UNIT 4 UNDERSTANDING FINANCIAL STATEMENTS

Structure

4.0 OBJECTIVES

After studying this unit you should be able to:

- prepare company financial statements in vertical form;
- acquaint with the concepts of revenues and provisions, profit and capital; and
- appreciate the uses and limitations of financial statements.

4.1 INTRODUCTION

According to Section 210 of the Companies Act, a company is required to prepare a balance sheet at the end of each trading period. Section 211 requires the balance sheet is to be prepared in the prescribed form. Schedule VI Part I permits presentation of Balance Sheet either in horizontal or vertical forms. The present trend of the whole corporate world is to present their annual accounts in vertical form which has now become a modern practice. The purpose of this unit is to provide knowledge of working model of annual financial statements prepared in accordance with Schedule VI of Companies Act 1956, Accounting Standards applicable to reporting enterprise and the basic concepts of reserves and provisions, profit and capital. It also deals with the uses and limitations of financial statements.

4.2 VERTICAL FORMAT OF CORPORATE FINANCIAL STATEMENTS

The Profit and Loss Account and Balance Sheet may also be presented in vertical form. In the vertical form, a summarised profit and loss account is prepared and details of the items are shown separately in the form of annexures. In the case of balance sheet, the liabilities are shown under the heading 'Sources of Funds' and the assets are shown under the heading 'Application of Funds'. Both the prescribed forms of profit and loss account and balance sheet require that figures of the previous year should be shown in separate column along with the figures of the current year with respect to each of the items. The current trend of the whole corporate world is to present their annual accounts in vertical form. Part I of Schedule VI permits preparation of financial statements in vertical form which has now become a modern practice.

4.2.1 Vertical format of Balance Sheet

Under vertical form, a Balance Sheet is prepared under single column divided in two sections. First section shows the "Sources of Funds" which includes Share Capital, Reserves and Surplus, Secured and Unsecured Loans. The second section is represented by "Application of Funds" in the form of Fixed Assets, Investments, Net Current Assets (Current Assets-Current Liabilities) and Miscellaneous Expenditure. A format is given below.

Balance sheet of ....
As on ......

		Schedule No.	Figures for the current year	Figures for the previous year
I	**Sources of Funds**			
	1. **Shareholders' Funds**			
	(a) Share Capital	1	....	....
	(b) Reserves and Surplus	2	....	....
	2. **Loan Funds**	3		
	(a) Secured Loans		....	....
	(b) Unsecured Loans		....	....
	Total		....	....
II	**Application of Funds:**			
	1. **Fixed Assets**	4		
	(a) Gross Block		....	....
	(b) Less Depreciation		....	....
	(c) Net Block		....	....
	(d) Capital Work-in-progress		....	....
	2. **Investments**	5	....	....
	3. **Current Assets, Loans and Advances**	6	....	....

	(a)	Inventories	
	(b)	Sundry Debtors	
	(c)	Cash and Bank Balances	
	(d)	Other Current Assets	
	(e)	Loans and Advances	
Less:		Current Liabilities and Provisions	7
	(a)	Liabilities	
	(b)	Loans and Advances	
	Net Current Assets		
4.	**(a)**	**Miscellaneous Expenditure** (Amount not written off)	
	(b)	**Profit and Loss Account** (Less) Balance in General Reserve	
		As per contra	
Total			
Significant Accounting Policies & notes on accounts			15

Various schedules as mentioned above, will provide necessary details of items and information as required to be given as per schedule VI of Companies Act 1956. The figures in the amount column may be rounded off to the nearest thousand (000) as may be decided by the management. These schedules, significant accounting policies and explanatory notes form an integral part of the Balance schedules, significant accounting policies and explanatory notes form an integral part of the Balance Sheet as required by applicable Accounting regarding disclosure of accounting policies. Contingent liabilities are shown by means of footnote to the Balance Sheet.

4.2.2 Vertical Format of Profit and Loss Account

Almost all the companies prepare and present their Income Statement (Profit and Loss Account) in vertical form. In fact the information relating to activities (operating , investing, financing) of the companies are arranged in vertical order rather than conventional (horizontal 'T' form). A format of Profit and Loss in vertical form is given below:

Particulars	**Schedule No.**	**Figures at the end of current year**	**Figures at the end of previous year**
I Income			
Sales			
Services			
Dividend			
Interest			
Other Income	8		
TOTAL			
II Expenditure			
Cost of goods sold/raw material consumed	9		
Selling and other expenses	10		
Depreciation	11		
Financial Expenses	12		
TOTAL			

Profit before Taxation, Extraordinary and Prior Period Items	
Provision of Taxation	
Net Profit before Extraordinary and Prior Period Items	12
Extra Ordinary Items (Net of Tax)	13
Prior Period Items (Net of Tax)	14
Net Profit	
Balance brought forward from Previous year profits available for appropriation	
Appropriation	
Interim Dividend	
Dividend on Preference Shares	
Proposed Final dividend	
Corporate Dividend Tax	
Transfer to Debenture Redemption Reserve	
Transfer to Capital Redemption Reserve	
Transfer to General Reserve	
Balance taken to Balance Sheet	
Significant Accounting Policies and notes on accounts	15

(For details of schedules learners are advised to refer to Horizontal (conventional) form of Balance Sheet)

A list of significant accounting policies and notes is as follows:

1. Basis of Accounting
2. Revenue Recognition
3. Fixed Assets
4. Depreciation and Amortisation
5. Investments
6. Inventories
7. Foreign Currency Transactions
8. Retirement Benefits
9. Deferred Revenue Expenditure
10. Hire Purchase-Lease rental income
11. Product warranty expenses
12. Provision for contingencies
13. Research and Development
14. Taxation
15. Investment in debt and equity shares
16. Long term contracts and property development activity
17. Government grants
18. Amortisation of License fees
19. Changes in accounting policies
20. Amortisation of License fees
21. Provision for re-inventing the company
22. Employees stock option scheme.
23. Amalgamation

24. Changes in provisions of retirement benefits of employees.
25. Investment in sick units
26. Contingencies
27. Approval of managerial remuneration
28. Extraordinary items.

Illustration 1

The following is the trail balance of ABC Ltd. as on 31st March 2003 (Rs. In '000')

Debit Balances	**Rs.**	**Credit Balances**	**Rs.**
Freehold Building	2750	Equity Share Capital (Shares of Rs. 10 each)	3750
Plant and Machinery at Cost	9500	10% Debenture	2500
Debtors	1200	General Reserve	1625
Stock (31.03.2003)	1075	Profit and Loss Account	900
Bank	250	Securities premium	500
Adjusted Purchases	4000	Sales	8750
Factory Expenses	750	Creditors	650
Administration Expenses	375	Provision for Depreciation	2050
Selling Expenses	375	Other Income	25
Debenture Interest	250		
Interim Dividend	225		
	20750		**20750**

Additional Information:

i) The authorised share capital of the company is Rs. 75,00,000.

ii) Freehold premises have been valued at Rs. 45,00,000.

iii) Proposed final dividend is 10% & corporate dividend tax 12.5%.

iv) Depreciation on Plant & Machinery is to be provided at 10% on cost.

v) Provided for income tax @ 40%.

You are required to prepare Profit and loss account for the year ended 31st March 2003 and a Balance Sheet as on that date in vertical form as per the provisions of Schedule VI of the Companies Act 1956.

