

# Foundations of Accounting & Finance

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Week - 02

Lecture - 07

## Preparation of Income Statement and Balance Sheet: Example - Part II

### Introduction

On April 9th, the income statement reflects the revenue earned, the expenditure incurred, and the total profit. The profit has not been distributed as dividends. Now, what happens if dividends are distributed? If Rs. 200,000 is distributed as dividends out of the Rs. 225,000 profit, it means that retained earnings will decrease to Rs. 25,000. Further, the bank balance will decrease by the same amount. Since dividends are not being distributed, retained earnings remain at Rs. 225,000, and the bank balance remains unaffected.

**April 13, 2020:** Purchased 40 tonnes HR from JS Steel e-auction at Rs.33,000 per tonne. The payment was made immediately after adjusting for security deposits. Additional transportation costs of Rs 50,000 are paid through the bank.

### *Transaction Analysis*

Let us break down the transaction. The company purchased 40 tonnes of HR steel at Rs. 33,000 per tonne, resulting in a total value of Rs. 13,20,000. Since the company already had a security deposit of Rs. 10 lakhs, the remaining balance to be paid was Rs. 3,20,000. The Rs. 10 lakhs previously paid as a security deposit has now been adjusted against this purchase. This means that the security deposit with JS Steel is now zero in the asset side of the balance sheet and the cash/bank account balances decreases by Rs 3,20,000 only.

Further, an additional Rs. 50,000 was paid through the bank. While this does reduce the company's assets (bank balance), it's important to note that transportation costs are typically included in the

cost of the raw material and when we account for the cost of raw material we only indicate the landed cost. This means that the Rs. 50,000 will be considered part of the cost of raw material itself. So, the landed cost per tonne of the HR steel, including transportation costs, is Rs. 34,250. This is the value at which the steel will be issued for production..

**April 17, 2020:** Order received from walk-in customer Modern Barrels for 12 tonnes HRPO at Rs. 39000 per tonne. Received an advance of 10% of the amount through a bank transfer. The order to be processed and delivered on April 25, and customers settled the balance on the same day through RTGS.

### ***Transaction Analysis***

As of today, the company has received an order from Modern Barrels. The value of the order is calculated as 12 tonnes multiplied by Rs. 39,000 per tonne, totaling Rs. 4,68,000. The company has received an advance payment of 10% of this amount, which is Rs. 46,800. This advance payment has increased the company's bank balance accordingly. However, it's important to note that this advance payment is not considered the company's money until the order is executed. If the order is canceled, the company is liable to return the advance payment. Therefore, as of today, this advance payment is recorded as a liability under "Advance from Modern Barrels." We will address the execution of the order and the payment through RTGS on April 25th.

**April 18, 2020:** While processing the above order, a 25-tonne HRPO lot from Tat Steel was found rusted. Rishi spoke to the Tat Steel plant immediately, and upon further inquiry, they agreed to take back the 25 tonnes of damaged material. However, they would only be able to process the refund as a credit note.

### ***Transaction Analysis***

On April 18th, 25 tonnes of damaged material were returned to the supplier, Tat Steel. Instead of receiving cash, TR Steel will receive a credit note to be adjusted against future purchases. Until TR Steel makes another purchase and uses the credit note, the money remains with Tat Steel. As a result of the return, TR Steel now only owns 20 tonnes of HRPO out of the 45 tonnes originally purchased from Tat Steel. The returned material is no longer in TR Steel's ownership. Therefore,

the inventory balance will be reduced by the value of the returned material, which is 25 tonnes \* Rs. 35,000 per tonne = Rs. 8,75,000.

Tat Steel will issue a credit note to TR Steel for the value of the returned material, calculated as 25 tonnes at Rs. 35,000 per tonne, totaling Rs. 8,75,000. This credit note will be recorded as "Credit Note from Tat Steel" on the assets side of the balance sheet.

