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Lecture-2

Understanding Corporate Financial Statement

Chapter 2: Understanding Corporate Financial Statements

Notes

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Objectives

After studying this Chapter, you will be able to:

- Know the types of financial statements
- Illustrate the form and contents of financial statements
- Describe the uses and limitations

Introduction

Financial statements are also known as financial reports. These are formal records of the financial activities of a business, person, or other entity. Since we are referring to the corporate financial statements, the corporate financial reports refer to the records of a corporate house.

Corporate financial statements provide an overview of a business's financial condition in both short-term and long-term. All the relevant financial information of a business enterprise, presented in a structured manner and in a form easy to understand, is thus called the financial statement. These statements comprise Balance Sheet or Position Statement and Profit and Loss Account or Income Statement. Of course, to give a full view of the financial affairs of an undertaking, in addition to the above, the business may also prepare a Statement of Retained Earnings and a Cash Flow Statement.

Caution In India, every company has to present its financial statements in the form and contents as prescribed under Section 211 of the Companies Act, 1956.

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2.1 Types of Financial Statements

There are four different types of financial statements. The different types of financial statements indicate the different activities occurring in a particular business house.

- Income Statement
- Retained Earnings Statement
- Balance Sheet
- Statement of Cash Flows
- Fund Flow Statement

Let us understand each of them one by one.

(i) ***Income Statement:*** Income statement, also called profit and loss statement (P&L) and Statement of Operations, is a company's financial statement that indicates how the revenue (money received from the sale of products and services before expenses are taken out, also known as the "top line") is transformed into the net income (the result after all revenues and expenses have been accounted for, also known as the "bottom line"). The purpose of the income statement is to show managers and investors whether the company made or lost money during the period being reported. The important thing to remember about an income statement is that it represents a period of time.

Example: The following example shows some of the common elements of the Income Statement

Sample Company Income Statement
January 1, 2009 to December 31, 2009

Particulars	Amount	Amount
Income		
Gross Sales	346,400	
Less returns and allowances	1,000	
Net Sales		345,400
Cost of Goods		
Merchandise Inventory, January 1	160,000	
Purchases	90,000	
Freight Charges	2,000	
Total Merchandise Handled	252,000	
Less Inventory, December 31	100,000	
Cost of Goods Sold		152,000
Gross Profit		193,400
Interest Income		500
Total Income		**193,900**
Expenses		
Salaries	68,250	
Utilities	5,800	
Rent	23,000	
Office Supplies	2,250	
Insurance	3,900	

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Notes

Advertising	8,650	
Telephone	2,700	
Travel and Entertainment	2,550	
Dues & Subscriptions	1,100	
Interest Paid	2,140	
Repairs & Maintenance	1,250	
Taxes & Licenses	11,700	
Total Expenses		**133,290**
Net Income		**` 60,110**

` ***Retained Earnings Statement:*** As the name suggests, a retained earnings statement explains the changes in a company's retained earnings over the reporting period. It breaks down changes affecting the account, such as profits or losses from operations, dividends paid, and any other items charged or credited to retained earnings. A retained earnings statement is required by Generally Accepted Accounting Principles (GAAP) whenever comparative balance sheets and income statements are presented. It may appear in the balance sheet, in a combined income statement and changes in retained earnings statement, or as a separate schedule.

Example: Written below is a sample of a retained earnings statement.

Quartz Corporation
Statements of Retained Earnings
For the year ending December 31, 2009

Retained earning - January 1, 2009	$400,000
Add: Net income	115,000
	$515,000
Less: Dividends	35,000
Retained earnings - December 31, 2009	$480,000

` ***Balance Sheet:*** The balance sheet provides an insight into the financial status of a company at a particular time. The balance sheet is different in comparison to the other types of financial statements. Other financial statements are prepared by taking into account the financial health of the company over a considerable span of time.

Example: Sample Balance Sheet

Sample Balance Sheet
for the Month Ended __________

Assets	`	Liabilities	`
Cash	15,300	Accounts Payable	–
Accounts Receivable	1,000	Equity	600
Supplies	500	Sample Business Plan, Capital	51,200
Land	10,000	Other	–
Building	25,000	Total Liabilities	–
Total Assets	51,800	Owner's Equity	51,800

10. ***Fund-flow Statement:*** Fund Flow Statements can be understood as the summary of a firm's changes in financial position from one period to another; it is also called a "sources and uses of funds statement" or a "statement of changes in financial position". Simply put, it tells

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investors where funds have come from and where funds have gone. The statements are often used to determine whether companies efficiently source and utilize funds available to them.

