Financial Statements Analysis and Reporting
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Lecture - 10
Financial Statements - Income Statement

Welcome students. We were discussing in our previous lecture about the preparation of the financial statements. And we learnt that how to prepare the first part of profit and loss account, that is the trading account and we will extend that account today, and then we will try to know the how to prepare the profit and loss account.

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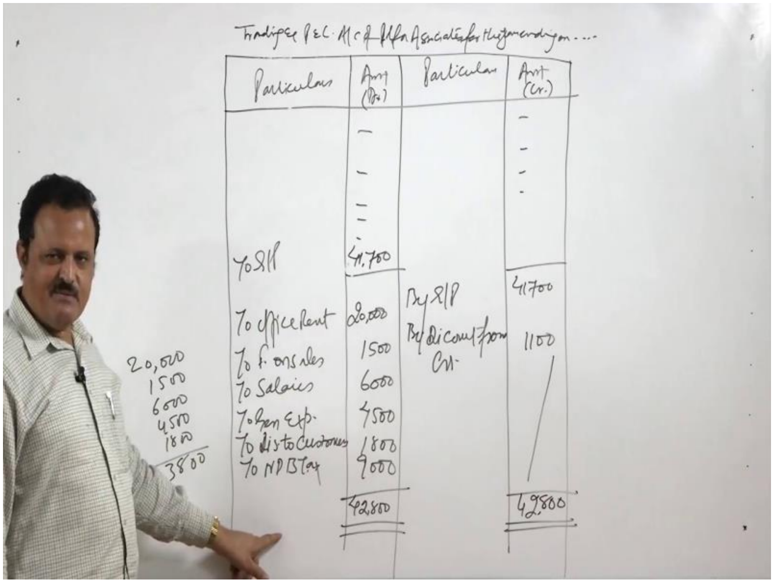

Again I am making the same format, which we made yesterday, by having two equal halves and we will prepare this account we will continue. So, we are again writing it trading and profit and loss account of Alfa associates for the year ending on, if the year is given to you can write here that for the year ending on this much. We are not given any year here. So, we can have these different columns and the statement can be prepared.

So, again as I made it yesterday we are going to have the same statement. We are going to have here particulars, this is amount again particulars and amount. So, this is the debit side and this is the credit side. So, when we prepared the trading account yesterday, we arrived at one figure here after putting certain figures here and two figures here or two or three figures here, we arrived at some figure and that figure was the two gross profit called as G P and the figure of the G P was 41,700 that we found out gross profit, because it is not the final profit to the owner of the or the owners of the firm, this is the gross profit against this, if we will subtract some more expenses and we will add some more incomes. So, that profit will be finally, calculated.

So, now this gross profit will be, because it is a income excess of income over expenses. So, we will be brought to the income side now. So, it is we will begin with the profit and loss account by transferring this gross profit to this side which is 41,700s by gross profit. This is the first income in the profit and loss account and we will take about the other heads of incomes means those items which have not been covered so far. We have already taken the sales; we have already taken the purchases so forget it. We have already taken the wages, ignore it, we have taken the factory rent, already done, we have not taken the office rent.

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Problem 1: Financial statements

Ascertain Gross profit and Net profit from the following balances extracted from books of Alfa Associates.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Sales	1,60,000	Purchase returns	4,000
Purchases	91,300	Sales Returns	5,000
Wages	18,100	Salaries (office)	6,000
Rent – Factory - Office	3,000 2,0000	General Expenses	4,500
Freight - Purchases Sales	3,000 1500	Discount from creditors	1,100
Opening Stock	24,000	Discount to customers	1,800
Closing stock	22,100		

So, first head of indirect expenses to office rent and this office rent in this case is 20,000 rupees, this is office rent 20,000 rupees and then we have we have already taken the freight on purchases. So, we will take now the freight on sales to freight on sales, it is an indirect expense and freight on sales is 1,500, then we have opening stock, we have already done closing stock, we have already done purchase returns, we have already factored sale returns, we have already factored. Salaries yes now we will take the salaries this is again indirect expense to salaries to salaries and this is 6,000 rupees, then we are left with general expenses. To general expenses, these general expenses are 4,500s, then we have one item discount from creditors discount from creditors is the discount earned or income earned.

