Business Finance Assignment 1

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Question & Answer

Q1. Which of the following errors in recording transactions has an impact on profitability?
Ans: C. I,II &IV

Q2. The auditor believes that the financial statement does not give a true and fair view and the effect is so material that a disclosure is required to the extent that financial statement may be misleading or incomplete in nature, the auditor should issue –
Ans: A. Disclaimer of Opinion

Q3. Which of the following is NOT required as part of a listed company's accounting statement: -?
Ans: C. Chairman's report

Q4. Which of the following accounting concepts are likely to distort the true economic value of an entity as reflected by its statement of financial position?
Ans: D. I,II & III

Q5.
a) Briefly explain the realization and accruals concepts of accounting concepts.
Ans:
Realization: Income is recognised as and when it is 'earned'. It is not, therefore, necessary to wait until the customer settles his or her bill. This avoids the fluctuations in reported income which might arise if everything was accounted for on a cash basis. It can also create the impression that the business is performing well when, in fact, it is in danger of running out of cash. A business might report income long before the related cash inflows which may be a problem for a growing business.
Accruals: Expenses are recognised as and when they are incurred, regardless of whether the amount has been paid. Again, this avoids the random allocation of costs to periods depending on whether the bill happens to have been paid or not.

b) A Health insurance company sells one-year medical plans throughout the year. Describe the specific ways the realization and accrual concepts are utilized in preparing the accounts of the company.
Ans: Both these concepts run alongside each other. Accrual concept states that profit should be recognized when earned, hence the health insurance company would record the earnings from sales of medical plans as and when they occur.

Q6. Explain different ways through which accounts can be manipulated along with example of each.
Ans: There are 2 approaches to manipulating financial statements. The first is to exaggerate current period earnings on the income statement by artificially inflating revenue and profits, or by deflating current period expenses. This approach makes the financial condition of the company look better than it actually is in order to meet expectations.

The second approach requires the exact opposite tactic, to minimize current period earnings on the income statement by deflating revenue or by inflating current period expenses. It seems counterintuitive to make the financial condition of a company look worse than it actually is, however there are many reasons to do so: to dissuade potential acquirers; getting all of the bad news "out of the way" so that the company will look better going forward; dumping the grim numbers into a period when the poor performance can be attributed to the current macroeconomic environment; or to postpone good financial information to a future period when it is more likely to be recognized.

Q7. What happens to the Gross profit and cash flow of the company for a financial year? (whether there is an increase/decrease) in the following cases:

i. **Property that the company possess has been revalued upwards by ₹100 crores by the Valuer.**
Ans. Increase in gross profit, no effect on cashflow

ii. **There has been an interest payment of ₹1000 crores towards Masala bond issued by the company.**
Ans. Gross profit won't be affected and cash flow will decrease

iii. **There has been an increase in inventory of ₹500 crores which were manufactured out of raw materials available in the previous year end, ignoring any man power and production cost.**
Ans. Gross profit will increase and cashflow won't be affected.

iv. **There was a depreciation of plant and machinery to the extent of ₹250 crores.**
Ans. Decrease to gross profit, no cashflow

v. **It was decided to write off ₹200 crores due to EHFL defaulting.**
Ans. Gross profit and cashflow won't be affected.

Q8. a) Briefly list the main roles of regulation in the financial system.

Ans: A financial regulator is an institution that supervises and controls a financial system. Their objective is to guarantee fair and efficient markets and financial stability. The main responsibilities of financial regulators are to enforce applicable laws, try to prevent cases of market manipulation, ensure the competence of financial service providers, execute regular inspections, protect traders and clients and investigate and prosecute misconduct, such as insider trading. Banks and brokers that are regulated are more secure to trade with, as they are obliged to meet certain standards and requirements.

b) Identify the regulatory bodies which regulate the Indian Financial system.

Ans: India has two primary financial services regulators – the Reserve Bank of India (RBI) regulating India's banking industry and the Securities & Exchange Board of India (SEBI) regulating the capital markets industry.

c) Identify the regulatory authorities currently responsible for supervising each of the following:

1. **Banks –** Reserve Bank of India
2. **Superannuation Products -** the Insurance Regulatory and Development Authority of India (IRDAI).
3. **General Insurance companies -** the Insurance Regulatory and Development Authority of India (IRDAI).
4. **Stock brokers –** the Securities & Exchange Board of India (SEBI)
5. **Mutual Funds –** the Securities & Exchange Board of India (SEBI)
6. **Market for listed securities -** the Securities & Exchange Board of India (SEBI)
7. **Foreign exchange dealers –** Reserve Bank of India (RBI)
8. **Money changers –** Reserve Bank of India (RBI)

Q9. a) A company's accounts should comply with various accounting concepts. Outline the cost concept and the going concern concept.

Ans: Cost Concept: Under that concept, non-current assets generally appear in the statement of financial position at their original cost less depreciation to date, subject to a possible impairment write-down.
The cost concept is being gradually phased out to provide more scope for realism in the financial statements. For example, tangible non-current assets such as property, plant and equipment can be shown at their fair value rather than their historical costs.
Going Concern Concept: it is an assumption that a business will continue indefinitely in its present form, and is used to support the cost concept of accounting

b) A company has entered into an unusual transaction that is not directly covered by any accounting standard. Explain how the Board of Directors can go about selecting the appropriate accounting policy for this situation.

