KMBN-103: Financial Accounting& Analysis (Unit-5)

Financial Statement Analysis

Financial statement analysis is the process of analyzing a company's financial statements for decision-making purposes. External stakeholders use it to understand the overall health of an organization as well as to evaluate financial performance and business value. Internal constituents use it as a monitoring tool for managing the finances.

ATTRIBUTES OF GOOD FINANCIAL STATEMENT ANALYSIS

1. Objectivity: Results of financial statement analysis should be analyzed objectively to reduce the possibility of any behavioral bias to minimum.

2. Precision and Brevity: Financial statement analysis should done with precision and should provide relevant information in concise form.

3. Understandability: Information provided by financial statement analysis should be presented in such a way that the analysis fosters understandability.

4. Relevance: Analysis of financial statement should be relevant to the purpose of the analysis. Financial statements used in analysis should be timely and should have a predictive value.

5. Reliability: The information derived from the analysis of financial statement must be free of material error and bias and should provide full and fair disclosure of the financial performance and other relevant information.

USERS OF FINANCIAL STATEMENTS ANALYSIS

1. Creditors: Creditors are concerned with the company’s ability to pay interest and principal when due and are concerned with the company’s cash flow ability.

2. Shareholders: Shareholders provide company with the much needed capital and are interested to know company’s ability to pay dividend, and growth of dividends and maximize shareholders wealth.

3. Prospective Investors: Financial statement analysis is used by the prospective investors to evaluate the attractiveness of the investment in the business.

4. Management: Management uses financial statement analysis to analysis the efficiency of operations and make important business decisions. For example whether or not to continue or discontinue part of its business, to make or buy certain material, or to acquire or rent/lease certain equipment.

5. Regulatory Authorities: For publicly traded companies, financial statements are analyzed to ensure compliance to various rules and regulations.

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Tools of Analysis of Financial Statements:-

1. Comparative Statements: These are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, balance sheet and statement of profit and loss prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as **'Horizontal Analysis'.**

2. Common Size Statements: These are the statements which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years. This analysis is also known as **'Vertical Analysis'.**

3. Trend Analysis: It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, in which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is detected or the sign of good or poor management is detected.

4. Ratio Analysis: It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.

5. Cash Flow Analysis: It refers to the analysis of actual movement of cash into and out of an organisation. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been utilised during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarises the causes for the changes in cash position of a business enterprise between dates of two balance sheets.

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Comparative Balance Sheet

A comparative balance sheet presents side-by-side information about an entity's assets, liabilities, and shareholders' equity as of multiple points in time. For example, a comparative balance sheet could present the balance sheet as of the end of each year for the past three years. Another variation is to present the balance sheet as of the end of each month for the past 12 months on a rolling basis. In both cases, the intent is to provide the reader with a series of snapshots of a company's financial condition over time, which is useful for developing trend line analyses (though this works better when the reader has the entire set of financial statements to work with and not just the balance sheet).

There is no standard format for a comparative balance sheet. It is somewhat more common to report the balance sheet as of the least recent period furthest to the right, though the reverse is the case when you are reporting balance sheets in a trailing Twelve Months format.

An example of a comparative balance sheet that contains the balance sheet as of the end of a company's fiscal year for each of the past three years:

ABC International Statement of Financial Position

	As of 31/03/2013	**As of 31/03/2012**	**As of 31/03/2011**
Current Assets			
Cash	**$1,200,000**	**$900,000**	**$750,000**
Accounts receivable	**4,800,000**	**3,600,000**	**3,000,000**
Inventory	**3,600,000**	**2,700,000**	**2,300,000**
Total current assets	**$9,600,000**	**$7,200,000**	**$6,050,000**
Total fixed assets	**6,200,000**	**5,500,000**	**5,000,000**
Total Assets	**$15,800,000**	**$12,700,000**	**$11,050,000**
Current Liabilities			
Accounts payable	**$2,400,000**	**$1,800,000**	**$1,500,000**
Accrued expenses	**480,000**	**360,000**	**300,000**

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Short-term debt	**800,000**	**600,000**	**400,000**
Total Current Liabilities	**$3,680,000**	**$2,760,000**	**$2,200,000**
Long-term debt	**9,020,000**	**7,740,000**	**7,350,000**
Total Liabilities	**12,700,000**	**10,500,000**	**9,550,000**
Shareholders' Equity	**3,100,000**	**2,200,000**	**1,500,000**
Total Liabilities and Equity	**$15,800,000**	**$12,700,000**	**$11,050,000**

Common Size Statement

Common size statements are not financial ratios. Rather they are a way of presenting financial statements that makes them more suitable for analysis. However, analysts always use them in conjunction with ratio analysis. In fact, financial analysts use common size statements as the starting point to help them dig deeper. Common size statements tell them what particular group of ratios deserves more attention for any given set of financial statements.

