

Chapter 19

Financial

Statements

Meaning of Financial Statements

Financial Statements refer to such statements which report the profitability and the financial position of the business at the end of accounting period.

Objectives of Preparing Financial Statements

- (i) To present a true and fair view of the financial performance (i.e., profit/loss) of the business;
- (ii) To present a true and fair view of the financial position (i.e., Assets/Liabilities) of the business.

Users of Financial Statements

Information provided by financial statements is used by the management, investors, creditors, employees, government etc.

(1) Management: The financial statements help the management in assessing the profitability of various activities and various departments. On their basis, the management can review the progress of the business and take decisions for controlling the non-profitable activities.

(2) Investors: They can assess the short-term and long-term financial soundness and earning capacity of the business with the help of financial statements. They can also study prospects of future growth of the enterprise.

(3) Creditors: On the basis of financial statements they assess whether the enterprise will be able to pay their debts when they fall due and may decide to extend, maintain or restrict the credit allowed to the enterprise.

(4) Employees and Trade Unions: On the basis of financial statements they can judge as to how much bonus and increase in their wages is possible from the profits of the enterprise.

(6) Government: Government uses the financial statements to study the profit margins of various industries to announce or withdraw various concessions and to increase or decrease the excise duty.

(7) Taxation Authorities: They use the financial statements for the purpose of assessment of income tax, sales tax etc.

(8) Other Users: Such as trade associations, consumer organisations, researchers etc.

TRADING AND PROFIT AND LOSS ACCOUNT

Trading and Profit and Loss account is prepared to determine the profit earned or loss sustained by the business enterprise during the accounting period. It is basically a summary of revenues and expenses of the business and calculates the net figure termed as profit or loss. Profit is revenue less expenses. If expenses are more than revenues, the figure is termed as loss. Trading and Profit and Loss account summarises the performance for an accounting period. It is achieved by transferring the balances of revenues and expenses to the trading and profit and loss account from the trial balance.

Relevant Items in Trading and Profit and Loss Account

The different items appearing in the trading and profit and loss account are explained hereunder:

Items on the debit side

(i) Opening stock: The stock of goods remaining unsold at the end of the previous year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. Opening Stock will include the following:-

- I. Opening Stock of Raw Material,
- II. Opening Stock of Semi-finished goods, and
- III. Opening Stock of Finished goods.

(ii) Purchases less returns: Goods which have been bought for resale appears as purchases on the debit side of the trading account. They include both cash as well as credit purchases. Goods which are returned to suppliers are termed as purchases return. It is shown by way of deduction from purchases and the computed amount is known as Net purchases.

(iii) Wages: Wages refer to remuneration paid to workers who are directly engaged in factory for loading, unloading and production of goods and are debited to trading account.

(iv) Carriage inwards/Freight inwards: These expenses are the items of transport expenses, which are incurred on bringing materials/goods purchased to the place of business. These are debited to the trading account.

(v) Fuel/Water/Power/Gas: These items are used in the production process and hence are part of expenses.

(vi) Packaging material and Packing charges: Cost of packaging material used in the product are direct expenses as it refers to small containers which form part of goods sold. However, the packing refers to the big containers that are used for transporting the goods and is regarded as an indirect expense debited to profit and loss account.

(vii) Salaries: These include salaries paid to the administration, godown and warehouse staff for the services

rendered by them for running the business. It will be debited to the profit and loss account.

(viii) Rent paid: These include office and godown rent, municipal rates and taxes, factory rent, rates and taxes. The amount of rent paid is shown on the debit side of the profit and loss account.

(ix) Interest paid: Interest paid on loans, bank overdraft, renewal of bills of exchange, etc. is an expense and is debited to profit and loss account.

(x) Commission paid: Commission paid or payable on business transactions undertaken through the agents is an item of expense and is debited to profit and loss account.

(xi) Repairs: Repairs and small renewals/ replacements relating to plant and machinery, furniture, fixtures, fittings, etc. for keeping them in working condition are included under this head. Such expenditure is debited to profit and loss account.

(xii) Miscellaneous expenses: Though expenses are classified and booked under different heads, but certain expenses being of small amount clubbed together and are called miscellaneous expenses. In normal usage these expenses are called Sundry expenses or Trade expenses.

Items on the credit side

(i) Sales less returns: Sales account in trial balance shows gross total sales (cash as well as credit) made during the year. It is shown on the credit side of the trading account. Goods returned by customers are called return inwards and are shown as deduction from total sales and the computed amount is known as net sales.

