

Module 02 - Orientation To financial statements

Income Statement, Balance Sheet and notes to accounts - Terms and Jargons in financial statements, Accounting concepts and conventions and GAAP.

→ Income Statement | Profit and Loss Account :

Income statement is one of the imperative component of financial statements. The aim of income statement is to quantify and present the financial performance of a company for a given period.

→ Important Features of Income Statement

- The income statement has been prepared for the year end; it covers the effects of all financial operations of the financial year.
- Comparative position of each account of the Income Statement on a particular period has also been disclosed. This helps the reader to understand the changes in the income, expenses, tax, profit and dividend over the previous year etc.
- The income statement is drawn vertically and not horizontally.

→ Objective :

- To know the results within given accounting period.
- To know the operating efficiency of the company
- To know the progress of the company as compared to its last year
- To forecast its future prospects etc.

→ Important Jargons in Income Statement :

- The top line (Revenue) - The line which every user of the financial statements invariably looks @ and that too, in the every first instance, because the aggregate of all sub-line items of this line provides the first indication of the size of the operations of a company. Normally 'Higher the income, the higher the profit' is what is generally believed to be and to a large extent it is true also. Top Line depicts the competence generation of sales.

- The Bottom Line (Net Profit) - Net profit on the bottom line is directly linked to the size of the operations as reflected in the income of the company and therefore, corporate management could use this as a handle to manipulate the bottom line. Bottom Line depicts the operational efficiency of the business.

* Reasons for Manipulation :

- To project an image that the company is a low risk company.
- To enhance managerial compensation
- To promote a perception that the management of the firm is competent
- To communicate more meaningfully about the long-term prospects of the firm.

* Suggestions to Detect the Manipulation :

- Acquire greater knowledge about how to prepare and present financial statements with rules.
- Carefully track the notes to financial statement i.e. changes in accounting policies
- Read Auditors Report
- Look at the performance of the company over a period of time.

→ Important Income Statement Accounting Concept :

- 01 Accounting period concept
- 02 Realization concept
- 03 Accrual concept
- 04 Matching concept.

NOTE :

- In Income Statement the Top Line refers to Revenue
- In Income Statement the Bottom Line refers to Net Profit.

Income Statement Problem Pattern :

Name of the Company.....

Perform of Income Statement for the Period.....

Particulars	Amount.
• Revenues / Sales	xxx
• Other operating income	xxx
	xxx
• Less :- Cost of Goods sold	xxx
• Gross Profit	xxx
• Less : Operating Expenses	xxx
• Earning before interest, tax, Depreciation and Amortization (EBITDA)	xxx
• Less : Depreciation and Amortization -	xxx
• Operating Profit (EBIT)	xxx
• Add : Non-operating expenses and losses income	xxx
• Less : Non-operating expenses and losses	xxx
• EBI / Taxable Profit	xxx
• Less : Tax Burden	xxx
• PAT / EAT / Net Profit	xxx
• Add : Previous year's balance of P&L account / Previous year undistributed profit	xxx
• Profit available for Appropriation	xxx
• Less : Appropriation	xxx
Total of Appropriations and Balance carried forward	xxx

or Revenue from sales

Sales (cash sales + Credit sales)	xxx
Less : sales returns and allowances	xxx
Net Sales	xxx

02. Other Operating Income

Other operating income like discount received, commission received can show it under other income after revenue only.

03. Cost of Goods Sold

a. Beginning / Opening inventory	xxx
• Add: Purchase	xxx
• Less: Purchase returns and allowances	xxx
	<hr/>
	xxx
• Less: Purchase discounts (if any)	xxx
	<hr/>
• Net Purchases	xxx
• Add: Freight in / Carriage / any other direct expenses like, wages, factory expenses, custom duty, coal, gas, water, fuel, power, manufacture using expenses, factory lighting & heating, Octroi etc	xxx
b. Net Cost of Purchases	<hr/>
	xxx
(c = a + b) Cost of goods available for sale	xxx
Less: Closing stock / Closing inventory	xxx
Cost of Goods Sold	<hr/>
	xxx

NOTE: Add: To net purchases if any conversion cost to

Add: To net purchases if any transport and handling costs on purchases like Govt. levies such as import duties, purchase tax, VAT and Octroi etc.

