

Section C

FINANCIAL

STATEMENT

ANALYSIS

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FINANCIAL STATEMENTS OF THE COMPANY

- **Meaning:**
 - i. An accounting process initiates with journalizing of the transactions and ends with the preparation of Trial Balance which comprises of all the debit and credit account balances.
 - ii. A summary of accounting data which is prepared by an enterprise at the end of an accounting process with the help of such Trial Balance is known as Financial Statements.
 - iii. **As per Section 2(40) of the Companies Act, 2013, a set of Financial Statements prepared in accordance with Schedule III of this Act comprises of a Balance Sheet, Notes to Accounts, Statement of Profit and Loss and Cash Flow Statement.**
- **Definition:**

"The Financial Statements provide a summary of accounts of a business enterprise, the Balance Sheet reflecting the assets, liabilities and capital as on a certain date and income statement showing the results and operations during a certain period."

Nature and Characteristics of Financial Statements:

- **Nature:** Nature of Financial Statements can be understood as a result of a combination of the following points:
 - i. **Recorded Facts:** It refers to the recorded transactions in the books of account on the basis of evidences.
 - ii. **Conventions:** All the transactions that are recorded in the books of account should follow all the relevant accounting conventions as may be applicable to the respective transactions. Such conventions make financial statements reliable, understandable and comparable.
 - iii. **Accounting Concepts:** All the transactions that are recorded in the books of account should follow the accounting concepts. Such concepts also make the financial statements reliable, understandable and comparable.
 - iv. **Personal Judgments:** Personal judgments also have an important bearing on the financial statements as it facilitates the selection of methods, etc. when any one alternative is to be chosen out of the various alternatives.
 - v. **Source of Financial Information:** Financial statements acts a source of financial information on the basis of which conclusions and interpretations can be drawn about the financial performance and position of a company.
- **Characteristics:** Following are the Characteristics of Financial Statements:
 - i. They are historical documents as are related to past period.
 - ii. They are expressed in monetary terms.
 - iii. They show financial performance through the Statement of Profit and Loss and financial position through Balance Sheet.

Objectives, Essentials and Limitations of Financial Statements:

Objectives: Financial Statements are prepared with an objective to:

- i. Compute profit or loss from operating activities of the business.
- ii. Present a true view of the financial position of the business.
- iii. Provide information on economic resources of the business.
- iv. Provide data about the inflow and outflow of cash and cash equivalent.

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- v. Determine the effectiveness of the management activities to ensure better performance of its business.
- vi. Provide necessary information to the users of such financial statements.
- vii. Present and disclose accounting policies and conventions used in the preparation of books of accounts of the business entity.

Essentials: Following are the Essentials of Financial Statements:

- i. **Factual Information:** Financial Statements should disclose the factual information about the financial position of the company.
- ii. **Understandability:** Financial Statements should be prepared following the accepted accounting principles for the better understanding of the users.
- iii. **Comparable:** Financial Statements should disclose the information in a manner that the user can compare the information of the same entity over years and also compare the reporting company's financial information with that of others.
- iv. **Verifiable:** Financial Statements of the company should disclose such information which is verifiable from the records of the company.
- v. **Relevant:** Financial Statements should disclose the financial information which is in accordance with the legal requirements.
- vi. **Timeliness:** After the end of the accounting period, financial statements should be prepared and presented within a reasonable period to avoid any undue effect on the relevance of these statements.

Limitations: Following are the limitations of the financial statements:

- i. **Historical Records:** Financial Statements provide information which is historical in nature and therefore, it is not useful for the potential investors or lenders as it does not provide any information of the future business or its future financial position.
- ii. **Affected by Estimated:** Financial Statements are the outcome of accounting concepts and conventions combined with estimates and are therefore, not free from bias.
- iii. **Different Accounting Practices:** Financial Statements can be drawn up on the basis of different accounting practices. Profitability determined by each of these practise will be different and hence, there is no standard practice which can be followed by all.
- iv. **Qualitative Elements are Ignored:** Financial Statements are based completely on monetary items and therefore, many non-monetary important factors that affect the profitability of the business are ignored.
- v. **Price Level Changes are Ignored:** Financial Statements follow the historical cost concept while disclosing the value of assets. Because of such practices, current market value is not taken into consideration.
- vi. **Does not meet the Interests of all Parties:** Financial Statements for a period are used by a number of interested users for various purposes and interests. It is not possible to meet the purpose of all interested parties.
- vii. **Aggregate Information:** Financial Statements show aggregate information and not detailed information and hence, it is not useful for the users in decision making.