Did u know? ***How to Prepare a Fund Flow Statement***

Fund flow statements are prepared by taking the balance sheets for two dates representing the coverage period. The increases and decreases must then be calculated for each item. Finally, the changes are classified under four categories: (1) Long-term sources, (2) long-term uses, (3) short-term sources, (4) short-term uses.

It is also important to zero out the non-fund based adjustments in order to capture only the changes that are accompanies by flow of funds. However, income accrued but received and expenses incurred but not received reckoned in the profit and loss statement should not be excluded from the profit figure for the fund flow statement.

Fund flow statements can be used to identify a variety of problems in the way a company operates. For example, companies that are using short-term money to finance long-term investments may run into liquidity problems in the future. Meanwhile, a company that is using long-term money to finance short-term investments may not be efficiently utilizing its capital.

Example: Determination of Sources and Uses

Assets	2007	2006	+/–	S/U
Cash and C.E.	$90	$100	–	S
Acct. Rec.	394	410	–	S
Inventories	696	616	+	U
Prepaid Exp	5	5		–
Accum Tax Prepay	10	9	+	U
Current Assets	$1,195	$1,140		N/A
Fixed Assets (@Cost)	1030	930		N/A
Less: Acc. Depr.	(329)	(299)		N/A
Net Fix. Assets	$701	$631	+	U
Investment, LT	50	50		–
Other Assets, LT	223	223		–
Total Assets	$2,169	$2,044		

Assets	2007	2006	+/–	S/U
Cash and C.E.	$90	$100	10	S
Acct. Rec.	394	410	16	S
Inventories	696	616	80	U
Prepaid Exp	5	5		–
Accum Tax Prepay	10	9	1	U
Current Assets	$1,195	$1,140		N/A
Fixed Assets (@Cost)	1030	930		N/A
Less: Acc. Depr.	(329)	(299)		N/A
Net Fix. Assets	$701	$631	70	U
Investment, LT	50	50		–

Contd…

Notes

Other Assets, LT	223	223		–
Total Assets	$2,169	$2,044		

Liabilities and Equity	2007	2006	+/–	S/U
Notes Payable	$290	$295	–	U
Acct. Payable	94	94		–
Accrued Taxes	16	16		–
Other Accrued Liab.	100	100		–
Current Liab.	$500	$505		N/A
Long-Term Debt	530	453	+	S
Shareholders' Equity				
Com. Stock ($1 par)	200	200		–
Add Pd in Capital	729	729		–
Retained Earnings	210	157	+	S
Total Equity	$1,139	$1086		N/A
Total Liab/Equity	$2,169	$2,044		

Liabilities and Equity	2007	2006	+/–	S/U
Notes Payable	$290	$295	$5	U
Acct. Payable	94	94		–
Accrued Taxes	16	16		–
Other Accrued Liab.	100	100		–
Current Liab.	$500	$505		N/A
Long-Term Debt	530	453	77	S
Shareholders' Equity				
Com. Stock ($1 par)	200	200		–
Add Pd in Capital	729	729		–
Retained Earnings	210	157	53	S
Total Equity	$1,139	$1086		N/A
Total Liab/Equity	$2,169	$2,044		

Fund Flow Statement

Particular	Amount	Amount
Sources		
Increase, Retained Earnings	$ 53	
Decrease, Accounts Receivable	16	
Increase, Long-Term Debt	77	
Decrease, Cash + Cash Equivalents	10	$156
USES		
Increase, Inventories	$80	
Increase, Accum Tax Prepay	1	
Decrease, Notes Payable	5	
Increase, Net Fixed Assets	70	
		$156

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5. ***Statement of Cash Flows:*** Statement of cash flows reports on a company's cash flow over a period of time. The cash flow may be from many activities of a firm involving particularly its operations, investment and finance.

Example: Sample Cash Flow Statement

Sample Business Plan
Sample Cash Flow Statement
Statement for the Month Ended_________.

