<u>Financial Accounting and Analysis</u>

<u>Unit 3</u>

<u>Final Accounts</u>

Every organisation prepares its final accounts after a particular period to know its financial results and financial position. Final accounts mean profit and loss account and the balance sheet. Profit and loss account also contains one more account, known as trading account, and if the business is manufacturing any item or article, then Manufacturing account is also there. All these accounts are prepared only after preparing trial balance.

Objectives of Preparing Final Accounts

You already know that final accounts are prepared at the end of a particular time period. The final accounts play an important role for every kind of organisation. There are two main objectives of preparing final accounts: (1) to know the operational results i.e., final accounts are prepared to know the profit or loss during a particular period through the profit and loss account which is also known as income statement, and (2) to ascertain the financial position of the business on a particular date through the balance sheet, also known as position statement.

Preparation of Final Accounts

The profit and loss account and the balance sheet are, together popularly known as the final accounts. The profit and loss account are prepared to show the financial results of a business and the balance sheet is prepared to show the financial position. To calculate the accurate amount of profit or loss, it is a must that there should be a recognition of the revenues and expenditures. If there is a wrong recognition of expenses or revenues, results of the business will also be wrong. Thus, the distinction between the capital and revenue items is very important.

There are two types of expenses and two types of incomes which are classified as:

1. Revenue expenditure/Revenue receipts
2. Capital expenditure/Capital receipts.

Classification of Expenditures

Expenditures of a business are classified into following three categories:

1. ***Capital expenditure:*** If an expenditure is incurred in the business to get its benefit for a long period, such expenditure is called capital expenditure.

Example: Expenditure to acquire a fixed asset as purchase of plant and machinery, land and buildings and furniture, etc.

2. ***Revenue expenditure:*** When an expenditure is done for a short period (less than one year) and for the regular operation of business, it is termed as revenue expenditure. Its benefit is taken by the business in the current period only.

Example: Expenses incurred during the normal course of business – as salaries of the staff, fuel and electricity used for the running of machinery and cost of sales.

3. ***Deferred revenue expenditure:*** When revenue expenditure is done for the benefit of two or three years, it is termed as deferred revenue expenditure.

Example: cost of heavy campaign of advertisement, preliminary expenses, etc. The benefit of such type of expenditure is enjoyed by the company for a number of years.