Common size statements are financial statements expressed in percentage form. Therefore a common size income statement would consider the sales figure as 100%. Every expense in the income statement will then be expressed as a percentage of the sales figure. Similarly in common size balance sheet the total assets figure is considered to be 100%. Everything else is expressed as a percentage of the same.

Standardized for Comparison

The logic behind creating common size financial statements is that they are easily comparable. Analysts can compare the COGS across two companies and state which one has lower COGS without any calculation! Thus, using the common size statements the analysts look step by step at the financial statements and compare them with other companies. This helps them understand how the company has a different asset structure and cost structure in comparison to its competitors and whether it is favorable or unfavorable for the organization.

Trend Analysis

Trend analysis is analysis which entails comparison with the company's own past performance. The problem in conducting this analysis is that all the numbers keep changing and there is no fixed base. With the help of common size statements, the base gets fixed at 100% and all the numbers can be compared across years. Thus with the help of this trend analysis, a company can figure out whether its advertising costs have gone up compared to last year and if so why?

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Sample of a typical common size income statement:

Particulars	Percentage
Sales	100%
Less: COGS (Cost of Goods Sold)	38%
Gross Profit	62%
Less: SG&A (Selling, General and Administrative Expenses)	14%
EBIDTA (earnings before interest, taxes, depreciation, and amortization)	48%
Less: Depreciation	10%
EBIT (Earning Before Interest & Tax)	38%
Less Interest	6%
PBT (Profit Before Tax)	32%
Less: Taxes	11%
PAT (Profit After Tax)	21%

LIMITATION OF FINANCIAL STATEMENTS ANALYSIS

1. Comparing companies with different fiscal year end can be difficult.

2. Comparing companies with different accounting methods (for example Inventory LIFO vs. FIFPO, depreciation method) can be difficult.

3. Estimates are as accurate as input and depends on the integrity of the input data.

4. Takes into account only quantitative factors and ignore qualitative factors such as efficiency, loyalty and honesty of the human resource.

5. Explanation of the results of the analysis involves human decision.

6. Data based on historical events which may not hold in future.

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Trend Analysis

Trend analysis evaluates an organization's financial information over a period of time. Periods may be measured in months, quarters, or years, depending on the circumstances. The goal is to calculate and analyze the amount change and percent change from one period to the next.

For example, in fiscal years 2010 and 2009, **Coca-Cola** had the operating income shown as follows. (Amounts are in millions. To convert to the actual amount, simply multiply the amount given times one million. For example, $8,449 × 1,000,000 = $8,449,000,000. Thus **Coca-Cola** had operating income of $8,449,000,000 in 2010.)

	Amount 2010	**Amount 2009**	**Amount Change**	**Percent Change**
Operating income	$8,449	$8,231	?	?

Although readers of the financial information can see that operating income increased from 2009 to 2010, the exact dollar amount of the change and the percent change is more helpful in evaluating the company's performance. The dollar amount of change is calculated as follows:

Key Equation

Amount of change = Current year amount – Base year amount

$$\begin{aligned} \text{Amount of change} &= \text{Current year amount} - \text{Base year amount} \\ \$218 &= \$8{,}449 - \$8{,}231 \end{aligned}$$

Question: *As you can see, operating income increased by $218,000,000 from 2009 to 2010. Is this a significant increase for* **Coca-Cola**?

Answer: Most of us consider $218,000,000 to be a huge amount, but the only way to gauge the true significance of this amount for **Coca-Cola** is to calculate the percent change from 2009 to 2010. The percent change is calculated as the current year amount minus the base year amount, divided by the base year amount.

Key Equation

Percent change = (Current year amount – Base year amount) ÷ Base year amount

The calculation that follows shows operating income increased 2.6 percent from 2009 to 2010. Although not an extraordinarily significant increase, this does represent positive results for **Coca-Cola**.

$$\begin{aligned} \text{Percent change} &= (\text{Current year amount} - \text{Base year amount}) \div \text{Base year amount} \\ 2.6\% &= (\$8{,}449 - \$8{,}231) \div \$8{,}231 \end{aligned}$$