Cash Flow From Operating Activities		
Net Income		1,800
Non-cash Expenses and Revenues		
Include income		
Increase in Accounts Receivable	1,000	
Increase in Supplies	500	
Increase in Accounts Payable	600	(900)
Net Cash Flow from Operating Activities		900
Cash Flows From Investing Activities		
Purchase of land	(10,000)	
Purchase of Building	(25,000)	
Net Cash Flow used by Investing Activities		
Cash Flow Financing Activities		
Invested	50,000	
Withdrawals	(600)	
Net Cash Flow Provided by Financing Activities		49,400
Net Increase (Decrease) in Cash		15,000

For large corporations, these statements are often complex and may include an extensive set of notes to the financial statements and management discussion and analysis. The notes typically describe each item on the balance sheet, income statement and cash flow statement in further detail. Notes to financial statements are considered an integral part of the financial statements.

Self Assessment

Fill in the blanks:

5. Income statement is also called profit and loss statement (P&L) and ……………………
6. The purpose of the …………………… is to show managers and investors whether the company made or lost money during the period being reported.
7. A retained earnings statement explains the …………………… in a company's retained earnings over the reporting period.
8. The …………………… provides an insight into the financial status of a company at a particular time.
9. The cash flow may be from many activities of a firm involving particularly its operations, …………………… and finance.

2.2 Form and Contents of Financial Statements

The following are some important forms and their contents of financial statements:

2.2.1 Trading and Profit & Loss Account

Notes

In the Trading and Profit & Loss Account all those accounts are disclosed which affect the profit or loss of the business. In other words, all the nominal accounts of the Trial Balance are used to prepare the Trading and Profit & Loss Account. In the left hand side, all the expenses incurred during a period and in the right hand side all the incomes earned during a period are disclosed.

Did u know? ***What are the capital and revenue expenditure?***

The expenditure incurred for acquiring a fixed asset or which results in increasing the earning capacity of the business is known as Capital Expenditure. For example, acquisition of a fixed asset.

An expenditure incurred in the course of regular business transactions of a concern is availed during the same accounting year is known as Revenue Expenditure. For example, expenditure incurred on the purchase of raw materials.

This account contains two parts:

Trading Account

Profit & Loss Account

Trading Account

This is first financial statement prepared by the owner of the enterprise to determine the gross profit during the year, through the matching concept of accounting. The gross profit of the enterprise is calculated through the comparison of purchase expenses, manufacturing expenses, and other direct expenses with the sales.

It is prepared normally for one year in accordance with accounting period concept, i.e. operating cycle of the enterprise, which should not exceed 15 months with reference to the Companies Act 1956. The proforma of Trading Account is given below:

Proforma of Trading Account
In the Books of …………….
Trading Account
(for the year ending …………….)

To Opening Stock		XXXX	By Cash Sales	XXXX	
To Cash Purchases	XXXX		Add Credit Sales	XXXX	
Add Credit Purchases	XXXX		By Total Sales	XXXX	
To Total Purchases	XXX		Less Sales Return	XXX	
Less Purchase Return	XXX		By Net Sales		XXXX
To Net Purchases		XXXX	By Closing Stock		XXXX
To Wages		XXXX	By Gross Loss C/d**		XXXX
To Carriage Inward		XXXX			
To Factory lighting		XXXX			
To Fuel, coal, oil		XXXX			
To duty on Import of Materials		XXXX			
To Octroi duty		XXXX			
To Gross Profit* C/d		XXXX			

Notes

Notes

= There is no particular proforma of the Trading Account. The above proforma given is traditional one. That is not as per law. Here the students are advised to follow this proforma.

= If the total of credit side is more than the total of debit side, difference is called gross profit or vice versa gross loss.

Task Calculate the Gross Profit from the following:

	`
Opening stock	11,500
Purchases	1,05,000
Wages	3,500
Sales	1,40,000

Hint: ` 20,000

Profit & Loss Account

It is a second statement of accounting in connection with the earlier to determine the net profit/ loss of the enterprise out of the early found gross profit/loss. This is an accounting statement which matches the administrative, selling and distribution expenses with the gross profit and other incomes of the enterprise.

This is an account prepared for one operating cycle of the firm, i.e. 12 months in period. The transactions are recorded in accordance with golden rules of nominal account. In the profit & loss account, the expenses and losses are debited and incomes and gains are credited. The reason for bringing down the gross loss/gross profit of the trading account into the debit and credit side of Profit & Loss A/c respectively, are only to the tune of nominal accounting ruling with reference to debit all expenses and losses, and credit all incomes and gains.

