Foundations of Accounting & Finance

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Week - 02

Lecture - 06

Preparation of Income Statement and Balance Sheet: Example - Part I

Introduction

In the previous lecture, we focused on explaining how a transaction impact the profit and loss statement and the balance sheet with the help of a few illustrations uising an Excel sheet. The purpose of the exercise was to provide an overview of how transactions are simultaneously reflected in the balance sheet and income statement. In this lecture, there is a set of formal transactions for a particular company spanning two months: April and May. Let us record these transactions in both the income statement and balance sheet. The goal is to understand how each transaction impacts the balance sheet and/or the income statement.

List of transactions

Glorified Steel (GS) was incorporated in 1974 as a family operated enterprise in Chennai. It is in the business of trading steel flat products across the Southern region of India. GS deals in steel coils and sheets of HR, CR, and HRPO grades of varying sizes. As the second generation joined the business in 2017, they decided to expand the scope by setting up a subsidiary to perform a few operations catering to the current needs in the industry. Thus, TR steel was incorporated in April 2020.

April 1, 2020: Incorporation of TR STEEL. GS holds 50 Lakh shares of Rs. 5 each. Additionally, two members of the family (Tanay and Rishi) from the second generation hold 25 Lakh shares of Rs. 5 Each. Tanay and Rishi are also directors, drawing a monthly salary of Rs. 70,000 each. TR opened a bank account to receive the amount invested in the share capital.TR Hired a factory shed on a monthly rent of Rs 50,000, payable at the end of every month.

Transaction Analysis

Capital Contribution

We have GS's equity holding of 50 lakh shares at Rs. 5 each. Each share is valued at Rs. 5, making the total equity capital for TR Steel. This represents the equity that TR Steel has received. Liabilities plus equity represent the company's capital or equity. The cash has come in the form of a cheque, with GS depositing about Rs. 2.5 crores into TR Steel's bank account. Once the money is deposited in the TR Steel's account, it becomes an asset owned by TR Steel.

The second generation also contributes to the equity. Thanai and Rishi hold 25 lakh shares each at Rs. 5 each, totaling Rs. 1.25 crore each. All three contributors form the equity contribution, which is considered capital. Thanai and Rishi’s capital, worth Rs. 1.25 crores each, was deposited into TR Steel's bank account. As a result, a total of Rs. 5 crores is now in TR Steel's bank account, which the company owns.

Why is capital contribution is not considered as a revenue?

When the money comes in, is it not revenue for the company? No, it is not; the company has not earned that money. Somebody has contributed in the form of capital, and you are obligated to return the capital at the time of dissolution after selling all the assets. They have contributed capital, not revenue; revenue is what the company earns.

The salary payments to Tanay and Rishi

The salary payments to Tanay and Rishi will be considered transactions at the end of the month, not on April 1st. As of April 1st, no expenditures have occurred, this is only a contractual agreement.

Hired factory shed

TR hired a factory shed on a monthly rent of 50,000, payable at the end of every month. As of today, there is no transaction. A contract has been signed, but no payment has been made yet. The rent will become an expenditure only when the benefits are enjoyed, and payment is made at the end of the month. So, in this particular case, it is not an expenditure because the company has not enjoyed the benefits, and payable only at the end of the month.

April 2, 2020: Purchased De-coiling cum slitting machine from ABC Machines, Delhi for Rs. 42 Lakhs. A Shearing machine was purchased for Rs. 15 Lakhs from XYZ Works, Hyderabad. Based on the parent company relationship from ICIC Bank, the machinery was financed at 40% credit by the bank at 11% pa with monthly interest payments and quarterly principal payments for 3 years. The balance had been paid by GS in January 2020 while placing the order and had to be paid back to the parent company by end of the financial year. The machinery would be depreciated over its useful life of 12 years with salvage value of Rs. 4.8 Lakhs for De-coiling cum slitting machine and Rs. 90,000 for shearing machine.

Transaction Analysis

Upon purchasing these machines, ownership was transferred to TR Steel, making them assets for the company. The De-coiling cum slitting machine, valued at Rs. 42 lakhs, and the Shearing machine, valued at Rs. 15 lakhs, both represent valuable assets for TR Steel.

TR Steel financed 40% of the machinery cost through credit obtained from ICIC Bank, with an interest rate of 11% per annum. This financing arrangement involves monthly interest payments and quarterly principal payments over three years. For the remaining 60% of the machinery cost, GS, the parent company, provided funding. GS had initially paid this amount in January 2020 while placing the order, and TR Steel is obligated to repay this sum to GS by the end of the financial year.

As a result of these transactions, TR Steel has liabilities in the form of bank loans and obligations to the parent company. The assets acquired through the purchase of machinery are balanced by these liabilities in the company's financial records. While the purchase of machinery increases TR Steel's asset value, it does not immediately impact the expenditure side of the income statement. Expenditures are recognized when the benefits of the purchased assets are consumed or utilized over time. The value of the asset depreciates over the life of the asset and the amount of expenditure added to the P& L account will be equial to the depreciation charged. Consequently the value fo the machinery will also decrease by the amount of depreciation.

April 3, 2020: Office furniture and equipment setup of Rs. 1.5 lakhs were paid to Page Office Solutions. The useful life of these asset is presumed to be 3 years with no salvage value.

Transaction Analysis

This represents an investment in assets for the company. Upon purchasing the office equipment, TR Steel owns these assets, which are valued at Rs. 1.5 lakhs. As a result of this transaction, the company's bank balance decreases by Rs. 1.5 lakhs, reflecting the payment made for the office furniture and equipment. This reduction in the bank balance is offset by the increase in the value of the office assets acquired.