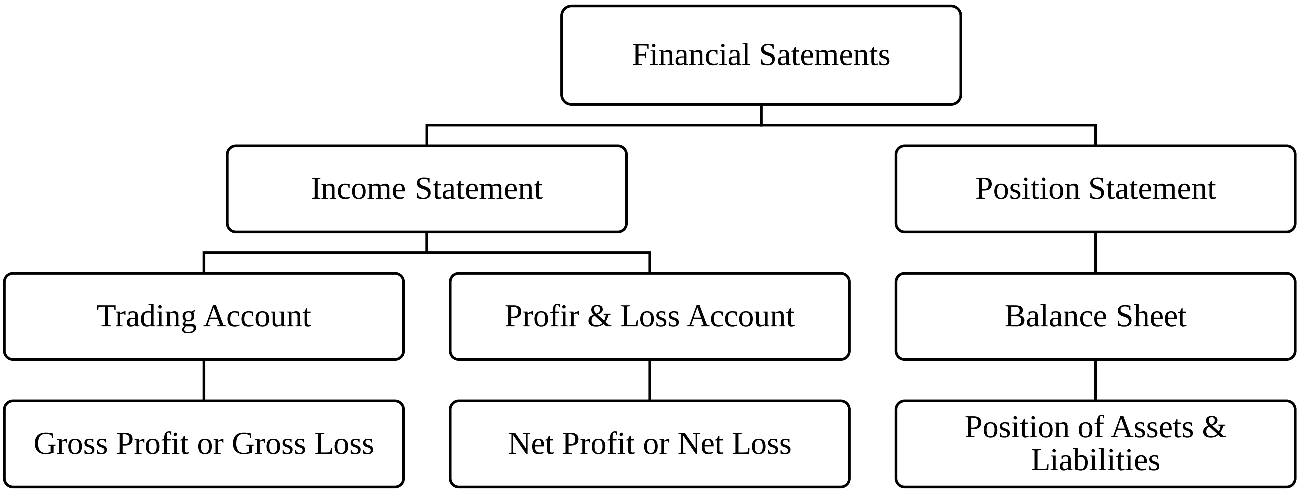
Classification of Receipts

Receipts of a business are classified into following categories:

1. ***Capital receipts:*** Capital receipts include the sale of fixed assets, long-term investments, issue of share capital, debentures and loan raised. Capital receipts are different from the capital profits or loss. The entire amount from the sale of assets is called capital receipts and the difference of sale proceeds and cost of assets is capital profit or loss.

2. ***Revenue receipts:*** Receipts which are obtained during the normal course of business are called revenue receipts. In other words, the receipts which are not capital receipts are revenue receipts as sale of goods.

Example: goods worth 5,000 are sold at 6,000. Here, the entire sale of 6,000 will be revenue receipts and the revenue profit will be 1,000 only.



TRADING ACCOUNT

At the end of the year, as has been seen above, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases.

Trading Account of….for the year ended…..

		₹			₹
To Opening Stock		XXX	By Sales	XXX	XXX
To Purchases	XXX		*Less*: Returns Inwards	XXX	XXX
Less: Returns outwards	XXX	XXX	By Closing Stock		XXX
To Direct expenses:		XXX	By Gross Loss c/d*		XXX
Freight & Carriage	XXX				
Customs & Insurance	XXX				
Wages	XXX				
Gas, Water & Fuel	XXX				
Factory Expenses	XXX				
Royalty on production	XXX	XXX			
To Gross Profit c/d*		XXX			
		XXX			XXX

*Only one will appear

PROFIT AND LOSS ACCOUNT

The Profit and Loss Account starts with gross profit on the credit side. If there is gross loss, it will be written on the debit side. After that all those expenses and losses, which have not been entered in the Trading Account, will be written on the debit side of Profit and Loss Account. Incomes and gains, other than sales, will be written on the credit side.

Profit and Loss Account for the year ended

Particulars	**₹**	**Particulars**	**₹**
Gross Loss b/d		**By Gross Profit b/d**	
Management expenses		**Other Income**	
To Salaries (administrative)		By Discount Received	
To Office rent, rates and taxes		By Commission Received	
To Printing and stationery		**Non-trading Income**	
To Telephone charges		By Bank Interest	
To Postage		By Rent of property let-out	
To Insurance		By Dividend from investment in shares	
To Audit Fees		**Abnormal Gains**	
To Legal Charges		By Profit on sale of machinery	
To Electricity Charges		By Profit on sale of investment	
Maintenance expenses			
To Repairs & renewals		**By Net Loss (transferred to capital A/c)**	
To Depreciation on:			
Office Equipment			
Office Furniture			
Office Buildings			
Selling and Distribution expenses			
To Salaries (selling staff)			
To Advertisement			
To Godown rent			
To Carriage Outward			

To Bad Debts To Provision for bad debts To Selling commission **Financial expenses** To Bank charges To Interest on loans To Discount on bills To Discount allowed to customers **Abnormal Losses** To Loss on sale of machinery To Loss on sale of investment To Loss by fire **To Net Profit (transferred to Capital A/c)**			

Note:

i. Gross loss appears in the debit side of the Profit and Loss Account at the top; while Gross Profit on the credit side.

ii. Net loss appears in the credit side of the Profit and Loss Account, while Net profit on debit side as balancing figures.

STATEMENT OF PROFIT AND LOSS

Name of the Company……………………….

