UNIT-I: ANALYSIS OF FINANCIAL STATEMENTS: Financial Statements – Meaning – Objectives – Types – Uses – Limitations

Meaning, Nature and Objectives of Financial Statements

The financial statements of a company reflect a true picture of its financial performances. They depict not only profits and losses, but even assets and liabilities. It is only at the end of all accounting processes that we can generate financial statements. Let's take a look at the objectives of financial statements along with their features.

Meaning of Financial Statements

Financial statements are basically reports that depict financial and accounting information relating to businesses. A company's management uses it to communicate with external stakeholders. These include shareholders, tax authorities, regulatory bodies, investors, creditors, etc.

Financial statements basically include the following reports:

1. Balance sheet
2. Profit and Loss statement
3. Cash flow statement

Nature of Financial Statements

Financial statements are prepared using facts relating to events, which are recorded chronologically. We have to first record all these facts in monetary terms. Then, we have to process them using all applicable rules and procedures. Finally, we can now use all this data to generate financial statements.

Based on this understanding, the nature of financial statements depends on the following points:

1. **Recorded facts:** We need to first record facts in monetary form to create financial statements. For this, we need to account for figures of accounts like fixed assets, cash, trade receivables, etc.
2. **Accounting conventions:** Accounting Standards prescribe certain conventions applicable in the process of accounting. We have to apply these conventions while preparing financial statements. For example, valuation of inventory at cost price or market price, depending on whichever is lower.
3. **Postulates:** Apart from conventions, even postulates play a big role in the preparation of financial statements. Postulates are basically presumptions that we must make in accounting. For example, the going concern postulate presumes a business will exist for a long time. Hence, we have to treat assets on a historical cost basis.
4. **Personal judgments:** Even personal opinions and judgments play a big role in the preparation of financial statements. Thus, we have to rely on our own estimates while calculating things like depreciation.

Now that we understand the meaning and nature of financial statements, a glance at their objectives would be appreciable.

Browse more Topics under Financial Statements Of A Company

- Forms and Content of Balance Sheets and Peculiar Items
- Types of Financial Statements
- Uses of Financial Statements and Their Limitations

Objectives of Financial Statements

Stakeholders of a company heavily rely on financial statements to understand its functioning. They portray the true state of affairs of the company. Here are some objectives of financial statements:

- Financial statements show an accurate state of a company's *economic assets and liabilities*. External stakeholders like investors and authorities generally do not possess this information otherwise.
- They help in predicting the extent of a company's *capacity to earn profits*. Shareholders and investors can use this data to make their financial decisions.
- Financial statements of a company depict the *effectiveness of its management*. How well a company is performing depends on its profitability, which these statements show.
- They even help readers of these statements know the *accounting policies* used in them. This helps in understanding statements more comprehensively.
- These statements also provide information relating to the company's *cash flows*. Investors and creditors can use this data to predict the company's liquidity and cash requirements.
- Finally, financial statements explain the *social impact of businesses*. This is because it shows how the company's external factors affect its functioning.

Classification of Activities for Cash Flow Statement

Every business uses cash flow statement for knowing the changes in the cash and cash equivalents. Even though these statements are much bothered about cash flows, these also help in assessing balance sheet and income changes. Hence these are classified based on the various activities let us discuss them in brief.

Classification of Activities for Cash Flow Statement

Cash flow activities majorly classified into three categories they are:

- *Operating activities*
- *Investment activities*
- *Financing activities*

These three activities help us to asses the financial position of a firm and also helps to know various cash and cash equivalent transactions incurred.

Operating Activities

These are the main or primary activities of a business. Operating activities mainly deals with major activities of buying and selling of goods and services of a business firm. These activities include manufacturing, distributing, selling, marketing etc. Even though these activities does not include investing and financing activities but provides a major cash flow in the organization and also helps in better assessing the profitability of the firm.

Cash Flow From Operating Activities = Earnings before interest and Tax + depreciation – Taxes +/- Change in working capital

Cash Inflows from Operating Activities

- Receipts from the sale of goods and services.
- Cash receipts from the sale of patents.