Users of Financial Statements:

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Following are the categories of Users of Financial Statements:

1. Internal Users:

- i. **Shareholders:** Shareholders are those users who provide funds or contribute capital to the company and are therefore, exposed to risks. In view of the risk involved, they are always interested in the profitability, returns, financial and cash position of the company.
- ii. **Management:** Management is responsible to safeguard the investment in business and increase the value of business by managing the business effectively and thereby maximizing the profits. It makes use of the financial information to arrive at the informed decisions to increase the profitability of the business.
- iii. **Employees:** Employees work in the company for a consideration in the form of salary. In addition to the salary these employees are also entitled to various benefits in form of bonus which is directly linked to the profits of the business.

2. External Users:

- i. **Banks and Financial Institutions:** These are the organizations which provide loans to the businesses and are therefore, concerned about the performance of the company to ensure that the business is able to repay the loan along with the interest due.
- ii. **Investors and Potential Investors:** Investors wish to know how safe their investments into a business are. The investors gain the information related to investment directly from financial reports of the business so as to judge profitability and growth status of business.
- iii. **Creditors:** Creditors are the suppliers who provide goods and services on credit and are therefore, concerned about the financial stability of the company to ensure that the dues are cleared on time without any delay.
- iv. **Government and its Authorities:** These users use the financial statements to compile national income and then further take some important policy decisions.
- v. **Securities and Exchange Board of India (SEBI):** SEBI and Other agencies study the financial statements of the companies to check if the companies are operating within the prescribed limits and investor interests are being protected.

Understanding Balance Sheet:

Meaning, Characteristics, Format and Contents of a Balance Sheet:

- **Meaning:** Balance Sheet or the Position Statement shows the financial position of a business by providing complete details of its Assets, Liabilities and Equity at a particular date.
 - **Equity:** A liability towards the shareholders is termed as 'Equity' or 'Shareholders' Funds'. Equity includes Share Capital, Money received against Share Warrants.
 - **Liabilities:** It is a liability towards the outsiders/external parties. It is shown as Non-Current Liabilities and Current Liabilities.
- **Characteristics:** Following are the characteristics:
 - i. It comprises of balances of all the assets, liabilities and owner's equity.
 - ii. It considers opening balances, transactions during the year and closing balances for the items appearing in the Balance Sheet.
 - iii. It satisfies the accounting equation of $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.
 - iv. It gives a true picture of the financial position of an entity on a particular date.

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- **Format:** As prescribed in Part I of Schedule III of the Companies Act, 2013, Balance Sheet is prepared as follows:

BALANCE SHEET

Particulars 1	Not e no. (2)	Figures at the end of the Current Reporting Period (3)	Figures at the end of the Previous Reporting Period (4)
I. EQUITY AND LIABILITIES			
1. Shareholders' 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		...xxxxxxx	...xxxxxxx
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			

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a) Current Investments			
b) Inventories			
c) Trade Receivables			
d) Cash and Cash Equivalents			
e) Short-term Loans and Advances			
f) Other Current Assets			
TOTAL	

• **Contents/Heads of Balance Sheet:**

I. Items under Equity and Liabilities part of the Balance Sheet:

1. **Shareholders' Funds:** This heading comprises of 3 more items which are as follows:

a. **Share Capital:** It is the value of shares issued by the company for subscription to be received in cash or for consideration other than cash. As per schedule III of the Companies Act, 2013 details of such share capital are to be shown in the Notes to Accounts as follows:

i. **Authorized Capital:** or Nominal Capital is the amount of capital that is stated in the Memorandum of Association under Capital Clause. It is the maximum capital that a company can issue for subscription.

ii. **Issued Capital:** It is a part of Authorized Capital which is issued by the company for subscription up to the date of Balance Sheet.

iii. **Subscribed Capital** (fully paid, not fully paid, calls in arrears and forfeited shares are also to be shown under Subscribed Capital): It is a part of the Issued Capital which has been subscribed.

1. **Subscribed and Fully Paid-up:** To disclose shares on which company has called the entire face value of share and same has been received.

2. **Subscribed but Not Fully Paid-up:** To disclose shares on which company has either called full amount but not received or company has not called the full face value.

3. **Calls-in-Arrears:** Amount not received by the company against the amount called up by it towards share capital.

4. **Amount in Forfeiture Account, i.e. Amount received on forfeited shares and not reissued.**

b. **Reserves and Surplus:** It is the amount of profits set aside out of profits and surpluses and not distributed to the shareholders which can then be used for any future uncertainties. As per Schedule III of the Companies Act, 2013, reserves and surplus is to be shown in Notes to Accounts under following heads:

i. **Capital Reserve:** It is a reserve which is created out of capital profits like gain on sale of investment, gain on sale of fixed assets, gain on reissue of

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shares, etc.