In this transaction, the asset side of TR Steel's balance sheet is impacted twice: once by the increase in office furniture and equipment assets valued at Rs. 1.5 lakhs, and again by the decrease in the bank balance of Rs. 1.5 lakhs. However, the sum total of the balance sheet remains unchanged, with the sources and utilization of funds balanced.

April 4, 2020: The accountant and stock manager were transferred from GS to the books of TR at a monthly salary of Rs. 20,000 each. TR also hired 2 foremen for operation of both machines at Rs. 15,000 per month. A shed manager with a monthly salary of Rs. 20,000 per month. Watchman’s salary is set at Rs. 8,000 per month. 4 other people were hired for the manual labour on the site at Rs. 8,000 per month. They were hired with effect from 1st April, 2020, and their salaries were paid at the end of each month.

Transaction Analysis

As of April 4th, these employment contracts represent future liabilities for TR Steel. However, since the employees have not yet performed their duties and no payments have been made, these contracts do not impact the current balance sheet or income statement. They are considered contractual obligations that will result in expenditures at the end of the month when salaries are paid. As a result, the balance sheet and income statement for April 4th remain unchanged from the previous day, as there are no new transactions to report.

April 6, 2020: Received and executed an order from GS for a de-coiling and slitting job work on behalf of its customer Dulite for 25 Tonne CR Material to be cut from coils to sheet. The job work was done for Rs. 1000 per tonne. The same was sold by the parent company to Dulite for Rs. 41000 per tonne. The payment would be done by GS in 30 days.*

Transaction Analysis

TR Steel earned revenue of Rs. 25,000 for the executed job work. Since the payment from GS is due in 30 days, the revenue is accrued. Therefore, the accrued revenue of Rs. 25,000 was reflected in the income statement. Since the payment has yet to be received, Rs. 25,000 is recorded as receivables on the assets side of the balance sheet. When a revenue is recorded it results in profit or loss which eventually belongs to the equity providers hence added(subtracted) to equity. The exact format is depicted.

Liabililties & Equity	
GS's equity holding 50 lakh shares @ 5 each	
Tanay's equity holding 25 lakh shares @ 5 each	
Rishi's equity holding 25 lakh shares @ 5 each	
Retained earnings	
NET WORTH	

Profit before tax	
Less: Tax	
Profit after tax	
Less: Dividends	
Retained earnings	

The rentention of profits by the company increases the total capital of the shareholders. Therefore, the net worth of the business increases due to the retained earnings of Rs. 25,000, reflecting the total money belonging to the shareholders.

April 7, 2020: For future orders, pre-empting demand from existing clients of GS, TR purchased 95 tonnes CR from JS Steel at Rs. 41,000 per tonne. Another 45 tonnes HRPO coils were ordered from Tat Steel at Rs. 35,000 per tonne. The payment on the order were made upfront through RTGS and sale by the vendors was executed and received on the same date.

Transaction Analysis

Firstly, 95 tonnes of CR were purchased from JS Steel at a rate of Rs. 41,000 per tonne. This purchase constitutes an asset for TR Steel, as ownership has been transferred on purchase. The total value of this transaction amounts to Rs. 3,895,000. Secondly, 45 tonnes of HRPO coils were ordered from Tat Steel at a rate of Rs. 35,000 per tonne. Similar to the CR purchase, this is also recorded as an asset. The total payment for this transaction was made upfront through RTGS, amounting to Rs. 1,575,000. As a result of these transactions, TR Steel's balance sheet reflects the increase in assets and a reduction in bank balance.

April 8, 2020: Registered for an e-auction service for JS Steel with a security deposit of Rs. 10 lakhs.

Transaction Analysis

The transaction involves a transfer of funds from TR Steel's bank account to JS Steel as a security deposit. As of April 8, 2020, the balance sheet reflects a decrease in TR Steel's bank balance by Rs. 10 lakhs, representing the outflow of cash. Simultaneously, an asset is created for TR Steel in the form of a security deposit with JS Steel, valued at Rs. 10 lakhs. This security deposit is TR Steel's money, held by JS Steel temporarily for the purpose of participating in the e-auction. If TR Steel does not participate or win the e-auction, the deposit will be returned. Hence, the security deposit is classified as an asset for TR Steel. As a result of this transaction, the balance sheet as of April 8, 2020, reflects a decrease in bank balance and an increase in assets due to the security deposit with JS Steel.

April 9, 2020: Satisfied with the previous order service, received direct order from Dulite for 20 Tonnes CR cut to their size. The order was executed immediately. The selling price was agreed at Rs. 51,000 ex-TR factory. The payment would be done in 30 days.*

Transaction Analysis

Upon receiving the order, TR Steel utilized 20 tonnes of CR. The value of the utilized material, at Rs. 41,000 per ton, amounted to Rs. 8,20,000, led to a decrease in TR Steel's assets and an increase in expenditure. Subsequently, TR Steel sold 20 tonnes of CR to Dulite at the agreed price of Rs. 51,000 per ton, resulting in a total revenue of Rs. 10,20,000. Although the payment from Dulite has not been received yet, the revenue has accrued resulting in an increase in receivables, indicating that TR Steel is eligible to receive the amount from Dulite.

This transaction can be divided into two parts: the utilization of material, which decreased assets and increased expenditure, and the sale of material, which increased revenue. In the event that Dulite fails to make the payment, TR Steel may resort to legal measures. However, as of April 9, 2020, TR Steel is eligible to receive the payment from Dulite.