**

- **Definition**: Every business transaction has two sides. One side is debited and the other side is credited. Since both sides are accounted for in this system, it is called a Double accounting system.

Difference Between Double Entry and Single-Entry System

Feature	Double Entry System	Single Entry System
Definition	Each transaction is recorded twice, once as debit and once as credit, maintaining the accounting equation	Each transaction is recorded only once, usually in a single account (cash book or personal account)
Origin / Year	Popularized in **15th century (Luca Pacioli, 1494)**; widely adopted in modern accounting	Originated earlier; informal system used before double entry became standard
Completeness	Provides complete record of all transactions	Records are incomplete; not all transactions are recorded
Accounts Prepared	Enables preparation of **Trial Balance, Profit & Loss Account, and Balance Sheet**	Only a cash book or partial accounts can be prepared; **Trial Balance cannot be made**
Error Detection	Errors can be easily detected through trial balance and reconciliation	Errors are difficult to detect
Accuracy	More accurate and reliable	Less accurate and less reliable
Complexity	Complex, requires knowledge of debit and credit rules	Simple, easy to maintain
Use / Example	Used by companies like **Tata, Infosys**; example: sale of goods → debit cash, credit sales	Used by **small shops**, sole proprietors; example: only record cash received from sales
Software	**Tally, QuickBooks, Zoho Books, SAP FICO**	Can be maintained in **Excel, manual cash books, or simple billing software**

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles or GAAP is a defined set of rules and procedures that needs to be followed in order to create financial statements, which are consistent with the industry standards. GAAP helps in ensuring that financial reporting is transparent and uniform across industries. As financial information is based on historical data, therefore in order to facilitate comparison between data from various sources, GAAP must be followed.

History of GAAP

- The development of GAAP began after the **1929 Stock Market Crash** and the **Great Depression**, when the U.S. government sought to improve trust in financial reporting.
- The **Securities Act of 1933** and the **Securities Exchange Act of 1934** led to the creation of the **U.S. Securities and Exchange Commission (SEC)**, which was given authority over accounting standards.
- Initially, accounting standards were developed by organizations such as the:
  - ✓ **Committee on Accounting Procedure (CAP)** (1939–1959)
  - ✓ **Accounting Principles Board (APB)** (1959–1973)
- In **1973**, the **Financial Accounting Standards Board (FASB)** was established to create a more independent and structured system for accounting standard-setting.
- Since then, FASB has been the primary body responsible for developing and updating GAAP in the United States.

GAAP (Generally Accepted Accounting Principles) consists of accounting assumptions, concepts, and principles that guide the preparation and presentation of financial statements.

10 Key Accounting Principles:

1. **Business Entity Assumption**
   - ✓ A business is treated as a separate accounting entity distinct from its owner, creditors, or other businesses.
   - ✓ Personal transactions of the owner are not recorded in business books.
   - ✓ It helps determine the actual financial position of the business.

   Example: If the owner pays personal house rent from personal funds, it will not be recorded in business accounts.

2. **Going Concern Assumption**
   - ✓ It assumes that the business will continue operating for an indefinite period in the future.
   - ✓ Financial statements are prepared assuming the business is not likely to liquidate soon.
   - ✓ Because of this assumption, assets are recorded at cost rather than liquidation value.

   Example: Machinery purchased by a company is depreciated over several years because the business is expected to continue operating.

3. **Monetary Unit Assumption**
   - ✓ Only those transactions that can be measured in money are recorded in accounting.
   - ✓ Accounting records are maintained in a stable currency unit such as dollars or rupees.
   - ✓ Qualitative factors like employee morale or customer satisfaction are not recorded directly.

   Example: Purchase of equipment for ₹50,000 is recorded, but employee honesty is not recorded.

4. **Periodicity Assumption**
   - ✓ The life of a business is divided into artificial accounting periods such as months, quarters, or years.
   - ✓ It enables periodic measurement of profit and financial position.
   - ✓ Financial statements are prepared at regular intervals.

