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SUMMARY SHEET

Income Statement and Balance Sheet

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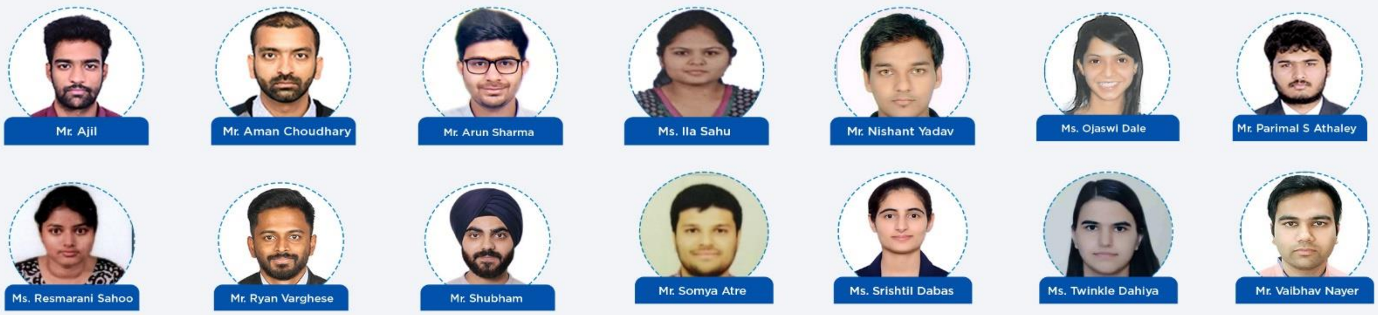

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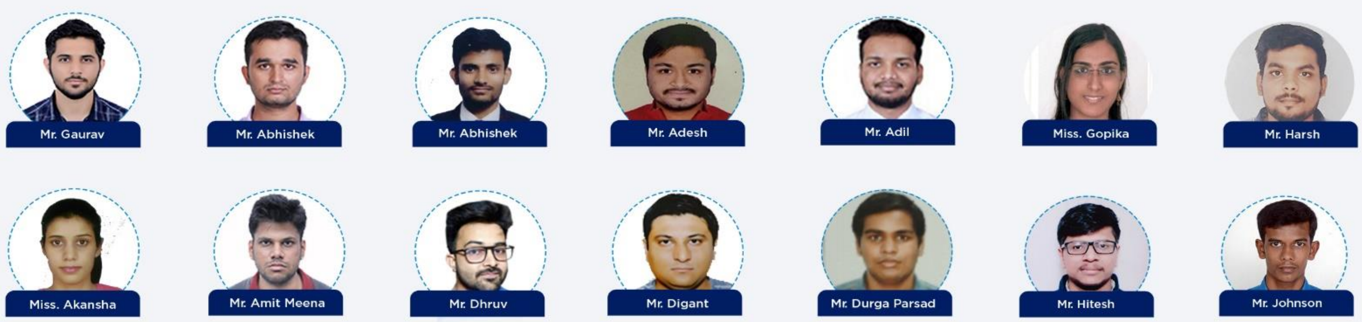

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Important Points

1. This Summary Sheet shall only be used for Quick Revision after you have read the Complete Notes

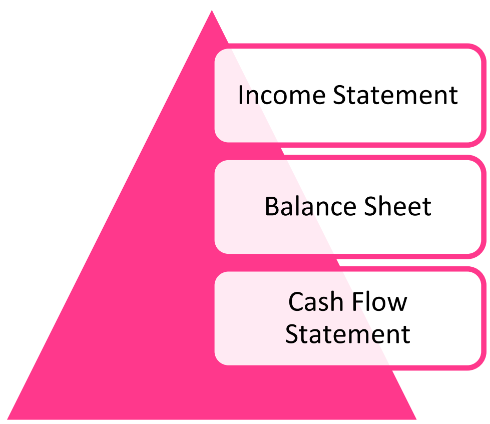
2. For Building Concepts along with examples/concept checks you should rely only on Complete Notes

3. It would be useful to go through this Summary sheet just before the exam or before any Mock Test

4. Questions in the exam are concept based and reading only summary sheets shall not be sufficient to answer all the questions