Cash Outflows from Operating Activities

- Payments made on salaries to the employees.
- Cash payments made to suppliers.

Investment Activities

Investment activities are the other type of cash flow statement activities in which cash transactions made on purchasing or sale of investments. These activities include money spent on long-term assets, shares, debentures etc.

These activities provide minor cash flow in the firm when compared with operating activities but have a great impact on the profitability of the firm. Cash flow from investment activities helps in the growth of capital also creates stability of the firm.

Cash Inflow from Investment Activities

- Investment activities cash inflow include the sale of assets.
- Cash received on interest on loans and advances given to the third parties.
- Cash receipts received on the investment made in the other companies or firms.
- Receipts received on trading of shares, debentures, bonds etc.

Cash Outflow from Investment Activities

- Cash payments on purchasing long-term assets and other intangible goods like patents.
- Payments made on acquiring of other company shares, debentures and other debt issues.
- Advances and loans given to third parties.

Financing Activities

Financing activities can be defined activities involving in the rise of the company's capital. Even though these lie at the bottom of the statement but had its own importance. These activities are confined mainly financial activities of the firm like trading of company's shares, repaying investors, adding or changing loans, or issuing more stock whenever required. Most importantly these activities change the capital and borrowings of the firm.

Cash Flow from Financing activity = Cash Received from Issuing shares or debts – Cash Paid as Dividends and Reacquiring of shares or debts

Cash Inflow from Financing Activities

- Receipts on the issuing of shares and other debt instruments.
- Cash received from issuing of debentures, loans and other borrowings.

Cash Outflow from Financing Activities

- Interest paid on long-term borrowings and debentures.
- Dividends paid to the shareholders of the company.
- Repaid borrowings made by the firm.

Balance Sheet

Preparing the final accounts is the last stage of the accounting cycle. They help in determining the financial position of the business at the end of the financial as well as the accounting year. These include Trading account, Profit and loss account, and Balance sheet.

Balance Sheet

The balance sheet is a statement which states the assets and liabilities of a firm as at a certain date. As even a single transaction can make a difference in assets or liabilities, so the balance sheet is true only at a particular period of time. This is the significance of “asset” in the balance sheet. It is based on the accounting equation that is:

Total assets = Total liabilities + Capital

As balance sheet is a statement and not an account so there is no debit or credit side. So, Assets are shown on the right-hand side and liabilities on the left-hand side of the balance sheet.

Classification of Assets and Liabilities

Assets

Assets can be classified as:

a. Long term assets:

Long-term assets are those assets which are not to be sold by the firm and to be used for a long period of time, such types of assets are also known as Fixed assets. For example, land and building, plant and machinery, vehicles, equipment, etc.

b. Current assets:

Currents assets are those assets which can be converted into cash easily from the market. Generally within a year. For example, cash in hand, cash at bank, trade receivables, inventory, etc.

c. Intangible assets:

Intangible assets are those which cannot be seen or touched. For example, goodwill, patents, copyrights, etc.

Liabilities

Liabilities can be classified as:

a. Long term liabilities:

Long-term liabilities are those which exists for one or more than one year. For example, long-term loan from the bank.

b. Current liabilities:

Current liabilities or short-term liabilities are those which are to be settled within a year. For example, trade payables, creditors, outstanding expenses, etc.

Proforma of the Balance Sheet is given below

In the books of XYZ

Balance sheet

As at 31st March

Liabilities	Amount	Assets	Amount
Capital a/c:		Tangible fixed assets:	
Balance xxxx		Land and building	Xxxx
Add: net profit/less net loss xxxx		Plant and machinery	Xxxx
Less: drawings xxxx	xxxx	Vehicle	Xxxx
Long term loans:		Furniture and fixtures	Xxxx
Term loans	Xxxx	Intangible assets:	
Other loans	Xxxx	Goodwill	Xxxx
Short term loans:		Patents	Xxxx
Cash credit	Xxxx	Investments:	
Overdraft	Xxxx	Long term investment	Xxxx
Other loans	Xxxx	Current assets:	
Current liabilities:		Cash in hand	Xxxx
Trade payables	Xxxx	Cash at bank	Xxxx
Outstanding expenses	Xxxx	Inventory	xxxx
Advance taken	Xxxx	Trade receivables	Xxxx
Provision:		Prepaid expenses	Xxxx
Provision for bad and doubtful debts	xxxx	Short term investment	Xxxx

Provision for taxation	xxxx	Advance	Xxxx
	Xxxx		Xxxx

Proper presentation of the balance sheet improves the understandability of the information that is to be communicated to its users.