   Example: A company prepares annual financial statements for the financial year ending March 31.

5. **Historical Cost Principle**
   - ✓ Assets are recorded at their original purchase price.
   - ✓ Changes in market value are generally ignored unless required by standards.
   - ✓ It ensures objective and verifiable accounting records.

   Example: Land purchased for ₹5 lakh is recorded at ₹5 lakh even if its current market value rises to ₹8 lakh.

6. **Revenue Recognition Principle**
   - ✓ Revenue is recognized when it is earned and realizable, not necessarily when cash is received.
   - ✓ It follows the accrual basis of accounting.
   - ✓ Revenue is recorded after goods are delivered or services are provided.

   Example: A company records sales revenue when goods are sold on credit, even if payment is received later.

7. **Accrual Principle or Matching Principle**
   - ✓ Expenses are matched with the revenues they help generate during the same accounting period.
   - ✓ It ensures accurate calculation of profit.
   - ✓ Related revenues and expenses are recorded together.

   Example: Salary paid to workers involved in production is recorded in the same period in which related sales revenue is earned.

8. **Full Disclosure Principle**
   - ✓ All material and relevant financial information must be disclosed in financial statements and accompanying notes.
   - ✓ It promotes transparency and informed decision-making.
   - ✓ Important liabilities, accounting policies, and risks must be reported.

   Example: Pending lawsuits against the company are disclosed in notes to accounts.

9. **Consistency Principle**
   - ✓ The same accounting methods and procedures should be applied consistently from one period to another.
   - ✓ It improves comparability of financial statements.
   - ✓ Any change in accounting method must be disclosed properly.

   Example: If a company uses the FIFO inventory method, it should continue using it in future years unless justified.

10. **Conservatism or Prudence Principle**
   - ✓ In situations of uncertainty, accountants should avoid overstating assets or income.
   - ✓ Expected losses should be recognized immediately, while gains are recorded only when realized.
   - ✓ It promotes cautious and prudent accounting.

   Example: A company creates provision for doubtful debts even before actual bad debts occur.

There are three fundamental accounting assumptions:

(i) Going Concern

(ii) Consistency

(iii) Accrual

All the above three fundamental accounting assumptions have already been explained above.

These principles ensure **uniformity, reliability, comparability, and transparency** in accounting practices.

Limitations of Accounting

1. The Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in the long run and not for the past date.

2. Certain accounting estimates depend on the sheer personal judgement of the accountant, e.g., provision for doubtful debts, method of depreciation adopted, recording certain expenditure as revenue expenditure or capital expenditure, selection of method of valuation of inventories and the list is quite long.
3. Financial statements consider those assets which can be expressed in monetary terms. Human resources although the very important asset of the enterprise is not shown in the balance sheet. There is no generally accepted formula for the valuation of human resources in money terms.
4. Different accounting policies for the treatment of the same item adds to the probability of manipulations. Through various laws and Accounting Standards, efforts are made to reduce these options to minimum but certainly could not be reduced to one.
5. Accounting ignores changes in some money factors like inflation etc.
6. There are occasions when accounting principles conflict with each other.

Going forward, accounting will continue to serve as the backbone of business decision-making. Emphasis on accuracy, transparency, and digital tools will strengthen financial management. Adoption of advanced software and principles will make accounting more efficient, reliable, and future-ready.

3 CHAPTER Financial Statements Analysis

Introduction of Financial System:

A financial statement is a systematic process of dividing the financial information into simple and valuable elements, establishing relationships between inter-related elements and interpreting the same to understand the working and financial position of an enterprise from its financial statements. It helps stakeholders make informed business and investment decisions.