1 Summary Points

- **Three important Financial Statements** which help to assess the financial viability of a company are,



- **Income Statement (Earnings Statement or Profit and Loss Statement):** An accounting statement that **matches a company's revenues with its expenses over a period of time.** The basic objective is to calculate the Profits earned by the company, calculated by

$$\boxed{\textbf{Profit = Revenues – Expenses}}$$

- **Two principles** underlie measurement of Revenues and Profitability in Income Statement
    1. **Principle of Accrual Accounting and Cash Accounting:**
        - ✓ **Accrual Accounting:** This method accounts for revenue when it is **earned** and expenses goods and services when they are **incurred.**

- ✓ **Cash Accounting:** This method accounts for revenue only when the money is **received** and for expenses only when the money is **paid out**

2. **Principle of Categorization of Expenses:**
   - ✓ **Operating expenses:** Are related to expenses that provide benefits only for the current period of the business or product. Ex. Rent, raw materials, labour
   - ✓ **Financing expenses:** Are expenses arising from the non-equity financing used to raise capital for the business. Ex. Interest payments
   - ✓ **Capital expenses:** are expenses that are expected to generate benefits over multiple periods. Ex. Land, Buildings, etc.

➢ **Basic elements of Income Statement:**

Income Statement January 1—December 13, 2013		
	$	$
REVENUES		
Sales	350,000	
Interest Revenues	1,000	
Gains	2,000	
Total Revenues		**353,000**
EXPENSES & LOSSES		
Cost of Goods Sold	125,000	
Salaries	110,000	
Rent	7,000	
Utilities	2,000	
Interest Expense	1,000	
Losses	1,000	
Bad Debt Provision	4,000	
Depreciation	8,000	
Total Expenses & Losses		**(258,000)**
NET INCOME		**95,000**

1. **Revenues:** Denotes **direct sales of the company** i.e. revenue obtained by selling goods which is the primary business of the company. Revenues could also be earned from secondary activities like
   - ✓ **Interest Revenues:** Interest money earned from bank deposits

- ✓ **Rental Income:** Money earned through renting out free spaces owned by the company
- ✓ **Gains:** Money earned through the sales of assets like building, machinery, etc.

2. **Expenses:** These can be of three types:
   - ✓ **Direct expenses:** Are the expenses directly incurred for the manufacturing of the product. Consists of cost of goods sold, direct labour costs, manufacturing overhead, etc.
   - ✓ **Operating expenses:** Incurred in carrying out an organization's day-to-day activities, but not directly associated with production. Ex. Salaries, rent, utilities, depreciation, bad debt provision, rent, etc.
   - ✓ **Non-operating expenses:** Expenses incurred by an organization that does not relate to its main activity like interest payments, losses incurred, etc.
3. **Depreciation:** Denotes decrease in value of an asset over a period of time. The value of depreciation amount can be calculated by three methodologies:
   - ✓ **Straight Line Depreciation:** In this, the depreciation expense deducted each year is **constant**
   - ✓ **Declining Balance Method:** In this, a **certain percentage amount** of the remaining value of the asset is deducted each year due to which it is **not constant**
   - ✓ **Double Declining Method:** In this, just like in declining balance method firstly certain percentage of the remaining value of the asset is calculated and doubled and then eventually deducted
4. **Net Income** = Revenues – Expenses
5. There are **4 types of profits** in Income Statement:
   - ✓ **Gross Profit =** Sales – Cost of Goods sold
   - ✓ **Operating Income(also known as Earnings Before Taxes(EBIT)) =** Gross Profit – Operating Expense
   - ✓ **Profit before Taxes (also known as Earnings Before Taxes (EBT)) =** Operating Income + Non-Operating Income
   - ✓ **Net Income (also called Profit After Taxes(PAT) or Earnings of the firm)** = Profit before Taxes – Tax
6. **Note:** Sometimes Non-Operating Income could be negative then it is called Non-Operating Expense. In such a case the **Profit Before Taxes = Operating Income – Non Operating Expense**
7. **Earnings before Depreciation, Interest and Tax (EBDIT)** = Operating Income + Depreciation