04. Operating Expenses

These are expenses other than cost of goods sold, interest and income tax and are incurred in the running the normal business of a company. These expenses are often grouped into useful categories such as selling and General, Administrative expenses.

eg: Administrative expenses: Salary, Rent, rates and taxes, printing and stationery, postage, telegrams, telephone, Repairs and maintenance etc.

Selling and Distribution expenses - Commission paid, freight and Carriage on sales, sales tax, advertisement, trade expenses, travelling expenses, entertainment expenses, ~~Reserve~~ Reserve for discount on debtors, bad debts

05. Depreciation and Amortization (தகவல், மூலம் மீட்டர் மீட்டர்)

Value of fixed assets keeps on reducing over their useful lives due to their use. This reduction known as depreciation and is charged to income statement. Any company as and when they buy fixed assets, they kept some of the profit aside to replace existing fixed assets when life of the assets expired.

Depreciation is charged to tangible assets and Amortization is charged to intangible assets like copyright, trademark, patents etc.

06. Non-Operating Income

Non-operating income are the income earned without the help of day to day operations. Eg: Interest earned, interest on drawings, income received from investment, interest on FD, rent received, profit on sale of assets etc.

07. Non-Operating Expenses and Losses.

Non-operating expenses are the expenses incurred without reasons of the day to day operation. Eg: Interest paid, Loss on sale of fixed assets, Interest on capital and Loss by fire, discount allowed etc.

NOTE: Discount received is considered under other operating income because it is income earned from operation of the business and discount allowed is considered under Non-Operating expenses and losses (Finance cost) because it the expenses which is incurred for managing and supply sources of the finance which is necessary for the firm.

→ Balance Sheet :

The balance sheet is another vital constituent of financial statements. The intention of the Balance sheet is to gauge and present the financial position of a company on a given date. The balance sheet is enormously helpful in studying the enormity of the economic resources. It depicts the asset

composition of a company and how it has been financed.

→ Important Features of Balance Sheet :

- The balance sheet has been prepared as ~~is~~ at i.e. on a particular date and not for a particular period.
- Comparative position of each account of the Balance sheet on a particular date has also been disclosed. This helps the reader to understand the changes in financial position.
- The Balance sheet is prepared vertically not horizontally in corporate.
- The Balance sheet depicts the sources of funds, application of fund and net working capital employed in the business etc.

→ Objectives :

- To measure and present the financial position of a company on a given date.
- To depicts the asset structure of a company and how it has been financed.
- To know the sources and application of the fund.
- To act as an effective communication tools for stake holders.

→ Important Jargons in Balance Sheet :

- o/p Grouping : Grouping means putting together items of a similar nature under a common heading.
- o/s Marshalling of Balance sheet : It refers to the order in which the various assets and liabilities are shown in the balance sheet, they are:
 - In the order of Permanence
 - In the order of Liquidity

→ Important Balance Sheet Accounting Concept :

- o/p Monetary unit concept or Money measurement concept
- o/s Business entity concept
- o/s Going concern concept

o/s Cost Concept

o/s Accounting equation concept.