Solution **ABC Ltd.**

Profit and Loss Account for the year ended 31st March 2003

	Particulars	**Schedule No.**	**Rs. (in '000')**
Income:			
	Sales		8750
	Other Income		25
			8775
Expenditure:			
	Purchases (Adjusted)		4000
	Factory Expenses		750
	Administration Expenses		375
	Selling Expenses		375
	Depreciation		950
	Interest on debentures		250
			6700

	Profit before tax		**2075**
Less:	Provision for taxation @ 40% on Rs. 2075	830	
	Net Profit after tax		**1245**
Less:	Dividend: Interim	225	
	Final (Rs.3750 × 10%)	375	
	Dividend tax	75	675
	(225+375 = 700 × $12^1/_2$%)		**570**

Balance Sheet as on 31st March 2003

				Schedule No.	Rs. (in '000')
I	Sources of Funds				
	Shareholders Funds				
	(a) Share Capital			1	3750
	(b) Reserves and Surplus			2	5345
					9095
	Loan Funds: a) Secured				
	10% Debentures				2500
	Total				**11595**
II	Application of Funds				
	Fixed Assets			3	
	(a) Gross Block				1400
	(b) Depreciation				3000
	(c) Net Block				**11000**
	Current Assets, Loans and Advances				
	Current Assets:				
	(a) Stock	1075			
	(b) Debtors	1200			
	(c) Bank	250	2525		
Less:	Current Liabilities				
	Creditors	650			
	Provision for Taxation	830			
	Proposed Dividend	375			
	Corporate Dividend Tax	75	1930		
					595
	Net Current Assets				**11595**

Schedule 1:	**Share Capital:**	
	Authorised	
	75,000 shares of Rs. 10 each	**Rs. 75,00,000**
	Issued, Subscribed & paid up	
	37500 shares of Rs. 10 each	
	fully paid	Rs. 37,50,000
Schedule 2:	**Reserves and Surplus**	**Rs.**
	Securities Premium	5,00,000
	Revaluation Reserve	17,50,000
	General Reserve	16,25,000
	Profit & Loss Account*	
	(9,00,000 + 5,70,000)	14,70,000
* (Opening Bal. +Bal. of Current year's P&L A/c)		**53,45,000**

Schedule 3: Fixed Assets

	Opening Balance	Additions	Revaluation Reserve	Disposal	Provision for Dep.	Closing Balance
1 Freehold Premises	27,50,000	–	17,50,000 (4500000–2750000)	–	–	45,00,000
2 Plants & Machinery	95,00,000	–	–	–	30,00,000	65,00,000
	1,22,50,000		**17,50,000**		**30,00,000**	**1,10,00,000**

Illustration 2

From the following information, prepare a Balance Sheet in a vertical form as on 31st March 2003 as per the provisions of Schedule VI of Companies Act 1956.

Debit Balances	Rs. (000)	Credit Balances	Rs. (000)
Fixed Assets	14,300	Equity Share Capital	4,000
Finished Goods	1,500	10% Pref. Share Capital	1,600
Stores	800	Profits for the year	1,810
(Before interest & tax)			
Preliminary Expenses	206	12% Debenture	3,000
Advance Tax	400	P & L Account (1.04.2002)	100
Capital Work-in-progress	640	Security deposits from dealers	240
Interest on debentures (net)	324	Securities Premium	1,000
Interest on Loans (other)	160	Investment Allowances Reserves	300
Cas at Bank	550	Creditors	2,300
Loose Tools	100	Provision for doubtful debts	50
Short term investment at cost	450	Provision for Depreciation	3,000
(Market value Rs. 440)			
Advance to staff	120	Loan from Customers	400
Debtors	2,450	General Reserve	4,200
	22,000		**22,000**

Additional Information:

(i) Dividend is proposed on equity shares @ 0%.

(ii) Provide TDS:

Interest on debentures	@	10%
Corporate dividend tax	@	12.5%
Corporate Income tax	@	40%

Solution

Balance sheet of...

As on 31st March 2003

	Schedule No.	Rs. (in '000')
I Sources of Funds		
1 Shareholders funds		
a. Share Capital	1	5,600
b. Reserves & Surplus	2	5,738
		11,338
2 Loan Funds		
a. Secured Loans		3,000
b. Unsecured Loans	3	640
TOTAL		**14,978**

			Schedule	
II	Application of Funds:			
1.	Fixed Assets		4	
	a. Gross Block			**14,300**
	b. Less Depreciation			(3000)
	c. Net Block			**11,300**
	d. Capital work-in-progress			640
				11,940
2.	Short term Investments (at realisable value)			440
3.	Current Assets, Loans and Advances			
	a. Inventories	2400	5	
	b. Debtors less provision	2400		
	c. Cash at Bank	550		
	d. Loan & Advances (Advance to staff)	120		
		5470		
	Less: Liabilities and Provision			
	a. Liabilities	(2336)	6	
	b. Provisions	(742)	7	
	Net Current Assets (Working Capital)			2,392
4.	Miscellaneous Expenditure (Prelim. Exp.)			206
	TOTAL			**14, 978**

Schedule 1

Share Capital	
Equity Share Capital	4000
10% Pref. Share Capital	1600
	5600

Schedule 2

Reserves and Surplus:	
Securities Premium	1000
Investment allowance Reserve	300
General Reserve	4200
Profit & Loss Account	238
	5738

Schedule 3

Unsecured Loans:	
Security deposits from Dealers	240
Loans from Customers	400
	640

Schedule 4

Fixed Assets	14300
Less Depreciation	3000
	11300
Capital work-in-progress	640
	11940

Schedule 5

Current Assets, Loans and Advances		
a. Inventories		
Loose tools		100
Stores		800
Finished Goods		1500
		2400

Schedule 6

Current Liabilities		Rs.
Creditors		2300
TDS on interest on debentures		36
		2336

Schedule 7

Provisions:		Rs.
Provision for Income Tax	512	
Less Advance Tax	400	112
proposed Dividend:		
Equity		400
Preference		160
Corporate Dividend Tax		70
		742

Working:

Profit and Loss Appropriation Account

	Rs.		Rs.
To Interest on debentures	360	By Profit	1810
To Interest on Loan	160		
To Loss on Investment	10		
To Provision for Income Tax	512		
{1810 – (360+160+10) x 40/100}			
To Balance c/d	768		
	1810		1810
To Proposed Dividend:		By Balance b/d	768
Equiity	400		
Preference	160	By profit	100
To Corporate Tax	70	(1.4.02)	
To Balance (Carried to Balance Sheet)	238		
	868		868

Check Your Progress A

1) Under what headings will you classify the following items:

   a) Securities Premium

   b) Preliminary Expenses

   c) Live-Stock

   d) Unclaimed Dividend

e) Interim dividend declared but not paid

f) Arrears of fixed cumulative preference dividend

g) Share forfeited account

h) Loose tools

i) Advance income tax paid

j) Sinking fund

2. State briefly the items that are included under the following heads:

   a) Contingent Liabilities (b) Unsecured Loans (c) Secured Loans

   d) Reserve & Surplus (e) Current Liabilities & Provisions

   f) Current Assets, Loans & Advances

ι *Students are advised to see the annual reports of various companies to develop a better understanding of financial statements through notes attached thereto.*

4.3 RESERVES AND PROVISIONS

The reliability, and accuracy of income statement (profit & loss account) and financial position statement (balance sheet) depends to a greater extent, upon the estimates, which govern the amount of various provisions to be made. And similarly transfers to various reserves including statutory transfer, determine the financial soundness, creditworthiness and depict strong fundamentals which send clear signal to stock market and other interested parties. Hence, the concepts of ‘reserves’ and ‘provisions’ are of utmost importance while preparing, analysing and understanding the financial statements.