Balance Sheet as at………………………

(Rupees in…………)

Particulars		*Note No.*	*Figures for the current reporting period*	*Figures for the previous reporting period*
1		*2*	*3*	*4*
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Income (I + II)		xxx	xxx
IV.	Expenses:		xxx	
	Cost of materials consumed		xxx	xxx
	Purchases of Stock-in-Trade		xxx	xxx
	Changes in inventories of finished goods		xxx	xxx
	work-in-progress		xxx	xxx
	and Stock-in-Trade		xxx	xxx
	Employee benefits expense		xxx	xxx
	Finance costs		xxx	xxx
	Depreciation and amortization expense		xxx	xxx
	Other expenses		xxx	xxx
	Total expenses		xxx	xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)		xxx	xxx
VI.	Exceptional items		xxx	xxx
VII.	Profit before extraordinary items and		xxx	xxx

	tax (V - VI)					
VIII.	Extraordinary Items		xxx		xxx	
IX.	Profit before tax (VII- VIII)		xxx		xxx	
X.	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI.	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx		xxx	
XII.	Profit/(loss) from discontinuing operations		xxx		xxx	
XIII.	Tax expense of discontinuing operations		xxx		xxx	
XIV.	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx		xxx	
XV.	Profit (Loss) for the period (XI + XIV)		xxx		xxx	
XVI.	Earnings per equity share:					
	(1) Basic		xxx		xxx	
	(2) Diluted		xxx		xxx	

Meaning of Balance Sheet

The balance sheet of a company is a statement which shows the total value of assets owned and total of the company's liabilities owed by of trading on a particular date or at the end of trading period. Balance Sheet is also called the statement of assets and liabilities and net worth. The Balance Sheet of the company shall give true and fair view of the state of affairs of the company as at the end of the financial year. True and fair view means that there should be no window-dressing on any item of the balance sheet. For the true and fair view of the state of affairs of the company, assets and liabilities should be correctly given, provisions should be shown in the sufficient amount, contingent assets and contingent liabilities should be given as notes of the Balance Sheet and stock should be valued on the basis of accounting principles.

Balance Sheet as at…

Liabilities	**Amount**	**Assets**	**Amount**
	₹		₹
Capital		Land and Building	
Reserves & Surplus		Plant & Machinery	
Outstanding Expenses		Furniture & Fixtures	
Loans		Stock	
Trade Creditors		Sundry Debtors	
Bills Payable		Bills Receivable	
		Other Investments	
		Government Securities	
		Cash at Bank	
		Cash in Hand	

CLASSIFICATION OF ASSETS AND LIABILITIES

Assets are basically of following types:

Current Assets: - these assets are meant to be converted into cash as quickly as possible. Generally, within one year. For example: - Cash in hand, Cash at Bank, Trade receivables, Inventories.

Long Term Assets: - Those that are meant to be used by the firm over a long period and not sold the former type of assets is also called fixed assets. For example: - Machinery, Building, Long term Investment.

Intangible Assets: - the assets which have no physical existence and cannot be seen or touched are called as Intangible Assets. For example: - Patents, Copyrights etc.

It is desirable that in the balance sheet the two types of assets should be shown separately and prominently. This would give meaningful and logical information.

Liabilities to outsider will be of two types:

Current Liabilities: - this liability must be settled in one year or less. It is also called as short-term liability. For example: - Creditors, Bills Payable etc.

Long Term Liability: - those liabilities which exists for more than one year are long-term liabilities. For example, long term loans from banks. Of course, it will include undistributed profits also.

