Financial Statements Analysis and Reporting
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Lecture - 04
TRIAL BALANCE & its Relevance

Welcome students. In my last lecture, I was talking to you about the accounting process and I discussed with you first three steps in the accounting process. First was transaction, second was journal, third was ledger, and the purpose of these journal and ledger I also discussed with you. And then the fourth thing I talked to you was, trial balance, that why we prepare the trial balance. Trial balance is basically a check of recording the transactions, and it is basically, when you prepare the trial balance, you make sure that the books of, means the business transactions have been properly recorded in the first two books of accounts. Means, they are properly recorded in the journal, they are correctly posted to the ledger, and the total of the debit side is equal to the total of the credit side.

And trial balance is basically a intervening statement, between the first two books; that is journal and ledger, and the next two books; that is the profit and loss account and the balance sheet. These are not books, but these are the statements. So, from the first two books that is from the journal and the ledger, by making sure that total of the debit is equal to the credit, you prepare the important financial statements; that is the profit and loss account and the balance sheet. And these are the very important two statements for the business; profit and loss account and the balance sheet.

In the profit and loss account what we do. We record on the one side total expenses happening in the business, and on the other side we record the total incomes of the business, and then we sum up. We total the credit side that how much incomes we had in the business by sales of the goods and services. On the other side we total how much expenses we incurred to generate those goods and services, and then we balance this account, we try to find out that what is the total of the credit side, and what is the total of the debit side; means how much income we have generated out of the expenses we incurred, and what is the difference. And the difference if the income side is bigger than the expense side, then the difference is the profit if it is vice versa, the expense side is bigger than the income side the business is in the state of loss.

So, I will take you to the format of the profit and loss account, and then we will come back, say this is the format of the profit and loss account.

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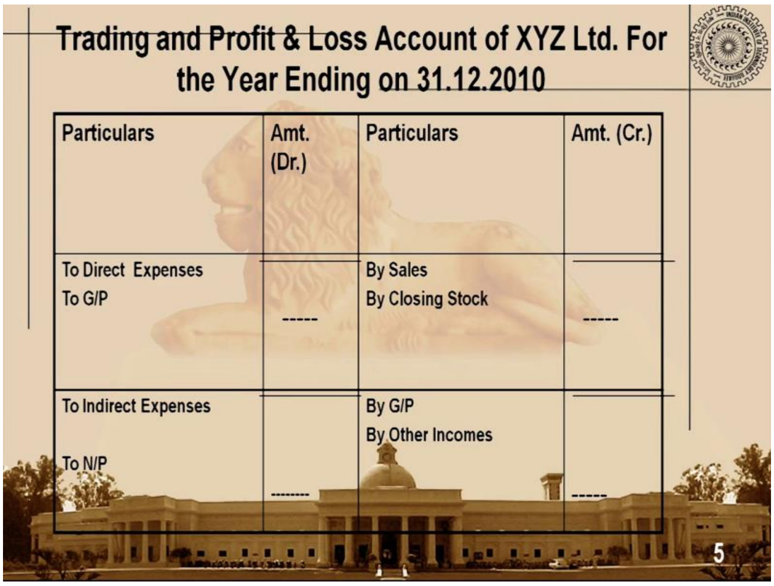

I have written here trading and profit and loss account of one company assumed X Y Z Limited, for the year ending on 31st December 2010. Now it can be any date, as I told you the accounting period concept, it can be 31st December, it can be say 30th June, it can be 30th September, anything. So, it means it has to be any period of 12 months. Business is free to choose that period that their one year's period, 12 months period can begin on any date, and after 12 months and that is not certainly to be a calendar year financial year, or any other, it has to be any period of 12 months.

Now, we are writing here trading and profit and loss account. You have to be careful about this title. Trading and profit and loss account of the X Y Z Limited for the year ending on. Please this statement which you are preparing, this is going to depict the results of the business for a period of; that is for the year ending, that is means for a period of 12 months, and in this case say for example, there the 12 months period is the calendar year; that is beginning on the 1st January ending on 31st December, and this is the total this statement is depicting the profit or loss situation of the business for the period of one year. This is the profit and loss account.

