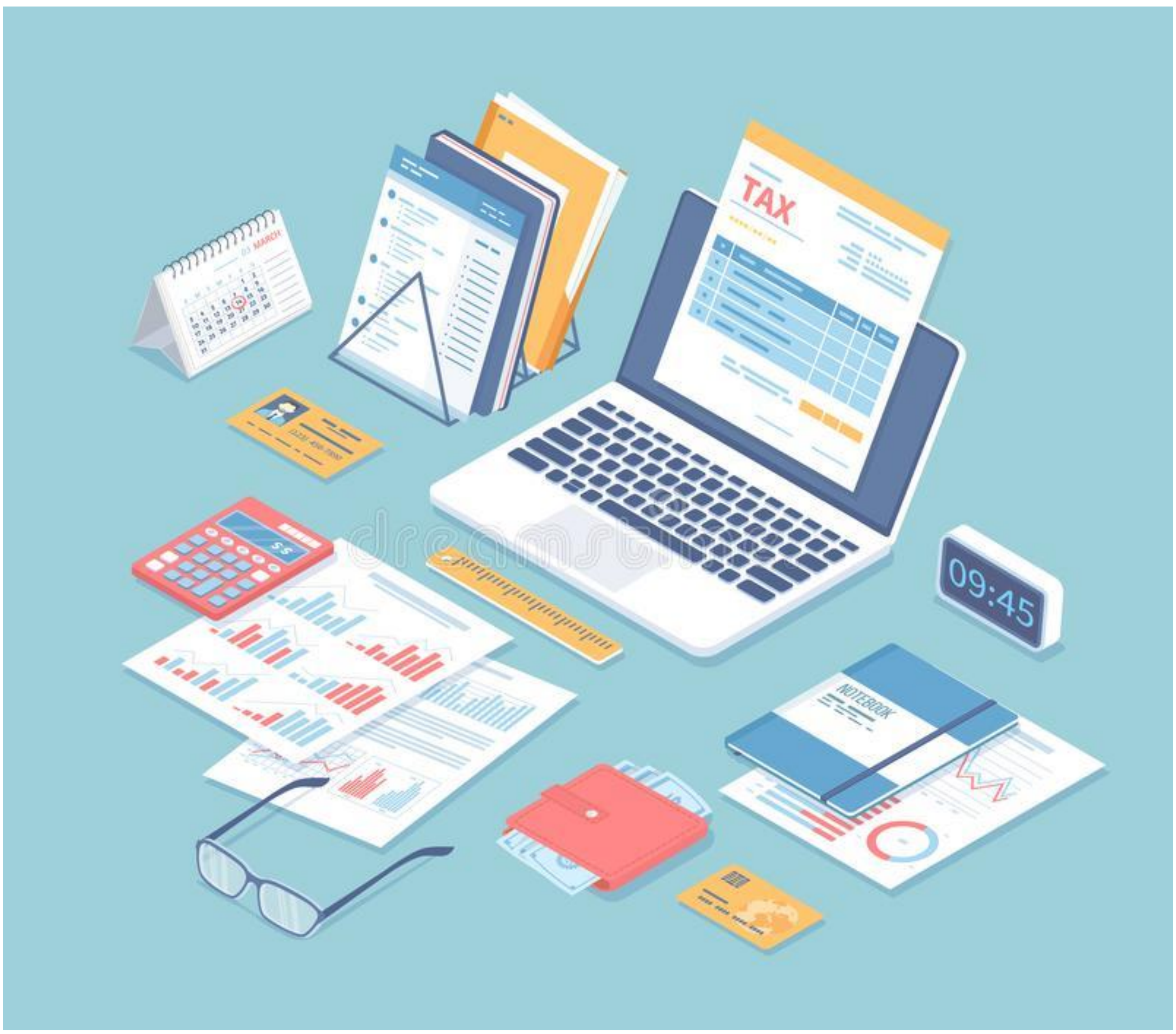
ACCOUNTANCY

Chapter 8: Financial Statements Of The Company



FINANCIAL STATEMENTS OF THE COMPANY

Introduction to Financial Statements

Meaning of Financial Statements:

- **Meaning:**

  i. An accounting process initiates with journalising of the transactions and ends with the preparation of Trial Balance which comprises of all the debit and credit account balances.

  ii. A summary of accounting data which is prepared by an enterprise at the end of an accounting process with the help of such Trial Balance is known as Financial Statements.

  iii. As per Section 2(40) of the Companies Act, 2013, a set of Financial Statements prepared in accordance with Schedule Ill of this Act comprises of a Balance Sheet, Notes to Accounts, Statement of Profit and Loss and Cash Flow Statement.

- **Definition:**

  i. As per John N. Myer: "The Financial Statements provide a summary of accounts of a business enterprise, the Balance Sheet reflecting the assets, liabilities and capital as on a certain date and income statement showing the results and operations during a certain period."

Nature and Characteristics of Financial Statements:

- **Nature:** Nature of Financial Statements can be understood as a result of a combination of the following points:

  i. **Recorded Facts:** It refers to the recorded transactions in the books of account on the basis of evidences.

  ii. **Conventions:** All the transactions that are recorded in the books of account should follow all the relevant accounting conventions as may be applicable to the respective transactions. Such conventions make financial statements reliable, understandable and comparable.

  iii. **Accounting Concepts:** All the transactions that are recorded in the books of account should follow the accounting concepts. Such concepts also make the financial statements reliable, understandable and comparable.

  iv. **Personal Judgements:** Personal judgements also have an important bearing on the financial statements as it facilitates the selection of methods, etc. when any one alternative is to be chosen out of the various alternatives.

v. **Source of FinancialInformation:** Financial statements acts a source of financial information on the basis of which conclusions and interpretations can be drawn about the financial performance and position of a company.

- **Characteristics:** Following are the Characteristics of Financial Statements:

i. They are historical documents as are related to past period.
ii. They are expressed in monetary terms.
iii. They show financial performance through the Statement of Profit and Loss and financial position through Balance Sheet.

Objectives, Essentials and Limitations of Financial Statements

- **Objectives:** Financial Statements are prepared with an objective to:

i. Compute profit or loss from operating activities of the business.
ii. Present a true view of the financial position of the business.
iii. Provide information on economic resources of the business.
iv. Provide data about the inflow and outflow of cash and cash equivalent.
v. Determine the effectiveness of the management activities to ensure better performance of its business.
vi. Provide necessary information to the users of such financial statements.
vii. Present and disclose accounting policies and conventions used in the preparation of books of accounts of the business entity.