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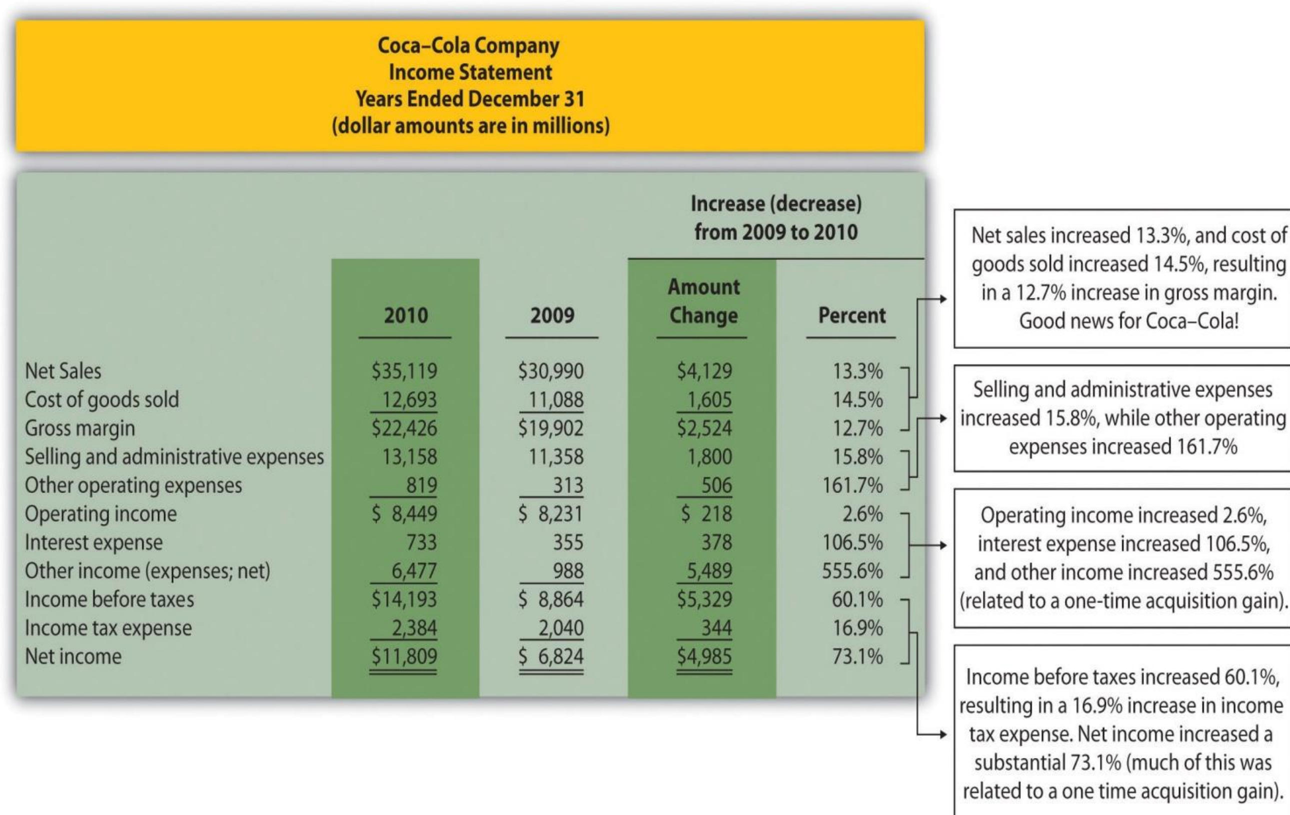
Trend Analysis for the Income Statement and Balance Sheet

Question: *Trend analysis is often used to evaluate each line item on the income statement and balance sheet. How is this analysis prepared?*

Answer: Figure 13.1 "Income Statement Trend Analysis for " shows **Coca-Cola's** income statement trend analysis, and Figure 13.2 "Balance Sheet Trend Analysis for " shows **Coca-Cola's** balance sheet trend analysis. Carefully examine each of these figures, including the comments.

Figure 13.1 Income Statement Trend Analysis for Coca-Cola



Coca-Cola Company
Income Statement
Years Ended December 31
(dollar amounts are in millions)

	2010	2009	Increase (decrease) from 2009 to 2010: Amount Change	Percent
Net Sales	$35,119	$30,990	$4,129	13.3%
Cost of goods sold	12,693	11,088	1,605	14.5%
Gross margin	$22,426	$19,902	$2,524	12.7%
Selling and administrative expenses	13,158	11,358	1,800	15.8%
Other operating expenses	819	313	506	161.7%
Operating income	$ 8,449	$ 8,231	$ 218	2.6%
Interest expense	733	355	378	106.5%
Other income (expenses; net)	6,477	988	5,489	555.6%
Income before taxes	$14,193	$ 8,864	$5,329	60.1%
Income tax expense	2,384	2,040	344	16.9%
Net income	$11,809	$ 6,824	$4,985	73.1%

Figure 13.1 "Income Statement Trend Analysis for " shows that net sales increased by $4,129,000,000, or 13.3 percent. Cost of goods sold had a corresponding increase of $1,605,000,000, or 14.5 percent. The increase in net sales and related increase in cost of goods sold resulted in an increase in gross margin of $2,524,000,000, or 12.7 percent. The increase in selling and administrative expenses of $1,800,000,000, or 15.8 percent, outpaced the increase in net sales, resulting in a relatively small increase in operating income of $218,000,000, or 2.6 percent.