4.3.1 Reserves

The portion of earning, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by management for a general or specific purpose is known as reserve. These reserves are primarily of two types: Revenue and Capital reserves which may be classified and treated as follows:

1) **Revenue Reserves:** are also know as free reserves. These are created to meet a **contingent** liability not specifically mentioned. These contingencies reserves indicate management’s belief that funds may be required for an **usual purpose** or to meet a possible obligation that does not yet have the status of a liability such as settlement of a pending law suit or to meet any trading loss. These reserves are also created for any other **general** purposes such as for expansion or modernisation. For accounting purposes the transfer of amount to such ‘general reserve’ or ‘contingency reserve’ is treated as appropriation and not a charge.

2) **Specific Reserve:** When a reserve is created for a specific purpose it is known as ‘specific reserve’. It may be created to maintain a stable rate of dividend or to meet redemption of debentures after a stipulated period of time. Such reserves may take form of “Dividend Equalisation Reserve”, “Debenture Redemption Reserve” etc. None of these reserves represent maney or anything tangible. From accounting point of view it is simply a transfer of divisible profit to other head.

   However, when these Revenue Reserves (General/Specific) are not retained within the business but invested outside business are termed as “reserve Funds”.

3) **Capital Reserve:** A reserve which is created not out of divisible profits is called capital reserves. Such reserve is not available for distribution among sharehold-ers as dividend. It is generally created out of capital profits such as profits prior to incorporation, securities premium, profit on re-issue of forfeited shares, profit

on redemption of debentures, profit on sale of fixed assets, profit on revaluation of fixed assets and capital redemption reserve crated as per the provisions of Companies Act on redemption of preference shares.

As stated above, such profits are not available for distribution as dividend. However, some of the capital profits (profit on sale of fixed assets) can be distributed as dividend if the same are realised in cash. But the companies act expressly prohibits the following to be used for payment of dividend:

Premium on issue of shares.
Profit on re-issue of forfeited shares and
Capital redemption reserve
Revaluation reserve

According to section 7 of Companies Act 1956, Securities Premium can be utilized only for the following purposes:

1) Issue of fully paid bonus shares.
2) Writing off the preliminary expenses, discount on issue of shares or debentures or other fictitious assets.
3) Providing for the premium payable on redemption of debentures or preference shares.

U/s80, Capital Redemption Reserve can be utilised only for the purpose of issuing fully paid bonus shares.

4) **Secret Reserve:** A reserve which is not disclosed in the Balance Sheet is known as secret reserve. The companies Act 1956 prohibits creation of secret reserve because it conceals the actual financial position. However, the financial position of the company is definitely better what it appears from the balance sheet. Such reserve is created in any of the following manner by:

1) Writing of excessive depreciation
2) Understating the value of assets.
3) Overstating liabilities.
4) Treating capital expenditure as revenue.
5) Creating excessive provision for bad debts.
6) Creating provisions which are not required.
7) Treating contingent liability as an actual liability
8) Treating revenue receipt as capital

Secret reserve may arise on account of a permanent appreciation in the value of assets or a permanent diminution in the value of a liability. Such changes usually are not accounted for in the books of accounts.

The policy of secret reserve is adopted by the management to achieve the following objectives:

- To meet the exceptional losses
- To bring down the market value of shares within the trading range.
- To enhance the availability of working capital
- To maintain dividend rate
- To elude competition by concealing large profits
- To minimize tax liability
- To keep strong financial position
- To lessen the dependence on external finances

All these reserves are shown on the liabilities side of the balance sheet.

4.3.2 Provisions

The companies Act 1956 states that, "Provision means amount written off or retained by way of providing depreciation, renewals of diminution in the value of assets or retained by way of providing for any known liability the amount of which can not be determined with substantial accuracy".

Thus the above definition clearly mentions that a provision may be created either for depreciation or for a known liability, the amount which cannot be ascertained with substantial accuracy such as:

– Provision for bad & doubtful debts

– Provision for Repairs and renewals.

– Provision for discount on debtors

– Provision for fluctuation in investments

Therefore, it can be summed up that a provision is created either against the loss (fall) in the value of assets in the normal course of business operation or against a known liability the amount of which cannot be determined accurately but in estimated only.

4.3.3 Distinction between Provision and Reserve

1) A provision is a charge against the profits which reserve is simply an appropriation of profits.
2) A provision is created to meet a known liability whose amount is uncertain while reserve is created to strengthen the financial position and the meet contingency, if any.
3) A provision is shown as a deduction out of the assets concerned whereas reserve is shown separately on the liabilities side.
4) The sum so set aside as provision is never invested outside business whereas reserves may be invested outside business.
5) Provision is part of divisible profits but the same cannot be made available for the purpose of distributing dividend while reserves (revenue) are always available to be distributed as dividends.
6) Provisions have to be created whether there is profit or loss while reserve is created only when there is profit.

Check Your Progress B

I.

1. .... is created to meet a known liability. (Provision)
2. .... is built to meet a contingency. (Revenue reserves)
3. .... is treated as a charge against profits. (Provision)
4. Transfer to .... is an appropriation. (General reserve)
5. .... is not affected by profit or loss of the enterprise. (Secret reserve)
6. .... is made only when there are profits. (Reserve)

II. Write a short note on usage of "Securities Premium", U/s 78

III. Prepare a list of possible capital profits.

IV.. What are managerial objectives for creating secret reserves, and how is it created?

V. Distinguish between: Reserve and Reserve Fund
General Reserve Vs Specific Reserve.

4.4 CONCEPTS OF PROFITS

The main objective of this topic is to make students familiar with the various concepts of profits which are used by the management as the basis for taking appropriate decisions. A clear line of demakation between these terms will help to understand their application for decision-making purposes.

4.4.1 Gross Profit

It is also known as gross margin. As per the provisions of Companies Act 1956, Gross profit is 'the excess of the proceeds of goods sold and services rendered during a period over their cost, before taking into account administration, selling and distribution and financing expenses".

So the difference between the revenue (Sales) and cost of goods sold is the gross profit. Normally, the profit and loss account is prepared in two parts– (1) Trading Account and (2) Profit and Loss Account. Trading Account shows the "result" of trading operation under normal conditions which represents "Gross Profit" or "Gross Loss". Revenue means the inflow from main business activity in which the enterprise deals in whereas the cost of goods sold, in case of trading concerns, comprises purchases (of goods in which concern deals in) and direct expenses incurred (such as freight, octroi, duty etc) on or before purchases. However, in case of a manufacturing concern, the cost of goods sold will include cost of materials consumed, wages and other manufacturing expenses.

Modern practice of the whole corporate world is to present the information in a summarized statement (called abridged profit and loss account) giving the details in various schedules forming part of income statement.

Illustration 3

From the following details of ABC manufacturing company find the gross profit:

	Rs.
Raw Material Purchased	12,00,000
Stock of raw material in the beginning	2,50,000
Productive wages	3,50,000
Carriage Inward	20,000
Freight and Octroi	60,000
Other manufacturing expenses	1,20,000
Stock of raw material at the end	2,40,000
Sales	18,75,000

Solution

ABC Company
Profit and Loss Account
For the year ended ....

Particulars	**Schedule No.**	**Rs. (in '000')**
Income:		
Sales	1	1875
Other Income* (not related business)		–
		1875
Expenditure		
Cost of goods sold	2	1760
Gross Profit	115	

* Not to be considered for gross profit purposes.

Schedule 1: Provides the details of sales: product-wise, segment-wise (Business segment/Geographical segments) etc in India and outside India less returns inwards & sales or trade discount.

Schedule 2:

		Rs.
	Cost of goods sold:	
	Opening stock of raw material	2,50,000
Add:	Purchases	12,00,000
		14,50,000
	Less: Closing Stock	2,40,000
	Raw Material Consumed	12,10,000
Add:	Direct expenses	
	Carriage Inward	20,000
	Freight & Octroi	60,000
	Productive wages	3,50,000
	Other manufacturing expenses	1,20,000
	Cost of goods produced (sold)	17,60,000

- Because there is no closing balance
- When there is opening and closing work in progress (semi-finished goods), then along with the opening and closing stock of raw material, the work-in-progress (semi-finished goods) will also be added and subtracted accordingly.
- However, if there is opening and closing stock of finished goods, this will also form the part of inventory.

