Financial Accounting
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Lecture – 07
Balance Sheet 5

Namaste. I hope you have enjoyed the last week sessions, and you are also able to comfortably complete the assignment. So, we were discussing financial statements; particularly we were discussing balance sheet, we also seen the format of balance sheet, and now we are discussing each element of balance sheet. So, already on the screen you are seeing three major elements assets, liabilities and owners funds.

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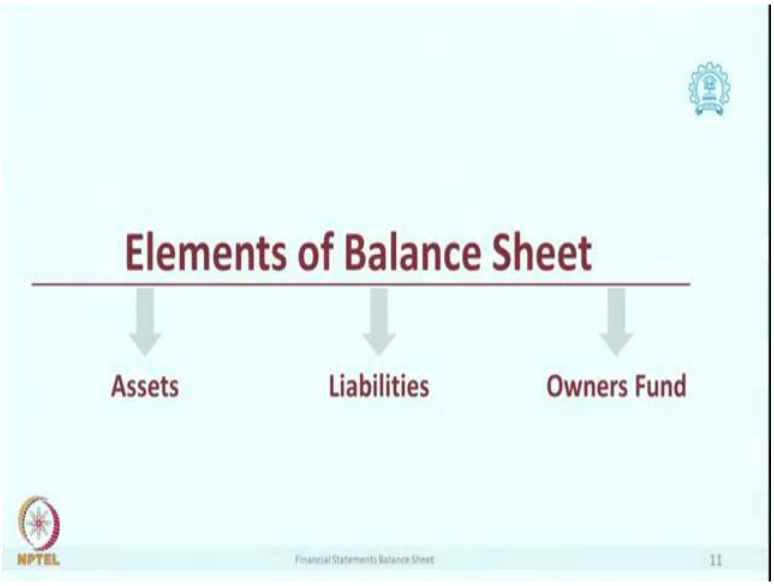

Within that we have already discussed asset and almost completed the liability. Today will going to owners fund, then we will see the process how the balance sheet emerges, and then we will go to discuss what is a profit and loss account.

Right now, let us briefly revise asset and liabilities.

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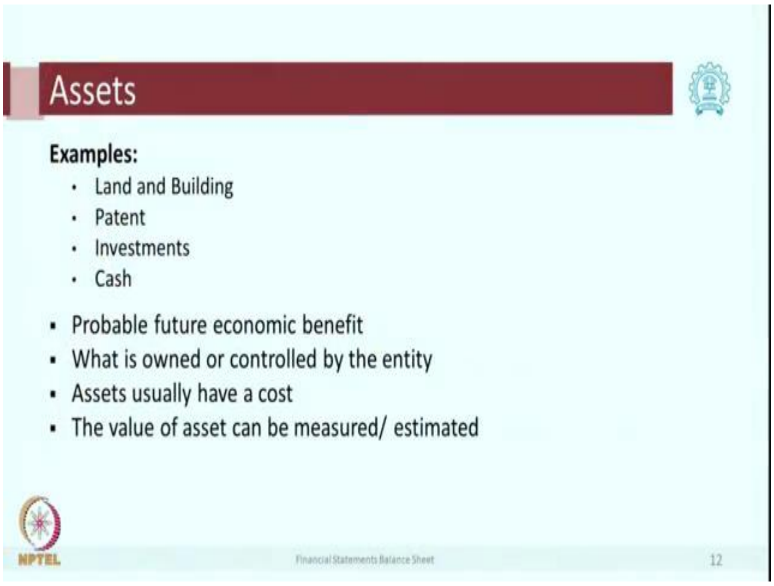

So, these are assets. I think you all know this is something which is a property or a resource of a company which has a value, and it is likely to give some probable future cash flow. There are variety of examples which are in front of you, so I am not repeating them.