So, we will write in the income side by discount from creditors and this is the income, discount means it is discount earned, means to whom we had to pay. We have got the discount from those customers and those creditors this amount is income of 1,100 rupees and then as we have this firm has received the discount; they are also paying the discount to their buyers. So, this is discount to discount to customers to discount to customers. So, this amount is 1,800 rupees right. So, almost we have now covered all items. We have taken the sales, purchase, wages, in the trading account in our previous lecture. Then we have taken the factory rent, we have taken the freight on purchases, we have taken the freight on sales today, opening stock is already done, closing stock is already done, purchase return is taken in the previous discussion, sales return is also done in the trading account, salaries we are taking today, general expenses we are taking today, discount from creditors we have taken today, and then discount to customers we have taken in the profit and loss account.

So, now we have to total it up and see that which side is bigger and which side is small. So, I think this side seems to be bigger. So, income side is more than the expense side. So, it means this is 00 this is 8 this is 2. So, this total of this side is 42,800s. This is 42,800s should has to be, this account has to be balanced like ledger account. So, this is net profit before tax, because we are not given the tax information so far, so, it is net profit before tax to be paid to the government. So, how much it is? We will total it up on a separate page this is 20,000 then it is 1,500 then it is 6000s it is 4,500 and this is 1,800. So, this total works out as 000, then it is 812831 and it is 3. So, it is 33,800s.

So, total of the credit side is 42,800s and this side is 33,800s. So, it means the net profit is 000 9000 rupees. So, net profit before tax is the 9000 rupees. So, this may be prepare the trading and profit and loss account. We generally call it as a profit and loss account, but it has two parts; first part is the trading account, which explains us about the direct incomes from the business. It means how the direct income is possible we have taken yesterday, in our previous lecture that is the sales return and then we have taken the closing stock, here these are the sources of the incomes and to generate that income how much expenses are required to be incurred here we have taken the raw material, we have taken the wages, we have taken the other expenses, we have taken the purchase return also. So, we have calculated the difference that income minus expense is the gross profit.

So, basic difference between these two statements is here you take the direct expenses; here you take the direct incomes. Direct expenses are those expenses without which no business is possible. For example, any firm is a manufacturing firm, any firm is manufacturing color TV’s. So, whatever the expenses they are incurring for buying of raw material or paying the wages to the worker on the plant and then the say, any other kind of home heads; like lighting, lubricants, oiling, fueling of the plant, and everything those expenses are called as direct expenses, means without which, any expense without which the production is not possible those expenses are called as the direct expenses and the output of those expenses is in terms of the sales.

How much we have directly earned from the business that whatever the products we are manufacturing in this firm, how much we have earned by selling that in the market, number one and if there is something left unsold which will be sold in the future period that will be, this is the total output this is the total input and the output minus input income minus expense is the gross profit, but this profit as I told you earlier is not the final profit against this profit we have to subtract some other expenses which are called as indirect expenses and we have to add some other incomes, which are called as indirect incomes.

So, we are transferring this profit, because the profit is a positive figure, we are transferring it to this side. So, this is the first head of income and then we have added indirect income here discount from creditors. So, discount earned from creditors this is not a direct income to the companies, it is not the direct income from the business. It is some discount given by the suppliers, to whom we had to pay, they have given some discount. So, this is discount is also income, discount earned is also income. So, we have to add this indirect income. So, total direct income plus indirect income is the total income and then from the total income you have to subtract some indirect expenses.

Why we call them indirect expenses, because without even these expenses production will be possible. You can produce the product and you can for supporting the business, you need these expenses to be incurred that are why they are called as indirect expenses. Upper part of expenses we discussed in the previous lecture are the direct expenses and then we calculate these are the indirect office rent. Even the office is not there you can have the production in the factory. Even you have that freight on the sales; you do not pay the sales freight on the sales. So, you cannot sell, but you can go for the production. So, freight on the sales is indirect expense. Similarly, salaries to the employees working in the office are indirect expense, general expense, and indirect expense. Discount given to customers is kind of a loss.

