

CHAPTER-21

FINANCIAL STATEMENTS

1. Meaning of Financial Statement

Financial Statement refers to such statements which report the profitability and the financial position of the business at the end of accounting period. The term financial statements include at least two basic statements which are as under:

- i. Income Statement (or Trading and Profit & Loss Account) which shows results of business operations during an accounting period, and
- ii. Statement of Financial Position (or Balance Sheet) which shows financial position of an enterprises at a specified point of time.

In the words of **John N. Mayer**, “The financial statement provide a summary of the accounts of a business enterprises, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period.”

These two financial statements are termed as 'Final Accounts'.

In modern times, in addition to the aforesaid two basic financial statements, two other statements namely a Statement of Retained Earnings and a Cash Flow Statement are also generally included in financial statements.

Objectives of Preparing Financial Statements:

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

Users of Financial Statements

- i. Management
- ii. Investors
- iii. Short-term Creditors
- iv. Long-term Creditors
- v. Employees and Trade Unions
- vi. Government
- vii. Taxation Authorities
- viii. Other Users

INCOME STATEMENT-It is divided into two parts:

- (i)The first part is called 'Trading Account'. It shows the gross profit or gross loss,

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(ii) The second part is called 'Profit & Loss Account'. It shows the net profit or net loss.

2. Trading Account

According to J.R.Batliboi:- “The Trading Account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included.”

Need and Importance of Trading Account

Preparation of Trading Account serves the following objectives:

- (1) It provides information about Gross Profit and Gross Loss
- (2) It provides information about the direct expenses
- (3) Comparison of closing stock with those of the previous years
- (4) It provides safety against possible losses

Format of a Trading Account

ABC Co. Trading Account For the year ended 31st Dec. 2019			
	\$		\$
Opening Stock		Sales	xxxx
Purchases	xxxx	Less: Sales Return	xxxx
Add: Omission	xxxx	Less: Goods sold on Sale or return basis	xxxx
	xxxx	Closing stock	xxxx
Less: Purchases Return	xxxx	Gross Loss (Transfer to P&L A/c	xxxx
Less: Private Purchases	xxxx		
Less: Goods taken away by the proprietor	xxxx		
Less: Goods Distributed as free samples	xxxx		
Carriage Inwards	xxxx		
Cartage	xxxx		
Freight	xxxx		
Railway Charges	xxxx		
Octroi Duty	xxxx		
Landing and Wharf Charges	xxxx		
Import Duty	xxxx		
Clearing Charges	xxxx		
Dock Charges	xxxx		
Custom Duty	xxxx		
Excise Duty	xxxx		
Motive Power	xxxx		
Gas, Water, Fuel	xxxx		
Coal, Coke	xxxx		
Factory electricity	xxxx		
Wages	xxxx		
Manufacturing expenses	xxxx		
Factory rent, rates and insurance	xxxx		
Stores Consumed	xxxx		
Oil, Tallow Grease	xxxx		
Cotton, Waste, Jute, Oilseeds	xxxx		
Raw Material	xxxx		
Royalty	xxxx		
Gross Profit (Transfer to P&L A/c	xxxx		
	xxxx		xxxx

Profit & Loss Account

According to Prof. Carter- “A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or *vice-versa*”

Need and Importance of Profit & Loss A/c

1. **To ascertain the Net Profit or Net Loss**
2. **Comparison with previous years' profits**
3. **Control on Expenses**
4. **Helpful in the preparation of Balance Sheet**

Preparation of Profit and Loss Account- A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account are now debited to Profit & Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