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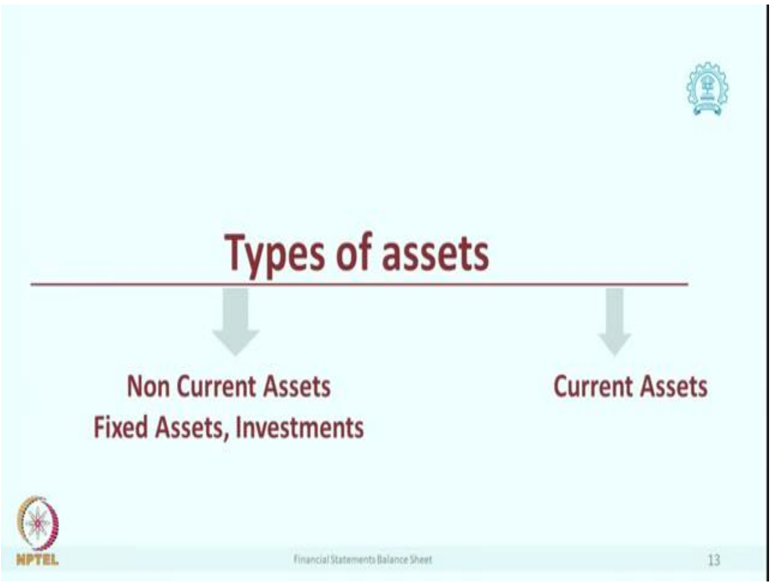

Then two major types of assets noncurrent current, within noncurrent you have got fixed and fix assets and investment. Now, what do you mean by fixed assets? This is a infrastructure or a property which is going to last for more than 1 year it acts as a catalyst in our operations.

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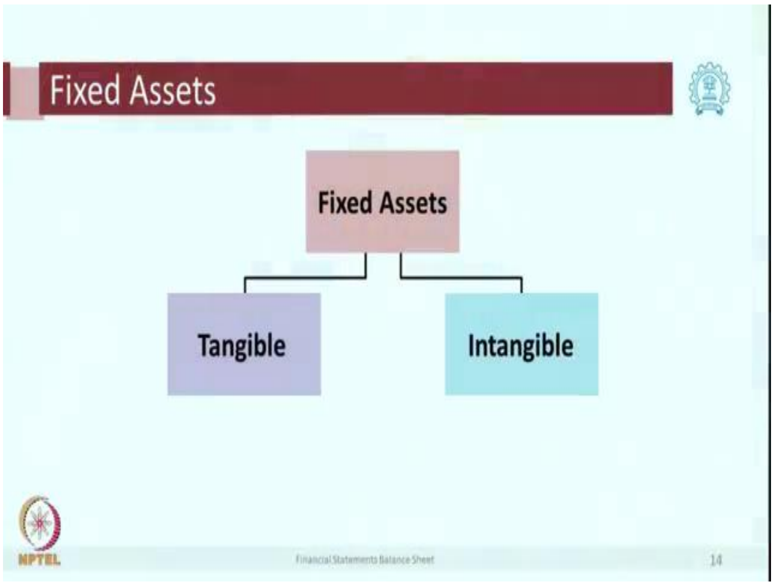

There are two types: tangible fixed assets, intangible fixed assets. Tangible example are: land, building, plant, machinery, variety of things which we see in front of us, which are going to have a longer life; these are all tangible. Intangible: we cannot see or we cannot as such touch it, but they have a value, they are very important to us. They can include software, they can include apps on your mobiles, they can include patterns and so on. So, these are the examples.