The significant increase in other income (expenses), net of 555.6 percent relates to a one-time gain of $4,978,000,000 resulting from **Coca-Cola's** acquisition of **Coca-Cola Enterprises, Inc.,** in 2010 (this information comes from the notes to the financial statements). This one-time gain caused an unusually large increase in net income for 2010. This is important as we continue our analysis of **Coca-Cola Company** throughout the chapter. Net income will appear to have an unusually large increase as we cover various measures of performance, but keep in mind that the one-time gain in 2010 of $4,978,000,000 caused most of the increase from 2009 to 2010.

Figure 13.2 Balance Sheet Trend Analysis for Coca-Cola

Coca-Cola Company
Balance Sheet
(dollar amounts are in millions)

	2010	2009	Increase (decrease) from 2009 to 2010: Amount	Increase (decrease) from 2009 to 2010: Percent
Assets				
Current assets				
Cash and cash equivalents	$11,199	$ 9,151	$ 2,048	22.4%
Marketable securities	138	62	76	122.6%
Accounts receivable (net)	4,430	3,758	672	17.9%
Merchandise inventory	2,650	2,354	296	12.6%
Other current assets	3,162	2,226	936	42.0%
Noncurrent assets				
Long-term investments	9,706	8,731	975	11.2%
Property, plant, and equipment (net)	14,727	9,561	5,166	54.0%
Intangible assets	26,909	12,828	14,081	109.8%
Total assets	$72,921	$48,671	$24,250	49.8%
Liabilities and shareholder's equity				
Current liabilities				
Accounts payable and accrued liabilities	$ 8,859	$ 6,657	$ 2,202	33.1%
Loans and notes payable	8,100	6,749	1,351	20.0%
Other liabilities	1,549	315	1,234	391.7%
Noncurrent liabilities				
Long-term debt	14,041	5,059	8,982	177.5%
Other liabilities and deferred taxes	9,055	4,545	4,510	99.2%
Shareholder's equity				
Common stock	10,937	9,417	1,520	16.1%
Retained earnings	49,592	42,084	7,508	17.8%
Accumulated other income (loss)	(1,450)	(757)	(693)	91.5%
Treasury stock	(27,762)	(25,398)	(2,364)	9.3%
Total liabilities and shareholders' equity	$72,921	$48,671	$24,250	49.8%

Cash and cash equivalents increased 22.4%, marketable securites increased 122.6%, inventory increased 12.6%, and other current assets increased 42.0%.

Long-term investments increased 11.2%; property, plant, and equipment increased 54.0%; and intangible assets increased 109.8%.

Total assets increased 49.8%.

Accounts payable and accrued liabilities increased 33.1%. Loans and notes payable increased 20.0%, and other liabilities increased 391.7%.

Long-term debt increased 177.5% and other liabilities and deferred taxes increased 99.2%.

Common stock and retained earnings increased. Accumulated other loss and treasury stock went further into negative territory.

Total liabilities and shareholders' equity increased 49.8%.

Note: Percent change for each line item is found by dividing the increase (decrease) amount by the 2009 amount. For example, cash and cash equivalents 22.4 percent increase equals $2,048 ÷ $9,151.

Use of Trend Analysis

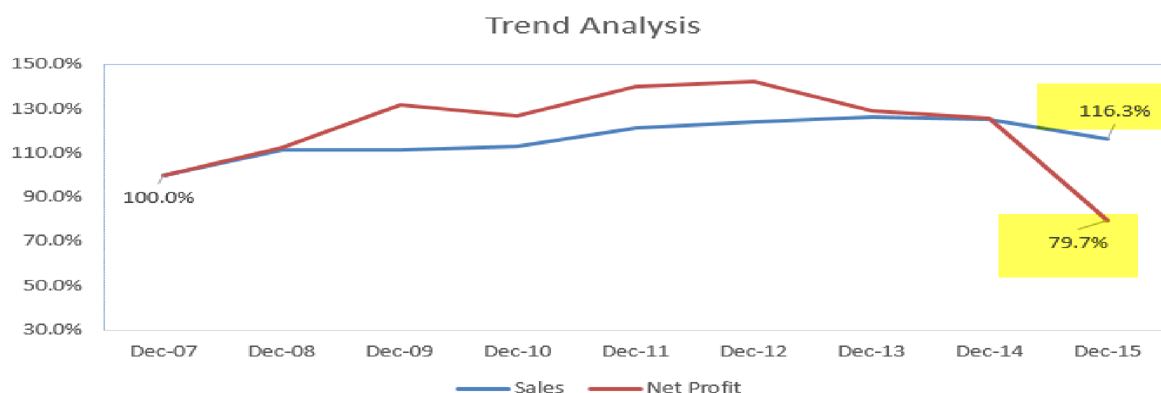
1.Use in Accounting

Sales and cost information of the organization's profit and loss statement can be arranged on a horizontal line for multiple periods and examined the trends and data inconsistencies. For instance, take the example of a sudden spike in the expenses in a particular quarter followed by a sharp decline in the next period, is an indicator of expenses was booked twice in the first quarter. Thus the trend analysis in accounting is essential for examining the financial statements for inaccuracies, to see whether the adjustment of the certain heads should be made before the conclusion is drawn from the financial statements.