Now, I am writing here it as a trading and profit and loss account, what does it mean? This statement has two parts; this is the upper part, this is the names, particulars, amount, debit column, particulars amount credit column right. Now in this case we have this side which is called as the debit side. Now when we talk about this side, this is the debit side, this is the credit side. On the debit side I am putting what. It is the direct expenses, and here it is written as direct expenses. I have written these side two items, sales by sales, and closing stock. So, this side whatever the items you write here, we denote them with to, and the items we put this side we denote them by right. And this side is the expense side. So, all the direct expenses, and this side is the credit side, so all the incomes.

So, there are only two direct incomes to the business; one is income from the sales, and second is the income which will happen in future from the stock, which is a closing stock which we have not sold in the market. So far we will be selling it tomorrows income, means the current income which already has come to us, and means the sales which I have already made income from the sales, and the income from the sales to be made when this stock will go to the market. So, total this is the output side and this is the input side as a input side is say direct expenses, and when you talk about the direct expenses, we generally have only three direct expenses in a manufacturing concept, three direct expenses not more than that.

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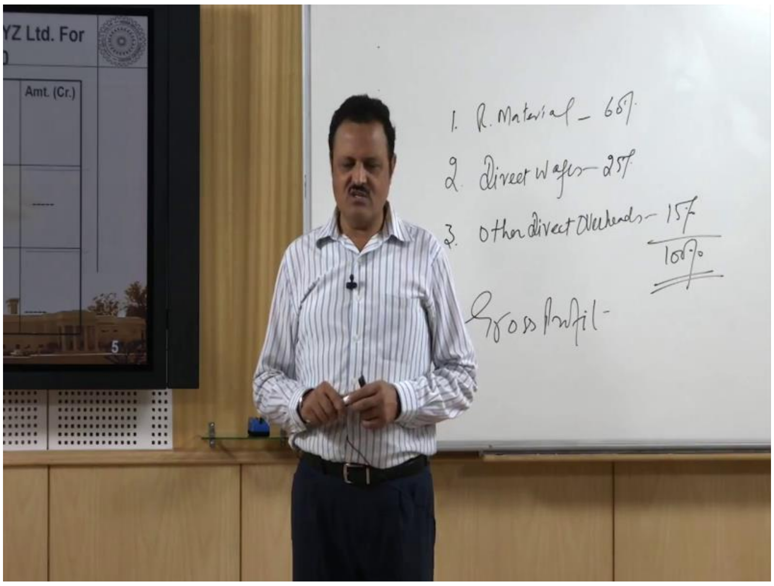

It means these three direct expenses are what. First is the raw material this is the first head of the direct expense, major chunk of the raw material expenses on account of the raw material, this is somewhere about 60 percent of the cost of production. Then you have the second that is the direct wages, wages means which are to be paid to the workers working on the plant, who are the daily wage workers, they are not permanent employees. If they are permanent employees' indirect expense, and if the workers were working on the plant, they are called as the workers, and whatever the payment you make to them that is called as the direct wages. This component is normally say, you can call it as 20 to 25 percent.

And then the third head is the other direct expenses, or other direct, you can call it as other direct overheads, these are other direct overheads which is the remaining part 10 to 15 percent and this way it becomes 100 percent of all your expenses. These are the three direct expenses. Why we call them direct expenses, because if you do not incur these expenses you would not be able to have any kind of the finished production. Raw material if it is not there, no production is possible, if the workers to run the plant if they are not available, plant will not run.

Similarly other direct overhead means power lubricants, oils, water. So, many other things are required in the plant, and the expenses on those are the direct overheads, they are also direct overheads, because if you do not have power you, your factory will not run, if you do not have water, sometime the manufacturing process will not work, some oiling lubrication some other kind of the inputs are there, if they are not there in the plant, your plant will not walk. So, these three are the direct expenses. So, we only put in the trading account, upper part, up to this part is called as, this part, this part to this part is called as the trading account.

Trading account is basically a comparison of direct income with the direct expenses, and direct incomes are from the two out, means from the total output and the expenses are these three, and the difference if this side is bigger, this side is smaller, which normally should be in the business, in that case the difference is to G P, G P is gross profit, G P is the gross profit, G P is not the final profit, it is not the final divisible profit, it is not the final profit to be enjoyed by the business, it is the gross profit, gross part of the profit it is the gross profit.

