1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 04 (Class XII, Semester – 2)
Module Name/Title	Financial Statements of a Company – Part 1
Module Id	leac_20301
Pre-requisites	Basic knowledge of Financial Statements
Objectives	At the end of the lesson, the learners will be able to: • Explain meaning of Financial Statements • State the nature of Financial Statements • State the objectives of Financial Statements • State the importance of Financial Statements • Enlist the limitations of Financial Statements
Keywords	Financial Statements, Balance Sheet, Profit and loss statement, Cash Flow statement.

2. Development Team

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Table of Content

1. Introduction
2. Meaning of Financial Statements
3. Nature of Financial Statements
4. Objectives of Financial Statements
5. Importance of Financial Statements
6. Limitations of Financial Statements

1.1. Introduction

The financial statements are the end products of accounting process. They are prepared as per the accounting policies and accounting standards prescribed in the Companies Act. The accounting concepts, principles, procedures and also the legal environment in which the business organisations operates are also taken into consideration before their preparation. These statements are the outcome of the summarising process of accounting and are, therefore, the sources of information on the basis of which conclusions are drawn about the profitability and the financial position of a company. Hence, they need to be arranged in a proper form with suitable contents so that the shareholders and other users of financial statements can easily understand and use them in their economic decisions in a meaningful way.

This module will cover the meaning of financial statements, its objectives and its features.

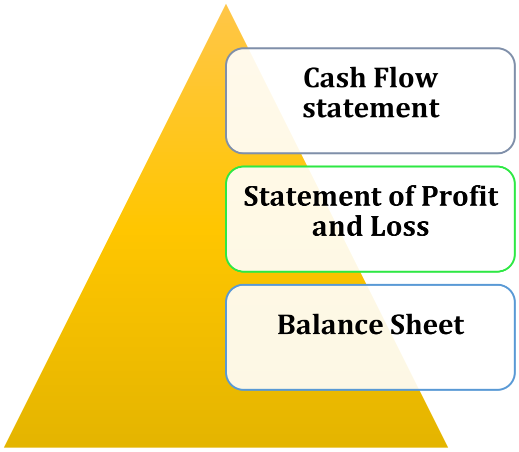
2.1. Meaning of Financial Statements

The financial details that are prepared by the business enterprises so as to meet the information requirement of the decision-makers are known as financial statements. These statements provide financial data that require analysis, comparison and interpretation for taking decisions by the external as well as internal users of accounting information. This act is termed as financial statement analysis.

Financial statements are the basic and formal annual reports through which the corporate management communicates financial information to its owners and various other external parties which include investors, tax authorities, government, employees, etc.

Thus, financial statements are written records that convey the business activities and the financial performance of a company. Financial statements are often audited by government agencies, accountants, firms, etc. to ensure accuracy and for tax, financing, or investing purposes.

Financial statements include:

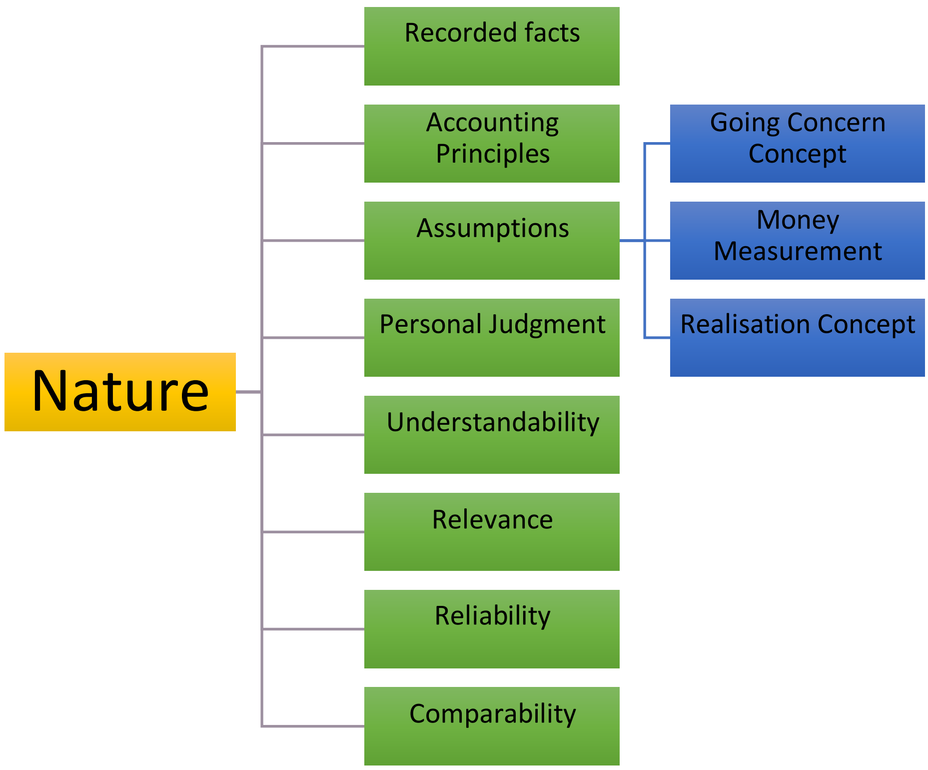


3.1. Nature of Financial Statements

The American Institute of Certified Public Accountants states the nature of financial statements as, "*The statements prepared for the purpose of presenting a periodical review of report on progress by the management and deal with the status of investment in the business and the results achieved during the period under review. They reflect a combination of recorded facts, accounting principles and personal judgements*".

Thus, they are the records that convey the business activities and the financial performance of a company.

The nature or features of financial statements are:



1. Recorded Facts

The term ‘recorded facts’ means recording of transactions based on evidences in the books of accounts. Financial statements has the information gathered from the accounting records. These accounts (cash account, debtors, creditors, fixed asset account, etc) are maintained at the original cost or historical cost. The marketable value is not recorded. So since such accounts are taken as a part of the statements, they do show the current financial condition of the entity.

2. Accounting Principles

While preparing the financial statements certain accounting principles, standards, methods have to be followed. These get reflected in a financial statement. Incorporation of such accounting principles makes the financial statement uniform, more reliable and comparable as well. For e.g.: The valuing of assets at cost less depreciation principle for balance sheet purposes is followed. The convention of materiality is followed in dealing with small items like pencils, pens, postage stamps, etc. These items are treated as expenditure in the year in which they are purchased even though they are assets in nature.

3. Assumptions

When recording financial transactions an enterprise will make certain postulates or assumptions. The three common ones are

- ***Going Concern Concept –*** The Going concern postulate assumes that the enterprise is treated as a going concern and exists for a longer period of time. So the assets are shown on historical cost basis.
- ***Money Measurement Concept -*** Money measurement postulate assumes that the value of money will remain the same in different periods. Though there is drastic change in purchasing power of money, the assets purchased at different times will be shown at the amount paid for them.
- ***Realisation Concept -*** While, preparing statement of profit and loss the revenue is included in the sales of the year in which the sale was undertaken even though the sale price may be received over a number of years. The assumption is known as realisation postulate.

4. Personal Judgement

While the accounting principles, conventions and assumptions have to be followed, there are certain things which are left to the judgment of the accountant. Like provision for debts, while deciding either cost of inventory or market value of inventory should be included, many personal judgements are to be made based on certain considerations.. These personal judgment decisions of the accountant will be reflected in the financial statements.

5. Understandability

One of the most important features of a financial statement is that it should be easily understood by the user. We assume that the user has a basic understanding of finance and accounting. So the information should be presented in such a manner that he understands and comprehends it.

6. Relevance

The financial statements must contain relevant information for them to be useful to the users. For such users, any information that helps their decision making about investing is useful information. Such information should help them evaluate past, present or even future events. The information can be predictive or confirmatory and usually both. Say for example information about the dividend paid in the last year is valuable information for a potential investor. Similarly, information about the asset structure of the company can help a user evaluate the future of a company.

7. Reliability

The information communicated to the users will be worthless if it is not reliable and trustworthy. For the information to be reliable it must be error-free and free of any form of material bias. If the information is important but a reliable estimate cannot be made. In such a case the information can be included in the notes to accounts.

8. Comparability

Firstly the users should be able to compare the financial statements of an enterprise over a period of time (a few years). This will enable them to do trend analysis and better understand the finances of the company. This is important for their investment decision.