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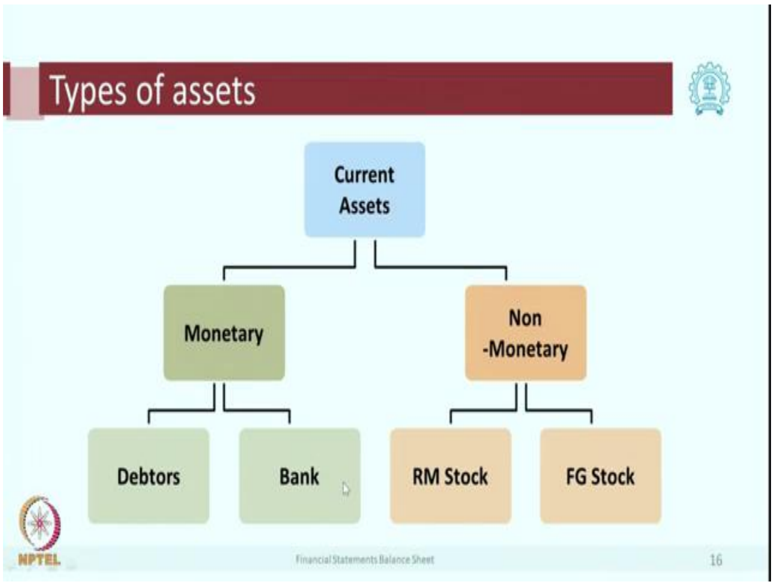

Then the next type is current assets. Current assets have a life of less than 1 year. There are two major types monetary and non-monetary so, within monetary what are the example; debtors and bank balances, as we saw last time. And in non-monetary category you have got variety of inventory or stock; like raw material or like finished goods, there is also one more type known as work-in-progress stock. That is also an example of non-monetary asset.

Then we went to discuss the liabilities, these are the present obligation. These are the dues which company or an enterprise has to pay and you can reasonably estimate the amounts and they would result in outflow in future.

Now, what are the types and what are the examples of the liabilities. So, again you got long-term liabilities short-term liabilities. So, what are the examples of long-term? Mostly bank loans or loans from NBFC or deferred tax obligations. These are all long-term liabilities.

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The other one is current or a short-term liability. What are the examples? They include bank overdraft, they include payables or creditors, they include variety of outstanding expenses. Can you give an example of outstanding expense? Last time we discussed about salary, but do you think of any other expense which is not paid on time. Suppose we have purchased stationery, but we do not pay the stationary bill immediately, we will pay after some time till the time is paid it becomes outstanding expense. Any expense you can think of if not paid on the date you got the service or the product, it becomes an outstanding expenses, ok.

Now provisions; now, this is a specific type of liability, wherein the amount is not known with substantial accuracy. We know the existence of liability, but not the amount. So example, can you think of any example? The four examples are in front of you, but apart from that is there any other example of a provision, just think over it.

Suppose some repair work is done in our factory or in office, we do not know exactly what was done in the repairs; the particular party who has done repair as not yet send the bill. So, we do not know the charges, but we know the repairs has been done and we are required to prepare balance sheet on say 31st of March, then we will make a provision for repair.

There is another possible case: we have sold products for which we have given a guarantee because of guarantee clause, now for 1 year we will have to provide a free service. Suppose there is any damage in the product we will have to repair it for free or we may you have to replace it. Then for 1 year there is an existence of an obligation, but we do not know the amount. We may have to pay more or less, but we will calculate some estimation; based on our past record or based on whatever is likelihood of the repair and replacement cost. Let us say 2 percent or 3 percent maybe set aside for provision for repairs.

Can you think of any other example? One more example is gratuity; I think most of you know that whenever an employee retires or in case of unfortunate death of employee, we have to pay gratuity to the employee. The gratuity is calculated on the basis of number of years of service, that service can be 5 years, 6 years, 10 years, 40 years whatever. According to the tenure of that employee and the retirement salary of that employee company has to pay gratuity. Now, as on the day of balance sheet we are not sure about the gratuity amount payable, but the liability exists.

So, in such case we will calculate provision for gratuity, ok. And plus, four more examples given here I hope the concept of provision is clear to you.