- **Essentials:** Following are the Essentials of Financial Statements:

i. **Factual Information:** Financial Statements should disclose the factual information about the financial position of the company.

ii. **Understandability:** Financial Statements should be prepared following the accepted accounting principles for the better understanding of the users.

iii. **Comparable:** Financial Statements should disclose the information in a manner that the user can compare the information of the same entity over years and also compare the reporting company's financial information with that of others.

iv. **Verifiable:** Financial Statements of the company should disclose such information which is verifiable from the records of the company.

v. **Relevant:** Financial Statements should disclose the financial information which is in accordance with the legal requirements.

vi. **Timeliness:** After the end of the accounting period, financial statements should be prepared and presented within a reasonable period to avoid any undue effect on the relevance of these statements.

- **Limitations:** Following are the limitations of the financial statements:

i. **Historical Records:** Financial Statements provide information which is historical in nature and therefore, it is not useful for the potential investors or lenders as it does not provide any information of the future business or its future financial position.

ii. **Affected by Estimated:** Financial Statements are the outcome of accounting concepts and conventions combined with estimates and are therefore, not free from bias.

iii. **Different Accounting Practices:** Financial Statements can be drawn up on the basis of different accounting practices. Profitability determined by each of these practise will be different and hence, there is no standard practice which can be followed by all.

iv. **Qualitative Elements are Ignored:** Financial Statements are based completely on monetary items and therefore, many non-monetary important factors that affect the profitability of the business are ignored.

v. **Price Level Changes are Ignored:** Financial Statements follow the historical cost concept while disclosing the value of assets. Because of such practices, current market value is not taken into consideration.

vi. **Does not meet the Interests of all Parties:** Financial Statements for a period are used by a number of interested users for various purposes and interests. It is not possible to meet the purpose of all interested parties.

vii. **Aggregate Information:** Financial Statements show aggregate information and not detailed information and hence, it is not useful for the users in decision making.

Users of Financial Statements:

Following are the categories of Users of Financial Statements:

- **Internal Users:**

    i. **Shareholders:** Shareholders are those users who provide funds or contribute capital to the company and are therefore, exposed to risks. In view of the risk involved, they are always interested in the profitability, returns, financial and cash position of the company.

    ii. **Management:** Management is responsible to safeguard the investment in business and increase the value of business by managing the business effectively and thereby maximising the profits. It makes use of the financial information to arrive at the informed decisions to increase the profitability of the business.

    iii. **Employees:** Employees work in the company for a consideration in the form of salary. In addition to the salary these employees are also entitled to various benefits in form of bonus which is directly linked to the profits of the business.

- **External Users:**

    i. **Banks and Financial Institutions:** These are the organisations which provide loans to the businesses and are therefore, concerned about the performance of the company to ensure that the business is able to repay the loan along with the interest due.

    ii. **Investors and Potential Investors:** Investors wish to know how safe their investments into a business are. The investors gain the information related to investment directly from financial reports of the business so as to judge profitability and growth status of business.

    iii. **Creditors:** Creditors are the suppliers who provide goods and services on credit and are therefore, concerned about the financial stability of the company to ensure that the dues are cleared on time without any delay.

    iv. **Government and its Authorities:** These users use the financial statements to compile national income and then further take some important policy decisions.

    v. **Securities and Exchange Board of India (SEBI):** SEBI and Other agencies study the financial statements of the companies to check if the companies are operating within the prescribed limits and investor interests are being protected.

Understanding Balance Sheet:

Meaning, Characteristics, Format and Contents of a Balance Sheet:

- **Meaning:** Balance Sheet or the Position Statement shows the financial position of a business by providing complete details of its Assets, Liabilities and Equity at a particular date.

  i. **Equity:** A liability towards the shareholders is termed as 'Equity' or 'Shareholders' Funds'. Equity includes Share Capital, Money received against Share Warrants.

  ii. **Liabilities:** It is a liability towards the outsiders/external parties. It is shown as Non-Current Liabilities and Current Liabilities.

- **Characteristics:** Following are the characteristics:

  i. It comprises of balances of all the assets, liabilities and owner's equity.

  ii. It considers opening balances, transactions during the year and closing balances for the items appearing in the Balance Sheet.

  iii. It satisfies the accounting equation of Assets = Liabilities + Owner's Equity.

  iv. It gives a true picture of the financial position of an entity on a particular date.

- **Format:** As prescribed in Part I of Schedule Ill of the Companies Act, 2013, Balance Sheet is prepared as follows:

Particulars (1)	Note no. (2)	Figures at the end of the Current Reporting Period (3)	Figures at the end of the Previous Reporting Period (4)
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds			
a) Share Capital		...	...
b) Reserves and Surplus		...	...
c) Money received against Share Warrants		...	...
2. Share Application Money Pending Allotment		...	...
3. Non-Current Liabilities			
a) Long-term Borrowings		...	...
b) Deferred Tax Liabilities (Net)		...	...
c) Other Long-term Liabilities		...	...
d) Long-term Provisions		...	...
4. Current Liabilities			
a) Short-term Borrowings		...	...
b) Trade Payables		...	...
c) Other Current Liabilities		...	...
d) Short-term Provisions		...	...
Total		...	...
II. ASSETS			
1. Non-Current Assets			
a) Fixed Assets:			
i. Tangible Assets		...	...
ii. Intangible Assets		...	...
iii. Capital Work-in-Progress		...	...
iv. Intangible Assets under Development		...	...
b) Non-current Investments		...	...
c) Deferred Tax Assets (Net)		...	...
d) Long-term Loans and Advances		...	...
e) Other Non-Current Assets		...	...
2. Current Assets			
a) Current Investments		...	...
b) Inventories		...	...
c) Trade Receivables		...	...
d) Cash and Cash Equivalents		...	...
e) Short-term Loans and Advances		...	...
f) Other Current Assets		...	...
Total		...	...

Contents/Heads of Balance Sheet:

- **Items under Equity and Liabilities part of the Balance Sheet:**

  1. **Shareholders' Funds:** This heading comprises of 3 more items which are as follows:

a. **Share Capital:** It is the value of shares issued by the company for subscription to be received in cash or for consideration other than cash. As per schedule Ill of the Companies Act, 2013 details of such share capital are to be shown in the Notes to Accounts as follows:

- **Authorized Capital:** Or Nominal Capital is the amount of capital that is stated in the Memorandum of Association under Capital Clause. It is the maximum capital that a company can issue for subscription.