Illustration 4

In the above illustration, if the following balances also appear, findout the cost of goods sold:

	Rs.
Opening balance of work-in-progress	35,000
Opening balance of finished goods	1,25,000
Closing balance of work-in-progress	55,000
Closing balance of Finished goods	1,75,000

Solution

The following changes will be made in the Schedule 2:

Schedule 2: Cost of goods sold will be as follows

	Inventory on 1st April..........		
	Raw Material	2,50,000	
	Semi-finished goods	35,000	
	Finished goods	1,25,000	4,10,000
Add:	Purchases		12,00,000
	Direct Expenses		5,50,000
			21,60,000
Less:	Inventory on 31st March		
	Raw Material	2,40,000	
	Semi-finished goods	55,000	
	Finished goods	1,75,000	4,70,000
Cost of Goods Sold			16,90,000

4.4.2 Operating Profit

It refers to net profit arising from the main revenue producing activities of an enterprise after accounting for operating expenses but before taking into account expenses of financial nature and non-operating income. Operating expenses include over and above the cost goods sold, such as:

- Factory overheads
- Administration Overheads (Office Over-Heads) and
- Selling and Distribution over-heads

In other words, when above mentioned operating expenses are subtracted from the gross profit, the resultant figure is "operating profit" and if total operating expenses exceed gross profit, the difference is treated as operating loss. Operating profit is the measure of operating efficiency of the enterprise and it is referred as OPBIT (Operating Profit before and Tax). When non-operating items are also considered, the resultant figure is Profit Before Tax (PBT). Let us consider the following illustration:

Illustration 5

From the following information, calculate gross profit and OPBIT

	Rs. (in '000')
Sales (Gross)	2,075
Return Inwards	15
Return Inwards	60
Rent Received	25
Interest & Dividend on investments	35
Direct Expenses (Manufacturing)	375
Selling and Distribution expenses	75
Office and Administration Expenses	150
Purchases Less returns	850
Inventories (1.4.2002)	145
Inventories (31.03.2003)	165

Solution

Profit and Loss Account
For the year ended 31st March 2003

Particulars	**Schedule No.**	**Rs. (in '000')**
Sales	1	2,060
Less Cost of goods sold	2	1,205
Gross Profit		855
Operating Expenses:		
Office and Administration expenses	150	
Selling and Distribution expenses	75	
		225
Operating Profit (OPBIT)		630

Schedule 1:	**Rs. (000)**
Gross Sales	2,075
Less Returns	15
	2,060

Schedule 2:

Inventories (1.4.2002)	145
Add: Purchases Less Returns	850
	995
Add: Direct Expenses	375
	1,370
Less: Inventories (31.03.2203)	165
Cost of goods sold	1,205

4.4.3 PBIT (Profit Before Interest and Tax)

It refers to net profit before deducting any amount of financing expenses and income tax. other words when interest expense and tax liability are not accounted for while calculating profit or loss of an enterprise, it is treated as PBIT. Interest expense includes:

Interest on debentures
Interest paid or public deposits accepted by a trading or manufacturing organisation
Interest on Loan from public
Interest on Loan from Banks, financial institution or from Government.
Cas packaging or credit from Banks.

PBIT = Operating Profit + Other Income

*** PBT (Profit Before Tax)**

PBT = PBIT – Interest

When interest expense is subtracted from 'Profit Before Interest & Tax' (PBIT) (or total net earnings) before providing for any income tax thereon, it is called 'Profit before Tax'. This shows overall performance of an enterprise resulting from operating, investing and financing activities. This is also termed as EBT (Earnings before tax). Thus,

PBT = PBIT – Interest.

*** Pat (Profit After Tax)**

This refers to net profit after taxes, but before making nay appropriation during the year. The net profit before tax (PBT) is adjusted for tax liability calculated at the current rate of taxation. For various sources of incomes there are different rates. Such as income from business is taxed at a flat rate of 35%, income from long-term capital gains @ 20%. The tax so calculated will be enhanced by a surcharge of 5% for assessment year 2003-2004 and 2.5% for 2004-2005 However, for foreign companies the tax rate is 40%.

PAT = PBT – Provision for Taxation

It should be noted that income tax purposes the profits are recomputed for determining tax liability by income tax authorities. The actual tax liability is determined only after the assessment is completed. That's why in the profit and loss account the amount of tax so determined on the basis of net profit as disclosed by Profit and Loss Account is transferred to 'Provision for Taxation'. This provision is adjusted against the actual tax liability. You might have already learnt more about provision for taxation under Unit 3.

Illustration 6

From the above Illustration 5, calculate Gross Profit, Operation Profit, PBIT, PBT and PAT

Solution

Particulars	**Schedule No.**	**Rs. (in '000)**
Sales	1	2,060
Less cost of goods sold	2	1,205
Gross Profit		855
Operating Expenses:		
Office and Administation expenses		150
Selling Distribution expenses		75
		225
Operating Profit (OPBIT)		630
Add: Non Operating Incomes		60
Net profit before interest and tax (PBIT)		690
Less: Financial expenses (Non-operating)		60
Net profit before tax (PBT)		630
Less: Provision for Taxation		220.5
(630000 × 35%)		220.5
Profit After Tax (PAT)		
		409.5

Schedule 1:

	Rs. (000)
Gross Sales	2,075
Less: Returns	15
	2,060

Schedule 2:

Inventories (1.4.2002)	145
Add: Purchases Less Returns	850
	995
Add: Direct Expenses	375
	1,370
Less: Inventories (31.3.2003)	165
Cost of goods sold	1,205

Schedule 3:

Other Income (Non-operating):	
Rent Received	
Interest and Dividend	25
	35
	60

4.4.4 Cash Profit

When all the non-cash charges which have been debited to Profit and Loss Account are added back to net profit, the amount so arrived at is termed as **cash profit**. Non-cash charges are those expenses in respect of which no payment is to be made to outside parties. It includes

– Depreciation
– Discount on issue of shares & debentures written off
– Preliminary Expenses written off, etc.

It should be noted that 'outstanding expenses' are not treated as non-cash charges because in respect of such expenses, the payment has to be made in the next accounting year. Whereas cash does not flow-out in respect of depreciation and discount on issue of shares or debentures. Preliminary expenses are the formation expenses which have already been incurred in yester years, hence question of making payment of such expenses does not arise. That's why while calculating cash profit such non-cas charges are added back to net profit. Suppose net profit of an enterprise amounts to Rs. 15,30,000 after changing depreciation of Rs. 3,70,000 and writing off of Rs. 15,000 preliminary expenses. The cash profit will be taken at Rs. 19,15,000. (Rs. 15,30,000 + 3,70,000 + 15,000).

The concepts of Gross Profit, Operating Profit before interest and Tax, Operating Profit before Tax and Operating Profit after Tax can be found out with the help of the following format:

Operating Income Statement for the period ....