The expenses that are matched with the credit total of the profit and loss account classified into various categories:

1. Administrative Expenses
2. Selling & Distribution Expenses
3. Financial Expenses
4. Legal Expense.

Did u know? ***What are the capital and revenue receipts?***

The receipts which do not arise out of normal course of business are known as Capital Receipts. For example, receipts from sale of fixed assets.

The receipts which arise out of normal course of a business are known as Revenue Receipts. For example, income from sale of goods.

The proforma of Profit & Loss Account is given below:

Proforma of Profit & Loss Account
Profit and loss a/c for the year ending…….

To Gross Loss B/d Balancing figure	**XXXX**	**By Gross Profit B/d Balancing Figure**	**XXXX**
Office and Administrative Expenses			
To Salaries			
To Rent, Rates and Taxes		By Rent received	
To Office Lighting			
To Printing and Stationery			
To Insurance premium			
To postage			
To General expenses			
To Miscellaneous expenses			
Selling and Distribution Expenses			
To Salary to sales staff			
To Commission charges		By Commission received	
To Advertising expenses			
To Carriage outward			
To Bad debts			
To Packing expenses			
Financial Expenses			
To Interest on capital		By Interest on drawings	
To Interest on loans		By Interest on investments	
To Trade discount allowed		By Trade discount received	
To Cash discount allowed		By Cash discount received	
Maintenance Expenses			
To Depreciation on Fixed assets			
To Repairs and maintenance of			
Productive Assets			
To loss on sale of assets		To Profit on sale of assets	
Other Expenses To Provision for debts			
To Net profit c/d*		By Net loss c/d**	

The balancing process of the profit and loss account leads to two different categories:

Net profit is the resultant of excess of income in the credit side over the expenses in the debit side of the Profit and Loss account.

Net Loss is an outcome of excess of expenses in the debit side over the incomes in the credit side.

Notes

Example: From the following information, prepare the Profit & Loss account.

	Debit `	Credit `
Gross profit from the trading account	1,00,000	
Manager Salary	30,000	
Office lighting	5,000	
Office Rent	15,000	
Local Taxes	1,000	
Salary paid to salesmen	20,000	
Commission charges paid	10,000	
Legal charges paid	3,000	
Bad debts	1,500	
Advertising charges	25,000	
Package charges	7,500	
Discount allowed	3,000	
Discount received		4,000
Dividend received		2,000
Rent received		1,000
Depreciation charges	10,000	
Repairs and Maintenance	2,500	
Interest on loans	1,500	500

Solution:

Dr **Profit and Loss Account for the year ended …………………………** Cr

	`		`
To Manager Salary	30,000	By Gross profit B/d	1,00,000
To Office lighting	5,000	By Discount received	4,000
To Office Rent	15,000	By Dividend received	2,000
To Salary paid salesman	20,000	By Rent received	1,000
To Commission charges	10,000	By Interest received	500
To Legal charges	3,000	By Net Loss c/d*	24,500
To Bad debts	1,500		
To Advertising charges	25,000		
To Package charges	7,500		
To Depreciation charges	10,000		
To Repairs and maintenance	2,500		
To Interest on loan	1,500		
To Local taxes	1000		
	1,32,000		**1,32,000**

5 Net loss is the excess of the expenses total in the debit side `24,500 over the incomes total in the credit side of the profit and loss account.

2.2.2 Balance Sheet

Notes

After the determination of the net profit of the business through the Trading and Profit and Loss Account, the businessman wants to know the financial position of the business. For this purpose he prepares a statement which is called the Balance Sheet. The Balance Sheet depicts the financial position of the business on a fixed date. A Balance Sheet is prepared with those balances of Trial Balance which are left out (personal and real accounts) after taking out the nominal accounts' balances to prepare the Trading and Profit and Loss Account. A Balance Sheet has two sides – assets side and liabilities side. The assets and liabilities are shown in a particular order.

Marshalling of Assets and Liabilities

Order of presenting the assets and liabilities in the balance sheet is called marshalling of assets and liabilities. A balance sheet may be prepared by marshalling the assets and liabilities in the following orders:

Balance Sheet prepared in Liquidity Order

Here liquidity means conversion of assets into cash. When a Balance Sheet is prepared on the basis of liquidity order, more easily convertible assets into cash are shown first and those assets which can not be easily converted into cash are shown later and so on. In the case of liabilities, first those liabilities are shown which are payable earlier and then those liabilities are shown which are payable later. The proforma of such a Balance Sheet is given below:

Proforma of Balance Sheet in Order of Liquidity
(as on …………………..)