- **Issued Capital:** It is a part of Authorized Capital which is issued by the company for subscription up to the date of Balance Sheet.

- **Subscribed Capital:** (fully paid, not fully paid, calls in arrears, and forfeited shares are also to be shown under Subscribed Capital): It is a part of the Issued Capital which has been subscribed.

    - **Subscribed and Fully Paid-up:** To disclose shares on which company has called the entire face value of share and same has been received.

    - **Subscribed but Not Fully Paid-up:** To disclose shares on which company has either called full amount but not received or company has not called the full face value.

    - **Calls-in-Arrears:** Amount not received by the company against the amount called up by it towards share capital.

    - **Amount in Forfeiture:** Account, i.e. Amount received on forfeited shares and not reissued.

b. **Reserves and Surplus:** It is the amount of profits set aside out of profits and surpluses and not distributed to the shareholders which can then be used for any future uncertainties. As per Schedule Ill of the Companies Act, 2013, reserves and surplus is to be shown in Notes to Accounts under following heads:

- **Capital Reserve:** It is a reserve which is created out of capital profits like gain on sale of investment, gain on sale of fixed assets, gain on reissue of shares, etc.

- **Capital Redemption Reserve:** It is a reserve created at the time when the company purchases it's owns shares out of free reserves or securities premium reserve.

- **Securities Premium Reserve:** It is a reserve which is created with the amount received in excess of the nominal or face value of securities issued.

- **Debenture Redemption Reserve:** It is a reserve which is credited with the amount prescribed under section 71(4) of the Companies Act, 2013 and its respective rules by a company before redeeming its debentures.

- **Revaluation Reserve:** It is a reserve which is credited by the upward revision of the book value of an assets and debited with a downward revision of the book value of an asset or when asset is sold or discarded.

- **Shares Options Outstanding Account:** It is a reserve which is credited with the amount of difference between the market value of the shares issued to the employees and its issue price over its vesting period.

- **Other Reserves:** It is a reserve which is of such nature and purpose which is not specified under any of the heads above.

- **Surplus, i.e., Balance in Statement of Profit and Loss:** It is the excess of incomes over expenses during a particular period.

c. **Money Received against Share Warrants:** Financial instruments that give the holder right to acquire equity shares at a specified date and specified price. These warrants will be converted into Equity Shares at a later date at a predetermined price and therefore, are classified under Shareholder's Funds.

2. **Share Application Money Pending Allotment: It** shows the amount received by the company towards the share application and against which it will certainly allot shares.

   Share Application Money to be treated as Current Liability:

   When share application money received by the company is to be refunded to the applicants against which shares will not be allotted is shown as 'Current Liabilities' under the sub-head 'Other Current Liabilities'.

3. **Non-Current Liabilities:** As per Schedule Ill of the Companies Act, 2013, these are those liabilities which are not current liabilities. Such liabilities are to be classified into following heads:

a. **Long-term Borrowings:** These are the borrowings/loan that is repayable by the company after 12 months from the date of Balance Sheet or after the period of operating cycle. Long term borrowings are shown under following heads, (i) Debentures, (ii) Bonds, (iii) Term Loans- a. from Banks and b. Others, (iv) Public Deposits, (v) Other Loans and Advances.

b. **Deferred Tax Liabilities:** Deferred tax is the amount of tax that is calculated on the amount of difference being temporary in nature, between the Accounting

Income and the Taxable Income for a particular year. If the Accounting Income is more than the Taxable Income, it results in Deferred Tax Liability.

c. **Other Long-term Liabilities:** This head comprises of all long-term liabilities other than long-term borrowings which are classified as follows:

- **Trade Payables:** As per Schedule Ill of the Companies Act, 2013, "Trade Payables are the amounts payable for goods purchased and services taken in the normal course of business." Trade Payables if agreed to be settled after 12 months of the date of Balance Sheet or after the period of operating cycle are shown under Other Long term Liabilities.

- **Others:** This head comprises of all long-term liabilities other than long-term borrowings and trade payables.

d. **Long-term Provisions:** It is an amount that is kept aside to meet future liability with an amount that is difficult to ascertain but may be estimated and only in case if liability will arise after 12 months or after the period of operating cycle.

4. Current Liabilities: As per Schedule Ill of the Companies Act, 2013, a current liability is the one which satisfies any of the following conditions:

a. To be settled within the company's operating cycle or.

b. To be settled within 12 months after the reporting date or.

c. Primarily held for the purpose of being traded or.

d. There is no unconditional right to defer settlement for at least 12 months after the reporting date.

Such current liabilities are further classified as follows:

- **Short-term Borrowings:** These are the borrowings which are repayable within 12 months from the date of Balance Sheet or within the period of Operating Cycle.

- **Trade Payables:** As per Schedule Ill of the Companies Act, 2013, "Trade Payables are the amounts payable for goods purchased and services taken in the normal course of business." Such amount includes sundry creditors and bills payable, i.e. when amount is due to be paid within an operating cycle or 12 months from the date of reporting.

- **Other Current Liabilities:** All current liabilities that are not short-term borrowings or trade payables are shown as Other Current Liabilities. This includes Current Maturities of Long term debt, Interest Accrued but not due on borrowings, Interest Accrued and due on borrowings, Income received in Advance, etc.

- **Short term Provisions:** It is a liability of an uncertain amount that has been estimated, which is likely to be paid within 12 months of the date of Balance Sheet or within the period of Operating Cycle, whichever is longer.

- **Items under Assets part of the Balance Sheet:**

1. **Non-Current Assets:** As per Schedule III of the Companies Act, 2013, these are the assets which are not current assets. It includes following major heads:

   a. **Fixed Assets:** These are the assets which are not held by the company for the purpose of trade or resale. Instead they are used to earn more and more profits or are held by the business to increase earning capacity of business.

   These are further categorized as follows:

   - **Tangible:** Assets which can be seen, touched and have a physical existence are termed as Tangible Assets.
   - **Intangible:** Assets which cannot be seen, touched and do not have a physical existence are termed as Intangible Assets.
   - **Capital Work-in-Progress:** These are the Tangible Assets which are under construction.
   - **Intangible assets under development:** These are the Intangible Assets which are under development.

   b. **Non-current Investments:** These are the investments which are not held by the business for the purpose of trade or resell. Instead they are retained for a longer period of time to earn income. This includes both Trade Investments held by business to promote its own trade and business and other investments like investments in property, binds, mutual funds, etc.

   c. **Deferred Tax Assets (Net):** Deferred tax is the amount of tax that is calculated on the amount of difference being temporary in nature, between the Accounting Income and the Taxable Income for a particular year. If the Accounting Income is less than the Taxable Income, it results in Deferred Tax Assets.

   d. **Long-term Loans and Advances:** These are those loans and advances which are expected to be received back in cash or kind after a period of 12 months from the date of Balance Sheet or after the period of Operating Cycle.