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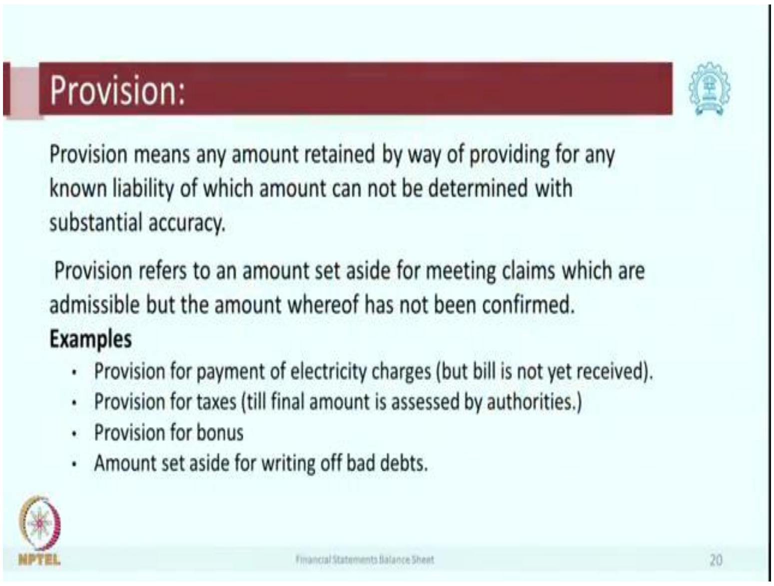

Now, there is one more special type of liability, where neither we know the amount nor we know the existence of asset.

Now, you question might come in your mind that neither the amount is known nor its existence is certain, whether the liability would be created or no is also not known. Is it necessary to show such a liability in the balance sheet? What do you think? The answer is yes. Even if there is a very small likelihood of getting an obligation; there is no certainty of obligation, but there is a very small chance that we make an obligation. In such scenario also we will have to show that liability; that liability is called as Contingent Liability.

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As the name suggest contingent liability is a possible obligation that this obligation may arise. Since it is not a present obligation if you remember when we discussed or defined the liability, we had said that it is a present obligation arising from the past event.

Now, contingent liability is a possible obligation, since it is just a possible obligation it is not actually shown as a part of balance sheet, but it is required to be shown as a footnote. So, below the balance sheet we have to give a note for all the contingent liabilities; are you getting me? Now, can you think of any examples? I think you are seeing what is a meaning that, it may or may not arise as for occurrence of some events. In which everything is uncertain, but liability or obligation can be there and enterprise or a company has no control over that event. Can you think of any example?

One of the best example are court cases. Suppose one of our customer feels that whatever service we have given is not a satisfactory service, we have say given a wrong product or sold wrong product to a customer which is of a poor quality. Customer files a complaint against us to a consumer court or even files a case against us in the court; saying that this product was faulty and we will have to give compensation to the customer.

Now there are two possibilities: in possibility one, we accept that there was a fault on our part and we agree to pay some compensation, but amount is not yet known. Some discussion is going with customer; customer is asking for 10 lakh compensation, we say no 10 lakh is too much we will pay you 1 lakh. Then there will be a negotiation between them and then the amount will be decided. In such case it will be called as the provision, because we have accepted our obligation.

Now, the liabilities there is certain, but the amount is still being decided, but in a case where we refuse our obligation. That means, we say that nothing is payable as a damages or as a compensation our product is of good quality. But still customer says no product is of bad quality, claims a compensation of 10 lakhs, we are saying nothing is payable. Customer files a case in the court. now court decision is unknown. If court gives decision against us we may have to pay, if court decision in our favour we may not have to pay. Now, this is a proper example of contingent liability. I hope you are getting it. Any other example can you think of, of a contingent liability.

Now, suppose fire occurs, and because of fire lot of damages have occurred and some of the curtains are closed, they are sealed curtains we do not know whether they are damaged or not, and they do not belong to us they belong to some customer or somebody else. Now, if inside the package there damage we have to pay compensation, if they are not damage me do not have to pay a compensation. That we will be only when it reaches the customer, customer opens and ask for or not ask for compensation, that can also be a case of contingent liability, ok. I hope you are getting me.