Format :

Name of the Company

Performance of Balance sheet as at

Particulars	Amount	Amount
I. Sources of Fund		
01. Shareholders funds	xxx	
a) Share Capital (Schedule No. 1)	xxx	
b) Reserves and Surplus (Schedule No. 2)	<u> </u>	xxx
Total Shareholders fund		
02. Loan funds (Long-term Liabilities)	xxx	
a) Secured Loan (Schedule No. 3)	xxx	
b) Unsecured Loan	<u> </u>	xxx
Total Loan funds		<u> </u>
Total Sources of the fund		xxx
II. Application of Funds		
03. Fixed Assets (Schedule No. 4)		
a) Gross Block	xxx	
Less : Depreciation	xxx	
Net Block	xxx	
b) Capital work in progress	xxx	
Total fixed Assets	<u> </u>	xxx
04. Investments		xxx
05. Current Assets, Loans and Advances		
Inventories (Schedule No. 5)	xxx	
Debtors (Schedule No. 6)	xxx	
Cash @ Bank and Cash in hand (Schedule No. 7)	xxx	
Loans and Advances etc (Schedule No. 8)	xxx	
Total of Current Assets, Loans and Advances	<u> </u>	xxx
06. Less : Current Liabilities (Schedule No. 9) & Provisions. Creditors		xxx

Particulars	Amount	Amount
Bills payable	xxx	
Bank Over Draft	xxx	
Provisions etc., (Schedule No 10)	xxx	
	<hr/>	
	xxx	
Net Current Assets (5-6)		xxx
07. Miscellaneous Expenditure which is not written off (Schedule No. 11)		xxx
08. Losses (P/L)		xxx
Total Application of Funds		<hr/> xxx

→ Important Points to be known while preparing Balance Sheet :

* Sources of Funds :

01) Shareholder's funds

Shareholders funds are the funds contributed by the owners, i.e. Shareholders and include accumulated retained earnings and other reserves of the company. This funds represented by share capital and reserves and surplus.

- Share Capital includes equity share capital, preference share capital
- Reserves and Surplus.

Reserves : It represents that portion of earnings and receipts, both capital and revenue of a company which are set apart by the management for a general or a specific purpose. Reserve would generally include capital reserve, capital redemption reserve, share premium, other reserves such as debenture redemption reserve, revaluation reserve, general reserve and sinking fund reserve.

Surplus : It represent credit balance in the profit and loss account retained in the business after providing for proposed appropriation towards dividend and reserves.

02) Loan Funds (Long-Term Liabilities) :

These are the funds borrowed by a company, secured as well as unsecured.

Secured Loans : These are the loans available by a company against the security of one or more assets of the company. Eg: Term loans from financial institutions, debentures, working capital loans etc.

Unsecured Loans : Unsecured loans are not backed by any security in the form of assets of the company. Eg: fixed deposits, loans and advances from holding/subsidiary companies, unsecured debentures, security deposits from suppliers, short-term loans and advances which are repayable ~~and~~ within one year of the balance sheet.

* Application of funds :

01) Fixed Assets :

Fixed Assets represents assets held with the intention of being used for the purpose of producing or providing goods or services and are not held for sale in the normal course of business. Fixed assets mainly can be tangible like land, building, plant and machinery etc. and intangible like goodwill, copyright, patents etc.

Capital Work in Progress refers to fixed assets under construction/installation.

02) Investment :

Investment represents assets held for earning income by way of dividend, interest and rentals, capital appreciation and other benefits. In simple investment refers to deployment of surplus funds to earn income, commonly known as non-operating income. Eg: companies may diversify into other lines of business through investments in associate companies, joint venture and subsidiary companies.

03) Current Assets, Loans and Advances :

- **Current Assets :** are those assets which held for consumption or for sale and are expected to be realised in cash during the normal operating cycle. Eg: Inventories, Sundry debtors, cash and bank balances etc.

- **Loans and Advances :** Current assets also include assets that are held for a short-term and expected to be realised within 12 months.

04) Current Liabilities and Provisions :

- **Current Liabilities :** The operating cycle of the business need current assets, this means demand for funds, but the cycle generates some funds, that is,

spontaneous credit, known as current liabilities as well and to that extent eases the financial burden of the company. Eg: Sundry creditors, expenses payable, advances from customers, unclaimed dividends, BOD etc.