Liabilities		`	Assets	`
Current Liabilities			Current Assets	------
Sundry Creditors		------	Cash in Hand	
Bank Overdraft		------	Cash at Bank	------
Short-term Loan		-----	Short-term Investment	------
Outstanding Expenses		-----	Prepaid Expenses	------
Unaccrued Income		-----	Bills Receivable	------
Bills Payable		-----	Accrued Incomes	------
Long-term Liabilities			Debtors	------
Capital	-------		Closing Stock	------
(+) Net Profit	-------		Fixed Assets	
	-------		Land & Building	-----
(–) Drawings	-------	-----	Plant & Machinery	-----
Long-term Loans		-----	Furniture	-----
Contingent Liabilities			Investments (Long-term)	-----
	--------		Goodwill	------
	--------		Patents & Trademarks	------
			Livestock	------
		-------		-------

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Balance Sheet prepared in Permanency Order

Balance Sheet prepared under this order is the reverse of the Balance Sheet prepared in liquidity order. In this case first those assets are shown which are more permanent means fixed assets and then less permanent assets (Current Assets) are shown. Similarly, first long-term liabilities (more permanent) are shown then less permanent (short-term on current) liabilities are shown. The proforma of such type of Balance Sheet is given below:

Proforma of Balance Sheet in Permanency Order
(as on …………….)

Liabilities		`	Assets	`
Long-term Liabilities			**Fixed Assets**	
Capital	------		Land & Building	-----
(+) Net Profit	------		Plant & Machinery	-----
	------		Furniture	-----
(–) Drawings	------	------	Long-term Investment	-----
Long-term Loans		------	Goodwill	-----
Current Liabilities			Patents & Trademarks	-----
Sundry Creditors		------	Livestock etc.	-----
Bank Overdraft		------	**Current Assets**	
Bill Payable		------	Cash in Hand	-----
Short-term Loan		------	Cash in Bank	-----
Outstanding Expenses		------	Short-term Investments	-----
Un-accrued Incomes		------	Bill Receivable	-----
			Prepaid Expenses	-----
			Accrued Incomes	-----
			Debtors	-----
			Closing Stock	-----
		------		-----

Example: From the following Trial Balance of Mr. Aditya, prepare a Trading Manufacturing and Profit and Loss Account and Balance Sheet as on 31st December, 2007.

Trial Balance
(as on 31st December, 2007)

Particulars	`	`
Stock on 1.1.2007:		
Raw Materials	8,000	---
Work-in-Progress	20,000	---
Finished Goods	40,000	---
Manufacturing Wages	40,000	---
Purchases of Raw Materials	1,20,000	---
Factory Rent	20,000	---
Carriage of Raw Materials	12,000	---
Salary of the Works Manager	8,000	---
Office Rent	8,000	---

Contd…

Notes

Printing and Stationary	4,000	---
Bad Debts	4,000	---
Sales	---	2,40,000
Land and Buildings	1,20,000	---
Plant and Machinery	80,000	---
Depreciation on Plant	8,000	---
Sundry Debtors	20,000	---
Sundry Creditors	---	1,20,000
Cash in Hand	20,000	---
Capital	---	1,72,000
	5,32,000	**5,32,000**

Closing stock on 31st December, 2007 were as follows:

Raw Materials	20,000
Work-in-Progress	16,000
Finished Goods	40,000

Solution:

In the Books of Mr. Aditya Manufacturing Account
(for the year ended 31st December, 2007)

Particulars		`	Particulars		`
To Opening Stock:			By Closing Stock:		
To Raw Materials	8,000		By Raw Material	20,000	
To Work-in-Progress	20,000	28,000	By Work-in-Progress	16,000	36,000
To Purchase of Materials		1,20,000	By Cost of Production		
To Carriage on Raw Materials		12,000	(Transfer to Trading A/c.)		2,00,000
To Depreciation on Plant		8,000			
To Manufacturing Wages		40,000			
To Factory Rent		20,000			
To Salary of Works Manager		8,000			
		2,36,000			**2,36,000**

Trading and Profit & Loss Account
(for the year ending 31st December, 2007)

Particulars	`		`
To Opening Stock:		By Sales	2,40,000
Finished Goods	40,000	By Closing Stock	
To Cost of Production	2,00,000	Finished Goods	40,000
(Transfer from Manufacturing A/c)			
To Gross Profit			
(carried to P& L A/c)	40,000		
	2,80,000		**2,80,000**