Gross Sales	xxx	
Less: Returns	xxx	
Net Sales		xxx
Less: Cost of sales:		
Material consumed	xxx	
Direct wages	xxx	
Manufacturing expenses	xxx	
Finished goods, etc.	xxx	xxx
Less: Closing stock		xxx
Gross Profit		xxx
Less: Operating expenses:		
Office & Administrative expenses	xxx	
Selling ad Distribution expenses	xxx	xxx
Net Operating Profit (Opit)		xxx
Add: Non-operating Incomes		
Interest Received	xxx	
Dividend Received	xxx	
Rent Received, etc.	xxx	
Less: Non-operating expenses:	xxx	
Discousnt Allowed	xxx	
Interest on Debentures	xxx	
Interest on Borrowings, etc.	xxx	xxx
Net Profit Before Tax (PBT)		xxx
Less: Provision for Income Tax		xxx
Net Propfit After Tax (PAT)		xxx

4.4.5 Profits Available to Equity Shareholders (Residual Profit)

Residual profit is that portion of profit which is available for equity share holders. It means the profit which the directors consider, should be distributed among equity shareholders after making necessary adjustments as per the provisions of companies Act. In normal course, profits are distributed as dividend only after meeting all expenses, losses, depreciation (current & unabsorbed), fall in the amount of current assets, taxation, past losses, preference dividend and transfer to sinking fund, debenture redemption fund and to general reserve U/s 205 (2A). However, profit arising out of revaluation of fixed assets and other profits of extra ordinary nature (capital profits) are not included in the profits available for equity shareholders ads dividend. It should be noted that the depreciation must be calculated as per the provisions of the section 205 of the Companies Act 1956.

Illustration 7

You are given the following information:

	Rs. (000)
PBIT	5,782
Depreciation charged as per Books	182
Depreciation as per Section 205	360
10% Preference Share Capital	1,500
Past Accumulated Losses	1,500
Transfer to Debenture Redemption Fund	1,200
Unabsorbed Depreciation as per section 205	560
Interest on Loans & Advances	252
Transfer to General Reserves	600

Calculate profit available for equity shareholders, presuming tax rate of 40%.

Solution

		Rs. (000)
PBIT (as given)		5782
Less Interest		252
		5530
Less provision for transfer @ 40%		2212
		3318
Add Depreciation as per books		182
		3500
Less Depreciation as per section 205		360
		3140
Less Unabsorbed Depreciation		560
		2580
Less Accumulated Past Losses		1200
		1380
Less Transfers-Debenture Redemption Fund150	150	
General Reserve	600	750
		630
Less Preference Dividend		150
Profits available to equity shareholders		**480**

Check Your Progress C

1. Gross Profit is the result of two variables
   (i) Turnover & (ii) ....
2. Turnover is the total of:
   (i) Gross Profit & (ii) ....

3. Operating profit is equal to
   (i) .... (ii) Operating expenses
5. Operating expenses include:
   (i) ....
   (ii) ....
   (iii) ....
6. Financial expenses are treated as ....
7. When non-cash charges are added back to net profit the resultant is ....
8. Non-cash charges include:
   (i) ....
   (ii) ....
   (iii) ....

4.5 CONCEPTS OF CAPITAL

There are certain key terms which are used in the process of analysis of financial statements, to draw certain conclusions after judging the company's networth, liquidity, solvency and credit worthiness etc.

4.5.1 Capital Employed

The term capital employed has been defined as the finances deployed by an enterprise in it's fixed assets, investments and working capital. However, if the investments are non-business or non-trading, the same may be excluded from the capital employed.

The capital employed can be worked out by two methods:

First Method: Capital Employed = Fixed assets (Less Depreciation)

+ Net working capital (Current Assets – Current Liabilities)

Since spare funds are used to buy government, semi-govt, or commercial securities the same are treated as non-trading assets. Hence, such funds are not used for business purposes. However, if such assets have to be acquired, these should be treated as trade investments and should form part of capital employed.

Second Method: Capital employed can also be worked out and expressed as the total sum of share capital (Preference & Equity both), reserves (accumulated till date) and long-term liabilities (loans & debentures) as reduced by fictitious assets such as Debit balance of profit and loss account, preliminary expenses, discount on issue of shares and debentures and non-business assets.

It should be noted that certain intangible assets which have been generated over the years and no payment has been made to acquire them, are not considered for the purpose of determining capital employed. These intangible assets include goodwill, patents, copyrights, trade marks etc.

Thus capital employed = Paid-up share capital (Preference & Equity) + Reserves + Accumulated profits + Revaluation – Revaluation Loss-Fictitious assets–intangibles (generated.)

Average Capital Employed

It is calculated by adding the capital employed in the beginning and at the end divided by two. Alternatively, half of the current year's profits may be added to the capital employed in the beginning or subtracted from the capital employed at the end to arrive at the figure of average capital employed which fairly represents capital employed throughout the year.

$$\text{Average capital employed} = \frac{\text{Capital Employed at the beginning} + \text{Capital Employed at the end}}{2}$$

It should be remembered that when capital employed is calculated for the purpose of determining the rate of net profit on capital employed then, debentures and loans are excluded for the purpose of computing the capital employed because net profit does not include interest on loans and debentures.

Illustration 8

From the following Balance Sheet, calculate capital employed under both the methods:

Liabilities	Rs.	Assets	Rs.
9% 2500 preference shares of Rs. 100 each	2,50,000	Goodwill	50,000
50,000 equity shares of Rs. 10 each	5,00,000	Fixed Assets	9,00,000
Reserve Fund	4,50,000	Investment in Govt. Securities	1,00,000
10% Debentures	2,50,000	Current Assets	5,00,000
Provision for Taxation	50,000	Preliminary Expenses	50,000
Creditors	1,25,000	Discount on issue of debentures	25,000
	16,25,000		16,25,000

Fixed assets are valued at Rs. 9,25,000.

Solution

Computation of capital employed: (First Method)

			Rs.
Fixed Assets (after revaluation)			9,25000
Current Assets			5,00,000
			14,25,000
Less:	Creditors	50,000	
	Provision for taxation	1,25,000	1,75,000
			12,50,000

Alternatively: (Second Method)

			Rs.
9% Preference Share Capital			2,50,000
Equity Share Capital			5,00,000
Reserve Fund			4,50,000
10% Debentures			2,50,000
			14,50,000
Add:	Revaluation Profit		25,000
			14,75,000
Less:	Goodwill	50,000	
	Investment	1,00,000	
	Preliminary Expense	50,000	
	Discount on issue of shares & debentures	25,000	2,25,000
Capital Employed			**12,50,000**

4.5.2 Shareholders Funds

Shareholders funds are also referred as networth which is equal to the excess of total assets (excluding fictitious) over the liabilities. This represents the amount belonging to shareholders i.e. what amount the shareholders will be paid, had there been liquidation of the company.

Hence, shareholders funds = All assets (excluding fictitious) less liabilities (short-term and long-term both)

or

Shareholders funds = Preference share capital + Equity share capital + Reserves + Accumulated Profits (Capital/Revenue)–Fictitious assets– Assets which are worth less + revaluation profit - Revaluation loss.

Illustration 9

From the following information compute shareholders' funds

11% Preference Share Capital	3,00,000	Goodwill	2,50,000
Equity Share Capital	7,00,000	Fixed Assets	10,00,000
Reserves (Revenue)	1,50,000	Investments	2,50,000
Capital Reserves	75,000	Current Assets	3,75,000
Securities Premium	1,25,000	Preliminary Expenses	80,000
9% Debentures	5,00,000	Discount on debentures	45,000
Current Liabilities	1,50,000		
	20,00,000		20,00,000

Fixed assets include Rs. 40000 for patents which are considered useless and freehold premises which is valued Rs. 75000 more than its bookvalue. Goodwill is to be valued at Rs. 2,20,000.

