CH-07 FINANCIAL STATEMENTS OF A COMPANY

Meaning of Financial Statement:

Financial statements are the basic and formal annual reports through which the corporate management communicates financial information to its owners and various other external parties which include investors, tax authorities, government, employees, etc. These refer to: the balance sheet (position statement) as at the end of accounting period, the statement of profit and loss of a company and the cash flow statement.

Nature of Financial Statements

The chronologically recorded facts about events expressed in monetary terms for a defined period of time are the basis for the preparation of periodical financial statements which reveal the financial position as on a date and the financial results obtained during a period. The American Institute of Certified Public Accountants states the nature of financial statements as, "the statements prepared for the purpose of presenting a periodical review of report on progress by the management and deal with the status of investment in the business and the results achieved during the period under review. They reflect a combination of recorded facts, accounting principles and personal judgements". The following points explain the nature of financial statements:

1. Recorded Facts: Financial statements are prepared on the basis of facts in the form of cost data recorded in accounting books. The original cost or historical cost is the basis of recording transactions. The figures of various accounts such as cash in hand, cash at bank, trade receivables, fixed assets, etc., are taken as per the figures recorded in the accounting books. The assets purchased at different times and at different prices are put together and shown at costs. As these are not based on market prices, the financial statements do not show current financial condition of the concern.

2. Accounting Conventions: Certain accounting conventions are followed while preparing financial statements. The convention of valuing inventory at cost or market price, whichever is lower, is followed. The valuing of assets at cost less depreciation principle for balance sheet purposes is followed. The convention of materiality is followed in dealing with small items like pencils, pens, postage stamps, etc. These items are treated as expenditure in the year in which they are purchased even though they are assets in nature. The stationery is valued at cost and not on the principle of cost or market price, whichever is less. The use of accounting conventions makes financial statements comparable, simple and realistic.

3. Postulates: Financial statements are prepared on certain basic assumptions (pre-requisites) known as postulates such as going concern postulate, money measurement postulate, realisation postulate, etc. Going concern postulate assumes that the enterprise is treated as a going concern and exists for a longer period of time. So the assets are shown on historical cost basis

4. Personal Judgements: Under more than one circumstance, facts and figures presented through financial statements are based on personal opinion, estimates and judgements. The depreciation is provided taking into consideration the useful economic life of fixed assets. Provisions for doubtful debts are made on estimates and personal judgements. In valuing inventory, cost or market value, whichever is less is being followed. While deciding either cost of inventory or market value of inventory, many personal judgements are to be made based on certain considerations.

Objectives of Financial Statements

Financial statements are the basic sources of information to the shareholders and other external parties for understanding the profitability and financial position of any business concern. They provide information about the results of the business concern during a specified period of time in terms of assets and liabilities, which provide the basis for taking decisions. Thus, the primary objective of financial statements is to assist the users in their decision-making. The specific objectives include the following:

1. To provide information about economic resources and obligations of a business: They are prepared to provide adequate, reliable and periodical information about economic resources and obligations of a business firm to investors and other external parties who have limited authority, ability or resources to obtain information.

2. To provide information about the earning capacity of the business: They are to provide useful financial information which can gainfully be utilised to predict, compare and evaluate the business firm's earning capacity.

3. To provide information about cash flows: They are to provide information useful to investors and creditors for predicting, comparing and evaluating, potential cash flows in terms of amount, timing and related uncertainties.

4. To judge effectiveness of management: They supply information useful for judging management's ability to utilise the resources of a business effectively.

5. Information about activities of business affecting the society: They have to report the activities of the business organisation affecting the society, which can be determined and described or measured and which are important in its social environment.

6. Disclosing accounting policies: These reports have to provide the significant policies, concepts followed in the process of accounting and changes taken up in them during the year to understand these statements in a better way.

Types of Financial Statements

The financial statements generally include two statements:
balance sheet and statement of profit and loss which are required for external reporting and also for internal needs of the management like planning, decision-making and control. Apart from these, there is also a need to know about movements of funds and changes in the financial position of the company. For this purpose, a cash flow statement is prepard. Every company registered under The Companies Act 2013 shall prepare its balance sheet, statement of profit and loss and notes to account thereto in accordance with the manner prescribed in the revised Schedule III to the Companies Act, 2013 to harmonise the disclosure requirement with the accounting standards and to converge with new reforms.

Shareholders Fund

The shareholders' funds are sub-classified on the face of the balance sheet.

a) Share Capital

b) Reserves and Surplus

Reserve and Surplus Reserves and Surplus are required to be classified as:

i) Capital Reserve

ii) Capital Redemption Reserve

iii) Securities Premium Reserve

iv) Debenture Redemption Reserve

v) Revaluation Reserve

vi) Share Options Outstanding Account

vii) Other Reserves (Specifying nature and purpose)

viii) Surplus: Balance in statement of profit and loss; disclosing allocations and Appropriation such as dividend, bonus shares, transfer to/from reserve, etc.

c) Money received against Share Warrants:

It is the amount received by the companies which are converted into shares at a specified date on a specified rate. The instrument issued against the amount so received as share warrants. Money received against share warrants' to be disclosed as a separate line item under 'shareholder's fund'.