Now, this is a rare case. However, for big companies since they are into lakhs of transactions, there are bound to be some or other cases where there would be court cases for such things, they are required to be properly disclosed as per company law. So, they will come in notes to account.

I am hoping that you are properly reading the balance sheet of your company; I have already told you to select one company and read the annual report of that company. Go to the balance sheet of your company not in the main balance sheet, but below the balance sheet there are notes. In the notes there will be one of the items known as contingent liability, where they will have to discuss full details as to the nature of case filed by the customer or filed by any other person, what is a legal advice to the company on the likely charges and so on.

Now, suppose company accepts the obligation it will get converted into what provision. If court gives decision against us it becomes a contingent, it becomes our regular current liability. But as long as nothing of that sort happens it remains in the balance sheet as a contingent liability; I hope you getting me. Now, this was our last item in balance sheet liability side. Now, we will go to the next item that is known as owners fund.

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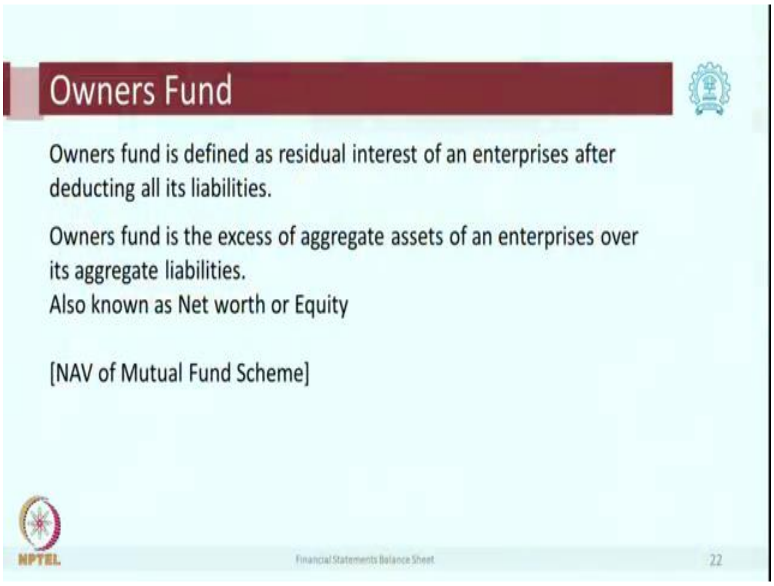

Now, we have already seen this item when we are seen the format earlier. Now, this is a residual interest of the enterprise or this is the amount which enterprise or company has to pay to the owners. Now why it is called residual; because these are your assets from their assets first you have to pay external liabilities. So, you have to pay your both current as well as noncurrent liabilities, it any amount remain after paying that amount, then owners will get it. That is why owners fund is considered as a residual interest.

If you remember the format of balance sheet earlier it has two components: there is a capital, owners have put in some money that is the capital plus the profits which enterprise gives to the owner that is called as reserves. That capital plus reserves together is known as Owners Fund. We can also put it in this way this is the total of assets minus total of all external liabilities, the balance is called as Owner Fund.

There are two more names to owners funds which are often quoted in phrase or if you read various information on reports, sometime they call that net worth of a particular company is 100 crore, that net worth is another name given to owners fund. Sometimes it is referred to as equity; so, it is said that equity of company is 500 crore, that equity refers to owners fund. Keep in mind this is rather tricky word; there is a type of capital known as equity capital, that equity capital is different and is a type of capital; now, only equity means owners fund, so it includes capital plus reserves.

Now, in the American terminology they call it equity, whereas in UK it is called as net worth, in India it is called as owners fund; this terms are used interchangeably. Since in a company shareholders are the owners, instead of owners fund it is also called as shareholders funds. Please go to your balance sheet in it may be shown as shareholder fund or owners fund in your balance sheet.

