Foundations of Accounting & Finance

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Week - 01

Lecture - 03

Contents of Income Statement and Balance Sheet Part I

Introduction

Welcome to the next lecture. So far, I have provided a very generic background about the course, covering the foundations or fundamentals of accounting and finance. We discussed various components, including what is financial accounting, who are the potential users of financial accounting information, what is cost accounting, who are the potential users of cost accounting information and what do we mean by finance. Essentially, accounting revolves around financial and cost accounting.

In the previous sessions, we explored different scenarios where decisions could be made using cost accounting information. We also briefly touched upon corporate finance, discussing aspects such as investing and sourcing funds.

Moving forward, I intend to delve deeper into each of these aspects. As mentioned earlier, approximately 40 to 50 percent of the course will focus on financial accounting, involving the recording and assessment of the financial position of an enterprise. About 20 percent of the course will cover cost accounting information, while 30 percent will address finance-related topics.

Process of Recording Transactions

In financial accounting, the primary task is recording transactions as they occur. While a typical accounting course would usually guide you through the step-by-step process of recording transactions and ultimately producing financial statements, we will focus more on understanding this process rather than delving into it extensively in this course.

1. Journal

When a transaction occurs, it is immediately recorded in the books of accounts. The first book used for recording transactions is known as a journal. Transactions are recorded in the journal as they happen, either manually or with the help of accounting software such as Tally and various other packages.

2. **Ledger**

The next stage involves grouping transactions at regular intervals. These grouped transactions are then recorded in the ledger, which serves as the next book of entry after the journal.

3. **Trial Balance**

The third stage involves consolidating and preparing a trial balance. This trial balance is a list of all the ledger accounts with their respective debit or credit balances, and it serves as a preliminary step before preparing the final financial statements.

4. **Income Statement, Balance Sheet and Cash Flow Statement**

Based on the trial balance the financial statements are prepared. These include the profit or loss account (also known as the income and expenditure account), the balance sheet, and the cash flow statement. These statements are crucial for assessing the profitability and financial position of the company.

Understanding Financial Statements

Now, let us take a couple of minutes to understand these financial statements—profit and loss account (or income statement), balance sheet, and cash flow statement. These statements provide essential information about a company's financial performance and position. We will discuss each of these statements in more detail, along with some examples related to profit and loss account, balance sheet, and cash flow statements.

1. **Recording in Books of Primary Entry: Journal**

Let us examine a few examples to understand the process of recording transactions in more detail. Imagine you are operating a business, and several transactions occur throughout the day:

a) **Buying a Product**: Let us say at 11:00 am, you purchase a product. This transaction increases your inventory, and your cash balance decreases because you have paid cash for the product.

b) **Selling Goods**: At 11:02 am, you sell some goods. This transaction decreases your inventory because you have sold products, but your cash balance remains the same because you have received cash from the sale.

c) **Receiving Cash on an Old Sale**: At 11:05 am, you receive cash from a customer who owed you money from a previous sale. This transaction increases your cash balance and reduces your accounts receivable (the amount owed to you by the customer).

d) **Selling Goods on Credit**: At 11:10 am, you sell more goods, but this time on credit. This means you have not received cash yet, but you've increased your accounts receivable because the customer now owes you money.

e) **Withdrawing Money from the Bank**: Finally, at 11:15 am, you withdraw money from the bank. This transaction decreases your bank account balance, and increases your cash.

Each of these transactions affects different accounts, such as inventory, cash, and accounts receivable. To record these transactions accurately, you would use a journal. In the journal, you record each transaction with corresponding debits and credits.

For example, when you buy a product for cash:

- Purchases account is debited (increased) because you've purchased inventory.
- Cash account is credited (decreased) because you've paid cash for the purchase.

It is important to note that understanding debits and credits is essential in accounting, but for now, the focus is on grasping the concept of recording transactions accurately and we will not specifically touch upon the terms debit or credit..

2. Posting in Second Book of Entry: Ledger

In the ledger, we group together transactions related to specific accounts to understand their positions more clearly. Let us use the examples of cash and inventory to illustrate this concept further:

1. Cash Account:

- We record all transactions involving cash in this account.
- For instance, when we pay cash to buy inventory, we decrease the cash balance.
- Conversely, when we receive cash from sales, the cash balance increases.
- Similarly, when we receive cash from an old sale, again the cash balance increases.