Solution

Computation of Shareholders' Funds

First Method

				Rs.
Goodwill				2,50,000
Fixed Assets				10,00,000
Investments				2,50,000
Current Assets				3,75,000
				18,75,000
Less:	9% Debentures		5,00,000	
	Current Liabilities		1,50,000	
	Revaluation Loss:			
		Patents	40,000	
		Goodwill	30,000	7,20,000
				11,55,000
Add:	Revaluation Profit (Freehold premises)			75,000
	Shareholders' Funds			12,30,000

Second Method: Shareholders' Funds may also be computed as follows:

			Rs.
Pref. Share Capital			3,00,000
Equity Share Capital			7,00,000
Revenue Reserve			1,50,000
Capital Reserve			75,000
Securities Premium			1,25,000
			13,50,000
Less:	Preliminary Expenses	80,000	
	Disc. On debentures	45,000	
	Revaluation Loss (Patent Rs. 40,000 + Goodwill Rs. 30,000)	70,000	1,95,000
			11,55,000
Add:	Revaluation Profit (Freehold premises)		75,000
Shareholders' Funds			12,30,000

4.5.3 Shareholders

It is the interest of equity shareholders in the net assets of the company. However, in case of liquidation it is represented by the residual assets meeting prior claims. If the claims of the preference shareholders are subtracted from the shareholders' funds the remaining balance is termed as equity shareholders' equity.

Shareholders' Equity = Shareholders' Funds – Preference Shareholders claim

In the above example, equity shareholders' equity will be Rs. 9,30,000 (Rs. 12,30,000-3,00,000). That is shareholders funds less preferences share capital, if the preference shares are participating i.e. they are entitled to share surplus assets after meting the claims, then such share of preference shareholders will also be subtracted from the shareholders' funds.

> *It is to be noted that "Shareholders' Equity" includes preference share capital also as against the "Equity Shareholders' equity" which expressly excludes preference share capital and other claim thereof.*

4.5.4 Debt Funds

Debt Funds are represented by outside liabilities. It is also known as "external equities". It consists of short-term as well as long-term liabilities. Debt funds are in the form of debentures, loans and borrowings, and current liabilities such as creditors, bills payable, bank overdraft and short term bank credit. By and large these current liabilities are always available year after year on a permanent basis, thus become a part of debt funds.

However, there is no unanimity or consensus on this point. Some authors do not treat current liabilities as a part of debt funds, especially for the purpose of calculating debt-equity ratio because of the following reasons:

i) Currnet liabilities are of a short-term nature and the liquidity ratios are calculated to judge the ability of the firm to honour current obligations.

ii) Current liabilities vary from time to time within a year and interest thereon has no relationship with the book value of current liabilities.

The reasons for taking both short-term and long-term debts are as follows:

i) When a firm has an obligation, no matter whether it is of short-term or long-term nature, it should be taken into account to evaluate the risk of the firm.

ii) Just as long-term loans have a cost, short-term loans do also have a cost.

iii) As a matter of fact, the pressure from the short-term creditors is often greater than that of long-term loans.

4.5.5 Net-working Capital Employed

Net working capital implies to the "funds available for conducting day-to-day operations of an enterprise". It can also be referred as excess of current assets over current liabilities. Hence working capital is the results of two variables viz current assets and current liabilities. A change in the amount of either of two variables brings about a change in the amount of working capital employed.

Net working capital employed = current assets–current liabilities.

Current assets refer to "cash and other assets which are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business. This includes stock, debtors, bill receivable, short-term trade investment or marketable securities & pre-paid expenses etc.

Current Liabilities are those liabilities which have to be paid within a normal course of business (within a year). It includes creditors, bills payable, Bank-overdraft, short-term loans, outstanding expenses of other liabilities which fall due for payment in a relatively short period, not more than twelve months.

An enterprise should employ enough working capital so that it can meet its current obligations to keep the enterprise on the margin of safety. However, tis margin of safety should not be big enough that the most of the funds remain idle. Otherwise the company cannot make optimum use of the funds employed. The ideal amount of net working capital to be employed, according to traditional belief, should be equal to current liabilities i.e. current assets should be double of the amount of current liabilities so that company enjoys better liquidity position and does not become technical insolvent.

4.6 USES OF FINANCIAL STATEMENTS

The financial statements are useful in many ways in the process of decision making. They are the basis of decision making for its users, namely management, investors, creditors, government authorities, etc. Let us now discuss the usefulness of financial statements.

1) **Economic Decision-making**

Sound economic decisions (of external users) require assessment of impact of current business activities and development on the earning power of the company. Information about economic resources and obligations of a business enterprise is needed to form judgement about the ability of the enterprise to survive, to adopt, to grow, to prosper amid changing economic conditions. In this process, the financial statements provide information that is important in evaluating the strength and weaknesses of the enterprise and its ability to meet it's commitments.

2) **Investors Decisions**

Adequate disclosure in the financial statements in expected to have favourable effect on security process of the company. An informed investor is always in a position to take appropriate and timely decision on investment or disinvestment. Financial statements and annual reports provide necessary information regarding profitability, dividend policy, net worth, intrinsic value of shares. Earnings per share (EPS) to assess future prospects to substantiate their investment decisions. The group is not only interested in present health of the enterprise but the future fitness as well. Bankers & financial institutions and foreign institutional investors are always worried about the future solvency of the invested firms.

3). **Employees' Decisions**

Employees' decisions are usually based on perceptions of a company's economic status acquired through financial statements. Employees and their trade unions use the financial statements to assess risk and growth potential of a company, which helps settle industrial disputes, avert lockout & strike or likewise situation arise form demand for wage hike, bonus, higher compensation, more fringe benefits, better working conditions and so on. Labour unions and individual employees use financial statements as the basis for collective bargaining and settlement. Tis develops sense of belongingness among the workers for they know that their interest is not being jeopardised.

4) **Creditors and Financiers**

Short-term creditors make use of the financial statements mainly to ascertain the ability of the firm to pay its current liabilities one time and the value of stock and other asset which can be accepted as security against credits granted. Long-term creditors and financiers are more concerned about the firm's ability to repay the principal amount as and when due. From the financial data provided by the periodic statements, it is possible to make projections about the generation of funds and cash flows, which may assure the safety of investment in debentures and loans.

5) **Customers' Public and Competitiors' Decisions**

Customers and the public in general may use financial statements to predict and forecast future prospect of the company. This information may be important in estimating the value of warranty or in predicting the availability of supporting services or continuing supplies of goods over an extended period of time. Likewise, competitors may analyse financial statements (from competition point of view) to judge the ability of competitor to withstand competition and it's absorbing capacity.

6) **Managerial Decisions**

Published account and reports forming part of financial statements may have economic effects through it's impact on the behaviour of the managers of corporate enterprises. Financial statements provide necessary information base for taking all managerial decisions. In the absence of accounting information neither the objectives of the enterprise can be laid down nor measurement and evaluation of performance is possible nor corrective measures can be taken. Managerial tools such as production budget, sales budget, cash budget, capital budget, and master budget etc. are all the offspring of financial statements. Similarly, wage policy, price policy, credit policy, recruitment policy and other policy matters are decided after careful analysis of financial statements.

7) **Government and it's Agencies**

Government Agencies include taxation authorities and regulatory bodies such as Ministry of Trade & Commerce, Company Law Board, Registrar of Joint Stock Companies, Securities Exchange Board of India (SEBI). These agencies require information for policy decisions purposes. It may be a fiscal policy of Central Board of Direct Taxes (CBDT) or a regulatory policy of company law board and so on, they all require financial statements for policy formulation purposes.

8) **Others**

The financial statements are also useful to stock exchange, brokers, underwriters, press and the public in general. Though Their interest and goals being altogether different in nature, yet they require accounting information in the form of financial statements to serve their own ends. For example researchers may provide some startling facts and findings which may be used by Government to set its economic policy, by regulatory agencies to take regulatory measures and by management to review its own policies and by the public (NGO's) for social reporting purposes. Social reporting aims at measuring adverse and beneficial effects of an enterprise activities both on the company and those affected by the firm; it measures social costs and the related benefits thereof.