Such loans are classified as follows:

- **Capital Advances:** These are the advances which are advanced for acquiring of fixed assets.

- **Security Deposits:** These are the security deposits which are given for a period that is beyond 12 months from the date of Balance Sheet or after the period of Operating Cycle of the business.

- **Others:** It comprises of all the long term loans and advances other than those classified as Capital Advances and Security Deposits.

e. **Other Non-Current Assets:** It comprises of all the non-current assets other than those specifically classified under each of the above heads.

2. **Current Assets:** As per Schedule Ill of the Companies Act, 2013, a current asset is the one that satisfies any of the following conditions:

   a. To be realised or intended for sale or consumption within the company's operating cycle or

   b. To be realised within 12 months after the reporting date or

   c. Primarily held for the purpose of being traded or

   d. Cash and cash equivalents unless they are restricted from being exchanged or used to settle a liability for at least 12 months after the reporting date.

   Current Assets are further classified into following heads:

   - **Current Investment:** These are those investments that are held to be converted into cash within a period of 12 months from the date of purchase of investment.

   - **Inventories:** This refers to the stock of goods held in the ordinary course of business for the purpose of trade and also stock of materials which are used in the manufacturing of goods. This will also include work in progress, stock in trade, stores and spares, loose tools, etc.

   - **Trade Receivables:** It is the amount receivable as a consideration for goods sold or services offered in the normal course of business where such amount is receivable within a period of 12 months from the date of Balance Sheet or within the period of operating cycle of the business.

   - **Cash and Cash Equivalents:** It includes balances with banks, cheques, cash in hand, earmarked balances with banks, balances held as margin money by the banks, bank deposits with more than 12 months maturity, etc.

- **Short term Loans and Advances:** These are those loans and advances which are expected to be realised within 12 months from the date of Balance Sheet or within the period of operating cycle.

- **Other Current Assets:** This includes all the current assets which are not specifically categorised under any of the above heads.

3. **Contingent Liabilities:** These are the liabilities which may or may not arise depending on the happening or non-happening of an event in the future. Such amount is not recorded in the books of account and therefore, is required to be disclosed in the Notes to Accounts in order to inform the users of the financial statements.

4. **Commitments:** These are the financial commitments due to activities agreed to by the company to be undertaken by it in future.

Basis	Provision	Reserve
Meaning	The amount provided for the future expected liabilities.	The part of profit retains for future use.
Purpose	To get Actual profit or loss of the business.	To distribution part of profit and retention part of the profit for the growth of the business.
Provides for	To cover the known liabilities	To Increase the share of capital employed in the business.
Need for Profits	Not necessary, Provision is also charged against loss because it is created against liability for expenses.	Profit is necessary, but in the creation of the capital reserve, it is not necessary.
Treatment in Balance	If it is created against asset then subtracted from it. if created against liability then it will be shown on the liability side of the Balance sheet.	It is always shown on the liability side of the balance sheet.
Investment outside	It cannot be invested outside the business.	It can be invested. In that case, it is called a fund.
Dividend	Business can never pay the dividend out of the provision.	Business can pay the dividend out of the provision.
Compulsion	It is compulsory as per GAAP guideline.	It is not compulsory to create, except in case of some capital reserves.
Usage	it is used only for the purpose for which it is created.	it can be used for any purpose if it is not created for a specific purpose.

- **Provisions and Reserves:**

Understanding Statement of Profit and Loss:

Meaning, Characteristics, Format and Contents/Heads of a Statement of Profit and Loss:

- **Meaning:** It is known as an Income Statement as it takes into consideration all the incomes and expenses for a particular period in order to determine whether the entity is a profit making entity or is running into losses. It shows the profitability of the business entity for a given period of time, say if the given period is accounting year 2018-19, then such statement is prepared for a period of 12 months starting from 1s April, 2018 to 31s March, 2019.

- **Characteristics: Following are the characteristics:**

  i. It comprises of all the incomes earned and all the expenses incurred during a particular accounting period.

  ii. It is based on the historical data as it records all transactions which have already taken place during that particular period.

- **Format:** As prescribed in Part II of Schedule Ill of the Companies Act, 2013, statement of profit and loss is prepared as follows:

Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
I. Revenue from Operations		...	...
II. Other Income		...	...
III. **Total Revenue (I+II)**		...	...
IV. **Expenses**			
Cost of Materials Consumed		...	...
Purchases of Stock-in-Trade		...	...
Changes in Inventories (Finished goods, Work-in-Progress and Stock-in-Trade)		...	...
Employee Expenses		...	...
Finance Costs		...	...
Depreciation Expenses		...	...
Amortisation Expenses		...	...
Other Expenses		...	...
Total Expenses		...	...
V. **Profit before Tax (III-IV)**		...	...
VI. **Less: Tax**		...	...
VII. **Profit or Loss for the period (V-VI)**		...	...

Note no. column has been kept for the purpose of specifying cross reference to the Note no. in the Notes to Accounts where detail of the respective item can be given.

- **Contents/Heads:**

1. **Revenue:**

   a. **Revenue from Operations:** It is the amount of revenue earned by the entity from the activities carried out by it with an objective to earn profits or operating activities.

   - In case of a manufacturing or trading company, revenue from operations is the amount of net sales i.e., Sales less Sales Return.
   - In case of a service company, revenue from operations is amount of fee earned.
   - In case of a finance company, revenue from operations is amount of interest and dividend earned.

   b. **Other Income:** It is the amount of revenue earned by an entity from its non-operating activities, i.e. sources that are not its business activities.

   - In case of a manufacturing, trading or service company, other income shall comprise of gain or loss on sale of fixed assets, bad debts recovered, interest on fixed deposits, etc.
   - In case of a finance company, other income shall comprise of any amount that is earned from a non-finance activity.

