12128CH03

Financial Statements of a Company

3

Learning Objectives

After studying this chapter, you will be able to :

- *explain the nature and objectives of financial statements of a company;*
- *describe the form and content of Statement of Profit and Loss of a company as per schedule III;*
- *describe the form and content of balance sheet of a company as per schedule III;*
- *explain the significance and limitations of financial statements; and*
- *prepare the financial statements.*

Having understood how a company raises its capital, we have to learn the nature, objectives and types of financial statements it has to prepare including their contents, format, uses and limitations. The financial statements are the end products of accounting process. They are prepared following accounting policies consistently accounting standards prescribed in the Companies Act and accounting concepts, principles, procedures and also the legal environment in which the business organisations operate. These statements are the outcome of the summarising process of accounting and are, therefore, the sources of information on the basis of which conclusions are drawn about the profitability and the financial position of a company. Hence, they need to be arranged in a proper form with suitable contents so that the shareholders and other users of financial statements can easily understand and use them in their economic decisions in a meaningful way.

3.1 Meaning of Financial Statements

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.

3.2 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. Money measurement postulate assumes that the value of money will remain the same in different periods. Though there is drastic change in purchasing power of money, the assets purchased at different times will be shown at

the amount paid for them. While, preparing statement of profit and loss the revenue is included in the sales of the year in which the sale was undertaken even though the sale price may be received over a number of years. The assumption is known as realisation postulate.

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. Personal opinion, judgements and estimates are made while preparing the financial statements to avoid any possibility of over statement of assets and liabilities, income and expenditure, keeping in mind the convention of conservatism.

Thus, financial statements are the summarised reports of recorded facts and are prepared the following accounting concepts, conventions, accounting policies, accounting standards and requirements of Law.

3.3 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.

3.4 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.

Balance Sheet as at 31st March, 20.....

Particulars	Note No.	Figure as at the end of Current reporting period	Figure as at the end of Previous reporting period
I. EQUITY AND LIABILITIES			
1) Shareholder's Funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
2) Share Application money pending allotment			

3) Non-current Liabilities			
(a) Long term borrowings			
(b) Deferred tax liabilities (net)			
(c) Other long term liabilities			
(d) Long term provisions			
4) Current Liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
Total			
II. ASSETS			
1) Non-Current Assets			
(a) Fixed assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long-term loans and advances			
(e) Other non-current assets			
2) Current Assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short term loans and advances			
(f) Other current assets			
Total			
See accompanying notes to the financial statements			
NOTES:			

Exhibit. 3.1: Form of Balance Sheet

Important Features of Presentation

1. It applies to all Indian companies preparing financial statement as per Schedule III to the Comapnies Act, 2013.
2. It does not apply to (i) Insurance or Banking Company, (ii) Company for which a form of balance sheet or income statement is specified under any other Act.
3. Accounting standards shall prevail over Schedule III of the Companies Act, 2013.
4. Disclosure on the face of the financial statements or in the notes are essential and mandatory.

5. Terms in the revised Schedule III will carry the meaning as defined by the applicable accounting standards.
6. Balance to be maintained between excessive details that may not assist users of financial statements and not providing important information.
7. Current and non-current bifurcation of assets and liabilities is applicable.

> **Box 1**
>
> **Rounding-off Rule for figures in the Presentation of Financial Statements**
>
> Rounding off of figures to be reported in the financial statements is based on the size of turnover:
>
> 1. Turnover < Rs.100 crore: Nearest hundreds, thousands, lakhs or millions or decimal thereof;
> 2. Turnover > Rs.100 crore: Nearest lakhs or millions or decimal thereof;

8. Rounding off requirements is mandatory (refer box 1).
9. Vertical format for presentation of financial statement is prescribed (refer Exhibit 3.1).
10. Debit balance in the statement of profit and loss to be disclosed as negative figure under the head "Surplus".
11. Mandatory disclosure for share application money pending allotment.
12. 'Sundry Debtors' and 'Sundry Creditors' replaced by terms 'Trade Receivables' and 'Trade Payables'.

Shareholders Fund

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

a) Share Capital
b) Reserves and Surplus
c) Money received against Share Warrants

Share Capital

Disclosures relating to share capital are to be given in notes to accounts. The following additions/modifications are significant:

a) For each class of shares, recognition of the number of shares outstanding at the beginning and at the end of the reporting period is required.
b) The rights, preferences and restrictions attached to each class of shares including restrictions on the distribution of dividends and repayment of capital.
c) In order to bring clarity regarding the identity of ultimate owners of the company:

i) Disclosure of shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of holding company or the ultimate holding company in aggregate.

ii) Disclosure of shares in the company held by each shareholder holding more than 5% shares specifying the number of shares held.

iii) Disclosure of the following for the period of 5 years immediately preceding the date of the balance sheet:
- Aggregate number and class of shares allotted as fully paid up pursuant to contracts without payment being received in cash.
- Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
- Aggregate number and class of shares bought back.