If TR Steel incurred transportation expenses, it would be recorded as an expenditure, reducing the bank balance. However, if Tat Steel arranged and paid for the transportation, it would not impact TR Steel's balance sheet. Here, it is assumed that Tat Steel arranged for the pickup of the damaged material as per the purchase agreement, so transportation costs are not included as an expenditure.

**April 23, 2020:** Sundry expenses incurred regarding logistics amounting to Rs 65,000 paid from the bank.

### ***Transaction Analysis***

These expenses likely include costs associated with transporting goods, as well as other miscellaneous expenses such as manual labor. Sundry expenses are miscellaneous in nature. So, on April 23rd, when these expenses were incurred, they were recorded as an expenditure of Rs. 65,000 in the income statement. The bank balance was also impacted because the expenses were paid from the bank account. Therefore, the bank balance decreased by Rs. 65,000.

**April 25th, 2020:** TR Steel delivered 12 tons of HRPO to Modern Barrels in accordance with the transaction initiated on April 17th

### ***Transaction Analysis***

On April 25th, TR Steel delivered 12 tons of HRPO to Modern Barrels in accordance with the transaction initiated on April 17th. As a result, TR Steel utilized 12 tons of HRPO, reducing the remaining stock to 8 tons, with a calculated cost of 12 tons \* Rs. 35,000 per ton. The sale to Modern Barrels, at Rs. 39,000 per ton as per the previous agreement, resulted in a total sale value of 12 tons \* Rs. 39,000 per ton, which equals Rs. 4,68,000. This transaction impacted the accounts by reducing the inventory asset due to utilization and generating revenue from the sale. The bank

account reflects the amount received from Modern Barrels, which is the total sale value minus any advances received earlier.

**April 29, 2020:** Withdrew cash from the bank for meeting petty expenses of Rs. 5,00,000

***Transaction Analysis***

The bank balance decreased by Rs. 5,00,000 as a result of the withdrawal, with the withdrawn amount now held in cash in the company's cash box, leading to an increase in cash holdings. This withdrawal was utilized to cover petty expenses exclusively and did not entail any additional financial transactions.

**April 30, 2020:** April salaries credited to the employees and directors accounts. The four employees for manual labour were paid in cash. Other petty expenses of Rs. 5780 were settled in cash. An electricity bill of Rs. 22,500 was paid through cheque.

***Transaction Analysis***

A shed manager with a monthly salary of Rs. 20,000 and a watchman with a salary of Rs. 8,000 were also paid, leading to a decrease in the bank balance. Four manual laborers were hired at Rs. 8,000 each, totaling Rs. 32,000, and their salaries were paid in cash, resulting in a reduction in cash balance. Additionally, other petty expenses amounting to Rs. 5,780 were settled in cash, further reducing the cash balance. Lastly, the electricity bill of Rs. 22,500 was paid through a cheque, which decreased the bank balance. Further, all the expenses will be reported under the expenditure side of the income statement.

**April 30, 2020:** Loan Interest payment made to ICIC Bank for the month of April 2020. Rent for the month of April was debited for the Factory shed.

***Transaction Analysis***

Regarding the loan interest payment to ICIC Bank, the interest is payable monthly at 11 percent on a loan of Rs. 22,80,000. The interest for April is calculated based on the entire month, considering the loan was sanctioned at the beginning of the month. The interest amount is calculated as 11 percent of the loan amount of Rs. 22,80,000, divided by 12, resulting in Rs. 20,900, representing the interest for one month. This interest payment further decreases the bank

balance and is considered an expense in the income statement. In addition to the rent and loan interest payment, depreciation is another factor to consider.

## **Depreciation**

Depreciation refers to the reduction in the value of an asset due to usage and the passage of time. For instance, if you purchase a new car but leave it unused for two years, its value will decrease when you try to sell it, even though it was not utilized. This reduction in value occurs because newer models become available over time. Similarly, if you use a car for two years before selling it, its value will further decrease due to both usage and the passage of time.