(ii) Other incomes: Besides salaries, other gains and incomes are also recorded in the profit and loss account. Examples of such incomes are rent received, dividend received, interest received, discount received, commission received, etc.

(iii) Closing Stock: The goods remaining unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the closing stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods.

Normally, the Closing Stock is given outside the Trial Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry: -

Closing Stock A/c
 To Trading A/c
(Closing Stock transferred to Trading A/c)

When the above entry is passed, the Closing Stock Account is opened. On the one hand, it will be posted to the credit side of the trading account and on the other hand, will be shown on the Assets side of the Balance Sheet, in order to complete the double entry. Sometimes, the Closing Stock is given inside the Trial Balance. This will mean that the entry to incorporate the closing stock in the books has already been passed. It would imply that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear on the Assets side of the Balance Sheet only.

Format of Trading and Profit and Loss Account

Dr. (for the year ending.....) Cr.

Particulars	Amount	Particulars	Amount
To Opening stock	By Sales	.....
To Purchases	Less Sales Returns	.....
Less Purchase Returns	By Closing Stock	.....
To Wages	By Gross Loss	.....
To Carriage inwards/			
To Gas, Fuel and power		
To freight, Octroi,			
cartage		
To Manufacturing			
Expenses		
To Factory Expenses			
Factory lighting			
Factory Rent		
To Dock Charges		
To Import Duty		
To Royalty		
To Gross profit

To Gross loss b/d	By Gross Profit b/d	.....
To Salaries and Wages	By Rent from tenant	.....
To Rent, rate and taxes	By Commission	.....
To Printing and stationery	received	.....
To Postage and Telegram	By Rent (Cr.)	.....
To Lightings	By Discount	.....
To Insurance Premium	Received	.....
To Telephone charges	By Interest on	.....
To legal Charges	investment	.....
To Travelling Expenses	By Dividend on	.....
To Establishment		shares	.....
Expenses	By Bad debt	.....
To Trade Expenses	recovered	.....
To General Expenses	By Profit on sale of	.....
To Carriage Outward	assets	.....
To advertisement		By Miscellaneous	.....
Expenses	Receipts	.....
To Brokerage	By Net loss	.....
To Bad debts	transferred to	.....
To Packing Charges	capital account	
To Discount		
To Repairs		
To Depreciation		

To Interest (Dr.)	.....	
To Bank Charges	.....	
To Entertainment Expenses	.....	
To Conveyance Expenses	.....	
To Donation and Charity	.....	
To loss on sale of assets	.....	
To Net Profit transferred to capital account	.....	

Gross Profit

The excess of sales over purchases and direct expenses is called gross profit. If the amount of purchases including direct expenses is more than the sales revenue, the resultant figure is gross loss. The computation of gross profit can be shown in the form of equation as

$$\text{Gross Profit} = \text{Sales} - (\text{Purchases} + \text{Direct Expenses})$$

The gross profit or the gross loss is transferred to profit and loss account.

Net Profit

If the total of the credit side of the profit and loss account is more than the total of the debit side, the difference is the net profit for the period of which it is being prepared. On the other hand, if the total of the debit side is more than the total of the credit side, the difference is the net loss incurred by the business firm. In an equation form, it is shown as follows

$$\text{Net Profit} = \text{Gross Profit} + \text{Other Incomes} - \text{Indirect Expenses}$$

Operating Profit (EBIT)

It is the profit earned through the normal operations and activities of the business. Operating profit is the excess of operating revenue over operating expenses. While calculating operating profit, the incomes and expenses of a purely financial nature are not taken

into account. Thus, operating profit is profit before interest and tax (EBIT). Similarly, abnormal items such as loss by fire, etc. are also not taken into account. It is calculated as follows:

Operating profit = Net Profit + Non-Operating Expenses – Non Operating Incomes

Balance Sheet

The balance sheet is a statement prepared for showing the financial position of the business summarising its assets and liabilities at a given date. The assets reflect debit balances and liabilities (including capital) reflect credit balances. It is prepared at the end of the accounting period after the trading and profit and loss account have been prepared.

Preparing Balance Sheet

All the account of assets, liabilities and capital are shown in the balance sheet. Accounts of capital and liabilities are shown on the left hand side, known as Liabilities. Assets and other debit balances are shown on the right hand side, known as Assets. There is no prescribed form of Balance sheet, for a proprietary and partnership firms. (However, Schedule III Part I of the Companies Act 2013 prescribes the format and the order in which the assets and liabilities of a company should be shown).