So, since this account is a nominal account profit and loss account is a nominal account. So, we take that loss into account here and that is means we are debiting profit and loss account, being a nominal account with all expenses and losses and we are crediting with all incomes and gains. So, it is an income, it is a gain, it is expense and this is a loss. So, we are debiting it finally, the net result is total of the income and gains minus total of the expense and losses is the net profit before tax. We have not paid the tax to government; this company Alfa associates has not paid any tax.

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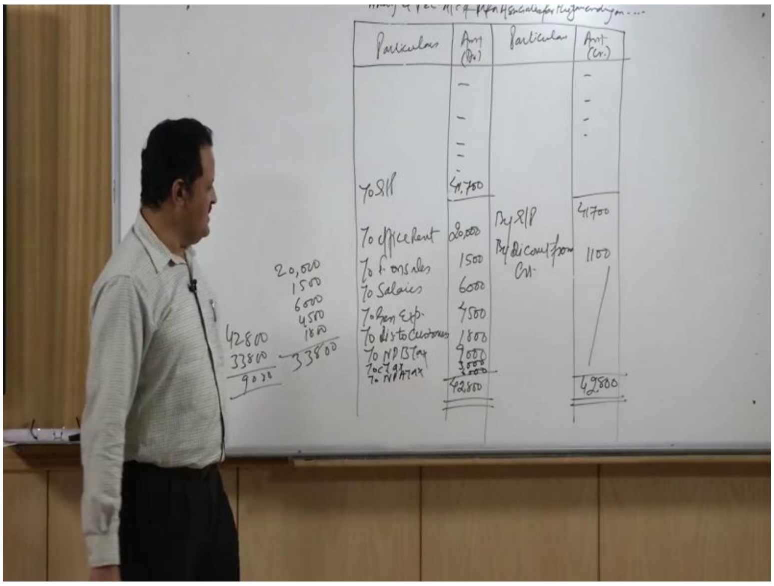

So far of this profit, if it comes in the purview of the tax, we will have to pay the tax on this and then finally, for example, here the tax is we assume the tax corporate tax is 3,000 rupees. So, your net profit to net profit after tax will be 6,000 rupees.

So, we will have to make the provision for the tax also, if the tax is to be paid, but if the no tax is to be paid, and then you can say that even 9,000 is the net profit after tax. So, this is the initial means learning about how to prepare the financial statements and how to prepare the first set of financial statements that is the trading and profit and loss account and then we will be talking about the other financial statements. So, just to help you to learn it properly, I would take up another small problem and there in that problem we would learn from the beginning and in this and go up to balance sheet. If you look at this problem the information given here we have already taken care of and we have only prepared the trading and profit and loss account or you.

Finally, can say it is called as profit and loss account also, it is called as income statement also. So, we have been able to prepare only income statement not the balance sheet, because the information given here is only sufficient for preparing the trading and profit and loss account, but balance sheet cannot be prepared. So, now we will learn, how to prepare the balance sheet means including the trading and profit and loss account and the balance sheet.

So, that it is clear to you, how to prepare the financial statement that is the first initial two statements that is the profit and loss account and balance sheet. So, now, we will take up another problem and we will try to learn that how to prepare the balance sheet that is the profit and loss account and balance sheet, we will learn to prepare both. So, this is the, first we did a very simple problem now we will also do another one, but we will prepare all the three statements trading and profit and loss account and balance sheet and for that I have another problem for you.

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Problem 2: Financial statements

The following balances are extracted from the books of Kautilya & Co. on 31st Dec., 2011. You are required to prepare the Trading and Profit & Loss Account and Balance Sheet as on that date:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Stock in 1st Jan., 2005	500	Return outwards	250
B/R	2250	Trade Expenses	100
Purchases	19,500	Office Fixtures	500
Wages	1400	Cash in Hand	250
Insurance	550	Cash at Bank	2375
Sundry Debtors	15000	Rent & Taxes	550
Carriage Inwards	400	Carriage outward	725
Commission (Dr.)	400	Sales	25,000
Interest on Capital	350	Bills Payable	1500
Stationery	225	Creditors	9825
Return Inwards	650	Capital	8950
Commission (Cr.)	200		

Closing stock was valued at Rs 12,500.