- ii. **Capital Redemption Reserve:** It is a reserve created at the time when the company purchases its own shares out of free reserves or securities premium reserve.
- iii. **Securities Premium Reserve:** It is a reserve which is created with the amount received in excess of the nominal or face value of securities issued.
- iv. **Debenture Redemption Reserve:** It is a reserve which is credited with the amount prescribed under section 71(4) of the Companies Act, 2013 and its respective rules by a company before redeeming its debentures.
- v. **Revaluation Reserve:** It is a reserve which is credited by the upward revision of the book value of assets and debited with a downward revision of the book value of an asset or when asset is sold or discarded.
- vi. **Shares Options Outstanding Account:** It is a reserve which is credited with the amount of difference between the market value of the shares issued to the employees and its issue price over its vesting period.
- vii. **Other Reserves:** It is a reserve which is of such nature and purpose which is not specified under any of the heads above.
- viii. **Surplus, i.e., Balance in Statement of Profit and Loss:** It is the excess of incomes over expenses during a particular period.

c. **Money Received against Share Warrants:** Financial instruments that give the holder right to acquire equity shares at a specified date and specified price. These warrants will be converted into Equity Shares at a later date at a predetermined price and therefore, are classified under Shareholder's Funds.

2. **Share Application Money Pending Allotment:** It shows the amount received by the company towards the share application and against which it will certainly allot shares.

Share Application Money to be treated as Current Liability:

When share application money received by the company is to be refunded to the applicants against which shares will not be allotted is shown as 'Current Liabilities' under the sub-head 'Other Current Liabilities'.

3. **Non-Current Liabilities:** As per Schedule III of the Companies Act, 2013, these are those liabilities which are not current liabilities. Such liabilities are to be classified into following heads:

- a. **Long-term Borrowings:** These are the borrowings/loan that is repayable by the company after 12 months from the date of Balance Sheet or after the period of operating cycle. Long term borrowings are shown under following heads, (i) Debentures, (ii) Bonds, (iii) Term Loans- a. from Banks and b. Others, (iv) Public Deposits, (v) Other Loans and Advances

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- b. **Deferred Tax Liabilities:** Deferred tax is the amount of tax that is calculated on the amount of difference being temporary in nature, between the Accounting Income and the Taxable Income for a particular year. If the Accounting Income is more than the Taxable Income, it results in Deferred Tax Liability.
- c. **Other Long-term Liabilities:** This head comprises of all long-term liabilities other than long-term borrowings which are classified as follows:
- Trade Payables:** As per Schedule III of the Companies Act, 2013, "Trade Payables are the amounts payable for goods purchased and services taken in the normal course of business." Trade Payables if agreed to be settled after 12 months of the date of Balance Sheet or after the period of operating cycle are shown under Other Long term Liabilities.
 - Others:** This head comprises of all long-term liabilities other than long-term borrowings and trade payables.
- d. **Long-term Provisions:** It is an amount that is kept aside to meet future liability with an amount that is difficult to ascertain but may be estimated and only in case if liability will arise after 12 months or after the period of operating cycle.
4. **Current Liabilities:** As per Schedule III of the Companies Act, 2013, a current liability is the one which satisfies any of the following conditions:
- to be settled within the company's operating cycle or
 - to be settled within 12 months after the reporting date or
 - primarily held for the purpose of being traded or
 - there is no unconditional right to defer settlement for at least 12 months after the reporting date.
- Such current liabilities are further classified as follows:
- Short-term Borrowings:** These are the borrowings which are repayable within 12 months from the date of Balance Sheet or within the period of Operating Cycle.
 - Trade Payables:** As per Schedule III of the Companies Act, 2013, "Trade Payables are the amounts payable for goods purchased and services taken in the normal course of business." Such amount includes sundry creditors and bills payable, i.e. when amount is due to be paid within an operating cycle or 12 months from the date of reporting.
 - Other Current Liabilities:** All current liabilities that are not short-term borrowings or trade payables are shown as Other Current Liabilities. This includes Current Maturities of Long term debt, Interest Accrued but not due on borrowings, Interest Accrued and due on borrowings, Income received in

Advance, etc.

- iv. **Short term Provisions:** It is a liability of an uncertain amount that has been estimated, which is likely to be paid within 12 months of the date of Balance Sheet or within the period of Operating Cycle, whichever is longer.