2. **Expenses:**

   a. **Cost of Materials Consumed:** It is the amount of raw or other materials used in the manufacturing of finished goods. In order to compute the amount of materials consumed, following formula is to be follows:

$$\begin{aligned}\text{Cost of Materials Consumed} = {} & \text{Opening Inventory (Stock) of Materials} \\ & + \text{Purchases of Materials} \\ & - \text{Closing Inventory (Stock) of Materials}\end{aligned}$$

   b. **Purchases of Stock-in-Trade:** It the amount of goods purchased for the purpose of trading or reselling. If any further process is carried out on such purchased goods then they are no longer termed as Stock-in-Trade as they become a part of Cost of Materials Consumed.

c. **Changes in Inventories (Finished goods, Work-in-Progress and Stock-in-Trade):** It is the difference between the opening and closing inventories of finished goods, work-in- progress and stock-in-trade which is recorded as an expense in the Statement of Profit and Loss.

d. **Employee Expenses:** It is the amount of payments made to and for the benefit of employees. It includes the amounts of wages, salaries, bonus, amount spent on staff welfare expenses, etc. Detailed information of the total amount spent is presented in the Notes to Accounts provided with the financial statements.

e. **Finance Costs:** It is cost that is incurred by the company on the borrowings or loans taken by it which includes interests on such borrowings, loans, overdraft, etc. used during a particular period by the entity.

f. **Depreciation Expenses:** It is a fall in the value of tangible fixed assets due to its use or obsolescence. Such amount is written off over the useful life of the respective asset by showing it as an expense in the Statement of Profit and Loss.

g. **Amortization Expenses:** It is a fall in the value of intangible fixed assets which is written off over their useful life and accordingly shown as an expense in the Statement of Profit and Loss.

h. **Other Expenses:** The expenses which are not shown separately in the Statement of Profit and Loss are shown under this head. Complete details of such expenses are given in the Note to Accounts as direct and indirect expenses.

Understanding Notes to Accounts, Cash Flow Statement and an Annual Report:

Meaning of Notes to Accounts and Cash Flow Statement:

- **Notes to Accounts:** It is a detailed description of the items stated in the Balance Sheet and Statement of Profit and Loss. It provides additional information about the financial statements like accounting policies followed, contingent liabilities, bills discounted, etc. as required to be disclosed as per Schedule III of the Companies Act, 2013. This helps to understand financial position of the entity in a better manner.

- **Cash Flow Statement:** As per AS-3, a Cash Flow Statement is required to be prepared in order to report all the cash inflows and cash outflows during a particular period. It gives a clear picture of the sources and application of cash and cash equivalents during the period under consideration.

- **Annual Report:** An Annual report of an entity is the one which disclose the prescribed information to enable the users of such report to understand the actual profitability and financial position of the entity. Based on such report and analysis of the same, valuable decisions are taken by the users. It comprises of Board of Directors' Report and an Auditor's Report which are explained as follows:

  1. **Board of Directors' Report:** As per the Companies Act, 2013, Board of Directors of a particular entity is required to prepare a Report which comprises of details related to the business operations carried out by them, profitability of the same and its impact on its future financial position. An Annual General Meeting is convened to adopt, consider and approve such Board Report and the set of Financial Statements prepared by the Board of Directors.

  2. **Auditor's Report:** Examination of the business operations and the records of the same is done at regular intervals. Such examination is termed as an Audit which is done by an Auditor. All the findings, observations, opinions, conclusions and suggestions are to be reported by the Auditor in a systematic format. Such report is termed as an Auditor's Report.

Understanding Annual Report:

- **Meaning:** An Annual report of an entity is the one which discloses the prescribed information to enable the users of such report to understand the actual profitability and financial position of the entity. Based on such report and analysis of the same, valuable decisions are taken by the users. Therefore, in order to ensure correct decision making, it is very essential to provide correct and systematic information in such annual report.

- **Contents:** Such a set of Annual Report of a company has:

  1. **A Board of Directors' Report comprising:**

     a. Report prepared in terms of Section 134 of the Companies Act, 2013;

     b. Directors' Responsibility Statement.

     c. Corporate Governance Report; and

     d. Discussion and Analysis done by the Management

  2. Report by the Auditor for the Shareholders.

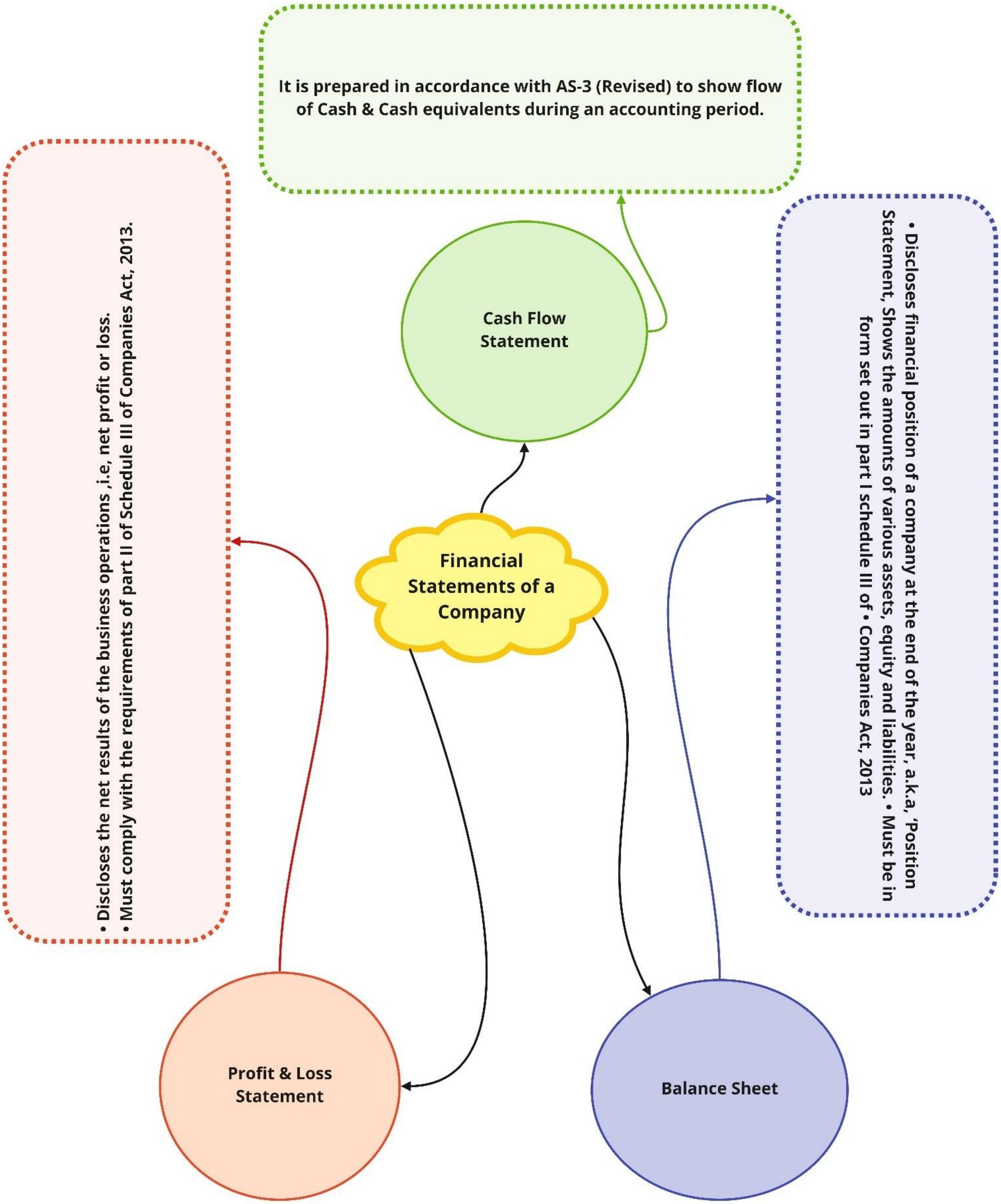
  3. **Set of Financial Statements comprising of:**