From this profit some other expenses also have to be subtracted, and then you will be left with some profit which will be called as the net operating profit after paying the tax, which is called as no pat. So, first we learn about the first part of the profit and loss account, and that account is the trading account. So, trading account having the 5 items; 2 items on the credit side, 3 items on the debit side, difference if this side is bigger than this side, in that case the difference is the gross profit.

Now, this gross profit is only, because the income side is bigger than the expense side it means, this balance should have a credit balance, this gross profit is basically a credit balance item, because of this side, this figure has appeared. So, now, we proceed further to the next part; that is now we are moving from the trading account to profit and loss account. So, first thing we have to do is, this item G P has to be brought to this side; that is by G P, because it is basically a credit item, it is not a expense it is a income, and this has appeared, because this side was bigger than that side. So, we have now brought this income to the credit side, because this is a real place for this, and now from this gross profit. In this gross profit, this is the direct income from the business, because business is a manufacturing firm. So, the first outcome is the direct gross profit, and first head of the income is the gross profit, then the other incomes are also added in this, which are called as indirect incomes.

Business does not have only direct incomes that they are manufacturing a process. So, they are a manufacturing concern. So, they only manufacture the product in the market and they have, they are selling it in the market. So, they are getting the profit only from the manufacturing. They might have some other say heads of indirect incomes also, and those heads off direct incomes are; like for example, business has surplus cash, and that cash is invested in the market. Now that investment is called as investments of the firm and any interest, which is accruing on those investments is the income which is not the income from manufacturing business, but from the investments. So, this is other income right.

Then we have for example, business has some surplus buildings, they are not used by the business, they are not required in the business. So, those surplus buildings are rented out. So, business is getting income from those buildings, and that income is called as rent.

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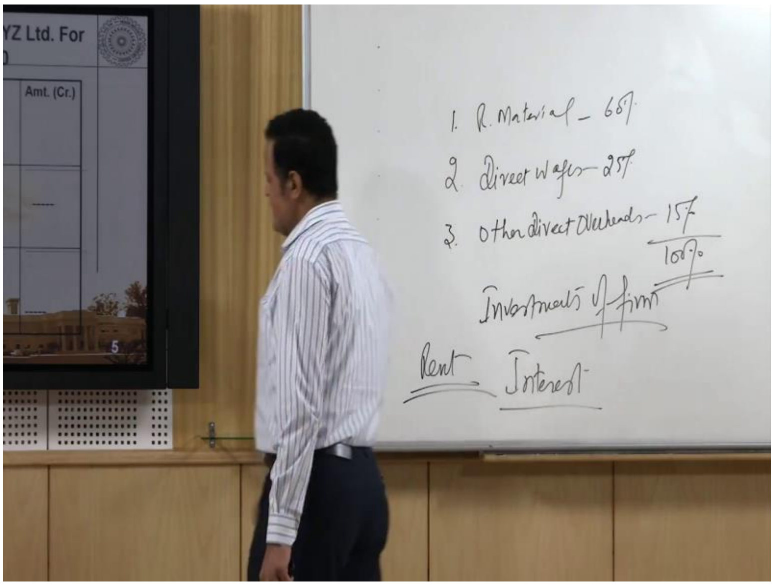

So, rent will also be the indirect income. Similarly for example, this business is very good in their manufacturing process, and they have some patents, and patents are given rented out to some other firms who are using their technology. So, they are getting back some royalty. So, that income from the royalty will also be added here.

Similarly, the business has, this business has trained the employees of the other business. So, in terms, in lieu of that training this business is giving to the other firm employees that the other firm will pay to this firm, and that is called as the income from the trading, in the technical sense we call it as apprentice premium. So, apprentice premium will also be the other income. So, many other incomes will be added here, this side will be having number of items. So, first sort of income is from the direct incomes; that is from the manufacturing process, because the firm is a manufacturing organization, and the other head of incomes are indirect incomes, which are coming from the other avenues of the, say earnings incomes, say investments rent, interest on investments, rent on building, apprentice premium, the royalty on the patents or something like that, all these have to be put on this side.