➢ **Example:** Andersen's Nursery has sales of $318,400, cost of $199,400, depreciation expense of $28,600, interest expense of $1,000, and a tax rate of 34%. Calculate the net income.
Solution:

Income Statement Jan 1 to Dec 31st , 2016		
Sales		*318,400*

Cost of Goods Sold		*199,400*
Gross Profit		*119,000*
Operating Expense		
Depreciation	*28,600*	
Total Operating Expense		(28600)
Operating Income (EBIT)		90400
Non-Operating or Other		
Interest Expense	(1000)	
Total Non-Operating Income		(1000)
Profit Before taxes (EBT)		89400
Taxes (34%)		34% of 89400 = 30396
PAT or Net Income		*59,004*
Remarks : The values in ( ) indicates the negative value or the expesne		

- **Balance Sheet:** Gives snapshot of the **financial position** of the company (i.e. what a company owns (or is owed) and what a company owes (or what others own)) at **a particular time.** Ex. Company's financial position on 31st of March

Balance Sheet

Company Name

For the *Time Period* **Ending** *Date*

ASSETS	**LIABILITIES**
Cash	Notes payable
Net accounts receivable	Accounts payable
Inventories	Accrued expenses
Total current assets	Current portion of L. T. debt
Gross fixed assets	**Total current liabilities**
(Less Accumulated depreciation)	Long-term (L.T.) debt*
Net fixed assets	**Total liabilities**
Total assets	Preferred stock
	Common stock
	Retained earnings
	Total liabilities and equity

* excluding current portion.

- **Categorization of company resources in Balance Sheet:**
    1. **Assets**
    2. **Liabilities**
    3. **Owner's Equity**
- **In Balance sheet, Assets must match the sum of Liabilities and Shareholders' Equity**

- **Formats of Balance Sheet:**
  1. **Account Form**: Assets are on left hand side and Liabilities and Equity are on right hand side
  2. **Report Form** : This is a Vertical Format issued where Assets are followed by Liabilities and Equity
- **Components of Assets:**
  1. **Cash or Cash Equivalents:** This represent highly liquid asset account i.e. cash. This can be in the form of bank deposits or investments by the company in short term marketable securities like certificates of deposits (CDs), Treasury bills, notes, and bonds, other US government securities that are highly liquid
  2. **Accounts Receivable:** This denotes Sales of products made by the company on credit to its customers. For contingency planning, companies create a reserve for sustaining bad debt resulting out of it which is called **allowance for doubtful accounts** or **Bad Debt Provision**

Net accounts receivable = Gross accounts receivable – allowance for doubtful accounts

  3. **Inventories:** These are of 3 types:
     - ✓ **Raw materials:** To be used for production in future
     - ✓ **Work in Progress**: Being used in Production but are not still a finished product
     - ✓ **Finished Goods**: Ready to be sold and include all costs such as labour costs and factory rent etc.
     - ✓ The valuation for inventories can be done using either the **FIFO (First in First Out), LIFO (Last in First Out), or Average Cost method**
  4. **Prepaid Expenses:** Includes expenses that have been made in advance by the company
  5. **Total Current Asset:** Includes sum of all items that are expected to be converted into cash in less than one year
  6. **Gross Fixed Assets (Property and Equipment):** Includes **non-current assets** like equipment, buildings, vehicles, tools, Brand Value, Patents and Copyrights, etc. **Balance sheet reports the value of fixed assets at Book Value.** That is,

Book Value = Buy Value – Depreciation till date

  7. **Accumulated Depreciation:** Includes decrease in the value of the assets calculated through Straight line or Accelerated depreciation methods
  8. **Net Fixed Assets = Gross Fixed Assets – Depreciation**
  9. **Total Assets = Current Assets + Non-Current Assets**