Now, many of you might be investing in mutual funds, if you do not invest then you can start investing. Now, if you invest in mutual fund for that scheme everyday NAV is announced; NAV, you can search for NAV on Google, they would give lot of NAVs. Because every day as per the requirements of SEBI, NAV is required to be published, now this NAV that is also actually owners fund of that particular scheme.

Do you know what is the full form of NAV? Full form is Net Asset Value; here net asset refers to total assets minus total liabilities that means, it is nothing but the owners fund for that scheme. So, it is the total owners fund divided by number of units they calculate per unit in NAV and they publish it anyway. Since that the particular term is often used I felt that you should know that NAV is also nothing, but the owners fund.

Now, let us go in to all the three components; now, as you know the balance sheet is required to tally or balance sheet is required to match.

Assets = Liabilities + Owners Fund

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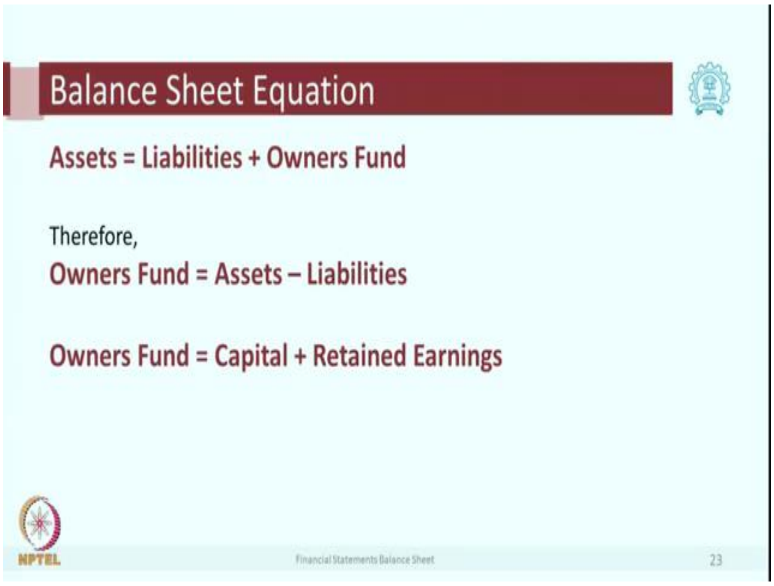

Now, you know that owners fund itself is capital plus retained earnings or reserves. So, owners fund can be calculated by two ways:

Owners Fund = Assets – Liabilities

Owners Fund = Capital + Retained Earnings

Now, let us go to balance sheet equation. Now, you all know that A that is assets is equal to L plus O.

A = L + O

Where, A= Assets, L= Liability and O= owner's fund

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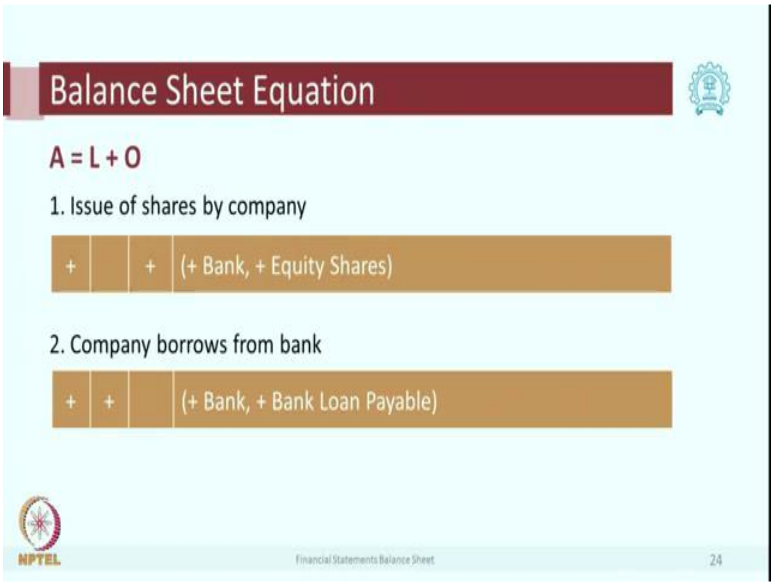

Now, if you want to understand how the balance sheet is prepared; we will take 5 simple transactions and for that transactions try to understand impact on A, L and O.