Ans: The board of directors should value the transaction at fair value to give the shareholders a reasonable figure.

c) The Directors of a listed company believe that if optimistic accounting policies are applied consistently, the stock market will reward the company by increasing its share price. Explain why this may not be true.

Ans: This will be true in the short term as this would indicate that the company is performing well. But as the shareholders and the stock markets realise that the improved numbers were due to change in policy and not due to better performance, the share price will correct itself and this will impact negatively on the reputation of the company.

Q10. Discuss the role, sources of funds and application of funds for the following financial institutions:

a) Investment Bank

1. **Role:** Investment banks are best known for their work as intermediaries between a corporation and the financial markets. That is, they help corporations issue shares of stock in an IPO or an additional stock offering. They also arrange debt financing for corporations by finding large-scale investors for corporate bonds. The investment bank's advisory role begins with pre-underwriting counselling and continues after the distribution of securities. The investment bank is responsible for examining a company's financial statements for accuracy and publishing a prospectus that describes the offering in detail to investors before the securities are available for purchase. Investment bank clients include corporations, pension funds, other financial institutions, governments, and hedge funds.
2. **Sources of funds:** A bank's sources and uses of funds are embodied in its statement of financial position. The sources of funds are primarily deposits, borrowed capital and shareholders' funds while the primary uses are loans and investments, defensive assets and required reserves. A bank's health is measured by CAMELS. Specifically, Capital serves as buffer against losses, deposits are the primary source of liquidity while the quality of assets is enhanced when provisioning on possible losses do not crystallize. A tractable model of the banking firm is a prerequisite to economy-wide analysis of financial and monetary systems that rely heavily on intermediation and inside money.
3. **Application of funds:** Receive fees for advice, underwriting commission, fund management, Eurobond dealing, trusteeship and bill acceptance. Borrow money by running banking accounts and issuing certificates of deposit.

b) Pension Scheme:

1. **Role:** Pension funds are collective investment undertakings (UCITs) that manage employee savings and retirement. Their primary objective is to provide pensioners who have reached retirement age with income in the form of a lifetime pension or capital. Unlike public pension funds managed on a pay-as-you-go basis, pension funds are managed by capitalization. When members reach retirement age, they are provided with either an annuity or a capital paid by the fund. At the core of pension fund operations are three types of activity: premium collection, investment of sums collected, benefits paid.

2. **Sources of funds:** Pension plans are funded by contributions by employers and employees, the former pay the largest share. Public employee pension plans tend to be more generous than plans from private employers. Private pension plans are subject to governmental regulation via ERISA.
3. **Application of funds:** Contributions from employers and employees only. No borrowings.

c) Life Insurance Company:

1. **Role:** Since life itself is uncertain, all individuals try to assure themselves of a certain sum of money in the future to take care of unforeseen events or happenings. Individuals in the course of their life are always exposed to some kind of risks. The risk may be of an event which is certain that is death. In that case, what will happen to the other members of the family who are dependent on a particular individual's income. The other risk may be living too long in which an individual may become too old to earn i.e. retirement. In this case also, the earnings will decline or end. Under such circumstances, individuals seek protection against these risks and life insurance companies

offer protection against such risks. A life insurance policy was introduced as a protection against the uncertainty of life. But gradually its scope had widened and there are various types of insurance policies available to suit the requirements of an individual. For example, disability insurance, health/medical insurance, annuity insurance and life insurance proper.

2. **Sources of funds:** Typical fund invests in a mixture of equities and short and long fixed interest securities. May have some investment in overseas securities, property, money market investments and index-linked gifts.
3. **Application of funds:** Premium income from policyholders. Do not usually borrow money.

Q11. There are general insurance and life insurance companies operating in a country, each of which is governed and regulated by a different regulator. If you want to interpret the accounts of these companies for your investment decision, what limitations and challenges are possible?

Ans: The underlying contracts (liabilities) fall due outside the accounting period and are uncertain in size. Premature transfer of 'profit' to shareholders may endanger the financial stability of the company and the ability to meet future liabilities.

Q12. a) Briefly describe why it is more complicated to compare insurance companies accounts as compared to normal company accounts.

Ans: The preparation of insurance company accounts is complicated by two special features:

- The underlying contracts (liabilities) fall due outside the accounting period and are uncertain in size.
- Premature transfer of 'profit' to shareholders may endanger the financial stability of the company and the ability to meet future liabilities.

b) List and define the major component of reserves for a general insurance company's technical account.

Ans: The major component of reserves for a general insurance company's technical accounts are as follows-

1. RR (Un-expired risk reserves): This reserve is kept to cover the claims and expense that are expected to emerge from an unexpired portion of the insurance cover in future period.
2. Outstanding claim reserves: This reserve is kept to cover the claims and expense for all outstanding claims that have not yet been settled. These claims and expense may or may not be reported or known at the time of preparation of accounts.