II. Items under Assets part of the Balance Sheet:

- o **Non-Current Assets:** As per Schedule III of the Companies Act, 2013, these are the assets which are not current assets. It includes following major heads:
 - a. **Fixed Assets:** These are the assets which are not held by the company for the purpose of trade or resale. Instead they are used to earn more and more profits or are held by the business to increase earning capacity of business. These are further categorised as follows:
 - i. **Tangible:** Assets which can be seen, touched and have a physical existence are termed as Tangible Assets.
 - ii. **Intangible:** Assets which cannot be seen, touched and do not have a physical existence are termed as Intangible Assets.
 - iii. **Capital Work-in-Progress:** These are the Tangible Assets which are under construction.
 - iv. **Intangible assets under development:** These are the Intangible Assets which are under development.
 - b. **Non-current Investments:** These are the investments which are not held by the business for the purpose of trade or resell. Instead they are retained for a longer period of time to earn income. This includes both Trade Investments held by business to promote its own trade and business and other investments like investments in property, bonds, mutual funds, etc.
 - c. **Deferred Tax Assets (Net):** Deferred tax is the amount of tax that is calculated on the amount of difference being temporary in nature, between the Accounting Income and the Taxable Income for a particular year. If the Accounting Income is less than the Taxable Income, it results in Deferred Tax Assets.
 - d. **Long-term Loans and Advances:** These are those loans and advances which are expected to be received back in cash or kind after a period of 12 months from the date of Balance Sheet or after the period of Operating Cycle. Such loans are classified as follows:
 - i. **Capital Advances:** These are the advances which are advanced for acquiring of fixed assets.
 - ii. **Security Deposits:** These are the security deposits which are given for a period that is beyond 12 months from the date of Balance Sheet or after the

period of Operating Cycle of the business.

- iii. **Others:** It comprises of all the long term loans and advances other than those classified as Capital Advances and Security Deposits.
- e. **Other Non-Current Assets:** It comprises of all the non-current assets other than those specifically classified under each of the above heads.
- o **Current Assets:** As per Schedule III of the Companies Act, 2013, a current asset is the one that satisfies any of the following conditions:
 - a. to be realized or intended for sale or consumption within the company's operating cycle or
 - b. to be realized within 12 months after the reporting date or
 - c. primarily held for the purpose of being traded or
 - d. cash and cash equivalents unless they are restricted from being exchanged or used to settle a liability for at least 12 months after the reporting date.Current Assets are further classified into following heads:
 - i. **Current Investment:** These are those investments that are held to be converted into cash within a period of 12 months from the date of purchase of investment.
 - ii. **Inventories:** This refers to the stock of goods held in the ordinary course of business for the purpose of trade and also stock of materials which are used in the manufacturing of goods. This will also include work in progress, stock in trade, stores and spares, loose tools, etc.
 - iii. **Trade Receivables:** It is the amount receivable as a consideration for goods sold or services offered in the normal course of business where such amount is receivable within a period of 12 months from the date of Balance Sheet or within the period of operating cycle of the business.
 - iv. **Cash and Cash Equivalents:** It includes balances with banks, cheques, and cash in hand, earmarked balances with banks, balances held as margin money by the banks, bank deposits with more than 12 months maturity, etc.
 - v. **Short term Loans and Advances:** These are those loans and advances which are expected to be realized within 12 months from the date of Balance Sheet or within the period of operating cycle.
 - vi. **Other Current Assets:** This includes all the current assets which are not specifically categorized under any of the above heads.
- o **Contingent Liabilities:** These are the liabilities which may or may not arise depending on the happening or non-happening of an event in the future. Such amount is not recorded in the books of account and therefore, is required to be disclosed in the Notes to Accounts in order to inform the users of the financial statements.

- **Commitments:** These are the financial commitments due to activities agreed to by the company to be undertaken by it in future.
- **Provisions and Reserves:**

Basis	Provisions	Reserves
Meaning	Proportion of profits set aside to meet known losses and expenses in future	Appropriation of profits for specific purpose
Nature	Liability or Diminution in value of asset or a loss	Shareholder's Money
Purpose	It is created for specific purposes like depreciation, expenses, etc.	It may either be created for a specific purpose or for a general purpose.
Charge vs. Appropriation	It is a charge against the profit and therefore, reduces amount of profit.	It is an appropriation out of profits and therefore, can be created only when there is profit.
Disclosure in the Income Statement	It is shown in the Income Statement under expenses.	It is not shown in the Income Statement.
Disclosure in Balance Sheet	It is shown in the Balance Sheet under Long-term or Short-term Provisions or as deduction from the value of concerned assets in the assets part of the Balance Sheet.	It is shown in the Balance Sheet under Reserves and Surplus in the Equity and Liabilities part of the Balance Sheet.
Investment Outside Business	It cannot be invested anywhere and therefore, remains in the business.	It can be invested outside the business which is then termed as fund.
Legal Requirement	It is created in accordance with the legal requirements and also to comply with the prescribed accounting Concepts and conventions.	It is created as a matter of financial prudence.