Now, this side you come to this side, when you come to this side in this case we put the other expenses. So, it means for running a business, manufacturing something and selling in the market, you do not need to incur only direct expenses; that is only by having this the material labor, and other direct overheads you can run the business; no. You have to incur so many other expenses also, and those expenses are called as indirect expenses. Here are those expenses; these expenses are called as indirect expenses. Say for example, now apart from the factory this firm has a office and employees working in the office which are normally of the permanent nature. Whatever the payment we make to those employees, they are called as the white collar employees, and workers working on the plant are the blue collar employees.

So, those white collar employees have to be paid the salaries, and they call them indirect expense, because even if office employees do not come to the office, they do not attend the office, nobody is coming, and the plant is going on, still the production will take place. So, this is a facilitating process, office is a facilitating process, whereas, the workers are directly helping to manufacture, convert those raw material into the finished product, so that is a direct expense. So, indirect expense like salaries of the employees, stationary unit, telephone you have, so you are paying expenses for that you have, so many assets, so you have got them insured, so insurance are the expenses.

Similarly you talk about the depreciation as I talked to you, depreciation is a indirect expense. So, so many other indirect expenses are there, which have to be put on the debit side, and all these direct and indirect incomes, G P and other indirect incomes on the credit side, and again like this statement you have to balance this statement also. You have to see the total of this side one, and the total of this side two. If this side is bigger than this side then like G P, here then now the difference is net profit 2 and 3, here I have written only 2 N P, but basically it is called as net profit before tax, or you can call it as net operating profit before tax.

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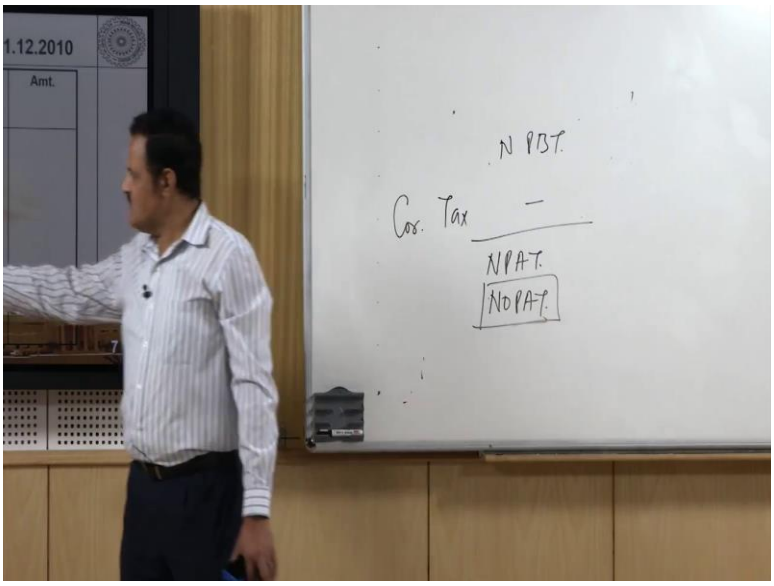

This is net operating profit before tax, or sometimes you can write it as N P B T also; net profit before tax, because whatever the profit business earns, whatever the income business earns, business has to pay the tax on that profit to the government, so that will be, and after that write here, we will pay the tax to the government, which is called as corporate tax. And if you have to subtract the corporate tax from here, then you are left with the net profit after tax, or it is called as the net operating profit after tax. So, you have to calculate this one.

So finally, what I have written here is, I have written here is two n p. So, it is that is to net profit, net operating profit after tax. So, this way your trading and profit and loss account is a complete statement, and it is the one which is going to give us the results of the business for a period of 12 months, 1 year, whether the business has ended up with the profit or with a loss, and accordingly after knowing this, that these results after 12 months will have to proceed for the next accounting period.

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Then the next statement is, we are going back again, and the next statement here is. A little bit before we start the next statement, I will talk to you about the profit and loss account. Profit and loss account is basically a nominal account. I told you we have three types of accounts, earlier sometimes I told you we have three types of accounts; one is the personal account, second is the real account and third one is the nominal account. And nominal account is the one, which records. What was the rule of passing general entries of nominal account? Debit all expenses and losses, credit all incomes and gains. So, what we are doing in this account. If you look at this account what we are doing here. We are debiting all incomes and losses, and we are crediting all incomes and gains. So, that is why it is a nominal account.