Trend Analysis in accounting compares the overall growth of **key financial statement line item** over the years from the base case.

For example, in the case of Colgate, we assume that 2007 is the base case and analyze the performance in Sales and Net profit over the years.

- We note that Sales has increased by only 16.3% over 8 years (2008-2015).
- We also note that the overall net profit has decreased by 20.3% over the 8 years.



2. Use in Technical Analysis

An investor can create his trend line from the historical stock prices, and he can use this information to predict the future movement of the stock price. The trend can be associated with the given information. Cause and effect relationships must be studied before taking concluding the trend analysis.

Trend Analysis in Manufacturing

1. B2B to B2C

B2B is the traditional way of doing business. This involves a relationship between one business and another – for instance, the manufacturer to the wholesaler, and from the wholesaler to the retailer. This model is however easing into a business-to-consumer (B2C) model whereas the manufacturer sells directly to the consumers and end-users of the product.

2. New ways to the Internet of Things (IoT)

In simple terms, the Internet of Things (IoT) refers to the network of physical objects that have now become embedded with sensors, software, and other modern technology. These are then used to collect and share data with other connected devices over the internet.

In the manufacturing industry, the IoT refers to the use of networked sensors and intelligent devices in factories. As a manufacturer, the IoT will give you the tools to make informed and strategic decisions using real-time data.

3. Accessible Automation

The use of automation is growing at a faster rate. Though this has been in use in the manufacturing industry for a long time, more and more manufacturing processes are now being automated. New inventions and technologies now make automation equipment more accessible to manufacturers.

Automation like easy-to-use robotics solutions, user-friendly manufacturing process management (MPM) systems, and human-robot collaboration now make it possible to reduce cost, increase production, and/or optimize workflows.

4. Artificial Intelligence (AI) and Machine Learning (ML)

It is projected that by 2035, AI-powered technologies will be widely adopted in the manufacturing industry such that it could increase labour productivity by 40% and add about 3.8 trillion dollars to the gross value added (GVA)[2]. Machine learning, for instance, can easily predict the impact of several variables in very complex situations.

Adapting Artificial intelligence and Machine Learning is another way you can improve your overall equipment efficiency (OEE) and boost production results.

AI and machine learning can help improve several aspects of the manufacturing process, such as:

- ✓ Quality control and checks
- ✓ Prediction of failure modes
- ✓ Inventory management
- ✓ Generative design
- ✓ Supply chain visibility
- ✓ Product and asset tracking
- ✓ Warehousing and transportation cost reduction.

5. **A New Approach to ERP**

When you need to plan the day-to-day business activities, enterprise resource planning (ERP) is the solution. ERP refers to software that helps your business with accounting, project and risk

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management, procurement, and compliance. ERP systems are now used to manage millions of businesses across industries.

Modern usage now allows the application of ERP systems in all spheres of production. ERP links business processes across all departments – like engineering, finance, human resources (HR), and marketing – with the workforce. In the manufacturing industry, you can use ERP to track the procurement of raw materials for easy analysis.

6. Increased importance of HR in Attracting and Retaining Manufacturing Workers

Part of dealing with the labor shortage and skills gap in manufacturing involves **attracting and retaining younger workers** and those re-entering the workforce post pandemic.

Older workers who have built expertise and hands-on experience are retiring. At the same time, automation and robotics are creating demand for new roles and skills in manufacturing.

Manufacturing companies need to **attract new workers and boost employee retention** to solve the skills gap and keep up with demand. Moving into 2022, we'll see HR departments rethink their approach to the employee life cycle.