Characteristics of the Balance Sheet

1) Balance sheet is prepared for a particular day rather than the entire period. It will be prepared by considering activities which happened on that particular day.

2) Total of both the sides i.e Assets and liabilities will tally otherwise it is considered as an error.

3) Preparation of balance sheet is only possible after the preparation of the profit and loss a/c. That is why the P& L Account, Balance Sheet and Cash flow Statement are collectively called Final Accounts.

Solved Example For You

From the following trial balance of Mr. Alfa prepare the trading account, profit, and loss account for the year ended 31st March 2018 and balance sheet as on date.

Trial balance as on 31st March 2018

Particulars	**Dr amount** (in Rs)	**Cr amount** (in Rs)
Capital		325000
Sales		485000
Purchases	215000	
Opening stock	55000	
Freight inward	20000	
Salaries	105000	
Administration expenses	75000	
Furniture	175000	

Trade receivables	105000	
Trade payables		95000
Purchase return	10000	
Sales return		6000
Discounts	9500	4500
Bad debts	2500	
Investment	50000	
Cash in hand	93500	
	915500	**915500**

Other information:

1. Closing stock amounted to Rs. 90,000
2. Depreciation on furniture @10%.

Ans.

In the books of Mr. Alfa

Trading account

For the year ended 31st March 2018

Particulars		**Amount**	**Particulars**		**Amount**
To Opening stock		55000	By Sales	485000	
To Purchases	215000		Less: Sales return	(10000)	475000
Less: Purchases return	(6000)	209000	By Closing stock		90000
To Freight inward		20000			
To Gross profit		281000			

		565000			**565000**

Profit and loss account

For the year ended 31st March 2018

Particulars	**Amount**	**Particulars**	**Amount**
To Salaries	105000	By Gross profit b/d	281000
To Administrative expenses	75000	By Discount received	4500
To Discount allowed	9500		
To Bad debts	2500		
To Depreciation @10%	17500		
To Net profit	76000		
	285500		**285500**

Balance sheet

As at 31st March 2018

Liabilities	**Amount**	**Assets**	**Amount**
Capital 325000		Furniture 175000	
Add: Net profit 76000	401000	Less: depreciation @10% (7500)	157500
Trade payables	95000	Cash in hand and Bank	93500
		Closing stock	90000
		Trade receivables	105000

		Investment	50000
	496000		**496000**

Profit And Loss Account

Every company prepares a Profit and Loss Account/statement at the end of the year generally, to get the visibility of the income, earning, expenses and loss incurred in a specific range of period. It is important to prepare Profit and Loss statement because this information helps an organisation to take the right business decision like where should we do the cost-cutting, from where can a business generate more profit and in which part business is suffering the loss. In this article, we will see types of Profit and Loss account and Profit and Loss account format.

Profit and Loss Account/Statement

Types of Profit and Loss

- Gross profit/ Gross loss
- Net profit/ Net loss

We prepare Trading account to ascertain the Gross profit/ Gross loss. While we prepare Profit and loss account to ascertain the Net profit/ Net loss.

Profit and loss account is made to ascertain annual profit or loss of business. Only indirect expenses are shown in this account. All the items of revenue and expenses whether cash or non-cash are considered in this account.

Only the revenue or expenses related to the current year are debited or credited to profit and loss account. The profit and loss account starts with gross profit at the credit side and if there is a gross loss, it is shown on the debit side.