As per Section 2(40) of Company's Act 2013, "financial statement", includes -

I. a **balance sheet** as at the end of the financial year;
II. a **profit and loss account**, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
III. **cash flow statement** for the financial year;
IV. a statement of **changes in equity**, if applicable;
V. any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Note: Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement;

Section 2(62) - "One Person Company" means a company which has only one person as a member;
Section 2(85) - "Small Company"' means a company, other than a public company,
i. paid-up share capital of which does not exceed 4 crore rupees;
ii. turnover of which as per profit and loss account for the immediately preceding financial year does not exceed 40 crore rupees
Section 455 - Dormant Company - Where a company is formed and registered under this Act for a future project or to hold an asset or intellectual property and has no significant accounting transaction, such a company or an inactive company may make an application to the Registrar for obtaining the status of a dormant company.

Objectives of Financial Analysis:

1. **To Assess the Earning Capacity or Profitability:** Earning Capacity and Profitability of the enterprise can be assessed from the financial statement analysis. It also facilitates forecasting of the same for the future years. External users are interested in earnings and hence, this is their prime objective of analysing financial statements.
2. **To Assess the Managerial Efficiency:** This assessment is possible because financial statement analysis identifies the areas where managers have been efficient and where they were not. Favourable and unfavourable variations can be identified to pinpoint the managerial inefficiency.
3. **To Assess the Short-term and Long-term Solvency of the Enterprise:** This assessment is possible by analysing the financial statements minutely. Creditors or suppliers are interested to know the ability of the entity to meet the short-term liabilities and Debenture holders and lenders are interested to know the long term and short-term solvency of the enterprise to assess the ability of the company to repay the principal and interest thereon.

4. **To facilitate Inter-firm Comparison:** Inter-firm Comparison helps an enterprise to assess its own performance as well as that of others if mergers and acquisitions are to be considered.
5. **To Forecast and Prepare Budgets:** Analysis of historical data in the financial statements helps in assessing developments in future. It facilitates forecasting and preparing budgets for the future years.
6. **To Understand Complicated Matter:** Financial Statement analysis helps the users in understanding the complicated matter. This can be facilitated by using charts, graphs and diagrams which are easy to explain and understand.

Parties Interested in Financial Analysis

Party	Interest / Purpose
Management	To assess profitability, efficiency, and financial position for better decision-making and planning
Investors / Shareholders	To evaluate the return on investment, dividend prospects, and overall financial health of the company
Creditors / Lenders	To check creditworthiness, liquidity, and ability to repay loans before providing finance
Employees	To understand the financial stability of the company, which affects job security, salaries, and benefits
Government / Regulatory Authorities	To ensure compliance with laws, taxes, and financial reporting standards
Suppliers / Trade Partners	To assess the company's ability to meet payment obligations and maintain business relationships
Public / Analysts	To gain insights into the company's performance, growth prospects, and market position
Researchers	Parties engaged in research activities analyze business entities to study profitability, growth, and financial position, gathering data on operations, finance, human resources, etc.
Customers	Interested in the continuance of the enterprise, especially if they depend on the business or have long-term involvement

Financial Statement Analysis is of 4 types as follows:

I. Inter-firm Analysis

- ✓ **Definition:** Comparison of a company's financial performance **with other companies in the same industry**.
- ✓ **Purpose:** To evaluate **relative performance, efficiency, and competitiveness**.
- ✓ **Example:** Comparing Tata Motors' profitability ratios with Maruti Suzuki.

II. Intra-firm Analysis

- ✓ **Definition:** Comparison of a company's **current financial performance with its past performance**.
- ✓ **Purpose:** To identify **trends, improvements, or deteriorations** over time.
- ✓ **Example:** Comparing Infosys' revenue growth of 2026 with 2025.

III. Horizontal Analysis or Dynamic Analysis

- ✓ **Definition:** Analysis of financial statements **over multiple periods** to identify **growth patterns, increases, or decreases**.
- ✓ **Purpose:** To study **performance trends and business growth** over time.
- ✓ **Example:** Revenue increased from ₹10,000 crore in 2023 to ₹12,000 crore in 2025 → **20% growth trend**.