Now, let us say a company is newly formed and it issue shares. Now, can you think of what will be the impact on A, L and O? Issue shares means what happens the prospective shareholders or investors approach the company they pay money, company will give them shares for that money, so company receives cash give shares. Now, can you think of what has happened to A L O? So, there is a plus in A; assets go up no change in liability owners fund go up. So, A plus O plus, are you getting and if you see in detail we have said plus bank, because bank balance of the company goes up and equity share balance also goes up. So, add to bank add to equity shares.

Now, those of who were commerce students you would have already studied journal entries. Now, what I am showing you is nothing but the journal entries, but just for the benefit of non-commerce people I am not using the terminology journal entry, but in the same way actually journal entries are derived. For every transaction some item of A L O changes and those items actually match there are equal number of debits and credits.

So, we are just trying to make it very simple for five sample transactions which are very easy transactions, but very basic. Most of the transaction of companies are based on these transactions. We are trying to understand the impact of A, L and O. Aare you getting the first one? Issue of share by the company, ok; now, the company is formed shareholders have already given the money and they have received the shares.

Now, next what company has done is; company borrows from bank. Now, what will be the impact on A L O? I think most of you have guessed it correct, because when company approaches bank, bank sanctions and pays the loan, the bank balance goes up companygot the money, bank balance goes up and a new liability kwon as bank loan is created. So, plus in bank and plus in bank loan payable; so, A is plus L is plus. Remember if company get rs. 10 Lakh loan then loan is added with 10 lakhs same amount is added in bank, that is why the balance sheet is always balances or matches. Are you getting the second one also?

Now, let us go to the third one. First look at 3 a: cash purchase of equipment. Now, company received a lot of cash from equity shares plus loans also. So, they have decided to use that cash and purchase machinery or equipment. Now, what will be the impact on balance sheet? How will you reflect it in terms of A L O? Company pays cash, so bank balance reduce, but they will receive machinery. So, it is plus in A minus also in A, if you go to explanation plus in equipment minus in bank.

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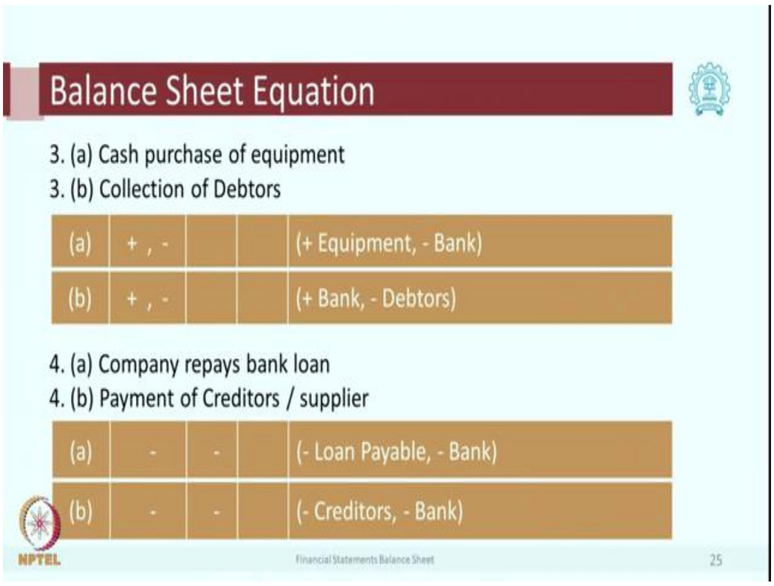

There is another example which is in 3 b: that is collection of debtors, company has already sold some money some goods to the customers, money is yet to be collected that is called as debtors. Now, if the money is collected company’s bank balance increase and debtors or receivables balance decrease: so, plus in bank minus in debtors. Actually transaction 3 a and 3 b appears to be opposite, because 3 a is a payment 3 b is a receipt. But here we are not looking at payment or receipt both are exchange of assets. So, if you look carefully neither L is affected nor O is affected within A only one asset is reduced other asset is added, ok. So, are you getting it?