And this problem is now, again we have some extended version of this problem and we will prepare from this statement. This statement you can call it as trial balance also and what trial balance we learnt in our previous discussion previous lecture you can say these are the balances taken out in the form of the trial balance and we have this information available with us and you can prepare from this statement that trading and profit and loss account and the and the and the balance sheet.

So, now we will, as we did it in our the previous lecture prepared the trading and profit and loss account, in this case also first we will prepare the trading and profit and loss account and then we will prepare the balance sheet. So, now, again do it and let us prepare the trading and profit and loss account and the balance sheet. So, here we talk about that, we start with the, as I started with the raw materials.

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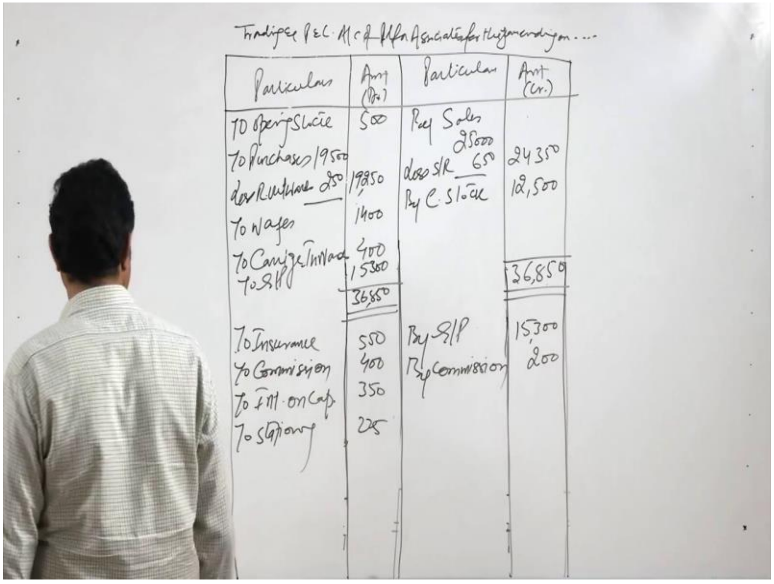

So, we will again start in this case that is with the raw material and the raw material in this case we start with these are to opening stock and the opening stock is the stock on 1st January is 500 rupees, this is the again we have taken material wages and other direct overheads we will be taking here, then we will be taking to purchases and our purchases are here we will put it in the inner column 19,500 and then, if there is any purchase return we will have to look for the purchase return also and here it is written that is return outwards. Return outwards is another name for the purchase return. We have to subtract it less return outwards return outwards and this amount is 20,050. So, part of the purchases we had, total purchases we had part of the purchases we returned. So, final balance of purchases is 19,250 this is purchases. So, purchases we had total material opening stock first we will consume, then we will purchase from the market part of the material is returned.

So, finally, we consume the material 500 plus the material for 19,250 rupees. Then the second head of the direct expense in the trading account is to wages. So, wages is one 1,400 wages is 1,400s, then we have any other direct expense, insurance is not a direct expense, it is indirect. We will take later on sundry debtors not, carriage inwards not, carriage inward is a carriage on purchases yes to carriage inwards, carriage paid on the material coming in.

So, purchases are coming in. So, carriage inwards is 400 rupees, then commission is indirect, interest on capital is indirect, stationary is indirect expense, return outwards is return inward is the sales return. So, we will take later on, commission is not now, return outward we have already taken, trade expenses indirect expenses, office fixtures, asset cash in hand not, rent taxes, carriage outward we have not to take, sales now, we have to take. Yes, on this side we have to take the sales, by sales.

So, sales figure is by sales and sales figure is 25,000 rupees, sales is 25000 rupees and we have now, I think sales returns also. So, that is returns inwards, returns inwards is this is 6,650 rupees. So, less sales returns S R 650 rupees. So, it is 24,350 rupees is our sales figure finally, and here closing stock we have to take and the closing stock is given here. So, closing stock we have to take that is by closing stock and this amount is 12,500, closing stock is 12,500.