Non- Current Liabilities:

Long Term Borrowings

Long Term Provisions

Current Liabilities :

Sundry Creditors

Trade Receivables

Outstanding Expenses

Provisions for tax

ASSETS:

NON CURRENT ASSETS:

TANGIBLE FIXED ASSETS

INTANGBLE FIXED ASSETS

NON CURRENT INVESTMENTS

CURRENT ASSETS:

Sundry Debtors
Bills Receivable
Inventories
Cash
Bank
Prepaid Expense

STATEMENT OF PROFIT AND LOSS

The items of statement of profit and loss are discussed as follows:

1. Revenue from operations This includes:
(i) Sale of products
(ii) Sale of services
(iii) Other operating revenues In respect to a finance company, revenue from operations shall include revenue from interest, dividend and income from other financial services. It may be noted that under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

2. Other income
(i) Interest income (in case of a company other than a finance company),
(ii) Dividend income,
(iii) Net gain/loss on sale of investments,
(iv) Other non-operating income (net of expenses directly attributable to such income).

3. Expense Expenses incurred to earn the income shown under various heads as discussed below:

(a) Cost of Materials It applies to manufacturing companies. It consists of raw materials and other materials consumed in manufacturing of goods.

(b)Purchase of Stock-in-trade It means purchases of goods for the purpose of trading.

(c) Changes in inventories of It is the difference between opening inventory (stock) finished goods, WIP and of finished goods, WIP and stock-in-trade and closing stock-in-trade inventory.

(d)Employees benefit expenses Expenses incurred on employees towards salary, wages, leave encashment, staff welfare, etc., are shown under this head. Employees benefit expenses may be further categorised into direct and indirect expenses.

(e) Finance cost It is the expenses towards interest charges during the year on the borrowings. Only the interest cost is to be shown under this head. Other financial expenses such as bank charges are shown under “Other Expenses”.

(f) Depreciation Depreciation is the diminution in the value of fixed assets whereas amortisation is writing off the amount relating to intangible assets.

(g) Other expenses All other expenses which do not fall in the above categories are shown under other expenses. Other expenses may further be categorised into direct expenses, indirect expenses and non-operating expenses.

The various uses and importance of financial statements :

1. Report on stewardship function: Financial statements report the performance of the management to the shareholders. The gaps between the management performance and ownership expectations can be understood with the help of financial statements.

2. Basis for fiscal policies: The fiscal policies, particularly taxation policies of the government, are related with the financial performance of corporate undertakings. The financial statements provide basic input for industrial, taxation and other economic policies of the government.

3. Basis for granting of credit: Corporate undertakings have to borrow funds from banks and other financial institutions for different purposes. Credit granting institutions take decisions based on the financial performance of the undertakings. Thus, financial statements form the basis for granting of credit.

4. Basis for prospective investors: The investors include both short-term and long-term investors. Their prime considerations in their investment decisions are security and liquidity of their investment with reasonable profitability. Financial statements help the investors to assess longterm and short-term solvency as well as the profitability of the concern.

5. Guide to the value of the investment already made: Shareholders of companies are interested in knowing the status, safety and return on their investment. They may also need information to take decision about continuation or discontinuation of their investment in the business. Financial statements provide information to the shareholders in taking such important decisions.

6. Aids trade associations in helping their members: Trade associations may analyse the financial statements for the purpose of providing service and protection to their members. They may develop standard ratios and design uniform system of accounts.

7. Helps stock exchanges: Financial statements help the stock exchanges to understand the extent of transparency in reporting on financial performance and enables them to call for required information to protect the interest of investors.

Limitations of Financial Statements

1. Do not reflect current situation: Financial statements are prepared on the basis of historical cost. Since the purchasing power of money is changing, the values of assets and liabilities shown in financial statement do not reflect current market situation.

2. Assets may not realise: Accounting is done on the basis of certain conventions. Some of the assets may not realise the stated values, if the liquidation is forced on the company. Assets shown in the balance sheet reflect merely unexpired or unamortised cost.

3. Bias: Financial statements are the outcome of recorded facts, accounting concepts and conventions used and personal judgements made in different situations by the accountants. Hence, bias may be observed in the results, and the financial position depicted in financial statements may not be realistic.

4. Aggregate information: Financial statements show aggregate information but not detailed information. Hence, they may not help the users in decision-making much.

5. Vital information missing: Balance sheet does not disclose information relating to loss of markets, and cessation of agreements, which have vital bearing on the enterprise

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