a. Balance Sheet on a particular date.
b. Statement of Profit and Loss for a particular period.
c. Cash Flow Statement.

4. Notes to Accounts that has details of:

a. Accounting policies followed.
b. Details of line items in Balance Sheet and Statement of Profit and Loss.
c. Explanatory note for significant transactions and events.
d. If required by Part Ill of Schedule Ill of the Companies Act, 2013, any other additional information can be provided.

Class : 12th Accountancy
Chapter-8 : Financial Statements of a Company



Important Questions

Multiple Choice questions-

Question 1. Preliminary expense are required to be written off within _______ from the date of incurring.

(a) one year

(b) five years

(c) same year

(d) three years

Question 2. In the notes to accounts, share capital in which company has not called the entire face value of shares is shown under the notes to accounts.

(a) Subscribed and fully paid up capital

(b) Subscribed but not fully paid up capital

(c) Reserve Capital

(d) None of these

Question 3. The debentures to be redeemed within 12 months from the date of balance sheet is shown under

(a) short term borrowings

(b) long term borrowings

(c) other current liabilities

(d) long term liabilities

Question 4. Which of the following item will not appear under short term provisions

(a) Provision for tax

(b) Proposed Dividend

(c) Provision for retirement benefits

(d) Provision for doubtful debts

Question 5. Capital Reserve will be shown under

(a) current liabilities

(b) share capital

(c) reserves and surplus

(d) deferred tax liabilities

Question 6. Dividend is paid on

(a) authorised capital

(b) issued capital

(c) called up capital

(d) paid up capital

Question 7. Which of the following is not required to be prepared under companies act

(a) Statement of Profit and Loss

(b) Balanc Sheet

(c) Cash Flow Statement

(d) Funds Flow Statement

Question 8. Goodwill appears in a company's balance sheet under

(a) Unamortised assets

(b) Non-current investments

(c) Intangible assets

(d) Tangible assets

Question 9. Which of the following is not required to be prepared under companies act

(a) Statement of Profit and Loss

(b) Balance Sheet

(c) Cash Flow Statement

(d) Funds Flow Statement

Question 10. Claims against the company not acknowledged as debts is shown under

(a) current liabilities

(b) non-current liabilities

(c) commitments

(d) contingent liabilities

Very Short Questions-

1. State the importance of financial analysis for labour unions.
2. If operating is not given, what is the time for the operating cycle assumed?
3. If the operating cycle is given for 12 months and the payment cycle for trade payables is 15 months, how will you classify the liability?
4. Name any one line item that can be shown under the major heading 'Equity and

Liabilities' in a company's Balance Sheet.

5. Name any one item that can be disclosed under 'Short Term Provisions'.

6. How would you treat preliminary expenses?

7. Give one example of unamortised expenses.

8. State any one component of shareholders' funds.

9. How would you treat share forfeiture account?

10. Mention one component of Reserves and Surplus.

Short Questions-

1. State the meaning of financial statements?

2. What are limitations of financial statements?
3. List any three objectives of financial statements?

4. State the importance of financial statements to

   (i) shareholders (ii) creditors (iii) government (iv) investors

5. Explain briefly any four objectives of 'Analysis of Financial Statements'.

6. From the following details calculate Interest Coverage Ratio:

   Net profit after tax – ₹ 7,00,000

   6 % debentures of – ₹ 20,00,000

   Tax Rate 30%

7. Under which major heads and sub-heads will the following items be placed in the Balance Sheet of the company as per Schedule III, Part I of the Companies Act, 2013?

   (i) Debentures with maturity period in current financial year

   (ii) Securities Premium Reserve

   (iii) Provident Fund

8. (i) One of the objectives of analysis of financial statement is to ascertain the relative importance of the different components of the financial position of the firm'. State two other objective of this analysis.

   (ii) List any four items of 'reserve' that are shown under the headings 'Reserves and Surplus' in the Balance Sheet of a company as per scheduel III of the Companies Act 2013.

9. (i) One of the objectives of 'financial Statement Analysis, is to identify the reasons for change in the financial position of the enterprise. State two more objectives of this analysis.

   ii) Name any two items that are shown under the head 'Other Current Liabilities' and any two items that are shown under the head 'Other Current Assets' in the Balance Sheet of a company as per Schedule III of the Companies Act, 2013.

10. List the major heads under which the 'Equity and Liabilities' are presented in the balance sheet of a company as per Schedule III Part I of the Companies Act, 2013.

Long Questions-

1. Explain the nature of the financial statements.
2. Explain in detail about the significance of the financial statements.
3. Explain the limitations of financial statements.
4. Explain the following items with adjustments entry:

   a. Closing Stock

   b. Outstanding expenses

   c. Income earned but not received

   d. Income received in advance

   e. Depreciation

   f. Manager's commission

   Adjustment Entry Treatment in

5. From the following balances, prepare the Profit and loss account and balance sheet.

Debit Balance	Amount	Credit Balance	Amount
Purchase Wages Opening stock Salaries Postage Printing and stationery Bills receivables	90,000 7,880 21,600 12,412 6,354 12,900	Sales Closing stock Office expenses Sundry debtors Sundry creditors Cash at Bank	165,000 70,000 1,247 14,500 21,020 13,487

	5,640		

6. From the following balances, prepare the Profit and loss account and balance sheet.

Debit Balance	Amount	Credit Balance	Amount
Purchase Wages Opening stock Salaries Postage Bad debts Printing and stationery Building Bills receivables Rate and insurance	70,000 5,980 11,200 21,100 8,799 1,990 15,500 30,000 15,000 2,900	Sales Office expenses Sundry debtors Sundry creditors Cash at Bank Rent (Cr.)	198,000 6,214 15,857 15,210 15,200 6,530

Prepare profit and loss account and Balance sheet keeping in regards the followingadjustment:

a. Write off further bad debts with Rs. 780.

b. Rent receivables of Rs. 650.

c. Unexpired insurance Rs. 390.