Second thing is expenses decrease capital, and incomes increase capital, because if incomes are more than the expenses you may have the profit, and that profit will be added into the capital of the business, that I will explain when we will prepare the, we will talk about the balance sheet. Then income is shown on the credit side and the expenses are shown on the debit side, as I already talked to you. There is no opening balance, but certainly there is a closing balance as the profit or the loss. We started with what. We started with the direct material, and we ended up with the net profit after tax.

So, we had closing balance; that is a net profit after tax, but in the beginning there was no opening profit or something like that, nothing. So, there is no opening balance of the profit in the profit and loss account, but certainly there is a closing balance of this account, this statement and that is called as the net profit after tax, which is what doubt on the basis of the gross profit.

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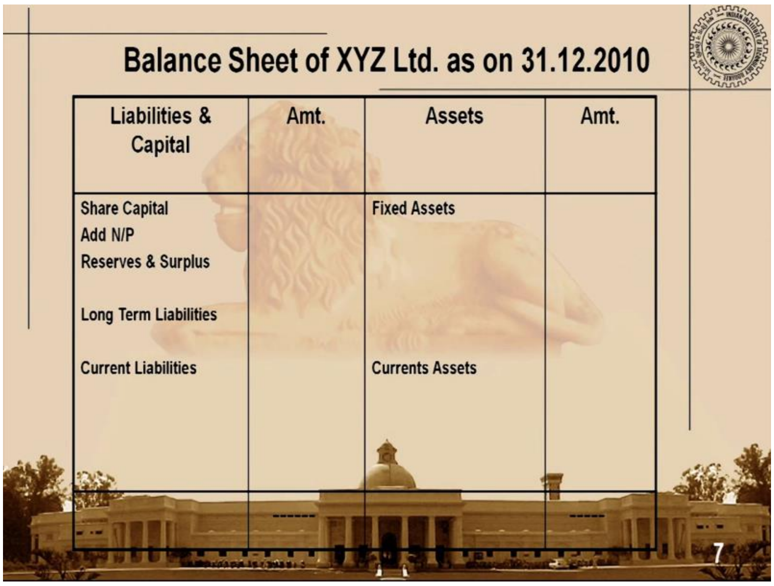

So, now we will talk about the next, and this was the statement we just discussed and then we will go back again, and we will talk about the other statements, and the last statement in the accounting process is the balance sheet. Balance sheet this is the crux of the financial statements. Balance sheet is basically what. I will show you the balance sheet. This is the balance sheet. The format of the balance sheet, this is the format of the balance sheet. So, balance sheet is number one; points of the concern, here you look at profit and loss account you look at the title there. Trading and profit and loss account of XYZ Limited for the year ending on 31stdecember 2010, and here I am writing balance sheet of XYZ Limited as on 31stdecember 2010, what is the difference.

There that statement is depicting the financial position, we say profit or loss position of the business for a period of 1 year, and this statement is telling the financial position of the business on a one single date; that is of the last date of the year, once in a year we check by preparing the statement, that total of your assets are equal to the total of your liabilities. Now what are the liabilities? Liabilities are the total financial resources, which the firm has generated from different sources. First one is the share capital, or the capital, which is invested by the owners of the business in the business.

First anyone for example, you want to establish a business tomorrow, you need some say for example, your requirement is 100,000, 100,000 rupees. You have 30,000 rupees in your pocket which you are ready to invest, and 70,000 rupees you have to borrow from external sources. So, you have two sources of the funds; first one is your own capital which is called as a capital or share capital, and the second is the borrowed money which is called as a loan. So, these two sources will become the liabilities of the business. If it is a sole proprietorship, if it is a one man organization, then the liability of the owner and business are same. If it is a partnership firm in that case, almost the liabilities of the partners and the firm are same, but if it is a private limited company or a public limited company, then whatever these liabilities are, these are the liabilities of the firm, not of the owners of the business, they are only limited to the extent of the capital they have promised to pay to the firm.