Now, let us get to 4. Now, have a look at 4 a: company repays bank loan and 4 b is payment of creditors or suppliers. Now, company repays bank loan, what will be the effect? We repay lone which we have borrowed earlier, so bank balance will come down, bank loan payable will also come down. If you remember entry number 2, entry number 2 exactly reversing earlier it was plus now minus, minus in bank minus in bank loan payable. And what about 4 b? 4 b is payment of creditors. That means, we have already purchased some goods. Now, we have to pay those vendors or supplier or creditors. That means our bank balance will be reduced, we are repaying, so minus in bank and minus in creditors, ok. So, A is minus L is also minus, no change in O. Are you getting it?

See these are very easy entries for those who have already learnt commerce, but for those who are doing it for the first time please look at them carefully. Because, based on the simple entries actually you can calculate or you can write down any entry, because the same entries are going to happen they may happen ten thousand times with slight changes, but the base remains same.

Now, go to the fifth entry. Now, company pays dividend to shareholders. Now, how it will be reflected? I hope you know what is a dividend: dividend means what happens is company earns profit, now company distributes this profit to the shareholders or to the owners that is called as Dividend. If you remember we saw business cycle, in business cycle your revenue minus expense you get profit that profit is either paid to owners or is plowed back or kept transferred back to balance sheet.

Now, we are assuming that that profit is paid to the owner or to the shareholders. Now, what will be the entry? We are making payment, so bank balance will come down, and what else will change? Are the assets changing? Because of bank yes, but no other asset is changing, are the liability changing? No, but O that is from the owner’s fund there is a reserve that reserve balance is coming down, ok.

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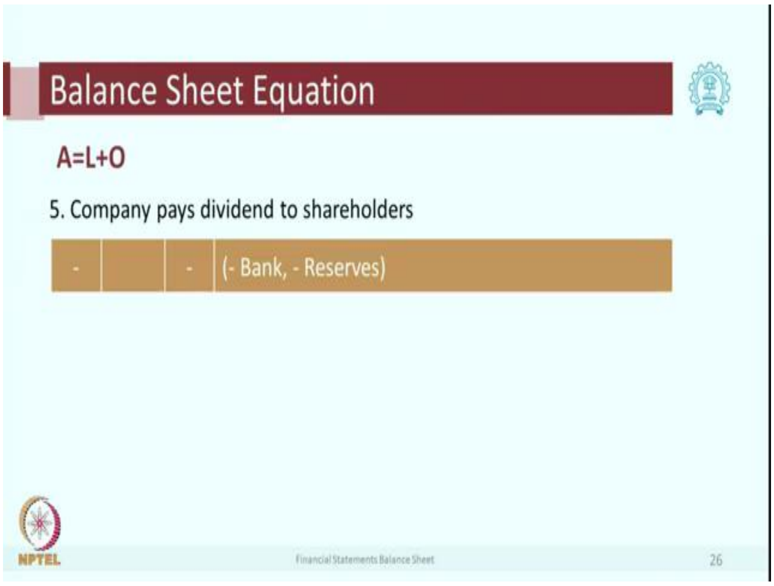

So, minus in A and minus in O or you can say minus in bank minus in reserves, are you getting. These were just the simple transactions we can look at hundreds of transactions, but once the basic logic is clear I hope you will be able to understand more and more transactions.

So, with this we are completing our session on balance sheet and in our next class we will start with profit and loss account. Namaste