So, total is 058, it is 6 and it is 6. So, it is 36,850 is total of income side and here also we have to make it equal. So, it is 36,850 and then it is to G P gross profit. The difference of this minus all these expenses is the gross profit and here we have to take the expenses like we have taken the 500 rupees, then we have to take the other expenses that is 19,250, then it is 1400. 400 we have already taken and now the balance is the gross profit which is called as 15,300 rupees.

So, total of both the sides is 36,850. So, we have taken here and we have prepared the trading account as we did it in the previous problem. In this problem also we have prepared the profit and loss account and now, we will move forward to prepare we have prepared the trading account we will move forward prepare the profit and loss account. So, it is by G P. G P will be now coming to the credit side and this credit income is credit side is 15,300 is the gross profit, which we have taken this side. So, now, we will be taking about the talking about the other heads of expenses and incomes.

So, now we have to take all indirect expenses. So, if you take all indirect expenses here, stock you have taken there we will not take. So insurance, here first is to insurance, this amount is 550 rupees. This is the insurance expense, insurance premium. Sundry debtors we will not take, carriage inwards we have taken, commission yes, commission paid is we have to take; this is the commission, because this is the debit balance. Debit balance means commission given by the firm.

So, it is kind of expense. So, it is 400 rupees commission, then we take the interest on capital, yes to interest on capital interest paid on capital is the interest on capital and this amount is 350 rupees, we will take it. Then we have the expense to stationary, stationery we have purchased is for 225 rupees, then we have to take the return inwards. We have already taken that 650 commission credit yes, this is the indirect income, by commission received now; this indirect income commission credit is 200 rupees.

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Then is the return outward trade expenses; again to trade expenses and the trade expenses are 100 rupees. Then we have office fixtures no, cash in hand no, cash at bank no, rents and taxes yes, then we have to rent and taxes.

So, it is 550 rupees and carriage outwards yes, to carriage, this is carriage on sales carriage outwards. So, carriage outwards is 725 rupees, then is the sales we have taken bills payable not take creditors and capital we will not take. So, I think this is the total of our indirect incomes, the total of direct and indirect incomes and this works out as 0 0 5 5 and this 15,500 rupees is the total of the indirect incomes, 15,500 rupees and now we will have to calculate our net profit and net profit in this case will be that is 12,600 rupees which is, now the total is 15,500 rupees.

So, our net profit is you can call it as before tax, if there is no tax, and then it is after tax next profit after tax is this is 12,600 hundred rupees which is the final result of the business, which is available to the owner of the business. So, this is how we prepare the profit and loss account. We did discuss in the last part of the discussion also. We are discussing it today also. So, I think we have done two problems to prepare the trading and profit and loss account. So, how to do it we have already done it and I think you must be clear to some extent by now that how we prepared the trading and profit and loss account. So, you must be wondering here, that I have taken some of the items here and some of the items here, but not all the items.

So, what is the logic which items I have taken and which items I have left out. Items I have taken is, because this account is only nominal account, in profit and loss account is a nominal account where we only take the expenses and losses this side, incomes and gains this side right. So, we have taken all expenses and losses given here and incomes and gains given in this statement and we have prepared the profit and loss account with the help of all expenses and losses and incomes and gains. The items which I have left out are they are called as assets and second is the liabilities. So, assets and liabilities are not to be taken in the income statement, they will be taken into the balance sheet.

So, for example, we have bills receivables they are assets. What are these I will discuss with you in the next lecture? Similarly, you talk about the sundry debtors again asset similarly, if you talk about the other say other things like cash in hand, cash at bank is asset. We will be taking that in the balance sheet similarly, if you talk about the bills payable they are the liabilities and likewise is the creditors they are also liabilities and capital is again a liability on the business.

So, I will be taking all these assets and liabilities in the next statement that is the balance sheet and in the profit and loss account. So, far we have taken into account all expenses and losses of this side and all incomes and gain on this side and net result is first is the gross profit and finally, it is the net profit. And next thing is that we have to learn how to prepare the balance sheet that I will be doing in the next lecture.

Thank you very much.