- **Components of Liabilities:**
    1. **Notes Payable:** Represents the short-term borrowings of a company from a bank for the seasonal financing of current assets, in particular, accounts receivable and inventory.
        - ✓ **Cash Conversion Cycle:** The **inventory conversion period** (the average number of days from the purchase of raw materials or finished goods inventory to the sale of the final good) **plus the receivables conversion period** (the average number of days from the sale of the final good to the collection of cash)
    2. **Accounts Payable:** Represents purchases (usually for inventory) made by the company from suppliers on credit
    3. **Accrued Expenses:** Represents direct or operating costs incurred by the company that needs to be paid at the end of the reporting period. Ex. utilities, rent, wages, etc.
    4. **Current Position of Long-term Debt:** Represents the principal portion of long-term debts issued by the company whose payments are due over the next 12 months
    5. **Total Current Liabilities:** Includes sum of all the liabilities that are expected to be paid off in less than one year
    6. **Long-term Debt:** Represents liabilities with maturities in excess of one year
    7. **Preferred Stock:** Equity issued by the company that generally has a dividend that must be paid out before dividends to common shareholders, and the shares usually do not carry voting rights
    8. **Common Stock:** Represents common equity issued by the company which is classified into **Common stock at par value** and **Additional paid-in capital (or, capital surplus)**
    9. **Retained Earnings:** Represents the cumulative total of all the net income that has been reinvested into the company

Retained Earnings = Net income – Dividends paid

10. **Company's Net Worth (Owners' equity, or Shareholders' equity or Book Value of the firm's equity)**

Net Worth or Owner's Equity = Stock at Par Value + Additional Paid in Capital + Retained Earnings

11. **Assets = Liabilities + Stock at Par Value + Additional Paid in Capital + Retained Earnings**

1.1 Another View to Balance Sheet

We discussed the format of balance sheet from global perspective. Some terms are used differently in Indian Context. Let me explain the same

ASSETS		Liabilities	
Cash	10	Notes Payable	10
Net Accounts Receivable	10	Accounts Payable	5
Investories	10	Accrued Expense	5
Total current Assets	30	Current Portion of Long Term Debt	5
Gross Fixed Assets	100	**Total Current Liabilities**	20
Less Accumulated Depreciation	10	Long Term Debt	20
Net Fixed Assets	90	**Total Liabilities**	40
Total Assets	120	Shareholder's Equity	
		Share Capital (Par Value of Common Stock and Preferred Stock)	20
		Reserves and Surplus	
		Share Premium Account (Additional Paid in Capital)	30
		Capital Reserves	
		General Reserves	
		Retained Earnings	30
		Total Liabilities + Shareholders Equity	120

Here We have specifically mentioned Shareholder's equity in the balance sheet unlike in the previous one's

Shareholder Equity = Share Capital + Reserves and Surplus

Share Capital is the Par Value (Face Value) of the Common Stock and Preferred Stock

Reserves and Surplus consist of the following

- Share Premium Account is the Additional Paid in Capital that Company got when Company Issued Shares. This can be used to meet issuance expenditure like payment of underwriter's or merchant bankers fee or to issue bonus shares
- Capital Reserves is the money reserved from Retained earnings for Capital Investment. Sometimes you do revaluation of your assets and you find that assets like land has increased in value, so in that case the increase in value of assets due to revaluation will go to tis reserve. This reserve cannot be used to issue dividends or Bonus shares. This can be used for making capital investments

- General Reserves are free reserves which can be used for anything. The money in General Reserves is also transferred from the Retained Earnings.
- Retained Earnings are the profits accumulated over the years. When money is transferred from Retained Earnings to Reserves then money in Retained Earnings account gets decreased
- Let's try to understand with some examples
- **Example 1:** Suppose company issued 10 shares at price of 5 with face value of 2. Here the Share Capital would be 10* 2 = 20 since 2 is the face value
- Share Premium would be 10 * (5-2) = 30 because a premium of 3 rupees have been obtained over the face value of 2
- Suppose profit accumulated till last year is 25 and this year's profit is 7 and dividend of 2 then retained earnings would become 25+5 = 30. We have added 5 and not 7 though 7 was this year's profit because out of that 7, 2 would be distributed as dividend
- Suppose they distribute 5 from this 30 of retained earnings to Capital reserves and 5 to General Reserve then Capital Reserve and General Reserve would show 5 each and Retained earnings will show 20. The same is shown below