7. Define following terms with adjustment entries:

Assertion Reason Questions-

1. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.

   a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
   b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
   c. Only Assertion is correct.
   d. Reason is correct but Assertion is not correct.

Assertion: While preparing Notes to Accounts on Share Capital, Calls-in-Arrears is shown by way of deduction from the Subscribed Capital (Subscribed but not fully paid-up).

Reason (R): As per the Companies Act, 2013, Part I of me Schedule III, Calls in Arrears is the other current asset of the company.

2. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.

    a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
    b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
    c. Only Assertion is correct.
    d. Reason is correct but Assertion is not correct

Assertion: Amount received in advance by a company, on calls not yet made should be shown in the Balance Sheet under Other Current Liabilities. It is called 'Calls-in-Advance'.

Reason (R): Company may receive amount against calls not yet made only if its Articles of Association permits.

Case Study Questions-

MCQ Answers-

1. Answer: (c) same year
2. Answer: (b) Subscribed but not fully paid up capital
3. Answer: (c) other current liabilities
4. Answer: (c) Provision for retirement benefits
5. Answer: (c) reserves and surplus
6. Answer: (d) paid up capital
7. Answer: (d) Funds Flow Statement
8. Answer: (c) Intangible assets
9. Answer: (d) Funds Flow Statement
10. Answer: (d) contingent liabilities

Very Short Answers-

1. Answer: Labor unions analyse the financial statements to assess whether an enterprise can increase their pay.

2. Answer: 12 months.

3. Answer: Non-current Liability.

4. Answer: Shareholder'sFunds

5. Answer: Provision for Doubtful debts.

6. Answer: Preliminary expenses are written off in the year in which they are incurred.

7. Answer: Discount on issue of shares/ debentures.

8. Answer: Reserves & Surplus.

9. Answer: Added in the subscribed.

10. Answer: Securities Premium Reserves.

Short Answers-

1. Financial statements are the end products of an accounting process, it provides a true picture of the performance of the company over a time period and such a statement is used by different users of accounting information. These statements are prepared annually.

2. **Limitation are:**

   i. Financial statements reflect historical data i.e it reflects the original price of the items or the price at which items were acquired. It fails to highlight the current price of items as per market and also inflated price due to rising inflation in the market. Hence data and information are historical in nature.

   ii. Financial statement do not portray the qualitative aspects of any transaction, the aspects such as size, colour, quality and the capabilities. Only quantitative data which can be expressed in monetary value are considered

   iii. Financial statement are biased in nature as it is dependent on human interference.

   iv. It becomes difficult to assess the performance of another company.

   v. It will be difficult to forecast as the statement is prepared based on historical data.

3. The objectives of preparing financial statements are:

   i. A financial statement provides timely and reliable information on the economic status of a company on a periodical basis. It also makes information available to external users or stakeholders who do not have direct access to the information.

   ii. A financial statement helps in revealing the true financial position of a company. It contains information related to liquidity, profitability, financial viability and solvency of an organisation.

iii. A financial statement is helpful in evaluating the earning capacity of a firm.

4. Following are the importance of financial statements for:

   i. Shareholders: For a shareholder, a financial statement is helpful in determining viability and profit making capacity of a business. It provides businesses with sufficient data to analyse the financial health and performance of the business.

   ii. **Creditors:** A financial statement is essential for a creditor to understand the credit worthiness of the business along with liquidity. It helps them to decide whether further investments can be done for this business.

   iii. **Government:** A financial statement helps government in determining GDP, national income, industrial growth etc. which leads to formulation of various policies and addressing problems like poverty and unemployment etc.

   iv. **Investors:** For Investors who have invested or those planning to invest, a financial statement is necessary. Financial statement helps determining the prospects and viability of new investments.

5. Four objective of 'Analysis of Financial statements are as follows:

   To assess the current profitability and operational efficiency of the firm as a whole as well its different departments so as to judge the financial health of firm.

   To ascertain the financial position of firm.

   To identify the reasons for change in the profitability and financial position of the firm.

   To Judge the ability of the firm to repay its debt and assessing the short-term as well as the long-term liquidity position fo the firm.

6.

Net Profit Before Tax – Tax paid = Net Profit After Tax

$$x - 30/100\,(x) = ₹\ 7,00,000$$

$$x = ₹\ 7,00,000\ (100/70)$$

$$x = ₹\ 10,00,000$$

Net Profit Before Tax = ₹ 10,00,000

Interest Payment = 6/100 (₹ 20,00,000) = ₹ 1,20,000

Earning Before Interest and Tax = Net Profit Before Tax + Interest Payment

= ₹ 10,00,000 + ₹ 1,20,000

= ₹ 11,20,000

Interest Coverage ratio $= \dfrac{\text{Net Profit Before Interest and Tax}}{\text{Interest Expense}}$

Interest Coverage Ratio = ₹ 11,20,000/₹1,20,000

Interest Coverage Ratio = 9.33 times

7.

S. No.	Item	Major Head	Sub Head
(i)	Debentures with maturity period in current financial year	Current Liabilities	Other Current Liabilities
(ii)	Securities Premium Reserve	Shareholder's Fund	Reserves and Surplus
(iii)	Provident Fund	Non-Current Liabilities	Long Term Provision

8. (i) Objectives of Analysis of Financial Statement:

- Assessing the earning capacity or profitability of the firm as a whole as well as its different departments so as to judge the financial health of the firm.
- Judging the ability of the firm to repay its debts and assessing the short term as well as long term liquidity position of the firm.

(ii) Reserve and Surplus

- Capital Reserve
- Securities Premium Reserve.
- Revaluation Reserve.
- Capital Redemption Reserve.

9. (i) Objectives

- To evaluate the business in Terms of profit in present and future.
- To evaluate the efficiency of various parts or departments of the business.