Trend Analysis in Service Sector

1. **Personalization:** The new service marketers are designing marketing strategies that favors engagement of human in delivering a service in order to build relationship factor. However, with increasing use of technology the human factor is placed less importance. Marketers are promoting use of internet transaction like online banking, online check in that reduced human engagement and flavors standardization of service delivery process.
2. **Understanding of Customer Expectation:** With increasing use of research on consumer behavior, marketers are able to measure customer expectation and try designing services that will fulfill consumer perceived value. Also, with increasing use of consumer database with tools like credits card, loyalty cards etc. Marketers are successfully able to analyse the buying behavior of consumers and are able to design targeted campaigns based on the behavioral study.
3. **Credibility:** Marketers are emphasizing on positioning themselves as organisation that effectively deliver brand promise by focusing on creating Emotional selling proposition rather than Unique Selling proposition. Companies are employing combination of above the line and below the line techniques. It's been observed that modern are favor branding and public relation opposed to pay advertising.
4. **Simplification:** Trends towards decreasing consumer complexity and increasing consumer knowledge. New cyber channels are being used as info-mediaries to provide consumer with quick and convenient information and access to service provider. Most of the marketers are designing marketing tools like website highly interactive and engaging that allows the consumer to consume services in easy, comfortable and convenient way.
5. **Internationalization:** Trend towards the dominance of global service brands operating in service sector. This is mainly because giant companies are able to invest in advancing technology to serve burgeoning customer needs. They are able employ advanced CRM tools that can help marketing and promoting their brands to consumers.

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6. **Bundling:** Trend towards aggregating a physical good or other service with basic service offering. This strategy is commonly being adopted in order to develop physical evidence. Also, it helps in reducing the impact of fundamental characteristic of intangibility in marketing services consumer.

7. **Rationing:** Marketers are putting strong efforts to maximize per output in provision of service to meet the challenge of high return on investment. Marketers are challenged on presenting profit impact of marketing strategy (PIMS). The marketing function has become more analytical opposed to designing creative strategy.

8. **Virtual experience:** Marketers are commonly using technological tools like virtual reality in provision of services or as a substitute for services. Marketers are also developing platforms like fan-clubs; forums in order share their experience to develop trust about the service offering.

9. **Market spaces:** The new cyber market has been able to successfully get more and more number of service users for the companies. Currently, it is strongest channel of distribution used by service providers. For example, Hotels, Broadband Services, Airline Industry etc.

10. **Multi-dimensional competition:** Marketers are trying to appear as non-traditional service providers in order to blur distinctions between markets. Marketers are adapting niche and focused marketing approach in order position their service as a customized package for the target market.

Trend Analysis in Banking Organisation

1.Digitization

With the rapid growth of technology, digital services became an indispensable part of banking operations as these institutions needed to keep up with the changes and introduce innovations that made services convenient. In India, the initial phase of digitization began in the 1980s when information technology was used to perform basic functions like customer service, bookkeeping, etc. Gradually core banking solutions were also adopted to improve customer experience. The main shift came during the 1990s when liberalization opened the Indian market to the global world. Private and international banks which came into operation boosted technological changes in the banking sector. Features like online banking, IMPS (Immediate Payment Service), RTGS (Real Time Gross Settlement), telebanking enabled customers to avail banking facilities from anywhere.

2.Mobile Banking

Almost a decade back, even though digital services came into the picture, it was only done through desktop computers which means the customer must be at home or at a place with a computer and internet connection. But the vast penetration of smartphones created a need among customers to avail banking services on their mobile phones. Cheap data charges also contributed towards the increase in usage of mobile banking.

3.Unified Payment Interface (UPI)

UPI is a trend that emerged in the last couple of years and it is revolutionizing the way we pay and receive money. Transactions can be done within seconds using this interface. Goggle Pay and BHIM

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(Government of India) are two major interfaces among numerous other services that enable easy payment even if you are out of physical cash.

4.Blockchain

Blockchain is a robust technology that is still in the development phase. Security is a major factor as far as digital services are concerned. Despite technical advances, fraud practices are still a challenge in the digital domain. Blockchain is the answer to these challenges. Like the way in which it operates, there is no scope for any malpractices in it. The technology works on computer science, data structures and cryptography.

5.Artificial Intelligence (AI) Robots

Many private and nationalized banks have started to make use of chatbots or Artificial Intelligence (AI) robots for assistance in customer support. The practice is still in its initial stage but will definitely evolve and make the entrance to the general public in the near future. Chatbots are one of the emerging trends that are estimated to grow.

6.Digital-only Banks

Digital-only banks operate only through IT platforms which can be accessed using mobile phones, laptops or tablets. Digital-only banks operate in a paperless and branchless model and seem to overtake the traditional system of banks in the future. These banks provide high-speed banking facility at a low transaction charge. These virtual banks are an ideal choice for the current fast-paced world.

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Recent Types Of Accounting:-

1. Human Resource Accounting

The American Association of Accountants (AAA) defines HRA as follows: ‘HRA is a process of identifying and measuring data about human resources and communicating this information to interested parties’.

Flamhoitz defines HRA as ‘accounting for people as an organizational resource. It involves measuring the costs incurred by organizations to recruit, select, hire, train, and develop human assets. It also involves measuring the economic value of people to the organization’.

According to Stephen Knauf, ‘ HRA is the measurement and quantification of human organizational inputs such as recruiting, training, experience and commitment’.