To Office Rent	8,000	By Gross Profit (brought from	40,000
To Printing & Stationary	4,000	Trading A/c)	
To Bad Debts	4,000		
To Net Profit (carried to Capital A/c)	24,000		
	40,000		**40,000**

Balance Sheet
(as on 31st December, 2007)

Liabilities	`	Assets	`
Capital 1,72,000		Land and Buildings	1,20,000
(+) Net Profit 24,000	1,96,000	Plant and Machinery	80,000
Sundry Creditors	1,20,000	Sundry Debtors	20,000
		Stock on 31st Dec., 2007:	
		Raw Materials	20,000
		Work-in-Progress	16,000
		Finished Goods	40,000
		Cash in Hand	20,000
	3,16,000		**3,16,000**

Self Assessment

Fill in the blanks:

7. ………………… is the comparison of sales and purchase.
8. The excess of credit side over debit side is called …………………
9. The Balance Sheet depicts the ………………… of the business on a fixed date.
10. Order of presenting the assets and liabilities in the balance sheet is called ………………… of assets and liabilities.
11. If in the business some goods are being manufactured along with the trading activities, a ………………… is also prepared.

2.3 Uses of Financial Statements

The uses of financial statements vary from entity to entity. For different people, they have different uses. Though no complete list can be provided for their uses, presented under is a brief list of benefits they give to their users:

(ii) ***For Equity Investors and Lenders:*** The existing equity investors and lenders to a company need to monitor their investments and to evaluate the performance of management. For this purpose, they have no aid else than the financial statements of a firm.

The prospective equity investors and lenders use financial statements to decide whether or not to invest in an organisation.

(iii) ***For Finance Specialists:*** Investment analysts, money managers, and stockbrokers, use financial statements to make buy/sell/hold recommendations to their clients.

(iv) ***For Credit Rating Agencies:*** Rating Agencies such as Moody's and Standard & Poor's assign credit ratings on the basis of the financial statements of a company.

4. ***For Customers and Suppliers:*** Major customers of and suppliers to an organization evaluate **Notes** the financial strength and staying power of the company as a dependable resource for their business. For this purpose, the best possible aids are those of the financial statements of the organization.

(ii) ***For Labor Unions:*** Labor unions use financial statements of a company to gauge how much of a pay increase a company is able to afford in upcoming labor negotiations.

(iii) ***For the Board of Directors:*** Board of directors of an organization uses its financial statements to review the performance of management in general and company in particular.

(iv) ***For Managers:*** Managers, too, are interested in measuring the operating performance in terms of profitability and return on invested capital. If they are not owners, managers must still satisfy the owners' expectations in this regard. As managers, they are interested in measures of operating efficiency, asset turnover, and liquidity or solvency. These will help them manage day-to-day activities and evaluate potential credit customers and key suppliers.

(v) ***For Competitors:*** Existing Competitors of an organization use its financial statements to benchmark their own financial results.

Potential competitors of an organization use its financial statements to assess how profitable it may be to enter the industry.

(vi) ***For Government Agencies:*** The financial statements of a company are very useful for the government agencies responsible for taxing, regulating, or investigating the company.

(vii) ***For Associated Personnel:*** The financial statements of a company are also useful for politicians, lobbyists, issue groups, consumer advocates, environmentalists, think tanks, foundations, media reporters, and others who are supporting or opposing any particular public issue the company's actions affect.

(viii) ***For Partners:*** The financial statements of a company are used by actual or potential joint venture partners, franchisors or franchisees, and other business interests who need to know about the company and its financial situation.

Self Assessment

State whether the following statements are true or false:

(i) The prospective equity investors and lenders use financial statements to decide whether or not to invest in an organisation.

(ii) Existing Customers of an organization use its financial statements to benchmark their own financial results.

(iii) Board of directors of an organization uses its financial statements to review the performance of management in general and company in particular.

2.4 Limitations of Financial Statements

Some of the limitations of the financial statements are as follows:

As the historical costs and money measurement concepts govern the preparation of the balance sheet and income statements, hence these financial statements are essentially statements reflecting historical facts. It ignore inflationary trend and does not reflect the true current worth of the enterprise,

Certain important qualitative elements are omitted from the financial statements because they are incapable of being measured in monetary terms like the quality and reputation of the management team, employee and other,

Notes

3. There are items in the assets side of the balance sheet which has no real value and are merely deferred charges to future incomes like preliminary/pre-incorporation expenses and other,

4. There are still the following issues or challenges in preparing the financial statements which may amount to overstatement of the accounting profit of an entity:

   (a) When to and how much to recognize revenue in the Income statement.