Format of a Profit & Loss Account

ABC Company			
Profit and Loss Account			
For the year ended 31st Dec.			
	\$		\$
Gross Loss (Transferred from Trading A/c)	xxxx	Gross Profit (Transferred from Trading A/c)	xxxx
Office and Administration Expenses:		Commission Received	xxxx
Salaries	xxxx	Rent Received	xxxx
Rent, Rates and Taxes	xxxx	Interest received	xxxx
Postage and Telegram	xxxx	Discount received	xxxx
Telephone Charges	xxxx	Discount from Creditors	xxxx
Printing and Stationery	xxxx	Discount on Purchases	xxxx
Office Electricity	xxxx	Dividend Received	xxxx
Insurance	xxxx	Interest on Drawings	xxxx
Legal Charges	xxxx	Reserve for Discount on Creditors	xxxx
Marketing and Selling Expenses		Interest on Renewal of bills	xxxx
Carriage outwards	xxxx	Bad Debts Recovered	xxxx
Freight Outwards	xxxx	Provision for Bad Debts (Cr.)	xxxx
Sales Salaries	xxxx	Royalty Received	xxxx
Advertisement	xxxx	Apprentice Premium	xxxx
Godown Rent	xxxx	Miscellaneous Income	xxxx
Commissions	xxxx	Sundry Income	xxxx
Discount Allowed	xxxx		
Bad Debts	xxxx		
Financial and Other Expenses:			
Bank Charges	xxxx		
Interest	xxxx		
Depreciation	xxxx		
Repairs and Maintenance	xxxx		
Audit Fees	xxxx		
Loss by Theft, Accident and Fire	xxxx		
Miscellaneous and Sundry Expenses	xxxx		
Net Profit Transferred to Capital	xxxx	Net Loss (Transferred to Capital)	xxxx

3. Balance Sheet

A Balance Sheet has been defined as Follows

In the words of Karlson

“A Business from showing what is owned and what the proprietor is worth, is called a Balance Sheet”.

“A balance sheet is a Statement prepared with a view to measure the exact financial position of a business on a certain fixed date.

Need and Importance of Preparing a Balance Sheet.

- i.** The Main purpose of preparing a Balance Sheet is to ascertain the true financial position of the business at a particular point of time.
- ii.** It helps in ascertaining the nature and cost of various assets of the business such as the amount of closing stock, amount owing from Debtors, amount of fictitious assets etc.
- iii.** It helps in determining the nature and the amount of various liabilities of the business.
- iv.** It gives information about the exact amount of capital at the end of the year and the addition or deduction made into it in the current year.
- v.** It helps in finding out whether the firm is solvent or not. The firm is solvent if the assets exceed the external liabilities. It would be insolvent if opposite is the case.
- vi.** It helps in preparing the Opening Entries at the beginning of the next year.

Balance Sheet of
As at.....

Liabilities	₹	Assets	₹
Current Liabilities: <i>Bank Overdraft</i> <i>Bills Payable</i> <i>Sundry Creditors</i> <i>Outstanding Expenses</i> <i>Income received-in-advance</i>		Current Assets: <i>Cash-in hand</i> <i>Cash at Bank</i> <i>Bills Receivable</i> <i>Short Term Investment</i> <i>Sundry Debtors</i> <i>Prepaid Expenses</i> <i>Accrued Income</i> <i>Closing Stock</i>	
Long-term Liabilities: <i>Long term loan</i>		Investment: (long term) Fixed Assets: <i>Furniture an Fixture</i> <i>Plant & Machinery</i> <i>Building</i> <i>Land</i> <i>Goodwill</i>	
Reserve and Surplus Capital <i>Add : Interest on Capital</i> <i>Add : Net Profit</i> <i>Less : Drawings</i> <i>Less : Interest on Drawings</i> <i>Less : Income Tax</i> <i>Less : Life Insurance Premium</i> <i>Less : Net Loss</i>			

Distinction between Tangible Assets Intangible Assets

Basis of Difference	Tangible Assets	Intangible Assets
1. Physical Existence	These assets have physical existence. Examples of these assets are plant and Machinery, furniture etc.	These assets do not have physical existence. Examples of these assets are Goodwill, patents, Trade Mark etc.
2. Non- Current V/s Current	These assets can be non-current assets or Current Assets.	These assets usually fall in the category of non- current assets.
3. Depreciation or Amortization	Depreciation is changed on fixed tangible assets	Intangible assets are amortised.
4. Acceptance as Security	Lenders accept these assets as security for providing.	Lenders usually do not acceptance intangible assets as securities for providing loan.
5. Risk of loss due to fire	Tangible assets may be lost due to fire.	Intangible assets cannot be lost due to fire.