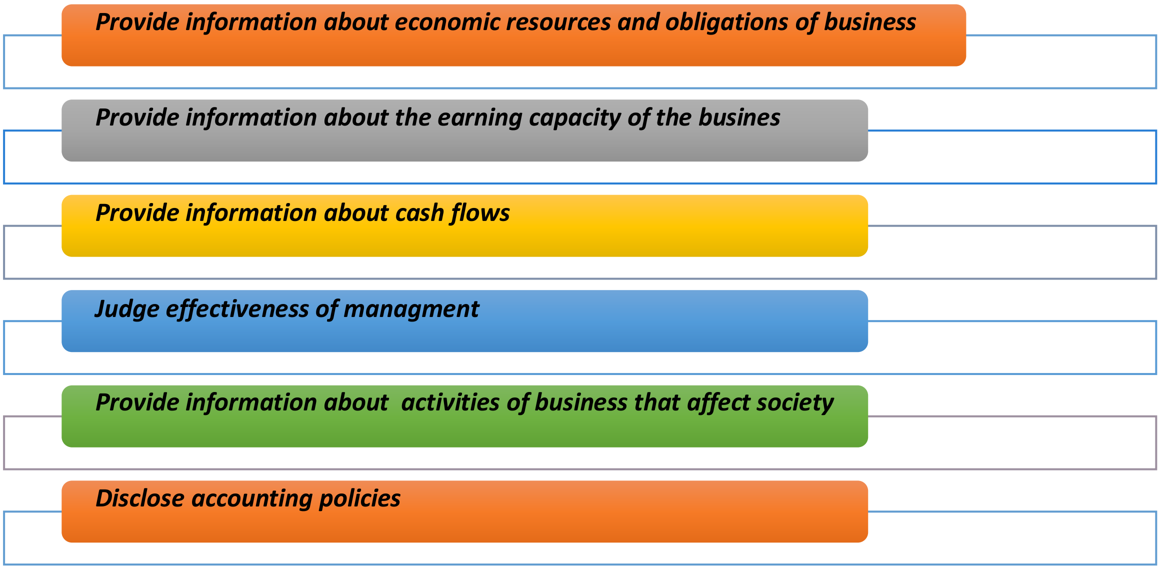
Thus, financial statements are the summarised reports of recorded facts and are prepared following accounting concepts, conventions, accounting policies, accounting standards and requirements of Law.

4.1 Objectives of Financial Statements

Financial statements are the basic sources of information to the shareholders and other external parties for understanding the profitability and financial position of any business concern. They provide information about the results of the business concern during a specified period of time in terms of assets and liabilities, which provide the basis for taking decisions.

Thus, the primary objective of financial statements is to assist the users in their decision-making.

The specific objectives include the following:



1. ***To provide information about economic resources and obligations of a business:***

They are prepared to provide adequate, reliable and periodical information about economic resources and obligations of a business firm to investors and other external parties who have limited authority, ability or resources to obtain information.

2. ***To provide information about the earning capacity of the business:***

They provide useful financial information which can gainfully be utilised to predict, compare and evaluate the business firm's earning capacity.

3. ***To provide information about cash flows:***

They provide information useful to investors and creditors for predicting, comparing and evaluating, potential cash flows in terms of amount, timing and related uncertainties.

4. ***To judge effectiveness of management:***

They supply information useful for judging management's ability to utilise the resources of a business effectively.

5. ***Information about activities of business affecting the society:***

They report the activities of the business organisation affecting the society, which can be determined and described or measured and which are important in its social environment.