Understanding Statement of Profit and Loss:

- **Meaning:** It is known as an Income Statement as it takes into consideration all the incomes and expenses for a particular period in order to determine whether the entity is a profit making

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entity or is running into losses. It shows the profitability of the business entity for a given period of time, say if the given period is accounting year 2019-20, then such statement is prepared for a period of 12 months starting from 1st April, 2019 to 31st March, 2020

- **Characteristics:** Following are the characteristics:
 - i. It comprises of all the incomes earned and all the expenses incurred during a particular accounting period.
 - ii. It is based on the historical data as it records all transactions which have already taken place during that particular period.

- **Format:** As prescribed in Part II of Schedule III of the Companies Act, 2013, statement of profit and loss is prepared as follows:

Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
I. Revenue from Operations	
II. Other Income	
III. Total Revenue (I+II)	
IV. Expenses			
Cost of Materials Consumed	
Purchases of Stock-in-Trade	
Changes in Inventories (Finished goods, Work-in-Progress and Stock-in-Trade)	
Employee Expenses	
Finance Costs	
Depreciation Expenses	
Amortization Expenses	
Other Expenses	
Total Expenses	
V. Profit before Tax (III-IV)	
VI. Less: Tax	
VII. Profit or Loss for the period (V-VI)	

Note no. column has been kept for the purpose of specifying cross reference to the Note no. in the Notes to Accounts where detail of the respective item can be given.

• **Contents/Heads:**

a. **Revenue:**

- i. **Revenue from Operations:** It is the amount of revenue earned by the entity from the activities carried out by it with an objective to earn profits or operating activities.
 - In case of a manufacturing or trading company, revenue from operations is the amount of net sales i.e., Sales less Sales Return.
 - In case of a service company, revenue from operations is amount of fee earned.
 - In case of a finance company, revenue from operations is amount of interest and dividend earned.
- ii. **Other Income:** It is the amount of revenue earned by an entity from its non-operating activities, i.e. sources that are not its business activities.
 - In case of a manufacturing, trading or service company, other income shall comprise of gain or loss on sale of fixed assets, bad debts recovered interest on fixed deposits, etc.
 - In case of a finance company, other income shall comprise of any amount that is earned from a non-finance activity.

b. **Expenses:**

- i. **Cost of Materials Consumed:** It is the amount of raw or other materials used in the manufacturing of finished goods. In order to compute the amount of materials consumed, following formula is to be follows:
$$\begin{aligned} \text{Cost of Materials Consumed} &= \text{Opening Inventory (Stock) of} \\ &\text{Materials} \\ &+ \text{Purchases of Materials} \\ &- \text{Closing Inventory (Stock) of} \\ &\text{Materials} \end{aligned}$$
- ii. **Purchases of Stock-in-Trade:** It the amount of goods purchased for the purpose of trading or reselling. If any further process is carried out on such purchased goods then they are no longer termed as Stock-in-Trade as they become a

part of Cost of Materials Consumed.

- iii. **Changes in Inventories (Finished goods, Work-in-Progress and Stock-in-Trade):** It is the difference between the opening and closing inventories of finished goods, work-in-progress and stock-in-trade which is recorded as an expense in the Statement of Profit and Loss.
- iv. **Employee Expenses:** It is the amount of payments made to and for the benefit of employees. It includes the amounts of wages, salaries, bonus; amount spent on staff welfare expenses, etc. Detailed information of the total amount spent is presented in the Notes to Accounts provided with the financial statements.
- v. **Finance Costs:** It is cost that is incurred by the company on the borrowings or loans taken by it which includes interests on such borrowings, loans, overdraft, etc. used during a particular period by the entity.
- vi. **Depreciation Expenses:** It is a fall in the value of tangible fixed assets due to its use or obsolescence. Such amount is written off over the useful life of the respective asset by showing it as an expense in the Statement of Profit and Loss.
- vii. **Amortization Expenses:** It is a fall in the value of intangible fixed assets which is written off over their useful life and accordingly shown as an expense in the Statement of Profit and Loss.
- viii. **Other Expenses:** The expenses which are not shown separately in the Statement of Profit and Loss are shown under this head. Complete details of such expenses are given in the Note to Accounts as direct and indirect expenses.