Relevant Items in the Balance Sheet

Items which are generally included in a balance sheet are explained below:

(1) Current Assets: Current assets are those which are either in the form of cash or a can be converted into cash within a year. The examples of such assets are cash in hand/bank, bills receivable, stock of raw materials, semi-finished goods and finished goods, sundry debtors, short term investments, prepaid expenses, etc.

(2) Current Liabilities: Current liabilities are those liabilities which are expected to be paid within a year and which are usually

to be paid out of current assets. The examples of such liabilities are bank overdraft, bills payable, sundry creditors, short-term loans, outstanding expenses, etc.

(3) Fixed Assets: Fixed assets are those assets, which are held on a long-term basis in the business. Such assets are not acquired for the purpose of resale, e.g. land, building, plant and machinery, furniture and fixtures, etc. Sometimes the term 'Fixed Block' or 'Block Capital' is also used for them.

(4) Intangible Assets: These are such assets which cannot be seen or touched. Goodwill, Patents, Trademarks are some of the examples of intangible assets.

(5) Investments: Investments represent the funds invested in government securities, shares of a company, etc. They are shown at cost price.

(6) Long-term Liabilities: Such liabilities are usually payable after one year of the date of the balance sheet. The important items of long term liabilities are long-term loans from bank and other financial institutions.

(7) Capital: It is the excess of assets over liabilities due to outsiders. It represents the amount originally contributed by the proprietor/ partners as increased by profits and interest on capital and decreased by losses drawings and interest on drawings.

(8) Drawings: Amount withdrawn by the proprietor is termed as drawings and has the effect of reducing the balance on his capital account. However it is shown by way of deduction from capital in the balance sheet.

Marshalling and Grouping of Assets and Liabilities

A major concern of accounting is about preparing and presenting the financial statement. The information so provided should be decision useful for the users. Therefore, it becomes necessary that the items appearing in the balance sheet should be properly grouped and presented in a particular order.

Marshalling of Assets and Liabilities

In a balance sheet, the assets and liabilities are arranged either in the order of liquidity or permanence. Arrangement of assets and liabilities in a particular order is known as Marshalling.

In case of permanence, the most permanent asset or liability is put on the top in the balance sheet and thereafter the assets are arranged in their reducing level of permanence.

Balance Sheet

as on or as at.....

Liabilities	Amount	Assets	Amount
Current liabilities:- Bank Overdraft Bill Payable Sundry Creditors Outstanding Expenses Unearned Income		Current Assets: - Cash in hand Cash at Bank Bills Receivable Short Term Investment Sundry Debtors Closing Stock Prepaid Expenses Accrued Income	
Fixed Liabilities: - Long term loans		Long Term Investment	
Reserves and Surplus:- Capital Add Net profit Less Drawings Less Income tax Less life insurance premium		Fixed Assets Furniture Loose Tools Motor Vehicles Plant and Machinery Land and Building Patents Goodwill	
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Need for Adjustments

According to accrual concept of accounting, the profit or loss for an accounting year is not based on the revenues realised in cash and the expenses paid in cash during that year. There may exist some receipts and expenses in the current year which partially relate to the previous year or to the next year. Also, there may exist incomes and expenses relating to the current year that still need to be brought into books of account. Such items duly adjusted, the final accounts will not reflect the true and fair view of the state of affairs of the business.

The purpose of making various adjustments is to ensure that the final accounts reveal the true profit or loss and the true financial position of the business. The items which usually need adjustments are:

1. Closing stock
2. Outstanding/expenses
3. Prepaid/Unexpired expenses
4. Accrued income
5. Income received in advance
6. Depreciation
7. Bad debts
8. Provision for doubtful debts
9. Provision for discount on debtors
10. Manager's commission
11. Interest on capital

Closing Stock

The closing stock represents the cost of unsold goods lying in the stores at the end of the accounting period.

The adjustment with regard to the closing stock is done by

- (i) By crediting it to the trading and profit and loss account, and

(ii) By showing it on the asset side of the balance sheet. The adjustment entry to be recorded in this regard is:

Closing stock A/c Dr.

To Trading A/c

Outstanding Expenses

A business enterprise have some unpaid expenses in the normal course of business operations at the end of an accounting year. Such items usually are wages, salaries, interest on loan, etc.

When expenses of an accounting period remain unpaid at the end of an accounting period, they are termed as outstanding expenses. The entry to bring such expenses into account is:

Concerned expense A/c Dr.