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Total Assets	120	Shareholder's Equity	
		Share Capital (Par Value of Common Stock and Preferred Stock)	20
		Reserves and Surplus	
		Share Premium Account (Additional Paid in Capital)	30
		Capital Reserves	5
		General Reserves	5
		Retained Earnings	20
		Total Liabilities + Shareholders Equity	120

- **Another Format Balance Sheet:**

	20X1	20X0
SOURCES OF FUNDS		
Shareholders' Funds		
Share Capital	146.48	146.48
Reserves and Surplus	698.03	636.07
Total Shareholders Funds	844.51	782.55
Loan Funds		
Secured Loans	558.22	524.64
Unsecured Loans	286.94	343.52
Total Debt	845.16	868.16
Total Funds	1,689.67	1,650.71
APPLICATION OF FUNDS		
Fixed Assets		
Gross Block	1,724.33	1,660.18
Less: Accumulated Depreciation	903.92	842.71
Net Block	820.41	817.47
Capital Work in Progress	134.41	62.43
Total Net Fixed Assets	954.82	879.90
Investments	227.07	229.72
Current Assets, Loans & Advances		
Inventories	243.10	226.51
Sundry Debtors	235.87	248.25
Cash and Bank Balance	17.50	18.16
Loans and Advances	354.71	338.82
	851.18	831.74
***Less*: Current Liabilities & Provisions**		
Current Liabilities	204.87	167.34
Provisions	142.34	128.29
	347.21	295.63
Net Current Assets	503.97	536.11
Miscellaneous Expenditure	3.81	4.98
Total Assets	1,689.67	1,650.71
Contingent Liabilities	186.20	220.82

1. Sources of Funds are typically Liabilities
2. Application of Funds are typically Assets
3. Share Capital is same Common Stock at par value + Preferred Stock
4. Reserves and Surplus is same as Retained Earnings + Shares Premium (Additional Paid-in Capital)
5. Sundry Debtors is same as Accounts Receivables
6. Loans and Advances can be taken as pre-paid Expenses
7. Current liabilities are put of Assets side and they are subtracted from current assets to find the Net Current Assets
8. **Capital Employed = Shareholder + Borrowings**
9. **Net Current Assets = Current Assets – Current Liabilities**
10. **Application of Funds** = **Fixed Asset + Investment + Net Current Assets + Miscellaneous Expenditure**
11. **Sources of Funds** is same as Capital Employed or Application of Funds

- **Generally Accepted Accounting Principles:**

1. **Business Entity Concept:** Assumes that business has a distinct and separate entity from its owners
2. **Money Measurement Concept**: States that only those transactions and happenings in an organization which can be expressed in terms of money such as sale of goods or payment of expenses or receipt of income, etc. are to be recorded in the book of accounts
3. **Going Concern Concept**: Assumes that a business firm would continue to carry out its operations **indefinitely**, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future
4. **Accounting Period Concept**: Accounting period refers to the span of time at the end of which the financial statements of an enterprise are prepared, to know whether it has earned profits or incurred losses during that period and what exactly is the position of its assets and liabilities at the end of that period
5. **Cost Concept**: It is **historical** in nature and requires that all assets are recorded in the book of accounts at their purchase price, which includes cost of acquisition, transportation, installation and making the asset ready to use
6. **Dual Aspect Concept**: States that every transaction has a dual or two-fold effect and should therefore be recorded at two places in the accounting statement
7. **Revenue Recognition (Realization) Concept**: Requires that the revenue for a business transaction should be included in the accounting records only when it is realized i.e. the point of time when goods have been sold or service has been rendered
8. **Matching Concept**: States that expenses incurred in an accounting period should be matched with revenues during that period
9. **Full Disclosure Concept**: Requires that all material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying footnotes
10. **Conservatism Concept (**also called **'Prudence'):** States that a conscious approach should be adopted in ascertaining income so that profits of the enterprise are not overstated
11. **Materiality Concept**: Requires that accounting should focus on material facts. Ex. when the amount involved is very small, strict adherence to accounting principles is not required
12. **Objectivity Concept**: Requires that accounting transaction should be recorded in an objective manner, free from the bias of accountants and others