IV. Vertical Analysis or Static Analysis

- ✓ **Definition:** Expressing each item in financial statements as a **percentage of a total** (total assets, total sales, etc.) to allow **standardized comparison**.
- ✓ **Purpose:** To analyze the **proportion of each item** and compare with other firms or periods.
- ✓ **Example:** If inventory is ₹2,00,000 and total assets are ₹10,00,000 → inventory is **20% of total assets**.

Tools or Techniques of Financial Statement Analysis

1. Comparative Statements

- ✓ A comparative statement involves studying individual components or items of the **Balance Sheet** and **Statement of Profit or Loss** over **two or more years**.
- ✓ The values of each item from multiple years are placed **side by side** for comparison.
- ✓ The **difference** between the amounts is calculated, followed by the **percentage change** from the base year.
- ✓ Comparative statements can be used for **intra-firm (within the same company)** or **inter-firm (between companies)** comparisons.

Example:

Liabilities	2021	2022	Difference	Assets	2021	2022	Difference
Capital	10	12	+2	**Building**	4	5	+1
Loan	8	10	+2	**Machine**	6	8	+2
Cash	10	10	0	**Cash**	10	10	0
Total	18	22	+4	**Total**	20	23	+3

2. Common Size Financial Statements

- ✓ This is a **vertical analysis** where amounts of individual items in the Balance Sheet or Profit & Loss Statement are expressed as **percentages of a common base** (e.g., total assets or total sales).
- ✓ These percentages are then compared across periods to **draw meaningful conclusions**.
- ✓ Common size statements can be used for **intra-firm and inter-firm comparisons**.
- ✓ They can be prepared for both **Balance Sheet** and **Income Statement**.

Example:

Liabilities (2018)	Amount	% of Total	Assets	Amount	% of Total
Capital	8 L	66.6%	**Building**	15 L	33.3%
Loan	5 L	33.3%	**Machinery**	5 L	20%
Cash	7 L	46.6%	–	–	–
Total	20 L	100%	**Total**	20 L	100%

3. Ratio Analysis

- ✓ Ratio analysis studies the **relationship among various financial factors** in a business.
- ✓ It involves calculating and interpreting **accounting ratios** to assess the company's **financial performance and position**.
- ✓ This technique helps in **understanding liquidity, profitability, efficiency, and solvency** by analyzing relationships between items in financial statements.

4. Cash Flow Statement

- ✓ A Cash Flow Statement shows the **inflows and outflows of cash and cash equivalents** during a period.
- ✓ **Inflows** increase cash or cash equivalents, while **outflows** decrease them.
- ✓ It is prepared in accordance with **Accounting Standard-3 (Revised) on Cash Flow Statements**.

- ✓ Cash flows are classified under three heads:
  a. **Cash Flow from Operating Activities**
  b. **Cash Flow from Investing Activities**
  c. **Cash Flow from Financing Activities**

5. **Fund Flow Analysis**

- ✓ Fund Flow Analysis is a technique used to study the movement of funds (working capital) between two accounting periods. It explains where funds came from and how they were used in the business.
- ✓ It mainly focuses on: Sources of funds, Applications (uses) of funds and Changes in working capital.
- ✓ **Sources of Funds:** These are activities that increase funds in the business.
- ✓ Examples:
  - Issue of shares
  - Taking long-term loans
  - Sale of fixed assets
  - Profit from operations

Steps in Fund Flow Analysis

- ✓ **Step 1: Prepare Schedule of Changes in Working Capital:** Compare current assets and current liabilities of two years.
- ✓ **Step 2: Calculate Funds from Operations:** Adjust non-operating and non-cash items from net profit.
- ✓ **Step 3: Prepare Fund Flow Statement:** Show sources and applications of funds.