By grouping these transactions together in the cash account, we can easily determine the current cash balance by subtracting the total receipts from total cash payments.

2. Inventory Account:

- Transactions related to inventory are recorded in this account.
- For example, when we buy inventory for cash, we increase the inventory balance.
- When we sell inventory, we decrease the inventory balance.

- Additionally, we may have an opening balance of inventory carried over from the previous month, which is taken into account when calculating the current inventory balance.

By consolidating these transactions in the inventory account, we can track the current inventory position, considering purchases, sales, and any opening balances.

Assessment of financial position

Moving on to the financial accounting, let's consider the purpose of recording transactions. The primary aim is to ascertain the financial position of an enterprise or organization. However, can we determine the financial position solely based on the groupings and entries we have made? The financial position can be accurately assessed using the three basic financial statements: *the profit or loss statement (income statement), the balance sheet, and the cash flow statement*. These statements are essential as they provide a comprehensive overview of the organization's financial health, incorporating various aspects such as revenues, expenses, assets, liabilities, equity, and cash flows. Therefore, while recording transactions is a crucial step, the ultimate goal is to prepare these financial statements to evaluate the organization's financial position effectively.

Annual Report of a Company

When you examine any annual report of a company, you will invariably find three key financial statements: *the balance sheet, the profit and loss statement (income statement), and the cash flow statement*. Are these three statements mandatory? Yes, for every registered organization, two out of the three statements are mandatory: the balance sheet and the profit or loss statement. However, the cash flow statement is mandatory for listed companies. All three statements must be prepared at the end of every financial year and are audited by a professional practicing auditor to ensure accuracy and compliance with regulatory standards.

Financial Year

The financial year, often abbreviated as FY, refers to the period used for accounting and financial reporting purposes. In India, the financial year spans from April 1st to March 31st of the following year. For example, FY 22-23 denotes the financial year from April 1st, 2022, to March 31st, 2023. However, financial years may vary in different countries. For instance, in the United States, the financial year aligns with the calendar year, from January to December. In neighbouring countries such as Bangladesh, the financial year extends from July to June.

While financial statements are typically prepared for the entire financial year, organizations have the flexibility to generate quarterly financial statements for internal reporting purposes. Each financial year consists of four quarters: Q1 (April to June), Q2 (July to September), Q3 (October to December), and Q4 (January to March). However, audited financial statements are mandated

only at the end of the financial year, ensuring accuracy and compliance with regulatory standards. Therefore, preparation of financial statements primarily occurs at the end of the financial year.

Understanding Financial Statements: Our Approach

1. **Content of Financial Statements:** The financial statements include the balance sheet, profit and loss statement (income statement), and cash flow statement. These documents provide information about the financial position, performance, and cash flows of an organization during a specific period.
2. **Interactions Between Financial Statements:** The three financial statements are interconnected. Changes in one statement can impact the others. For example, the net income reported in the profit and loss statement affects the retained earnings in the balance sheet, while cash flows from operating activities in the cash flow statement can influence the cash and cash equivalents in the balance sheet.
3. **Impact of Transactions on Financial Statements:** Every transaction affects one or more elements of the financial statements. These impacts are reflected in the financial statements through specific accounting entries. For example, a sale transaction increases revenue in the profit and loss statement, while a purchase transaction increases assets (such as inventory) in the balance sheet.

The purpose of financial statements is to provide stakeholders with insights into an organization's financial position, performance, and cash flows. Analysing these statements helps stakeholders make informed decisions and evaluate the company's overall health and viability.

Profit and Loss Account

Let us try and understand the first financial statement, commonly known as the profit or loss account, or the income and expenditure statement or the revenue and expenditure account. Is there any distinctions between an income and expenditure statement and a profit and loss account? Well, while there are some differences, for the most part, they provide similar information. This statement, commonly referred to as the profit or loss account, is used by for-profit organizations. What does it entail? It documents all revenue and expenditure, that have accrued. It captures every bit of revenue and every expenditure. Now, what does this entail? The difference between the revenue and expenditure, often termed as profit or loss.

That is the essence of it - the difference between revenue and expenditure. This statement, be it the profit or loss statement or the income and expenditure statement, reveals both income and expenditure, ultimately yielding the bottom line: either profit or loss. It is that straightforward. Now, you might wonder, how do we handle transactions? I simply record revenue and expenditure as they occur. However, there is a crucial concept to consider here - the accrual concept."