So, here this is the liabilities and capital side, you first have the first item is the share capital, that is the owners own investment. Then it keeps on increasing when you earn the profit and profit is added in the capital. So, capital keeps on increasing; for example, you invested 30,000 rupees, in the first tenure the profit of 3,000 rupees, and you did not take any dividend out of it. So, what you will do, you have 30,000 rupees plus 3,000 rupees you will reinvest in the business share capital fund will appreciate to 33,000 rupees. Then the reserve and surplus I will explain about these later on when we will prepare the balance sheet.

Then you have long term liabilities means the long term loans. The loans which are borrowed from the banks or financial institutions for a period of more than one year, they are called as long term liabilities, long term loans. And the current liabilities which are the borrowed funds for a period of maximum up to one year, they are the short term liabilities. So, total of this side is showing how much money you have borrowed and invested in the business, and whatever you have borrowed and invested in the business, that should be justified, where that money you have invested in; that is justified by this side.

Here you have assets fixed assets and current assets, the total assets total properties of the business, which are generated out of these resources or liabilities, are divided into two categories; fixed assets, those assets which are in the business for a period of more than one year, on which you charge the depreciation. And second is the current assets, those assets which are going to be there in the business, maximum for a period of up to one year.

So, for example, you have land, plant, building, machinery, furniture, buildings all these assets are going to be there in the business for a period of more than one year. So, they are fixed assets. And here are the current assets, those assets which are going to be there with the business only for a period of maximum 12 months they are current assets. For example, you have raw material. The raw material is going to stay with us for a month, then we are converting that into finished product and that is going to the market.

Similarly, you have, say you have you have sold part of your sales on credit sales. So, those invoices of the credit sales will be only for how much, maximum credit the firm can give 1 month, 2 months or 3 months, not more than 3 months credit the firms give. So, those credits were bills, which in the technical language we call them sundry debtors. Means the sales made today, and the residues, means the amount of those sales will be recovered after 2 months or 3 months. So, till then it will be a current asset with us.

So, all these assets, the benefit of which will be enjoyed by the business in the next 1 2 3 4 months, or maximum up to 12 months, they are called as the current assets, and they are the long term assets fits assets. So, total of these assets should be equal to total of the liabilities side, and if you this situation that you had invested 100000 rupees, and worth 100,000 rupees assets you have, it means your balance, financial position is balanced. Nobody can challenge, nobody can do anything, nobody can say suspect the owners of the business that they are misappropriating the business funds, and you have justified it that this much money I have invested in the business, this much assets I have, even today this firm is sold in the market you will be able to fetch this much of the amount, which will be sufficient to pay that much of the liabilities, and the owners are free. So, this statement is called as the balance sheet which explains, that the financial position of the business is balanced.

Now, we will go back and understand some important terms about the balance sheet. Balance sheet can be prepared in two ways; one way is the statement as I told you which is called as a T format. Here you prepare the statement divide it into two equal halves, one side is asset other side is liabilities, and then this is the T format, or you can prepare the statement in the vertical orders also that here you put the all your, say for example, capital on the top.

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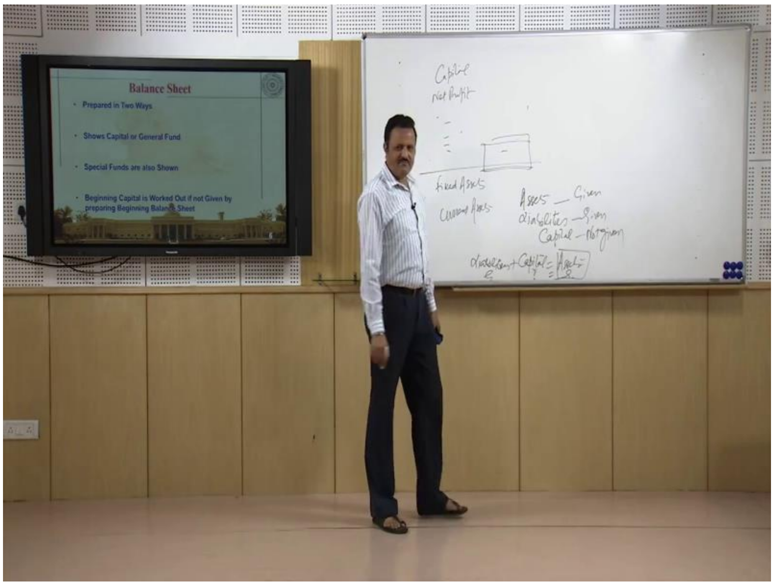