Balance Sheet as at…

Liabilities	**Amount**	**Assets**	**Amount**
	₹		₹
Capital A/c: Balance *Add:* Net Profit/*Less:* Net Loss *Less:* Drawings Long Term Loans: Term Loans Other Loans Short Term Loans: Cash Credit Overdrafts Other Loans Current Liabilities: Trade payables Outstanding Expenses Advances Taken Provision: Provision for Bad debts Provision for Retirement Benefits Provision for Taxation		Tangible Fixed Assets: Land and Building Plant and Machinery Furniture and Fixture Vehicles Intangibles: Goodwill Patent Rights Designs and Brand Names Investments: Long term investments Current Assets: Inventory in Trade Trade receivables Short term investments Prepayments Advances Bank Balances Cash In Hand	

BALANCE SHEET

Name of the Company……………………….

Balance Sheet as at………………………

(Rupees in…………)

			Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of previous reporting period*
			1	*2*	*3*	*4*
			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 (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises.			
	c		Other current liabilities			
	d		Short-term provisions			
			Total			
			ASSETS			
1.			**Non-current assets**			
	a	i	Property, plant and Equipment			
		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			

Cash Flow Statement

Meaning of Cash Flow Statement

The cash flow statement is being prepared on the basis of an extracted information of historical records of the enterprise. Cash flow statements can be prepared for a year, for six months, for quarterly and even for monthly. The cash includes not only means that cash in hand but also cash at bank.

The following are the main motives of preparing the cash flow statement:

1. To identify the causes for the cash balance changes in between two different time periods, with the help of corresponding two different balance sheets.
2. To enlist the factors of influence on the reduction of cash balance as well as to indicate the reasons though the profit is earned during the year and vice-versa.

Utility of Cash Flow Statement

1) To identify the reasons for the reduction or increase in the cash balances irrespective level of the profits earned by the firm.
2) It facilitates the management to maintain an appropriate level of cash resources.
3) It guides the management to take futuristic decisions on the prospective demands and supply of cash resources through projected cash flows.
   a) How much cash resources are required?
   b) How much cash requirements could be internally settled?
   c) How much cash resources are to be raised through external sources?
   d) Which types of instruments are going to be floated for raising the required resources?
4) It helps the management to understand its capacity at the moment of borrowing for any further capital budgeting decisions.
5) It paves way for scientific cash management for the firm through maintenance of an appropriate cash levels i.e., optimum level cash of resources.
6) It avoids in holding excessive or inadequate cash resources through proper planning of cash resources.
7) It moots control through identification of variations occurred in the cash expenses and expenditures.

ELEMENTS OF CASH

As per AS 3, issued by the Council of the ICAI,

'Cash' include:

(a) Cash in hand,

(b) Demand deposits with banks,

and Cash equivalents include:

(a) Components

➢ Short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value

➢ Securities with short maturity period of, say, three months or less from the date of acquisition

(b)Objective

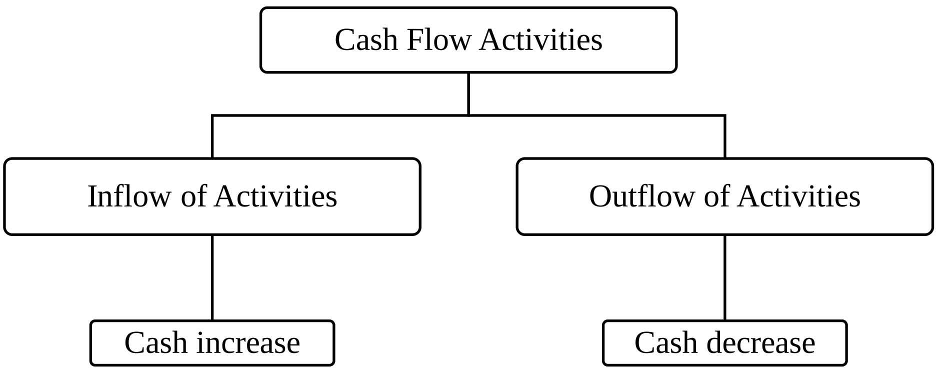
➢ Deploy, for a short period, idle cash required to meet short-term cash-commitments.