Distinction between Trial Balance and Balance Sheet

Basis of Difference	Trial Balance	Balance Sheet
1. Object	It is prepared to check the arithmetical accuracy of the books of accounts.	It is prepared to know the true financial position of the firm.
2. Information about profit or loss.	It is not possible to have information about net profit or net loss from a trial balance.	Since net profit or loss is recorded in the Capital shown in Balance Sheet, it is possible to have the information about net profit or net loss from a Balance Sheet.
3. Necessity	Though desirable, its preparation is not necessary.	It is necessary to prepare a Balance Sheet.
4. Headings	The headings of its two columns are debit and credit.	The headings of its two sides are assets and liabilities.
5. Period	It is normally prepared every month or whenever needed.	It is normally prepared half-yearly or yearly at the end of the accounting period.
6. Type of Accounts	All types of accounts whether personal, real or nominal must be written in it.	Only Personal and real accounts are included in it.
7. Adjustments	It can be prepared without making adjustments for outstanding expenses, prepared expenses, accrued incomes etc.	It cannot be prepared without making adjustments for outstanding expenses, prepared expenses, accrued incomes etc.
8. Evidence	It is not accepted by the court as documentary evidence.	It is accepted by the court as documentary evidence. It is also helpful while making payment of income-tax and Goods and Service Tax (GST)

VERY SHORT ANSWER QUESTION

1. What are Financial Statements ?

Ans. Financial statement those statements which provide information about the profitability and the financial position of a business. The term 'Financial statement' includes at least two statement which are:

(i) Balance sheet.(ii) Trading and Profit & loss A/c.

2. What is the primary objective of financial statements ?

Ans :The primary objective of financial statements is to communicate the meaningful information to different stakeholder in the business so that they can make inform decisions

3. What is a Trading Account ?

Ans : Trading Account is one of the financial statements which shows the result of buying and selling of goods and service of an accounting period .

4. What do we come to know by preparing Trading Account?

Ans :By preparing trading account we come to know the amount of ' Gross Profit' or 'Gross Loss'.

5. What is Gross Profit ?

Ans: It is the excess of selling price of the goods over the cost of goods sold

6. What is a Profit and Loss Account ?

Ans: It shows the overall result of business operations i.e., net profit earned or net loss incurred during an accounting period .

7. What is Net Profit?

Ans :Net Profit means the excess of all revenue over all expenses and losses of a business enterprise

8. Give a formula to calculate Operating Profit from Net Profit?

Ans :Operating Profit = Net Profit- Non Operating Income + Non Operating Expenses.

9. Give a formula to calculate 'Cost of Goods Sold'

Ans :Cost of Goods Sold = Sales- Gross Profit

Or

Opening Stock + Purchase + Direct Expenses – Closing Stock

10. What is a Balance sheet ?

AnsIt refers to a statement of Assets and Liabilities of an enterprises on a certain fixed date.

11. Give two characteristics of balance sheet?

Ans: Two characteristics of a Balance Sheet are :

(i) It is a statement and nor an account. It has no debit or credit side heading of the two sides are 'Assets' and 'Liabilities'.

(ii) It is prepared on a particular date and not for a particular period

12. Write one difference between a Trail Balance and a Balance sheet .

13. "Profit and Loss Account shows the financial position of the enterprise" Do you agree ?

Ans : No , It does not show the financial position of the enterprise. It shows the financial performance i.e ., i.e Profit or loss of an enterprise for a particular period .

14. **“Profit and Loss Account is a point statement whereas a Balance Sheet is a period statement”. Do you agree?**

Ans No Profit and Loss Account is a periodic statement because it is prepared for a particular date ,

15. **What is meant by Marshalling of assets and Liabilities ?**

Ans Marshalling is the arrangement of assets and liabilities in a particular order in the balance sheet . There are two ways of marshalling .

- (i) Order of liquidity
- (ii) Order of permanence

16. **“Under the liquidity approach assets which are most liquid are presented at the top of the balance sheet” Do you agree?**

Ans Yes.

17. **When does closing stock appear inside the Trial Balance ?**

Ans: Closing stock is given inside the Trial Balance when 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 purchase Account. Hence in such a case , Closing stock will be shown in the Trading Account but will appear on the Asset side of the Balance Sheet only.