In this case, the decoiling machine, shearing machine, and office equipment were purchased for Rs. 42 lakhs, Rs. 15 lakhs, and Rs. 1.5 lakhs respectively. The depreciation is calculated as follows:

### **For the Decoiling machine:**

- Original value = 42 lakhs
- Salvage value = 4,80,000
- Depreciation period = 12 years (depreciated monthly)
- Depreciation per month =  $((\text{Original value} - \text{Salvage value}) / (12)) / 12$
- =  $(42 \text{ lakhs} - 4,80,000) / (12) / 12$
- $\approx 25833.33$

### **For Shearing Machine:**

- Original value = 15 lakhs
- Salvage value = 90,000
- Depreciation period = 12 years (depreciated monthly)
- Depreciation per month =  $((\text{Original value} - \text{Salvage value}) / (12)) / 12$
- =  $(15 \text{ lakhs} - 90,000) / (12) / 12$
- $\approx 9792$

### **For the office equipment:**

- Original value = 1,50,000
- Depreciation period = 3 years (depreciated monthly)

- Depreciation per month =  $((\text{Original value} - \text{Salvage value}) / (3)) / 12$
- =  $1,50,000 / (3) / 12$
- $\approx 4166.67$

The value of each asset is reduced by the monthly depreciation amount calculated above. This reduction continues throughout the year until the end of the depreciation period. Further, the depreciation amount is also shown as an expenditure in the income statement.

### **Financial Position at the end of April**

The income statement and balance sheet for the April period are depicted below in Tables 1 and 2. Regarding the income statement, it indicates a loss of over 200,972. The capital provider bears this loss. Consequently, the net worth, which was five crores, has decreased to about 4.9 crores. Net worth is the total of equity plus retained earnings. Alternatively, it is the total assets minus the liabilities, representing the value of equity. The reduction in net worth is attributed to the loss incurred during this period.

**Table 1: Income Statement - April**

Income Statement of TR Steel from April 1, 2020 to April 30, 2020			
Revenue		Expenditure	
25 ton Job work for GS @ 1000 per ton	25,000	20ton for CR used for Dulite	8,20,000
20 ton of CR to Dulite @ 51000	10,20,000	sundry expenses	65,000
12 ton of hrpo for modern barrel	4,68,000	12 ton hrpo for modern barrel	4,20,000
		Director's salary	1,40,000
		accountant salary	20,000
		stock manager salary	20,000
		foreman salary	30,000
		shed manager	20,000
		watchman salary	8,000
		manual labor salary	32,000
		petty expenses	5,780
		electricity bill	22,500
		rent for factory shed	50,000
		interest on ICIC loan @ 11%	20,900
		<b>Depreciation</b>	
		decoiling machine	25,833
		shearing machine	9,792
		office equipment	4,167
	15,13,000		17,13,972

Profit before tax	-2,00,972
Less: Tax	0
Profit after tax	-2,00,972
Less: Dividends	0
Retained earnings	-2,00,972

**Table 2: Balance Sheet - April**

Balance Sheet of TR Steel as on April 30, 2020			
Asset		Liabilities & Equity	
Decoiling machine	41,74,167	GS's equity holding 50 lakh shares @ 5 each	2,50,00,000
Shearing machine	14,90,208	Tanay's equity holding 25 lakh shares @ 5 each	1,25,00,000
office equipment	1,45,833	Rishi's equity holding 25 lakh shares @ 5 each	1,25,00,000
		Retained earnings	-2,00,972
		NET WORTH	4,97,99,028
(95-20) ton of CR steel@41000	30,75,000	loan from ICIC bank @ 11%	22,80,000
(45-25-12) ton HRPO @ 35000	2,80,000	Loan from GS for machinery	34,20,000
40 ton of HR @ 34250	13,70,000		
		advance from modern barrels	-
Bank	4,25,81,600		
cash	4,62,220		
Security deposit with JS steel	-		
Receivables from GS for job work	25,000		
receivable from dulite	10,20,000		
credit note from Tat steel	8,75,000		
	5,54,99,028		5,54,99,028