LESSON-16
FINANCIAL STATEMENTS: AN INTRODUCTION

SUMMARY

Profit or loss of the business operations of a business enterprise after a certain period and financial position on a particular date. For this certain financial statements are prepared which are termed as income statement (i.e. Trading and Profit & Loss Account) to know what the business has earned during a particular period and the Position Statement (i.e. Balance Sheet) to know the financial position of the business enterprise on a particular date.

FINANCIAL STATEMENTS: MEANING AND OBJECTIVES

Financial statements are the statements that are prepared at the end of the accounting period, which is generally one year. These include Income Statement i.e. Trading and Profit & Loss Account and Position statement i.e. Balance Sheet.

Objectives of preparing Financial Statements

- **Ascertaining the results of business operations**
- **Ascertaining the financial position**
- **Source of information**
- **Helps in managerial decision making**
- **An index of solvency of the concern**

Importance of Financial Statements

- **Pertaining to Finance**
- **Facilitate in Decision Making**
- **Showing the Operational Performance**

Difference between Capital Expenditure and Revenue Expenditure

Basis of Difference	*Capital Expenditure*	*Revenue Expenditure*
1. Purpose	It is incurred for acquiring fixed assets.	It is incurred for the maintenance of fixed assets.
2. Earning capacity	It increases the earning capacity of the business.	It helps in maintaining the earning capacity of the business intact.
3. Periodicity of benefit	Its benefits are spread over a number of years.	Its benefits accrue only in one accounting year.
4. Placement in financial statements	It is an item of Balance Sheet and is shown as an item of asset.	It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two.
5. Occurrence of expenditure	It is non-recurring in nature.	It is usually a recurring expenditure.

Distinction between Capital Receipts and Revenue Receipts

Basis of Difference	*Capital Receipt*	*Revenue Receipt*
Source	Receipts that do not arise during the normal course of business.	Receipts that arise during the normal course of business.
Nature	These are of capital nature and hence are not treated as items of income of the business.	These are of revenue nature and hence are treated as items of income of the business.
Occurrence	These are of non-recurring	These are recurring in nature.

TRADING ACCOUNT

Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit.

Need of Trading Account

- Knowledge of Gross Profit
- Knowledge of All Direct Expenses
- Precaution against Future Losses

Important Items of Trading Account

- **Stock**
- **Purchases**
- **Sales**
- **Direct Expenses**
- **Gross Profit/Gross Loss**

TRANSFER ENTRIES

Before preparing Trading Account, closing or transfer journal entries are made in the journal proper of the business enterprise.

PROFIT & LOSS ACCOUNT

In business, there are some income from sources other than sales revenue. These may be interest on investments, discount received from creditors, commission received, etc. Another account is prepared in which all indirect expenses and revenues from sources other than sales are presented. This account when balanced shows net profit (or net loss). This account is termed as Profit and Loss Account.

The profit shown by this account is called 'net profit' and if it shows loss it is known as 'net loss'.

Some important items of Profit and Loss Account

Debit Items

- Selling and Distribution Expenses
- Office and Administration Expenses
- Financial Expenses
- Depreciation and Maintenance Charges
- Other Expenses

Credit Items

On the credit side of Profit and Loss Account, items of revenue and incomes are written. The first item on this side of Profit and Loss Account is the gross profit transferred from trading account. Other items of the credit side are : Interest on investment, interest on fixed deposits etc. rent received, commission received, discount received, dividend on shares received etc.

Activity

Procure trial balance of at least four business concerns and classify the items into :

(a) Revenue expenditure (b) Revenue receipts

(c) Capital expenditure (d) Capital Receipts