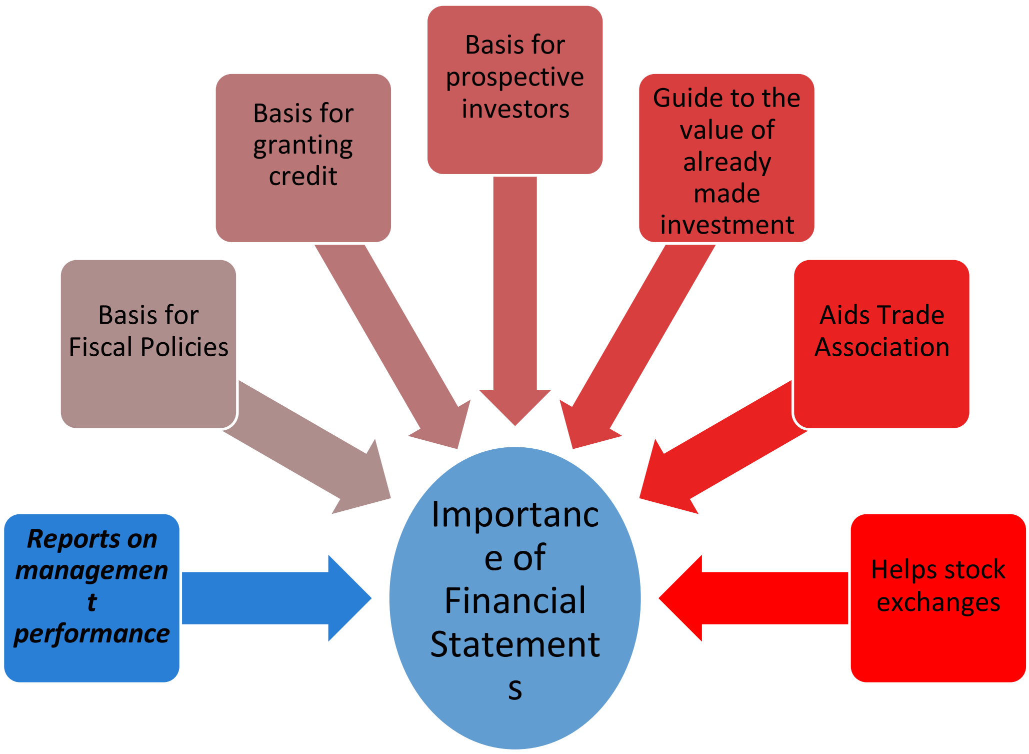
6. ***Disclosing accounting policies:***

These reports have to provide the significant policies, concepts followed in the process of accounting and changes taken up in them during the year to understand these statements in a better way.

5.1 Uses and Importance of Financial Statements

The users of financial statements include management, investors, shareholders, creditors, government, bankers, employees and public at large. Financial statements provide the necessary information about the performance of the management to these parties interested in the organisation and help in taking appropriate economic decisions. It may be noted that the financial statements constitute an integral part of the annual report of the company in addition to the director's report, auditors report, corporate governance report, and management discussion and analysis.

The various uses and importance of financial statements are as follows:



1. ***Reports on management performance:***

Financial statements report the performance of the management to the shareholders. The gaps between the management performance and ownership expectations can be understood with the help of financial statements.

2. ***Basis for fiscal policies:***

The fiscal policies, particularly taxation policies of the government, are related with the financial performance of corporate undertakings. The financial statements provide basic input for industrial, taxation and other economic policies of the government.

3. ***Basis for granting of credit:***

Corporate undertakings have to borrow funds from banks and other financial institutions for different purposes. Credit granting institutions take decisions based on the financial performance of the undertakings. Thus, financial statements form the basis for granting of credit.

4. ***Basis for prospective investors:***

The investors include both short-term and long-term investors. Their prime considerations in their investment decisions are security and liquidity of their investment with reasonable profitability. Financial statements help the investors to assess long- term and short-term solvency as well as the profitability of the concern.

5. ***Guide to the value of the investment already made:***

Shareholders of companies are interested in knowing the status, safety and return on their investment. They may also need information to take decision about continuation or discontinuation of their investment in the business. Financial statements provide information to the shareholders in taking such important decisions.