To Outstanding expense A/c

Outstanding Expenses is shown on the liabilities side of the balance sheet. The amount of outstanding expenses is added to the total of expenses under a particular head for the purpose of preparing trading and profit and loss account.

Prepaid Expenses

There are several items of expense which are paid in advance in the normal course of business operations. At the end of the accounting year, it is found that the benefits of such expenses have not yet been fully received; a portion of its benefit would be received in the next accounting year. This portion of expense, is carried forward to the next year and is termed as prepaid expenses. The necessary adjustment in respect of prepaid expenses is made by recording the following entry:

Prepaid expense A/c Dr.

To concerned expense A/c

The amount of prepaid part is deducted from the total of the particular expense, and prepaid expense is shown on the assets side of the balance sheet.

Accrued Income

It may also happen that certain items of income such as interest on loan, commission, rent, etc. are earned during the current accounting year but have not been actually received by the end of the same year. Such incomes are known as accrued income. The adjusting entry for accrued income is:

Accrued income A/c Dr.

To Concerned income A/c

The amount of accrued income will be added to the related income in the profit and loss account and the new account of accrued income will appear on the asset side of the balance sheet.

Income Received in Advance

Sometimes, a certain income is received but the whole amount of it does not belong to the current period. The portion of the income which belongs to the next accounting period is termed as income received in advance or an Unearned Income. Income received in advance is adjusted by recording the following entry:

Concerned income A/c Dr.

To Income received in advance A/c

The effect of this entry will be that the balance in the income account will be equal to the amount of income earned for the current accounting period, and the new account of income received in advance will be shown as a liability in the balance sheet.

Depreciation

Depreciation is the decline in the value of assets on account of wear and tear and passage of time. It is treated as a business expense and is debited to profit and loss account. This, in effect, amounts to writing-off a portion of the cost of an asset which has been used in the business for the purpose of earning profits. The entry for providing depreciation is:

Depreciation A/c Dr.

To Concerned asset A/c

In the balance sheet, the asset will be shown at cost minus the amount of depreciation.

Bad Debts

Bad debts refer to the amount that the firm has not been able to realise from its debtors. It is regarded as a loss and is termed as bad debt. The entry for recording bad debt is:

Bad debts A/c Dr.

To Debtors A/c

It is shown as an expense on the debit side of the Trading and Profit and Loss Account and in the balance sheet debtors are shown at book value less bad debts.

However, assuming that if debtors had become insolvent, and nothing is receivable from him. But the amount of bad debts related to the current year is still to be account for. This fact appears as additional information and is termed as further bad debts.

Provision for Bad and Doubtful Debts

It is quite possible that the whole of this amount may not be realised in future. However, it is not possible to accurately know the amount of such bad debts. Hence, we make a reasonable estimate of such loss and provide the same. Such provision is called provision for bad debts and is created by debiting profit and loss account. The following journal entry is recorded in this context:

Profit and Loss A/c Dr.

To Provision for doubtful debts A/c

Provision for doubtful debts is also shown as a deduction from the debtors on the asset side of the balance sheet.

Provision for Discount on Debtors

A business enterprise allows discount to its debtors to encourage prompt payments. Discount likely to be allowed to customers in an accounting year can be estimated and provided for by creating a provision for discount on debtors. Provision for discount is made on good debtors which are arrived at by deducting further bad debts and the provision for doubtful debts. The following journal entry is recorded to create provision for discount on debtors:

Profit and loss A/c Dr.

To Provision for discount on debtors A/c

The provision for discount on debtors will be created only on good debtors. It will be calculated on the amount of debtors arrived at after deducting the doubtful debts.

Manager's Commission

The manager of the business is sometimes given the commission on the net profit of the company. The percentage of the commission is applied on the profit either before charging such commission or after charging such commission.

In the absence of any such information, it is assumed that commission is allowed as a percentage of the net profit before charging such commission.

The manager's commission will be adjusted in the books of account by recording the following entry:

Profit and loss A/c Dr.

To Manager's commission A/c

Interest on Capital

Sometimes, the proprietor may like to know the profit made by the business after providing for interest on capital. In such a situation, interest is calculated at a given rate of interest on capital as at the beginning of the accounting year. If however, any additional capital is brought during the year, the interest may also be

computed on such amount from the date on which it was brought into the business. The following journal entry is recorded in the books of account:

Interest on capital A/c Dr.

To Capital A/c

In the final accounts, it is shown as an expense on the debit side of the profit and loss account and added to capital in the balance sheet.

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