Q13. A newly formed country is debating whether it should mandate compliance with the International Accounting Standards. As a reputed member of the accounting profession in a neighbouring country, you have been asked for your advice.

i) Describe four advantages and four disadvantages of compliance with the International Accounting Standards.

Ans: Advantages-

1) They eliminate, or at least reduce variations between companies in the way they prepare accounts.
2) They oblige companies to disclose more information than that required by national laws.
3) They allow some degree of flexibility in a way that legislation often does not.

Disadvantages-

1) The sets of rules contained in the standards may not be appropriate to all companies in all circumstances.
2) Some standards are so general as to be meaningless, while others are far too detailed
3) Standards often allow more than one alternative treatment, which negates the attempt to ensure conformity between companies.

ii) List the various sources of regulations that influence the preparation of financial statements for companies in addition to the accounting standards.

Ans:

- Principals, concepts and conventions
- National Company Laws
- Good practice by leading companies
- Stock Exchange requirements
- Other Legislation

iii) Describe the additional information that cash flow statements provide which is not available in the Statement of Financial Position and Statement of Comprehensive Income.

Ans: A cash flow statement is a valuable measure of strength, profitability, and the long-term future outlook for a company. The A cash flow statement is a valuable measure of strength, profitability, and the long-term future outlook for a company. The CFS can help determine whether a company has enough liquidity or cash to pay its expenses. A company can use a cash flow statement to predict future cash flow, which helps with matters of budgeting. can help determine whether a company has enough liquidity or cash to pay its expenses. A company can use a cash flow statement to predict future cash flow, which helps with matters of budgeting.

The cashflow statement allows investors to understand how a company's operations are running, where its money is coming from, and how money is being spent. The cashflow statement is important since it helps investors determine whether a company is on a solid financial footing.

Creditors, on the other hand, can use the cashflow statement to determine how much cash is available (referred to as liquidity) for the company to fund its operating expenses and pay its debts.

14.

Income statement for the year ended 31st march 2019

	(in 000's)
Revenue	1500
Cost Of Sales	(647)
Gross Profit	**853**
Distribution Cost	(266)
Administrative Expenses	(3)
Operating Profit	584
Finance Income	0
Finance Cost	(10)
Profit Before Tax	**574**
Tax Paid	0
Profit For The Year	**574**
Revaluation Reserve Gains	540
Total Comprehensive income	**1114**

Cost of sales	
Inventory Consumed	350000
Depreciation (Building)	7000
Factory Cost	100000
Depreciation (Machinery)	15000
	472000
Manufacturing Wages	175000
	647000

A statement of changes in equity

	Attributable to equity holders of the company			
	Share capital	Other reserves	Retained earnings	Total equity
	200	180	250	630
Revaluation (200+340)		540		
Profit for The Year			574	
Dividends			(45)	
	200	**720**	**779**	**1699**

Statement of financial position as on 31st march 2019

	(in 000's)
ASSETS	
Non current assets	1672
Current assets	
Inventory	30
Trade Receivables	210
Total Assets	**1912**
Total Equity	**1699**
Non Current Liability	
Loan (Repayable 2024)	145
Current Liability	
Bank Overdraft	18
Trade Payables	50
Total Liability	**213**
Total Equity And Liability	**1912**

Working Notes:

Non current asset	**Book Value**	**Dep To Date**	**Book Value**
Building	7,00,000	7,000	6,93,000
Delivery vehicle	3,25,000	2,01,000	1,24,000
Machinery	1,50,000	95,000	55,000
Land			8,00,000
			1672000

Distribution Cost

Machinery	55,000
Delivery Cost	60,000
Depreciation (Delivery vehicle)	31,000
Salaries	1,20,000
	266000

15.

Profit and loss account for the year ended 31st march 2019

Revenue (55,000+2,000+1,000)		58000
Gross Profit		**58000**
Administrative Expenses		
Depreciation On Laptop And Office Equipment	5041	
Office Supplies	1000	
Rent	14207	
Employee Salary	14000	
Office Electricity Bill	4000	
Mobile And Interest Bill	583	(38831)
Operating Profit		**19169**
Finance Cost And Income		0
Profit Before Tax		**19169**
Tax Payable		(3000)
Profit For The Year Attributable To Shareholders		**16169**

Statement of financial position as on 31st march 2019

Non Current Asset		
Laptop	31792	
Office Equipment	18167	49959
Current Asset		
Inventory Of Office Supplies	1000	
Trade Receivables	3500	
Cash	1000	
Bills Receivable	5000	
Prepaid Rent	1710	12210
Total Assets		**62169**
Equity		
Share Capital	32000	
Unearned Fees Reserve	9000	
Retained Earnings	11169	52169
Current Liability		
Outstanding Salary	4000	
Trade Payables	3000	
Tax Payable	3000	10000
Total Equity And Liabilities		**62169**

Statement Of Retained Earnings

Profit For The Year	16169
Dividend Paid	(5000)
Retained Earnings	**11169**