Profit and Loss Account Format

Particulars	**Amount**	**Particulars**	**Amount**
To Gross loss b/d		**To Gross profit b/d**	
Management expenses:		Income:	
To salaries		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 Insurance		By Rent received	
To Audit fees		By Dividend received	
To Legal charges		By Bad debts recovered	
To Electricity charges		Abnormal gains:	
To Maintenance expenses		By Profit on sale of machinery	
To Repairs and renewals		By Profit on sale of investments	
To Depreciation		By Net Loss	
		(transferred to Capital A/c)	
Selling distribution expenses:			
To Salaries			
To Advertisement			
To Godown			
To Carriage outward			
To Bad debts			
To Provision for bad debts			
To Selling commission			
Financial expenses:			
Bank charges			
Interest on loan			
Discount allowed			
Abnormal losses:			
To Loss on sale of machinery			
To Loss on sale of investments			

To Loss by fire			
To Net Profit			
(transferred to capital a/c)			
TOTAL		TOTAL	

Items not shown in Profit and Loss Account Format

1. Drawings: Drawings are not the expenses of the firm. Hence, debit it to the Capital a/c and not to the Profit and loss a/c.
2. Income tax: In the case of companies income tax is an expense but in the case of a sole proprietor, it is his personal expense. Therefore, debit it to Capital A/c.
3. Discount: As we know the discount is of two types – a trade discount and cash discount. We deduct Trade discount from the invoice amount and hence do not show it in the books of accounts. On the other hand, we allow a cash discount when the customer pays the amount on a certain date. We show the cash discount in the books of accounts. Thus, we debit it to profit and loss account.
4. Bad debts*:* It is the amount which is due from a customer and he does not pay it. We debit this amount to Profit and Loss A/c. In case if the provision is already made for bad bets than it is first written off from it. In case if bad debts are recovered, so it is again. Now it is not credited to the party's account but should be credited to bad debts recovered account. And it will be shown on the credit side of profit and loss account.

Closing entries

To complete profit and loss account these entries are necessary:

Date	**Particular**		**Amount (Dr.)**	**Amount (Cr.)**
1. For items of Expenses	Profit and loss account a/c	Dr.		
	To Expenses A/c (individually)			
	(Being the accounts of all the expenses closed)			
2. For items of Incomes	Incomes A/c (individually)	Dr.		
	To Profit and loss account a/c			

	(Being the accounts of all the incomes closed			
3. In case of profit:	Net profit a/c	Dr.		
	To Capital A/c			
	(Being net profit transferred)			
4. In case of loss:	Capital A/c	Dr.		
	To Net Loss A/c			
	(Being net loss transferred)			

Solved Example For You

Following is the trial balance of PQR company on 31st March 2018:

Particulars	Amount (Dr)	Amount (Cr)
Opening stock	32000	
Purchases	230000	
Sales		370000
Return inwards	25000	
Return outward		18000
Carriage inwards	8000	
Carriage outwards	5000	
Rent	36000	
Discount allowed	4000	
Salaries	48000	
Plant and machinery	180000	

Furniture	30000	
Drawings	9000	
Sundry debtors	120000	
Sundry creditors		175000
Capital		164000
Cash at bank	25500	
TOTAL	727000	727000

Additional information:

Value of the Closing stock is Rs. 63000.

Bad debts of Rs. 5000

Rent received Rs. 6000

Depreciation on:

Plant and machinery @10% and furniture @5%

Prepare profit and loss account for the year ended 31st March 2018.

Ans:

In the books of PQR company

Trading account

For the year ended 31st March 2018

Particulars	**Amount**	**Particulars**	**Amount**
To Opening stock	32000	By Sales 370000	
To Purchase 230000		Less: return 25000	345000
Less: return 18000	212000	By Closing stock	63000
To carriage inwards	8000		

To Gross profit	156000		
	408000		**408000**

Profit and loss account

For the year ended 31st March 2018

Particulars	**Amount**	**Particulars**	**Amount**
To Carriage outward	5000	By Gross profit	156000
To Rent	36000	By Rent received	6000
To Discount allowed	4000		
To Salaries	48000		
To Depreciation:	19500		
Plant and machinery 18000			
Furniture 1500			
To Bad debts	5000		
To Net profit- transferred to capital a/c	44500		
	162000		**162000**