- Provisions: Provisions are amounts set aside for any known liability as per a statute's requirements on whose amount requires measurement by using a substantial degree of estimation. Eg: Provision for taxation, proposed dividend, provision for contingencies, provision for retirement benefits for employees like pension, gratuity, leave encashment etc.

05) Miscellaneous Expenditure which is not written off

Miscellaneous expenditure represents revenue expenditure to the extent not charged to the profit and loss account. These are thus deferred over one or more accounting years. Eg: Preliminary expenses, public issue expenses, large advertisement campaigns etc.

06) Losses (P/L):

Debit Balance in Profit and Loss accounts after adjustments against uncommitted reserve if any and is the last line item of the asset.

→ Notes to the Accounts:

- Corporate annual reports contain a separate schedule on notes providing explanations on and significant accounting policies followed in the preparation of financial statements. It is imperative or essential to have their sound knowledge and understanding.
- The notes to the accounts are the most important feature in the financial statements as it are that the company actually states its company policies and the changes that it has done and the liabilities that it has not provided before.
- It refers any company annual ~~report~~ reports after the end of standalone and consolidated profit and loss account and Balance Sheet, instantly there will be significant accounting policies and notes to accounts, these notes accounts helps the readers to understand how the financial statements of the company prepared, vital accounting concepts ~~for~~ followed etc.

- GAAP - Generally Accepted Accounting Principles :
- GAAP Accounting is more an art than a science. It is based on a set of principles on which there is general agreement, but on rules that can be "proved".
 - This term refers to the various methods, rules, ~~pr~~ practices, and other procedures that have evolved over a period of time in response to the need for some form of regulation over the preparation of financial statements.
 - Accounting principle become "generally accepted" by agreement; such agreement is not influenced solely by formal logical analysis. Experience, custom, usage and practical necessity contribute to the set of principles. Astoundingly, it might be better to call them conventions, because principles suggest that they are the product of outright logic
 - Accounting is the language of business. It makes sense only when it is understood by many in the same way. Setting "Accounting Standards" is a step taken in that direction. Hence it can be said that the logic of standard setting is based on the necessity of harmonizing the diverse policies and practices adopted by different enterprises.
 - Accounting Standards ensures consistency in the reported information of an enterprise from year to year so that users of financial statements are in a position to understand and make proper use of the statements for decision-making purpose.

Balance Sheet

NOTE :

- 01) Share Capital - Equity Share Capital, Preference Share Capital
- 02) Reserves - Capital reserve, Capital redemption reserve, revaluation reserve, general reserve, debenture redemption reserve, sinking fund reserve.
- 03) Surplus -
- 04) Secured Loans - Term loans from financial institutions, debentures, working capital loans
- 05) Unsecured loans - fixed deposits, loans and ~~and~~ advances from holding/subsidiary companies, unsecured debentures, security deposits from suppliers, short term loans ~~which are~~ and advances which are repayable within 1 year.
- 06) Fixed Assets - Gross Block \rightarrow Tangible and Intangible Assets
- 07) Capital Work in Progress - construction / installation
- 08) Investments - Earning income by way of dividend, interest and rentals, capital appreciation and other benefits
- 09) Current Assets - Inventories, Sundry debtors, cash and bank balances, Closing Stock,
Loans and Advances - Short term loans and advances
- 10) Current Liabilities - Sundry creditors, expenses payable, advances from customer, unclaimed dividends, BOD
(Bank over draft)
- 11) Provisions - Provision for taxation, proposed dividend, provision for contingencies, provision for retirement benefits for employees like pension, gratuity, leave encashment.
- 12) Miscellaneous - Preliminary expenses, Public Issue expenses, Large advertisement campaigns, Cost of issue of shares.

or Operating Expenses - Administrative expenses (salary, rent, rate & tax),
selling and distribution expenses (commission paid, freight and carriage
on sales, sales tax, advertisement, trade expense).