   (b) The constant challenge of when to expense or to capitalize the expenses. It is important to determine definitely what is revenue expenditure and capital expenditure otherwise the accounting profit will be overstated or understated. For example, Capitalization of borrowing costs, etc.

   (c) Method of depreciations and the rates to depreciate into the income statement are selected by management to suit their business needs. Are the rates intentionally been made lower or the depreciation rates are higher to accelerate the depreciation of the fixed assets,

   (d) Adequacy of provisions and method of providing for doubtful debts. Are the trade debtors recoverable and to what extent the accounting method for provision for doubtful debts shows the realistic picture.

   (e) Basis of valuation of assets-when can costs change to reflect current values? Using replacement or current costs?

   (f) Consolidation challenges-what to eliminates to reflects the overall group performance. Some items might be omitted to show a higher accounting profits.

Self Assessment

Fill in the blanks:

Financial statements ignore ……………… trend and does not reflect the true current worth of the enterprise.

There are items in the assets side of the balance sheet which has no real value and are merely deferred charges to future incomes like ……………… expenses and other.

2.5 Summary

Financial statements are the most prominent and useful source of information to the investors.

The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

Financial statements also show the results of management's stewardship of the resources entrusted to it.

To meet this objective, financial statements provide information about an entity's:
assets; (b) liabilities; (c) equity; (d) income and expenses, including gains and losses; other changes in equity; and (f) cash flows.

The companies have four types of financial statements, viz. Balance sheet, Income statement, Statement of retained earnings and Statement of cash flows.

Financial statements are the most prominent and useful source of information to the investors.

Financial statements also provide useful information to the shareholders of a company concerning the company's financial position on a particular day, its performance and growth, its progress or regress, its future, etc.

Financial statements record only those facts, which are possible to be expressed in financial terms.

Non-monetary events, howsoever important they may be, are not recorded. Therefore, financial statements do not provide all the information about the firm.

2.6 Keywords

Balance Sheet: The balance sheet provides an insight into the financial status of a company at a particular time.

Marshalling of Assets and Liabilities: Order of presenting the assets and liabilities in the balance sheet is called marshalling of assets and liabilities.

Retained Earnings Statement: A retained earnings statement explains the changes in a company's retained earnings over the reporting period.

Trading Account: This account is prepared to determine the amount of gross profit or gross loss on sales.

2.7 Review Questions

Analyse why U.S. airline companies use a "by nature" income statement format.

What do you mean by Trading Account? Give the proforma of Trading Account and explain why it is prepared.

Calculate the cost of goods sold from the information given below:

	Amount (`)
Opening stock	20,000
Closing stock	18,000
Purchases	85,000
Carriage on purchases	2,300
Carriage on sales	3,000
Office Rent	5,800
Sales	1,40,000
Wages paid to keep the goods in the godown	3,000
Purchases Returns	5,000

How would a change in depreciation expense flow through the financial statements?

What could a company do with excess cash on the balance sheet?

If you want to assess the health of a company and you could choose between looking at 3 years of income statements or 3 years of balance sheets, which would you choose and why?

Which of the three financial reporting statements (balance sheet, income statement, statement of cash flows) is most important and why do you believe this is so?

Analyse the interrelationships between the four financial statements.

What financial statements are non-profits required to issue?

Notes

10. What do you think as the board's responsibility in investment?

    Where do you record common stock on the financial statements? Give reason behind it.

    What would a company need to do to record a loss on an available-for-sale investment? Give reasons to support your answer.

Answers: Self Assessment

1.	statement of operations	2.	income statement
3.	changes	4.	balance sheet
5.	Investment	6.	Trading account
7.	net profit	8.	financial position
9.	marshalling	10.	manufacturing account
11.	true	12.	false
13.	true	14.	inflationary
	preliminary/pre-incorporation		

2.8 Further Readings

Books

Benjamin Graham, Spencer B. Meredith, *The Interpretation of Financial Statements*, Harper Business.

Martin Fridson, Fernando Alvarez, *Financial Statement Analysis: A Practitioner's Guide*, Wiley.

Online links

cbdd.wsu.edu

www.textbooksonline.tn.nic.in