Example

Sources of Funds	**Amount (₹)**	**Applications of Funds**	**Amount (₹)**
Funds from Operations	1,20,000	Purchase of Machinery	1,00,000
Issue of Share Capital	1,50,000	Redemption of Debentures	50,000
Sale of Furniture	20,000	Payment of Dividend	30,000
Long-term Loan Raised	80,000	Payment of Tax	20,000
Decrease in Working Capital	30,000	Increase in Working Capital	2,00,000
Total	**4,00,000**	**Total**	**4,00,000**

Analysis of Fund Flow Statement

- ✓ The company generated ₹1,20,000 from normal business operations, showing good operational efficiency.
- ✓ Share capital issue and long-term loan indicate expansion and additional financing activities.
- ✓ Major application of funds was purchase of machinery worth ₹1,00,000, which suggests business expansion.
- ✓ Redemption of debentures and dividend payment show the company is meeting long-term obligations and rewarding shareholders.
- ✓ Increase in working capital indicates improvement in short-term financial position.

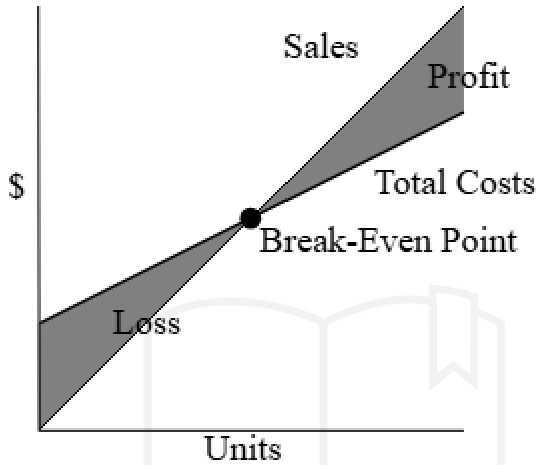
Advantages of Fund Flow Analysis	**Limitations of Fund Flow Analysis**	**Applications of Fund Flow Analysis**
Helps in financial planning	Ignores cash position	Used for long-term financial analysis
Shows sources and uses of funds	Based on historical data	Helps in working capital management

Analyzes changes in working capital	Complex to prepare	Assists management decision-making
Useful for evaluating financial position	Not useful for short-term analysis	Useful for investment planning
Helps identify financial strengths and weaknesses	Affected by accounting policies	Helps in raising long-term finance
Assists efficient fund management	Does not show exact liquidity position	Useful for budgeting and forecasting

6. Break-even Analysis

Break-even Analysis is a technique used to determine the level of sales at which total revenue equals total cost. At this point, there is neither profit nor loss.

This point is called the Break-even Point (BEP).



BEP (Sales in units) = Total fixed costs / Contribution margin.
Contribution = Sales − Variable Cost
BEP (Sales in ₹) = P/V Ratio ÷ Fixed Cost
P/V Ratio= (Sales ÷ Contribution) × 100
Contribution margin = Item price − Variable cost per unit

Fixed costs remain the same regardless of how many units are sold. Examples of fixed and variable costs include:

Fixed Costs	Variable Costs
Rent	Raw materials
Taxes	Production supplies
Insurance	Utilities
Wages or salaries	Packaging

1. **Example:** Selling price per unit is ₹50, Variable cost per unit is ₹30 and Fixed cost is ₹40,000. How many units a company must sell to avoid loss.
   Solution: Contribution per unit: 50 − 30 = 20
   Break-even point: 40,000 ÷ 20=2,000
   So, the company must sell 2,000 units to avoid loss.

2. **Example:** A company has fixed costs of ₹50,000. The selling price per unit is ₹100 and the variable cost per unit is ₹60. Calculate the Break-Even Point (BEP) in terms of sales value (₹).
   Solution:
   - **Contribution**=Selling Price−Variable Cost = 100 − 60 = ₹40
   - **P/V Ratio =** (Contribution ÷ Sales) × 100 = 40/100 × 100 = 40%
   - **BEP (Sales ₹)** = Fixed Cost ÷ P/V Ratio = 50,000/40%= 50,000/0.40 = ₹1,25,000

The business must achieve sales of worth ₹1,25,000 to cover all fixed and variable costs. At this point, there is neither profit nor loss.