4.7 LIMITATION OF FINANCIAL STATEMENTS

Despite the fact that financial statements are the back-bones of the decision-making process for different levels of executives in an organisation, financial analysts and advisors and other interested persons, these suffer from certain limitations because the facts and figures which are reported may not be precise, exact and final. Again some aspects which may be crucial for decision-making purposes may go unreported.

1) **Periodic nature of statements:** The profit or loss arrived at in the Profit and Loss Account is for a specified period. It does not give any idea about the earning capacity over time. Similarly, the financial position as at the date of Balance Seet is true of that point of time. The likely change in position on a future date is not depicted. Liabilities which were dependent on future events (contingent liabilities) are estimated and shown in the Balance Sheet. They are not accurate figures. Similarly, revenue expenditure is sometimes partly charged to Profit and Loss Account and partly deferred or carried forward. The proportion which is deferred and shown on the asset side of Balance Sheet is based on convenience and depends on the level of earnings relatively to the expenditure. In all these respects the annual statements do not reveal the exact earning capacity or financial state of affairs.

2) **The statements are not realistic:** Financial statements are prepared on the basis of certain accounting concepts and conventions. As a result, the financial position depicted in the statements cannot be considered realistic. For example, fixed assets are required to be shown on the basis of their value to the business as represented by their acquisition price less depreciation, not as per the estimated resale price. Also, the Profit and Loss Account invariably includes probable losses but does not include probable income. This is according to the accounting convention of conservation.

3) **Lack of objectivity due to personal judgement:** Values assigned to many items are determined on the basis of the personal judgement of accountants. Hence, relevant amounts shown in the financial statements have no objectivity and they are not varifiable. For instance, estimates of the life of fixed assets and the method of depreciation to be used are based on the personal judgement of accountants. So is the case with valuation of inventories (stock) of materials, work in progress, stores and spare parts, etc. The method of valuation to be adopted depends on the poilicy at the discretion of management based on their judgement.

4) **Only financial matters are reported:** The financial statements present information in terms of monetary units. There is no information relating to the non-monetary aspects of business operations. Facts which cannot be depicted in money terms are excluded from the statements. Thus, information relating to the development of skill and efficiency of employees, the reputation of management, public image of the firm, and such matters do not find a place in the financial statements. Yet these are very relevant for investors to consider while forming any opinion about the future prospects of the firm.

5) **No Suggestive Approach:** Financial Statements disclose information about the past (historical) i.e. what has happened? But it does not disclose why and how it happened. If a company makes profits or incurs losses, the financial statements will show only the amount of profits or losses made but fails to divulge any details as to why there is an increase or decrease in profits or losses.

6) **Subjective Approach of the Management:** Financial performance (profitability) cannot be taken as the only indicator of managerial performance. The profit figures, to a greater extent, are affected by managerial policy of charging depreciation, writing off fictitious assets, amortisation of intangible assets, allocation of advertisement cost,

valuation of stock etc. Likewise, objectivity factor is lost while preparing financial statements to depict the financial position of the concern. Further application of certain concepts and conventions does not allow to show the assets at the true current values (cost concept). The assets shown in the Balance Sheet reflect unexpired cost (W.D.V.) However, liabilities are shown at the same figures thereby distrorting the solvency position of the enterprise. Likewise, the accounting year may be chosen after due thought so that financial statements can send the desired signals to outside interested parties.

7) **Conflicting Principles:** According to Principle of conservatism stock may be valued at cost or market price whichever is less. This implies that current assets are shown at cost in one year and at marker price the other year. It shows clear violation of principle of consistency. Similarly the change of method of charging depreciation from straight line method to written down value method and vice versa highlights contradiction in application of accounting principles. Again, because of flexibility of accounting principles, certain liabilities are not provided for, such as no provision for gratuity payment is made. This is bound to give distorted picture of the financial statements.

8) **Figures are not-self explanatory:** How far the financial statements are useful depends upon the ability of the users to analyse and interpret accounting data for their decision making purposes. Truly accounting is the language of the business but financial statements do not speak themselves, you need certain expertise and tools to make them speak. Every user is not competent to draw conclusions from these statements. Even audited financial statements do not provide a complete and total guarantee of accuracy.

Check Your Progress D

1. Fill in the blanks:
   (a) Final accounts of a company are prepared according to .... Companies Act ....
   (b) Excess of current assets over current liabilities is called ....
   (c) Shareholders' funds comprise of .... and ....
   (d) Liquidity is the ability of the company to meet ....
   (e) Net worth of the company is equal to ....
   (f) .... are show by means of footnote under the Balance Sheet.

4.8 LET US SUM UP

The financial statements are presented either in horizontal or vertical form. The present practice of the corporate enterprises is to present their annual accounts in vertical form which has now become a modern practice. Under vertical form, in case of Balance Sheet, the liabilities are shown under the heading "Sources of Funds" and the assets are shown under the heading "Application of Funds". A summarised profit and loss account is prepared to know the profit or loss and the details of the items are shown separately in the form of annexures.

The concepts of "Reserves" and "Provisions" have its own significance in the preparation of financial statements. The portion of earning whether capital or revenue appropriated by management for a general or specific purpose is known as reserve. A reserve may be a revenue reserve or capital reserve. A revenue reserve may be either a general reserve or specific reserve. General reserve is created to meet a contingent liability. A specific reserve is created for a specific purpose. It may be created to maintain a stable rate of dividend or to meet redumption of debentures, etc. A reserve which is not created out of 'divisible profits' is called 'capital reserve' and is generally created out of capital profits. Capital profits are not available for distribution as dividends. A reserve which is not disclosed in the Balance Sheet is called as 'secret reserve'. Secret reserves may arise on account of permanent appreciation in the value of assets or permanent diminution in the value of a liability which is not accounted for in the books of accounts. A provision may be created either against the loss (fall) in the value of assets in the normal course of business operation or against a known liability the amount of which cannot be determined accurately but is estimated only.

Gross profit is the difference between the revenue (sales) and cost of goods sold. If we deduct operating expenses from the gross profit, the resultant figure is 'operating profit'. When interest expense and tax liability are not accounted for while calculating profit or loss, of an enterprise, it is treated as 'Profit before Interest and Tax' (PBIT). When interest expense is subtracted from PBIT before providing any income tax, the resultant figure refers to PBT. PAT refers to net profit after taxes. When all non-cash charges which have been debited to Profit and Loss account are added back to net profit, the amount so arrived at is termed as 'cash profit. There are certain key concepts which are used in the process of analysing financial statements. These concepts are: capital employed, shareholders' funds, equity shareholders' equity, debt fund and net working capital.

The financial decisions are useful in many ways in the process of decision-making. These statements are the basis for decision making for its users, e.g. management, investors, creditors, government authorities, etc. They help us in evaluating the strength and weaknesses of the enterprise and investment decisions. Inpsite of its uses, these statements are subject to certain limitations because the facts and figures which are reported may not be precise, exact and final. Further, some aspects which are crucial for decision making may go unreported.

4.9 KEY WORDS

Vertical form of Balance Sheet: A statement prepared under single column divided in two sections, viz. 'Sources of Funds' and 'Application of Funds'.

Vertical form of Profit and Loss Account: A summarised profit and loss account prepared in vertical form and details of the items are shown separately in the form of annexures.

Residual Profit: Net profit available for equity shareholders.

Secret Reserve: A reserve which is not disclosed in the Balance Sheet which may arise on account of a permanent appreciation in the value of assets or a permanent diminuation in the value of a liability.

Gross Profit: The difference between net sales and cost of goods sold.

Operating Profit: Gross profit minus operating expenses.