This may be noted that the information of shareholders funds are presented on the face of financial statements limited only to broad and significant items. Details are given in Notes to Accounts.

d) For each class of share capital:

i) The number and amount of share authorised.

ii) The number of shares issued, subscibed, fully paid and subscribed but not fully paid.

iii) Par value per share.

iv) Reconciliation of the number of shares outstanding at the beginning and end of the accounting period.

v) Rights, preferences and restrictions attaching each class of shares including restrictions on the distribution of dividends and repayment of capital.

vi) Aggregate number of shares with respect to each class in the company held by its holding company, its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company.

vii) Shares reserved for issue under options and contracts/ commitments for the sale of shares/disinvestment, including terms and amount.

viii) For a period of 5 years immediately proceeding the date at which balance sheet in prepared for:

(a) Shares reserved under contracts/commitments.

(b) Number and class of shares bought back.

(c) Number and class of shares allotted for consideration other than cash and bonus shares.

ix) Terms of any securities convertible into equity/preference shares issued along with earliest date of conversion in descending order, starting from the farthest such date.

x) Calls unpaid (aggregate).

xi) Forfeited shares (amout originally paid up).

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.

Significant additions/modifications regarding disclosure of reserve and surplus are as follows:

a) A reserve specifically represented by earmarked investments shall be termed as "Fund".

b) 'Debit' balance of statement of profit and loss shall be shown as a negative figure under 'Surplus' head.

c) The balance of "Reserve and Surplus" after adjusting negative balance of Surplus, if any, shall be shown under "Reserve and Surplus" read even if the resulting figure is 'negative'.

d) Share options outstanding account has been recognised as a separate item under 'Reserve and Surplus'. ICAI's Guidance Note on Accounting for Employee share based payments requires a credit balance in the *'Stock option outstanding Account'* to be disclosed in balance sheet under separate heading' between share capital and reserves and surplus as a part of shareholders fund.

Money Received against share warrants

It is the amount received by the company 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'.

Illustration 1

Dinkar Ltd. has an authorised capital of Rs. 50,00,000 divided into equity shares of Rs. 100 each. The company invited applications for 40,000 shares, applications for 36,000 shares were received. All calls were made and duly received except for 500 shares on which the final call of Rs. 20 was not received. The company forfeited 200 shares on which final call was not received. Show how share capital will appear in the balance sheet of the company. Also prepare 'Notes to Accounts' for the same.

Solution:

Books of Dinkar Limited
Balance Sheet as at .... (Date)

Particulars	*Note No.*	*Amount (Rs.)*
I. Equity and Liabilities		
1. Shareholders' funds		
a) Share capital	1	**35,90,000**

Notes to Accounts

Particulars	*Amount (Rs.)*	*Amount (Rs.)*
1. Share capital		
Authorised share capital		
50,000 equity shares of Rs. 100 each		50,00,000
Issued capital		
40,000 equity shares of Rs. 100 each		40,00,000
Subscirbed and fully paid up capital		
35,500 equity shares of Rs. 100 each fully paid		35,50,000
Subscirbed but not fully paid-up capital		
300 equity shares of Rs. 100 each fully called up	30,000	
Less: Calls-in-arrears (300 20)	6,000	
	24,000	
Add: Share forfeiture A/c (200 shares Rs. 80)	16,000	40,000
		35,90,000

Current and Non-current Classification

The classified balance sheet in terms of current and non-current assets and current and non-current liabilities have been introduced. The criteria for defining current assets and liabilities has been clearly spelled out with non-current assets and liabilities being the residual items.

Current/Non-current distinction

An item is classified as current:

- if it is involved in entity's operating cycle or,
- is expected to be realised/settled within twelve months or,
- if it is held primarily for trading or,
- is cash and cash equivalent or,
- if entity does not have on unconditional rights to defer settlement of liability for atleast 12 months after the reporting period,
- Other assets and liabilities are non-current.

Illustration 2

Show the following items in the balance sheet of Amba Ltd. as on March 31, 2017:

	Rs.
8% Debentures	10,00,000
Equity share capital	50,00,000
Securities premium	20,000
Preliminary expenses	40,000
Statement of Profit & Loss (cr.)	1,50,000
Loose tools	20,000
Bank balance	60,000
Cash in hand	38,000

Solution:

Books of Amba Ltd.
***Balance Sheet as at March 31, 2017**

Particulars		*Note No.*	*Amount (Rs.)*
I. Equity and Liabilities			
1. Shareholders' Funds			
a) Share capital			50,00,000
b) Reserve and surplus		1	1,30,000
2. Non-current Liabilities			
a) Long-term borrowings		2	10,00,000
II. Assets			
Current assets			
a) Inventories		3	20,000
b) Cash and cash equivalents		4	98,000
c) Other current assets		5	10,000

* Relevant items only