Objectives of Human Resource Accounting (HRA)

1. Providing cost value information about acquiring, developing, allocating and maintaining human resources.
2. Enabling management to monitor the use of human resources.
3. Finding depreciation or appreciation among human resources.
4. Assisting in developing effective management practices.
5. Increasing managerial awareness of the value of human resources.
6. For better human resource planning.
7. For better decisions about people, based on improved information system.
8. Assisting in effective utilization of manpower.

Need for Human Resource Accounting (HRA)

The need for human asset valuation arose as a result of growing concern for human relations management in the industry.

Behavioural scientists concerned with management of organizations pointed out the following reasons for HRA:

1. Under conventional accounting, no information is made available about the human resources employed in an organization, and without people the financial and physical resources cannot be operationally effective.
2. The expenses related to the human organization are charged to current revenue instead of being treated as investments, to be amortized over a period of time, with the result that magnitude of net income is significantly distorted. This makes the assessment of firm and inter-firm comparison difficult.
3. The productivity and profitability of a firm largely depends on the contribution of human assets. Two firms having identical physical assets and operating in the same market may have

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different returns due to differences in human assets. If the value of human assets is ignored, the total valuation of the firm becomes difficult.

4. If the value of human resources is not duly reported in profit and loss account and balance sheet, the important act of management on human assets cannot be perceived.
5. Expenses on recruitment, training, etc. are treated as expenses and written off against revenue under conventional accounting. All expenses on human resources are to be treated as investments, since the benefits are accrued over a period of time.

Limitations of Human Resource Accounting (HRA)

HRA is yet to gain momentum in India due to certain difficulties:

1. The valuation methods have certain disadvantages as well as advantages; therefore, there is always a bone of contention among the firms that which method is an ideal one.
2. There are no standardized procedures developed so far. So, firms are providing only as additional information.
3. Under conventional accounting, certain standards are accepted commonly, which is not possible under this method.
4. All the methods of accounting for human assets are based on certain assumptions, which can go wrong at any time. For example, it is assumed that all workers continue to work with the same organization till retirement, which is far from possible.
5. It is believed that human resources do not suffer depreciation, and in fact they always appreciate, which can also prove otherwise in certain firms.
6. The lifespan of human resources cannot be estimated. So, the valuation seems to be unrealistic.

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2. Forensic Accounting

Forensic accounting utilizes accounting, auditing and investigative skills to conduct an examination into the finances of an individual or business. Forensic accounting provides an accounting analysis suitable to be used in legal proceedings. Forensic accountants are trained to look beyond the numbers and deal with the business reality of a situation. Forensic accounting is frequently used in fraud and embezzlement cases to explain the nature of a financial crime in court.

Forensic accountants analyze, interpret and summarize complex financial and business matters. They may be employed by insurance companies, banks, police forces, government agencies or public accounting firms. Forensic accountants compile financial evidence, develop computer applications to manage the information collected and communicate their findings in the form of reports or presentations.

- Forensic accounting is a combination accounting and investigative techniques used to discover financial crimes.
- One of the key functions of forensic accounting is to explain the nature of a financial crime to the courts.
- Forensic accounting is used by the insurance industry to establish damages from claims.

Forensic Accounting for Litigation Support

Forensic accounting is utilized in litigation when quantification of damages is needed. Parties involved in legal disputes use the quantifications to assist in resolving disputes via settlements or court decisions. For example, this may arise due to compensation and benefit disputes. The forensic accountant may be utilized as an expert witness if the dispute escalates to a court decision.

Forensic Accounting in the Insurance Industry

Forensic accounting is routinely used by the insurance industry. In this capacity, a forensic accountant may be asked to quantify the economic damages arising from a vehicle accident, a case of medical malpractice or some other claim. One of the concerns about taking a forensic accounting approach to insurance claims as opposed to an adjuster approach is that forensic accounting is mainly concerned with historical data and may miss relevant current information that changes the assumptions around the claim.

Forensic Accounting for Criminal Investigation

Forensic accounting is also used to discover whether a crime occurred and assess the likelihood of criminal intent. Such crimes may include employee theft, securities fraud, falsification of financial statement information, identify theft or insurance fraud. Forensic accounting is often brought to bear in complex and high profile financial crimes.

Forensic accountants may also assist in searching for hidden assets in divorce cases or provide their services for other civil matters such as breach of contracts, tort, disagreements relating to company acquisitions, breaches of warranty or business valuation disputes. Forensic accounting assignments can include investigating construction claims, expropriations, product liability claims or trademark or patent infringements. And, if all that wasn't enough, forensic accounting may also be used to determine the economic results of the breach of a nondisclosure or noncompete agreement.