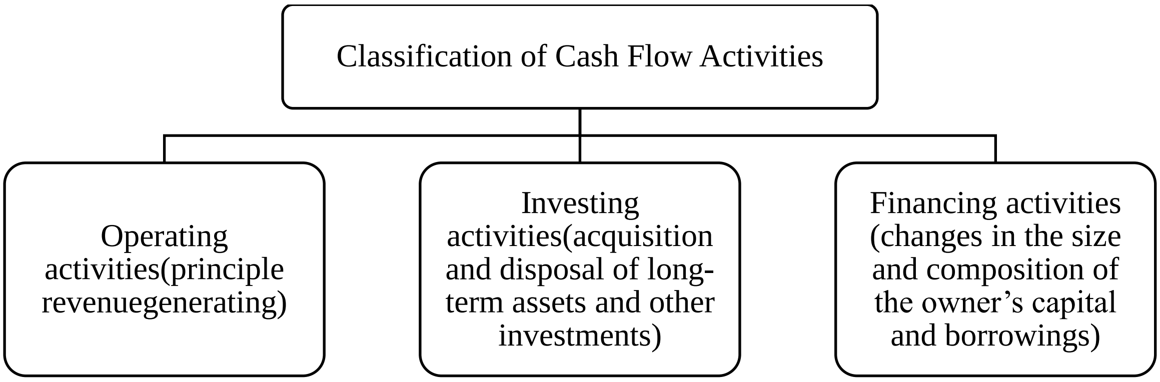
(c) Examples

➢ Acquisition of preference shares, shortly before their specified redemption date, bank deposits with short maturity period, etc.

CLASSIFICATION OF CASH FLOW ACTIVITIES

AS 3 provides explanation for changes in cash position of the business entity. As per Accounting Standard 3, cash flows during the period are classified as Operating, Investing and Financing activities.





Operating Activities

1) *Definition:* These are the principal revenue generating activities of the enterprise.
2) *Net Impact*: Net impact of operating activities on flow of cash is reported as 'Cash flows from operating activities' or 'cash from operations.'
3) *Key Indicator:* The amount of cash flows from operating activities is a key indicator of the extent to which the operations of the enterprises have generated sufficient cash flows to:
   a) Maintain the operating capability of the enterprise.
   b) Pay dividends, repay loans; and
   c) Make new investments without recourse to external sources of financing.
4) *Information Provided:* It provides useful information about financing through working capital.
5) *Benefits:* Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows arising from operating activities

Key indicator of the extent to which the operations of the entity have generated sufficient cash flows to

- repay loans
- maintain the operating capability of the entity
- pay dividends
- make new investments without recourse to external sources of financing

Primarily derived from the principal revenue-producing activities of the entity

Generally, result from the transactions and other events that have role in the determination of net profit or loss

Example

(a) Cash receipts from the sale of goods and the rendering of services

(b) Cash receipts from royalties, fees, commissions, and other revenue

(c) Cash payments to suppliers for goods and services

(d) Cash payments to and on behalf of employees

(e) Cash receipts and cash payments of an insurance entity for premiums and claims, annuities, and other policy benefits

(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities

(g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

(h) Cash flows arising from the purchase and sale of dealing or trading securities

(i) Cash advances and loans made by financial institutions since they relate to their main revenue-producing activity.

Investing activities

1) *Definition*: These are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
2) *Separate Disclosure*: Separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which the expenditures have been made for resources intended to generate future incomes and cash flows.