You add into this net profit then other long term liabilities, and this is over. This side you put as the fixed assets, this side you put as the current assets and here this side is equal to this side and this side is equal to this side, and both the sides are balanced. This amount is equal to this amount, and this is the vertical format of preparing the balance sheet. So, two forms, two formats the balance sheet is, can be prepared in Shows capital or generated, sorry general fund.

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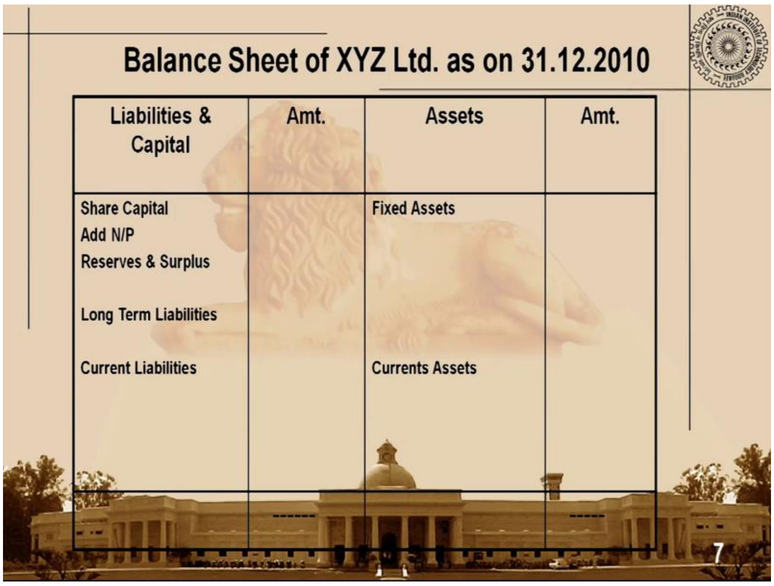

So, as I told you the balance sheet shows you what. Balance sheet shows the capital and the reserve and surplus, general fund. Total profit which we earn, part of the profit is added in the capital, and part of the profit is kept separates, for some general purposes, any contingencies, and this is called as the reserve and surplus. So, total of the capital is initially invested capital, part of the profit added into the capital, and then part of the profit kept as a reserve and surplus.

Then you have special funds are shown, also shown. Here now for example, you have some specific reserve. This is a general reserve, it can be used for any purpose any unforeseen contingency, but here you can create some specific reserve also, and then if you create any specific reserve, you have to show it that reserve here, and the reserves name will also be coming here, then what for this specific reserve has been created, and that will also be created from the profit and loss account.

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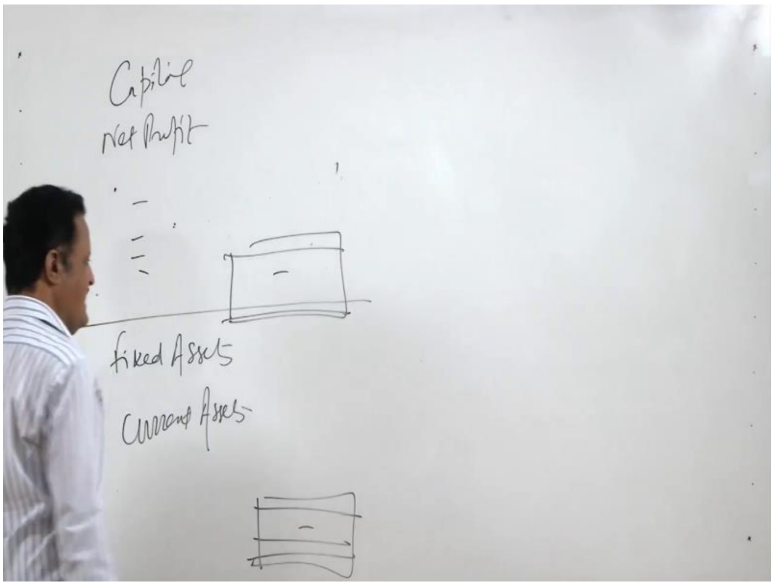