6. ***Aids trade associations in helping their members:***

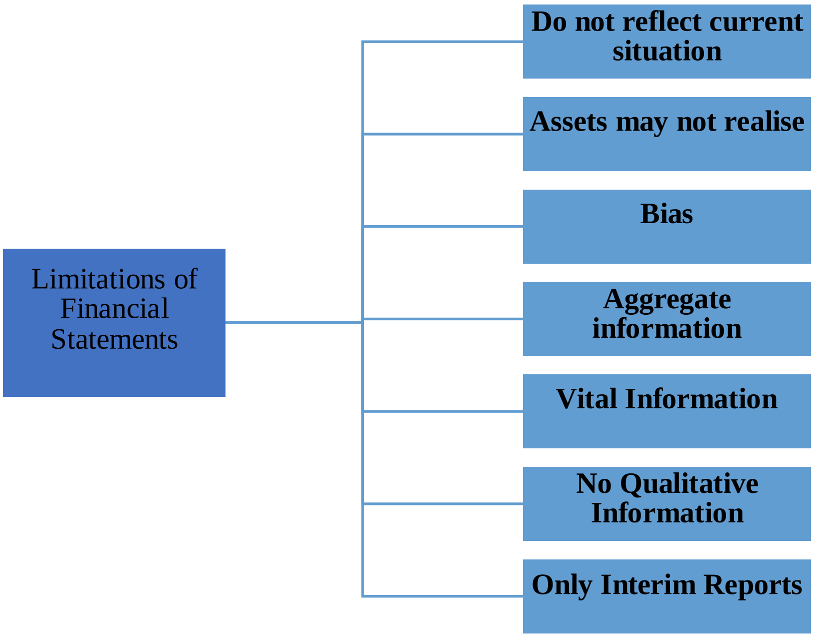
Trade associations may analyse the financial statements for the purpose of providing service and protection to their members. They may develop standard ratios and design uniform system of accounts.

7. ***Helps stock exchanges:***

Financial statements help the stock exchanges to understand the extent of transparency in reporting on financial performance and enables them to call for required information to protect the interest of investors. The financial statements enable the Stock brokers to judge the financial position of different concerns and take decisions about the prices to be quoted.

6.1 Limitations of Financial Statements

Though utmost care is taken in the preparation of the financial statements and provide detailed information to the users, they suffer from the following limitations:



1. ***Do not reflect current situation:***

Financial statements are prepared on the basis of historical cost. Since the purchasing power of money is changing, the values of assets and liabilities shown in financial statement do not reflect current market situation.

2. ***Assets may not realise:***

Accounting is done on the basis of certain conventions. Some of the assets may not realise the stated values, if the liquidation is forced on the company. Assets shown in the balance sheet reflect merely unexpired or unamortised cost.

3. ***Bias:***

Financial statements are the outcome of recorded facts, accounting concepts and conventions used and personal judgements made in different situations by the accountants. Hence, bias may be observed in the results, and the financial position depicted in financial statements may not be realistic.

4. ***Aggregate information:***

Financial statements show aggregate information but not detailed information. Hence, they may not help the users in decision-making much.

5. ***Vital information missing:***

Balance sheet does not disclose information relating to loss of markets, and cessation of agreements, which have vital bearing on the enterprise.

6. ***No qualitative information:***

Financial statements contain only monetary information but not qualitative information like industrial relations, industrial climate, labour relations, quality of work, etc.

7. ***They are only interim reports****:*

Statement of Profit and Loss discloses the profit/loss for a specified period. It does not give an idea about the earning capacity over time similarly, the financial position reflected in the balance sheet is true at that point of time, and the likely change on a future date is not depicted.

Summary

The financial details that are prepared by the business enterprisers so as to meet the information requirement of the decision-makers are known as financial statements. These statements provide financial data that require analysis, comparison and interpretation for taking decision by the external as well as internal users of accounting information.

Financial statements includes: Cash Flow statement, Statement of Profit and Loss and Balance Sheet.

The nature or features of financial statements are: Recorded Facts, Accounting Principles, Assumptions, Personal Judgement, Understandability, Relevance, Reliability, and Comparability.

Objectives of Financial Statements: To provide information about economic resources and obligations of a business, to provide information about the earning capacity of the business, to provide information about cash flows, to judge effectiveness of management, Information about activities of business affecting the society, Disclosing accounting policies:

Uses and Importance of Financial Statements : Report on stewardship function, Basis for fiscal policies, Basis for granting of credit, Basis for prospective investors, Guide to the value of the investment already made, Aids trade associations in helping their member, Helps stock exchanges.

Limitations of Financial Statements: Do not reflect current situation, Assets may not realise, Bias, Aggregate information, Vital information missing, No qualitative information, they are only interim report.