Cash Profit: The amount which is arrived at by adding back to net profits those non-cash charges which have been debited to the profit and loss account.

Capital Employed: Long-term funds including owners' capital and borrowed capital.

Net Working Capital: Excess of current assets over current liabilities.

4.10 ANSWERS TO CHECK YOUR PROGRESS

A. 1 (a) Reserves and surplus, (b) Miscellaneous expenditure, (c) Fixed assets, (d) Current liabilities and provisions, (e) Current liabilities and provisions, (f) Contingent liability, (g) Reserves and surplus, (h) Current assets, (i) Loans and advances or a deduction from liability for tax, (j) Reserves and surplus.

B. 1. Provision, 2. Revenue reserves, 3. Provision, 4. General reserve, 5. Secret reserve, 6. Reserve.

C. 1. Cost of goods sold, 2. Cost of goods sold.
4. Gross profit, 5(i) Factory overheads, (ii) Office and administrative overheads, (iii) Selling and distribution overheads, 6. Non-operating expenses, 7. Cash profit, 8(i) Depreciation, (ii) Discount on issue of shares and debentures written off, (iii) Preliminary expenses written off.

D. 1 (a) Schedule VI, 1956, (b) Net working capital, (c) Share capital, reserves and surplus, (d) Debts, (e) Excess of total assets over the liabilities, (f) Contingent liabilities.

4.11 TERMINAL QUESTIONS

1) Write notes on:
   a) Horizontal presentation of Balance Sheet, and
   b) Vertical presentation of Balance Sheet.
2) "Balance Sheet is a statement of assets and liabilities or sources and uses of capital or both". Comment.
3) What are the financial statements? How far are they useful for decision-making purposes?
4) Write a note on nature and limitations of financial statements.
5) Z Ltd. made a loss of Rs. 50,000 after providing depreciation of Rs. 1,00,000 in 2002. In 2003 the company earned a profit of Rs. 3,00,000 before charging depreciation of Rs. 75,000.
   b) Also find out cash profit for the year 2002 and 2003.

(Ans: (a) Rs. 1,25,000 (b) Rs. 50,000 and Rs. 3,00,000)

6) From the following calculate Gross Profit, operating profit, Profit before tax (PBT) and Profit after Tax (PAT). The balance of profit standing to the credit of Profit and Loss Account after making following adjustments Rs. 61,000.

	Rs.
Depreciation	85000
Proposed Dividend	1,50,000
General Reserves	45,000
Dividend Received	10,000
Loss on sale of fixed assets	23,000
Indirect Business Expenses	3,05,000

However, Income tax @ 50% has not been provided for.

(Ans:	Gross Profit	:	Rs. 6,53,000
	Net Profit	:	Rs. 2,50,000 (PBT) & Rs. 1,25,000 (PAT)
	Operating Profit	:	Rs. 2,40,000)

7) Explain the purpose and procedure of calculating the following:

   1) Gross Profit
   ii) Operating Profit
   iii) PBIT
   iv) PAT

8) An inexperienced accountant has prepared the balance sheet of ABC Ltd. as follows:

Balance Sheet of ABC Limited

Liabilities	Rs.	**Assets**		Rs.
Trade Creditors	80900	Stock:		
Advances from Customers	42,260	In hand		3,60,480
Share Capital	8,00,000	With Agents		24,300
Profit & Loss A/c	45,630	Cash in hand		23,540
Provision for Taxes	95,000	Investments		20,000
Proposed Dividend	59,000	Fixed Assets:		
Loan to Managing Director	5,000	Land		1,80,000
General Reserve	75,000	Plant and Machinery		
Development Rebate Reserve	30,000	(W.D.V.)		4,10,000
Provision for Contingencies	23,000	Debtors	2,15,450	
Share Premium A/c	22,000	Less: Provision		
Forfeited Shares	3,000	for B/D	9,300	
				2,06,150
		Bills Receivable		5,000
		Amount due from Agents		51,320
	12,80,790			12,80,790

Redraft the above Balance Sheet in the vertical form prescribed by Indian Companies Act, 1956 giving necessary details yourself.

9) From the following prepare a Balance Sheet in vertical form as on 31st March 2003

Sundry Debtors	612500
Profit & Loss A/c (Dr.) Current year	150000
Miscellaneous Expenses	29000
Investments	112600
Loose Tools	25000
Securities Premium	237500
Securities Premium	85000
Advances to staff	27500
Cash & Bank Balances	137500
Advances	186000
S. Creditors	572500
Term Loan	500000
Capital work-in-progress	100000
General Reserve	1025000
Finished Goods	375000

Gross Block (NDR)	2575000
Stores	200000
Provision for doubtful debts	10100
Loans from Customers	100000
Share Capital: Equity Shares	150000
10% Preference Shares	500000

Additional Information:

(1) Terms Loans are secured (2) Depreciation on fixed assets Rs. 2,50,000

10) From the following particulars prepare profit and loss account for the year ended 31st March 2003 and a Balance Sheet as on that data in vertical form. The company has a authorised capital of Rs. 50,00,000 divided in to 2,50,000 equity of Rs. 10 each and 2,50,000 10% preference shares of Rs. 10 each.

Debit Balances	Rs. (000)	Credit Balances	Rs. (000)
Materials Purchased	1233	4% debentures	500
Furniture & Fittings	150	Equity Share Capital	1500
Stock (1.4.2002)	665	10% Preference Share Capital	500
Discounts & Rebates	30	Bank overdraft	757
Patents	375	S. Creditors	240
Carriage Inwards	57	Sales	3617
Rent, Rates & Insurance	55	Transfer Fees	7
Wages	1305	Rent Received	30
Coal & Coke	63	Profit & Loss A/c (1.4.02)	67
Bank Balance	20		
Cash in Hand	8		
Debenture Interest (for 6 month)	10		
Bank Interest	91		
Preliminary Expenses	10		
Calls-in-Arrears	10		
Freehold Premises	1250		
Plant & Machinery	750		
Tools & Equipment	150		
Goodwill	375		
S. Debtors	266		
Bills Receivable	134		
Advertisement	15		
Commission & Brokerage	68		
Business Expenses	56		
Repairs	47		
Bad Debts	25		
	7218		**7218**

Additional Information:

The closing stock was valued at Rs. 712000. Outstanding liabilities for wages Rs. 25,000 and for business expenses Rs. 25,000 Charge depreciation on:

Plant and Machinery	@	5%
Tools and Equipments	@	20%
Patents	@	10%
Furniture & Fixtures	@	10%

Provide 2% on debtors for doubtful debts after writing off Rs. 16,000 as bed debts. Write off preliminary expenses Rs. 5000. Transfer Rs. 50,000 to debenture Redemption Fund. A dividend of 10% was declared. Corporate Income tax @ 5-% is to be provided. Ignore dividend tax.

Hints

1. Provision for Bad debts (Debtors-Additional Bad debts) 2% on (Rs. 2,66,000-16000) = 5000
2. Dividend @ 10 % on paid up capital:

Preference	:	50000
& on Equity Capital @ 10%	:	
(Rs. 150000-1000)		149000
		199000

3. Add amount of Outstanding expenses to their respective heads
4. Balance of profit and loss account after appropriation: Rs. 38,000
5. Outstanding debenture interest for six months: Rs. 10,000

(Ans: Net Profit Rs. 2,20,000 (after tax))

4.12 SUGGESTED READINGS

1. Report of the study group on the *“Objectives of Financial Statements”* AICPA, 1973
2. *‘Accounting for Financial Statements Presentation’* by Smith & Keith.
3. *Financial Accounting* “A Simplified Approach” by Dr. Naseem Ahmed–Atlantic Publishers & Distributors 2002, Darya Ganj, New Delhi.