Meaning, Usefulness and Types of Financial Statements

Financial statements, also known as final accounts, are periodic reports prepared by a business enterprise after the agreement of the trial balance. They present the financial progress and results achieved during a specific period.

These statements include the Trading Account, Profit & Loss Account, Balance Sheet, and other explanatory notes that form part of the final accounts.

Usefulness:

- Assist management in planning and controlling business operations.
- Provide valuable information to creditors, shareholders, and employees.

Types of Financial Statements:

- Trading Account
- Profit & Loss Account
- Balance Sheet

Example: A company prepares its financial statements annually to show its financial performance and position to stakeholders.

Practice Set

- *Level 1:* Define financial statements and list their types.
- *Level 2:* Explain the usefulness of financial statements for management.
- *Level 3:* Discuss how financial statements assist creditors and shareholders.

Answer Key

Financial statements are reports prepared to present the financial performance and position of a business over a period. They include the Trading Account, Profit & Loss Account, and Balance Sheet. They help management in planning and controlling, and provide information to creditors and shareholders for decision-making.

Quick Reference

- Financial Statements = Trading Account + Profit & Loss Account + Balance Sheet
- Purpose: Reporting financial progress and position

Glossary

- **Financial Statements:** Reports showing financial results and position.
- **Trial Balance:** A statement showing debit and credit balances to verify ledger accuracy.

Trading and Profit & Loss Account

The Trading and Profit & Loss Account is prepared to determine the profit earned or loss sustained by a business during a given period.

Trading Account: Shows gross profit or loss by comparing sales and cost of goods sold.

Profit & Loss Account: Shows net profit or loss by considering indirect expenses and incomes.

Need: To ascertain the net result of business operations during the period.

Closing entries transfer balances of expenses and revenues to this account. Net profit or loss is then transferred to the capital account.

Example:

If sales are ₹5,00,000 and cost of goods sold is ₹3,50,000, the gross profit is ₹1,50,000. After deducting indirect expenses of ₹50,000, the net profit is ₹1,00,000.

Practice Set

- *Level 1:* Define gross profit and net profit.
- *Level 2:* Prepare a simple trading account from given data.
- *Level 3:* Explain the process of transferring net profit to the capital account.

Answer Key

Gross profit is the excess of sales over cost of goods sold. Net profit is gross profit minus indirect expenses plus indirect incomes. Net profit is transferred to the capital account to update the owner's equity.

Quick Reference

- Gross Profit = Sales - Cost of Goods Sold
- Net Profit = Gross Profit + Indirect Income - Indirect Expenses

Glossary

- **Gross Profit:** Profit before indirect expenses.
- **Net Profit:** Profit after all expenses and incomes.
- **Capital Account:** Owner's equity account reflecting net profit or loss.

Meaning, Characteristic, Need and Structure of the Balance Sheet

The Balance Sheet is a statement showing the financial position of a business at a specific date by listing its assets and liabilities.

Characteristics:

- It is a statement, not an account.
- Assets and liabilities totals are always equal, reflecting the accounting equation:

Accounting Equation: Assets = Liabilities + Capital

Need: To know the exact financial position of the business on a given date.

Structure: Assets are classified as fixed and current assets; liabilities as long-term and current liabilities.

Example:

On 31st March, a business has assets worth ₹10,00,000 and liabilities plus capital totaling ₹10,00,000, showing a balanced financial position.

Practice Set

- *Level 1:* Define balance sheet and state its purpose.
- *Level 2:* Explain the accounting equation with examples.
- *Level 3:* Prepare a simple balance sheet from given data.

Answer Key

The balance sheet is a statement showing assets and liabilities at a point in time. It follows the equation Assets = Liabilities + Capital, ensuring both sides balance.

Quick Reference

- Balance Sheet = Assets (Fixed + Current) = Liabilities (Long-term + Current) + Capital

Glossary

- **Assets:** Resources owned by the business.
- **Liabilities:** Obligations payable by the business.
- **Capital:** Owner's investment in the business.

Key Words

Financial Statements: Reports prepared to present a periodical review of financial performance and position.

Income Statement: Statement showing true and fair view of operating performance.

Gross Profit: Excess of sales over cost of goods sold.

Gross Loss: Excess of cost of goods sold over sales.

Cost of Goods Sold: Cost directly related to sale of goods.

Direct Expenses: Expenses directly attributable to purchase and preparation of goods for sale.

Profit & Loss Account: Account prepared to determine income for a period.

Net Profit: Excess of gross profit and non-operating revenues over indirect expenses and non-operating expenses.

Net Loss: Excess of indirect expenses and non-operating expenses over gross profit and indirect revenues.

Operating Profit: Profit earned through normal business operations.

Balance Sheet: Statement depicting exact financial position on a date.

Capital Expenditure: Expenditure on purchase or construction of fixed assets benefiting business long-term.

Revenue Expenditure: Expenditure benefiting company for short period, recurring in nature.

Deferred Revenue Expenditure: Expenditure paid in current year but charged over future periods.

Fictitious Assets: Items shown as assets but having no market value (e.g., preliminary expenses).

Fixed Assets: Assets used in business operations, not for resale (e.g., land, machinery).

Current Assets: Assets held for short-term use in business (e.g., stock, debtors).

Tangible Assets: Assets that can be seen and touched (e.g., furniture).

Intangible Assets: Assets without physical existence but have value (e.g., goodwill).

Investments: Money spent to earn income or profit.

Fixed or Long-term Liabilities: Liabilities payable after more than one year (e.g., long-term loans).

Current Liabilities: Obligations payable within one year (e.g., creditors, outstanding expenses).

Contingent Liabilities: Possible liabilities depending on future events.

Marshalling of Assets and Liabilities: Systematic arrangement of assets and liabilities in the balance sheet.