Cash flows arising from investing activities

Represent the extent to which expenditures have been made for resources intended to generate future income and cash flows

Examples

(a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

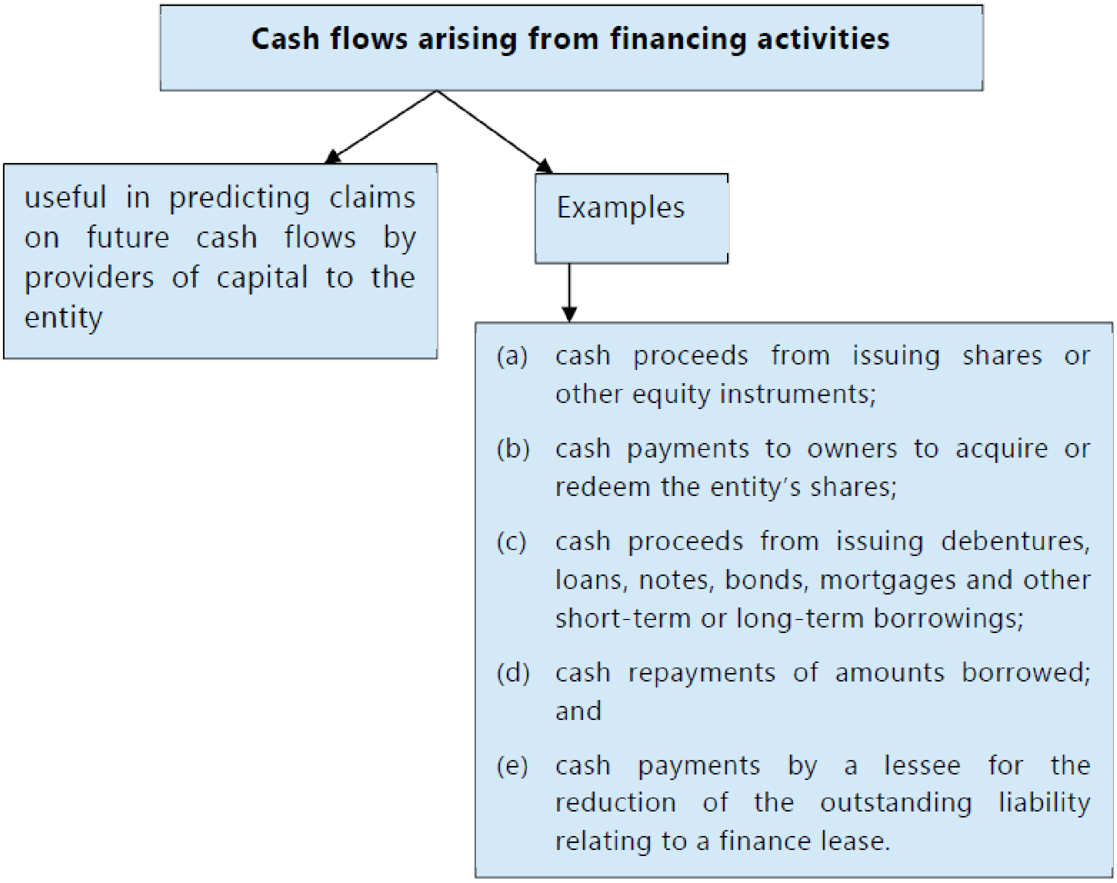
(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Financing activities

1) *Definition*: These are the activities that result in changes in the size and composition of the owner's capital (including preference share capital) and borrowings of the enterprise.
2) *Separate Disclosure*: The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.



METHOD OF PREPARING CASH FLOW STATEMENT

There are two methods of preparing the Cash Flow Statement. Both methods give the same results in respect of the final total as well as sub-totals of the three sections – operating, investing and the financing. They differ only in the manner the information regarding cash flow from operating activities is presented.