(ii) Other Current Liability

- Unpaid dividend
- Current maturity of long term debts.

Other Current Assets.

- Discount in issue of debentures (to be written off within 12 months).
- Accrued incomes.

10. The major heads under which 'Equity and Liabilities' are presented:

- Share holders Fund
- Share Application Money Pending allotment
- Non-Current liabilities
- Current Liabilities

Long Answers-

1. **The nature of financial statements are:**

   i. Financial statement record facts about the items at the original price at which they were purchased and doesn't take into account the prevailing market price, and also do not include price fluctuations due to inflation.

   ii. The financial statements are created based on various accounting conventions such as Prudence convention, matching concept etc. and adhering to such conventions result in the statements being easy to understand, compare and reflect the fair and true financial situation of the organisation.

   iii. A financial statement is based on many concepts such as going concern concept, realisation concept, and money measurement concept. A financial statement adheres to all these concepts when financial statements are prepared.

   iv. In preparing financial statements personal judgements play an important role. For example when determining which method to charge depreciation and recording of stock at market value or cost price. All these are based on personal judgement.

2. **The nature of financial statements are:**

i. It provides information to various users of accounting information which can be both internal and external. Users derive information as per their needs from such statements. For example it provides shareholders an idea about the viability of business while the same statement can be used by tax authorities to determine tax payable by organisation.

ii. It helps management in comparing performance which can be on both inter and intra firm basis, it helps in determining the viability of business and also is helpful in framing of policies for business. It enhances the decision making capabilities of the management.

iii. Financial statements help creditors and investors determine the state of solvency of a business which influences decision to offer loans and credit.

iv. Financial statements help provide information on different policies, methods, best practices and accounting processes. Disclosing accounting policies simplifies financial statements and makes users of accounting information.

v. The government uses accounting information to determine various parameters of national growth like GDP, National Income, Industrial growth etc.

vi. Investors need information on business solvency and profitability to offer further loans and invest in business and such information is obtained from financial statements.

3. **Limitation are:**

i. Financial statements reflect historical data i.e. it reflects the original price of the items or the price at which items were acquired. It fails to highlight the current price of items as per market and also inflated price due to rising inflation in the market. Hence data and information are historical in nature.

ii. Financial statement do not portray the qualitative aspects of any transaction, the aspects such as size, colour, quality and the capabilities. Only quantitative data which can be expressed in monetary value are considered.

iii. Financial statement are biased in nature as it is dependent on the personal judgement regarding the way transactions are recorded.

iv. It becomes difficult to assess the financial performance of one company with another due to differences in practices and methods adopted by each company.

v. It will be difficult to forecast as the statement is prepared based on historical data as it fails to capture inflation rates.

vi. The company can manipulate the data to show better liquidity position which can give false impression to the investors leading to project cancellation.

4. **Ans:**

Adjustment	Adjustment Entry	Treatment in the balance sheet

Closing stock	Closing stock A/c Dr. To trading A/c	Shown on the asset side
Outstanding expenses	Expenses A/c Dr. To outstanding A/c Expenses	Shown on the liabilities side
Income earned but not received	Accrued Income A/c Dr. To Income A/c	Shown on the asset side
Income received in advance	Income A/c Dr. To Income received in Advance A/c	Shown on the liabilities side
Depreciation	Depreciation A/c Dr. To Assets A/c	Deduction from the value of assets
Managers commission	Manager commission A/c To o/s commission A/c	Shown on the liabilities side

5. **Ans:**

Trading Profit and loss A/c

Expenses/profit	**Amount**	**Profit /gain**	**Amount**
Opening stock Purchase Wages Gross profit c/d Salaries Office expenses Postage Printing and stationery Net profit	21,600 90,000 7,880 1,15,520 2,35,000 12,412 1,247 6,354 12,900 82,607	Sales Closing stock Gross profit b/d	165,000 70,000 2,35,000 1,15,520
	1,15,520		1,15,520

Balance sheet as of March 31

liabilities	**Amount**	**Asset**	**Amount**
Sundry creditors	21,020	Cash at bank	13,487

Add: Net profit	82,607	Bills receivables Sundry debtors Closing stock	5,640 14,500 70,000
	1,03,627		1,03,627

6. **Ans:**

Trading Profit and loss A/c

Expense/profit	**Amount**	**Profit/gain**	**Amount**
Opening stock Purchase Wages Gross profit c/d	11,200 70,000 5,980 1,10,820	Sales	198,000
	1,98,000		1,98,000
Salaries Office expenses Postage Printing and stationery Rate and insurance 2,900 Less: unexpired insurance 390 Bad debts 1,990 Add: Further bad debts 780 Net profit	21,100 6,214 8,799 15,500 2,510 2,770 61,107	Gross profit b/d Rent 6,530 Add: Accrued rent 650	1,10,820 7,180
	1,18,000		1,18,000

Balance sheet as of March 31

Liabilities	Amount	Assets	Amount
Sundry creditors Add: Net profit	15,210 61,107	Cash at bank Bills receivables Building Sundry debtors 15,857 Less: Bad debts 780 Accrued rent Unexpired insurance	15,200 15,000 30,000 15,077 650 390
	76,317		76,317

7. Ans: Following terms are defined with their adjustment entries:

A. Provisions for bad and doubtful debts.

Provision for bad and doubtful debts occurs when there is a possible reason for debtors who are doubtful that they will not pay the debts on time.

Particular	Amount
Profit and loss A/c Dr	-
To provision for doubtful debts A/c	-

B. Depreciation:

Depreciation means the value of an asset is declined due to its usage in the passage of time +9*or wear and tear. It is usually treated as business expenses and is debited in profit and loss account.

Particular	Amount
Depreciation A/c Dr. To Concerned Asset A/c	- -

C. Accrued income: The items of income that are earned during the accounting year but actually it is not received at the end of the same year.

Particular	Amount
Accrued income A/c Dr. To Concerned Income A/c	- -

D. Prepaid expenses: Prepaid expenses are the expense need to be paid in future but they are paid in advance.

Particular	Amount
Prepaid expenses A/c Dr. To Concerned Expenses A/c	- -

E. Outstanding expenses: Prepaid expenses are the expense need to be paid in future but they are paid in advance.

Particular	Amount
Expenses A/c (Required) Dr. To Outstanding expenses A/c	- -

Assertion Reason Questions-

1. (c) Only Assertion is correct.
2. (a) Assertion and Reason both are correct and Reason is the correct explanation of assertion.