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Accounting for Corporate Social Responsibility

Social accounting (also known as social accounting and auditing, social accountability, **social and environmental accounting, corporate social reporting, corporate social responsibility reporting, non-financial reporting or accounting**) is the process of communicating the social and environmental effects of organizations' economic actions to particular interested groups within society and to society at large.

The companies Act 2013 is provided certain guidelines on reporting of CSR initiatives but it is necessary to have the standard which is acceptable at the global level. These guidelines apply only to Indian context and which are not recognizable at the international market because there are unique guidelines and standards which are applicable for reporting the CSR initiatives by the companies at the global level, for instance, GRI (Global Reporting Initiatives) sustainability reporting standards for reporting the non-financial performance-related information. Non-financial performances are also called as social performances of the companies. It is important to note that GRI SRs are the unique global level standards developed for reporting the social performance-related information and this will helps the companies to recognize at the international level and also enables the firms to attract the global investors thereby Indian companies can grow globally.

➢ Accounting for CSR and Sustainable Spending by the Companies in India

There is a legal and mandatory requirement to undertake CSR and sustainable projects by the companies in India. This creates the responsibility on the companies but not accountability so, to bring transparency in the CSR expenditure made by the companies which come within the ambit of section 135 of the companies Act 2013, the ICAI issued guidance note on accounting for expenditure for CSR activities. This assists with the accounting of the expenditure on CSR activities and brings more accountability. Generally, the expenditure on CSR activity is to be debited to the statement of profit and loss and extra provision is made for the expenses to be incurred.

➢ The Accounting Method for CSR and Sustainable Spending by the Companies in India

1. Contribution to Fund :- For any contribution made to a fund specified in Schedule VII, the same is treated as an expense for the year and debited to the statement of profit and loss.

2. Expenditure Incurred by a Company itself on the CSR Activities :- In this case, the company needs to analyze the nature of the expenditure by keeping in view the 'Framework for preparation and presentation of financial statements' issued by the ICAI. The revenue expenditure is charged as an expense for the year to the profit and loss account and the capital expenditure which gives rise to an asset is treated differently by assessing it whether it has control over the asset and earn future economic benefit from it. If the control of the asset is transferred by the company, then the same is not recognised as an asset in the books and such expenditure is charged to profit and loss account. In the other way round, if the control of the asset is retained by the company itself then it is further assessed whether it earns future economic benefits. But there will be no future economic benefits from a CSR asset in the form of any surplus and it further cannot be included in business profits as per rule 6(2) of the Companies Act 2013.

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3. Expenditure through Trust, Society etc. :- A company can do its CSR activities through a registered trust, or a society, or a company established under section 8 of the Act. The expenditure incurred in this case is also treated as an expense for the year and charged to the statement of profit and loss.

4. Grants Received from Others :- The CSR expenditure is measured net of the grant if a company receives a grant from others for carrying out CSR activities.

5. Goods Manufactured and Services Rendered :- If company supplies goods manufactured by it or renders service as CSR activities, the expenditure is recognized when the control of the goods is transferred or allowable services are rendered by the employees of the company.

- **Accounting Treatment of Income Earned from CSR Projects while Undertaking CSR Activities**

When the companies are undertaking CSR activities or programmes then it is necessary to determine whether any surplus created from the activity or not. If there is a surplus then it should not be the part of the profit of the business of the company. Since the surplus from the CSR activities is not related to direct business then it does not form the part of the surplus of the business so it should be considered as the liability of the business. Hence it should be the charge to the statement of profit or loss of the company.

It is noted that the surplus amount of CSR activities should not consider while calculating 2% of the amount to be spent.

- **Accounting for the Shortage of Funds when the Company Spends Excess for CSR**

When the company is not in a position to spend the specified amount for CSR then it has to disclose the reasons for the same. In some cases the company is having a shortage of funds to spend money for CSR then it is not allowed to make the provisions for the same. But for the contractual liabilities companies are allowed to make the provisions. In some specific cases if the company spent more than the prescribed limit that is 2% of net profit then the excess amount spent is cannot be carried forward to the future years.

For example, ABC Ltd. has unspent CSR amount on 31st March 2021 of Rs. 500 crores which relates to an ongoing project. Now, ABC Ltd. shall open Unspent CSR Account with the bank and transfer Rs. 500 crores in that account upto 30th April 2021. Let say it transferred amount on 29th April 2021 in the account and now it has to utilize this amount upto 28th April 2024 failing which the remaining amount will have to be transferred to fund specified in Schedule VII such as PM Cares Fund or PM National Relief Fund, etc.

Treatment of Excess CSR Amount :- If the company spends amount on CSR in excess of the 2% of average profits of past 3 years then it is free to do so as 2% is minimum amount and there is no maximum limit prescribed in law. However, **no set-off** will be allowed in subsequent years for excess amount spend in previous years and accordingly no asset should be recognised in books for such amount.

END OF UNIT-5

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