18. **Give any two example of Fictitious Assets ?**

Ans :

- (i) Debit balance of profit & Loss Account
- (ii) Advertisement Expenses not yet written off.

19. **‘T’ form presentation of financial statement is known as ‘Horizontal form’ or ‘Vertical form’?**

Ans Horizontal form.

20. **“Liabilities side of the Balance Sheet always represents Credit balances .” Do you agree ?**

Ans Yes.

OBJECTIVE TYPE QUESTIONS

(A) State whether each of the following statement is ‘True’ or ‘False’:-

1. Balance Sheet is prepared on a particular date and not for a particular accounting period .
2. Prepaid expenses are treated as liquid assets.
3. Goodwill is a tangible asset.
4. Current assets do not include closing stock.
5. Grouping means showing the items of similar nature under a common heading .
6. Marshalling means showing the assets and liabilities in a proper order in the Balance Sheet.

7. The asset which is most easily convertible into cash is shown first and the liability which is to be paid at the earliest will be shown last in order of liquidity.
8. The least liquid asset is shown first and the least urgent liability is shown last in order of permanence.

Ans :True : i , v , vi

False : ii , iii , iv , vii , viii

(B) Rearrange the following assets in order of liquidity:-

- | | |
|-----------------------------|--------------------|
| i Debtors | ii Bill Receivable |
| iii Goodwill | iv Closing Stock |
| v Prepaid insurance | vi Cash in hand |
| vii Short –term Investments | viii Loose Tools |
| ix Cash at bank | x Plant |

Ans: iv , ix , ii , vii , i , iv , v , viii , x , iii.

(C) Choose the best Alternate :-

1. The purpose of preparing final accounts is to ascertain:
 - a. Profit or loss
 - b. Capital
 - c. The value of assets
 - d. Profit or loss and financial position
2. The profit and loss Account shows
 - a. Financial position of the Concern
 - b. Gross profit
 - c. Net profit
 - d. Net profit and financial position
3. Balance sheet shows
 - a. Profit or Loss
 - b. Financial Position
 - c. Errors of Account
 - d. Total Debtors
4. Final Account are prepared
 - a. At end of calendar year
 - b. At end of Assessment year
 - c. On every Diwali
 - d. At the end of Accounting year
5. Trading and profit and loss account is prepared
 - a. For a particular period
 - b. On a particular date

- c. For the whole year
 - d. None above
6. Balance sheet is prepared
- a. For a particular period
 - b. On a particular date
 - c. For the whole year
 - d. None above
7. Excess of debit in profit and loss account is called
- a. Net profit
 - b. Net loss
 - c. Gross profit
 - d. Gross loss
8. "Salaries and wages" appearing in Trial Balance is shown
- a. On the Debit Side of Trading A/c
 - b. On Debit Side of P&L A/c
 - c. On the Assets side of Balance sheet
 - d. On the liabilities side of balance sheet
9. Balance Sheet is prepared with balance of which of the following
- a. All balance in the Ledger
 - b. Balance of personal account
 - c. Balance of real accounts
 - d. Balance of personal and real account
10. Balance of petty cash is
- a. Expenses
 - b. Income
 - c. Liability
 - d. Assets
11. Fixed assets are kept
- a. For earning revenue
 - b. For conversion into cash quickly as possible
 - c. For resale
 - d. For getting loan by mortgage
12. Goodwill is
- a. Current assets
 - b. Tangible assets
 - c. Intangible assets
 - d. Fictitious asset
13. Choose the current assets from the following
- a. Cash
 - b. Stock

- c. Debtors
 - d. Fictitious asset
14. Schedule of balance prepared from ledger account is known as
- a. Balance sheet
 - b. Trial balance
 - c. Statement of account
 - d. Statement of affairs
15. Closing stock appearing in the trial balance is shown
- a. On the Dr. Side of Trading A/c
 - b. On the Cr. Side of Trading A/c
 - c. On the Assets side of Balance side
 - d. On the Cr. Side of Trading A/c and on the Assets side of balance sheet

Ans.

1. d	2 . c	3 . b	4 .d	5 . a
6 . b	7 . b	8 .b	9 .d	10. d
11.a	12. c	1 3.d	14.b	15. c