INDEIRECT METHOD

	Particulars	₹	₹
(i)	Cash flows from operating Activities		
A.	Net profit before taxation and Extra ordinary items		xxx
	Adjustment for Non-Cash and Non-Operating Items.		
B.	*Add:*		
	Depreciation	xxx	
	Preliminary expenses	xxx	
	Discount on issue of shares and debentures written off	xxx	
	Interest on borrowings and debentures	xxx	

	Loss on sale of fixed assets	xxx	xxx
C.	*Less:*		
	Interest income/received	(xxx)	
	Dividend income received	(xxx)	
	Rental income received	(xxx)	
	Profit on sale of fixed asset	(xxx)	(xxx)
D.	Operating profits before working capital changes (A+B-C)		xxx
E.	Adjustment for working capital changes		
	Less: Increase in Current Assets	(xxx)	
	Add: Decrease in Current Assets	xxx	
	Add: Increase in Current Liabilities	xxx	
	Less: Decrease in Current Liabilities	(xxx)	xxx
F.	Cash generated from operations (D+E)		xxx
G.	Less: Income tax paid (Net of tax refund received)		xxx
H.	Cash flow from before extraordinary items		xxx
	Adjustment for extraordinary items (+/-)		xxx
	Net cash from operating activities	**(i)**	xxx
(ii)	Cash from investing accounting		
	Add:		
	Proceeds from sale of fixed assets	xxx	
	Proceeds from sale of investments	xxx	
	Proceeds from sale of intangible assets	xxx	
	Interest and dividend received	xxx	xxx
	Less:		
	Rent income	(xxx)	
	Purchase of fixed assets	(xxx)	
	Purchase of investment	(xxx)	
	Purchase of intangible assets like goodwill	(xxx)	(xxx)
	Net cash from (or used in) investing activities	**(ii)**	xxx
(iii)	Cash flows from financing activities		
	Add:		
	Proceeds from issue of shares and debentures	xxx	
	Proceeds from other long-term borrowings	xxx	xxx
	Less:		
	Final dividend fund	(xxx)	
	Interim dividend fund	(xxx)	
	Interest on debentures and loans paid	(xxx)	
	Repayment of loans	(xxx)	
	Redemption of debenture preference shares	(xxx)	(xxx)
	Net cash from (or used in) financing activities	**(iii)**	xxx
(iv)	Net increase/Decrease in cash and cash equivalent (i + ii + iii)		XXX
	Add: Cash and cash equivalents at the beginning of the year		XXX
	Less: Cash and cash equivalents at the end of the year		XXX

DIRECT METHOD

	Particulars	₹	₹
(i)	Cash flow from operating activities		
	A. Operating cash receipts		
	Cash Sales	xxx	
	Cash received from customers	xxx	
	Trading commission received	xxx	
	Royalties received	xxx	xxx
	B. Less: Operating cash payment		
	Cash purchase	(xxx)	
	Cash paid to the supplier	(xxx)	
	Cash paid for business expenses like office expenses, manufacturing expenses, selling and distribution expenses	(xxx)	(xxx)
	C. Cash generated from operation (A – B)		xxx
	D. Less Income tax paid (Net of tax refund received)		xxx
	E. Cash flow before extraordinary items		xxx
	F. Adjusted extraordinary items (+/–)/Receipt/payment		xxx
	Net cash flow from (or used in) operating activities		xxx
(ii)	Cash flow from investing activities (calculation same as under indirect method)		xxx
(iii)	Cash flow from financing activities (calculation same as under indirect method)		xxx
(iv)	Net increase/decrease in cash and cash equivalents (i + ii + iii)		xxx
(v)	Add cash and cash equivalent in the beginning of the year		xxx
(vi)	Less cash under cash equivalent in the end of the year		xxx

Calculation of Net Profit Before Tax and Extra Ordinary Items

	Particulars	₹	₹
	Net Profit for the year		xxx
	Add: Transfer to reserve	xxx	
	Proposed dividend for current year	xxx	
	Interim dividend paid during the year	xxx	
	Provision for tax made during the current year	xxx	
	Extraordinary items, if any, debited to Profit and Loss A/c	xxx	xxx
	Less: Extraordinary Items, if any, credited to Profit and Loss A/c	xxx	
	Refund of Tax credited to Profit and Loss A/c	xxx	xxx
	Net profit before taxation and Extra ordinary items		xxx