Then we talk about the beginning capital is worked out, if not given by preparing the balance sheet. How would you work it out? You will be given two things. You will be given total of the assets this, you will be given the total amount of the assets, and you will be given the total amount of the liabilities, and capital is not given to you. So, it means assets given, liabilities given, and capital is not given, which can be worked out. Now how would you work out this capital? I told you about the accounting equation. What is the accounting equation, that liabilities plus capital, liabilities plus capital is equal to assets. So, liabilities are given, and then assets are also given. So, you can easily find out what is the, you can easily find out from this what is the amount of the capital. So, total of the assets minus liabilities will be the balance, and that balance will be the capital.

So, this is basically what, we have already talked about is the accounting equation. With the help of accounting equation you can make out, that if any of that three things is not given to us. Three things are that they are the assets one, capital two, and liabilities three. If assets are given and liabilities are given, you can work out the capital. If the capital and liabilities are given, you can work out the assets. And if assets and capital is given, you can work out that remaining amount is the liabilities, with the help of accounting equation you can work out the liabilities.

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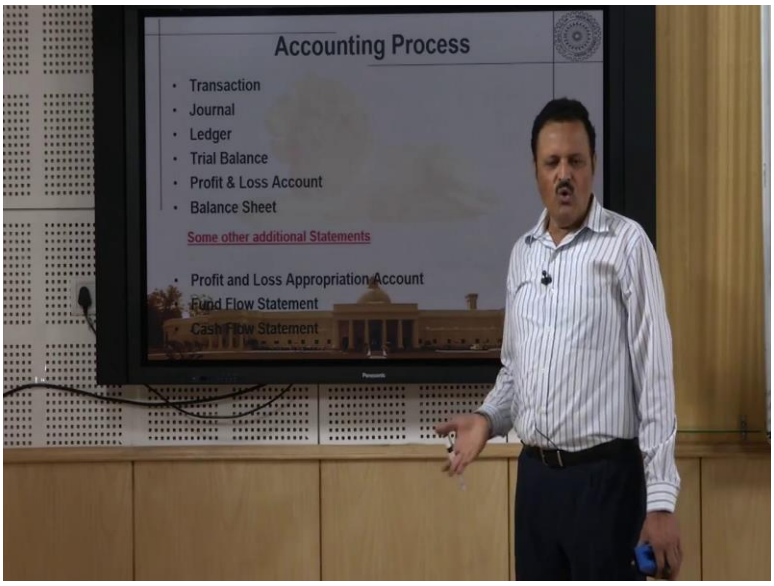

Then let us go back again, apart from this profit and loss account and balance sheet, you have some other statements also which are not mandatory, but they are required to be prepared sometimes. Profit and loss appropriation account, fund flow statement and cash flow statement. Cash flow statement has become now the statutory statement, mandatory statement. So, you have to prepare three statements profit and loss account and balance sheet, and from these two statements you have to prepare the third statement is the cash flow statement, when we are reporting these financial statements, we are using these statements for the financial reporting.

And fund flow statement is not a compulsory statement, it can be prepared for facilitating the better decision making and profit and loss account is also not a compulsory statement, but we generally prepare along with the profit and loss account. Because without profit and loss appropriation account you cannot know that how much profit has to be given as a dividend, how much profit has to be transferred to the capital, how much profit has to be transferred to the general reserve, how much profit has to be transferred to the specific reserve. So, for that we are also required to prepare the profit and loss appropriation account.

If in the finally, say presented financially statements, to be presented to the Chartered Accountant, if profit and loss appropriation account is not separately prepared, it can be prepared here along with this statement. There is no need to prepare it separately; you can add it up here in the profit and loss account. So, this is not a mandatory statement, but this profit and loss, trading and profit and loss account, balance sheet and cash flow statements are the three now statutory statements which we have to prepare, and we have to use them for the reporting purpose.

Thank you very much.