Uses of Break-even Analysis	**Advantages of Break-even Analysis**	**Limitations of Break-even Analysis**
Helps in profit planning	Simple and easy to understand	Based on assumptions
Assists pricing decisions	Helps determine minimum sales	Ignores market conditions
Useful for cost control	Useful for cost control	Assumes linear relationship
Helps in budget preparation	Assists management decisions	Not suitable for multiple products
Supports managerial decision-making	Helpful in forecasting profits	Fixed costs may change
Measures margin of safety	Measures business risk	Ignores qualitative factors

7. Margin of Safety

Margin of Safety (MOS) is the difference between actual sales and break-even sales. It shows how much sales can fall before the business starts suffering losses. It measures the safety level of a business.

Margin of Safety = Actual Sales −Break even Sales
Margin of Safety Ratio = (Margin of Safety / Actual Sales) × 100

Example: A company has fixed costs of ₹60,000. Its sales are ₹2,00,000 and the P/V Ratio is 40%. Calculate the Margin of Safety and Margin of Safety Ratio.

Solution:
Break-even Sales = Fixed Cost ÷ P/V Ratio
= 60,000 ÷ 0.40 = ₹1,50,000
Margin of Safety = Actual Sales − Break-even Sales
= 2,00,000 − 1,50,000 = ₹50,000
Margin of Safety Ratio = (Margin of Safety ÷ Actual Sales) × 100
= (50,000 ÷ 2,00,000) × 100 = 25%

Analysis:
- The company's sales can decrease by ₹50,000 before it reaches the break-even point.
- The company's actual sales are higher than the break-even sales, so it is earning profit.
- A Margin of Safety of 25% indicates that the business has a reasonable safety cushion against losses.
- A higher margin of safety indicates lower business risk and low margin of safety shows greater risk of losses.

8. DuPont Analysis

DuPont Analysis is a technique used to analyze a company's Return on Equity (ROE) by dividing it into different components. It helps identify whether profitability is generated through profit margin, efficient use of assets, or financial leverage. It was developed by the **DuPont Corporation in 1919**.

Objective of DuPont Analysis
- To measure overall financial performance
- To identify factors affecting Return on Equity (ROE)
- To evaluate operational efficiency and profitability
- To help management improve financial decisions

Formula of DuPont Analysis

Return on Equity (ROE) = Net Profit Margin × Asset Turnover × Equity Multiplier

Components of DuPont Analysis

Component	**Formula**	**Purpose**
Net Profit Margin	Net Profit ÷ Sales	Measures profitability
Asset Turnover	Sales ÷ Total Assets	Measures efficiency of asset use
Equity Multiplier	Total Assets ÷ Shareholders' Equity	Measures financial leverage

Example: During the financial year 2025, a company earned a net profit of ₹1,20,000 on sales of ₹10,00,000. The total assets of the company were ₹5,00,000 and shareholders' equity amounted to ₹3,33,333. Calculate the Return on Equity (ROE) using DuPont Analysis.

Solution:

Net Profit Margin = Net Profit ÷ Sales = 1,20,000 ÷ 10,00,000 = 0.12 = 12%

Asset Turnover Ratio = Sales ÷ Total Assets = 10,00,000 ÷ 5,00,000 = 2 times

Equity Multiplier = Total Assets ÷ Shareholders' Equity = 5,00,000 ÷ 3,33,333 = 1.5 times

Return on Equity (ROE) = Net Profit Margin × Asset Turnover × Equity Multiplier

= 12% × 2 × 1.5 = **36%**

Analysis

- The company generated a strong Return on Equity of 36%, indicating efficient use of shareholders' funds to earn profits.
- A healthy profit margin and efficient asset utilization significantly contributed to profitability, while moderate financial leverage further enhanced returns to shareholders.

Advantages of DuPont Analysis	**Limitations of DuPont Analysis**
Provides detailed profitability analysis	Depends on accounting data and can be affected by accounting policies
Helps identify strengths and weaknesses	Ignores external economic factors
Useful for comparing companies	Historical in nature
Measures operational efficiency	Different accounting methods affect comparison
Assists management decision-making	Can encourage excessive use of debt