Foundations of Accounting & Finance

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Week - 01

Lecture - 04

Contents of Income Statement and Balance Sheet Part II

Accrual Concept:

What is accrual concept? Let's delve into its meaning and discuss it further. To illustrate, let's consider the financial year 2022-2023 (FY 22-23). The fiscal year spans from April 1, 2022, to March 31, 2023.This timeframe is commonly referred to as FY 22-23.

Transactions:

In the financial year FY 22-23:

- March 15, 2023: Goods sold for 50,000 on a 30-day credit.
- March 18, 2023: Raw materials purchased for 25,000 on a 45-day credit.
- April 10, 2022: Received 100,000 rupees in cash for a sale in FY 21-22.
- April 20, 2022: Paid 50,000 rupees in cash for a purchase made in FY 21-22.

Now, let's focus on these transaction. How will each of the transaction affect the financial statement or the profit and loss statement for FY 22-23?

Transaction 1:

On March 15, 2023, a sale of goods occurred amounting to 50,000 on a 30-day credit basis. Specifically, will the revenue of 50,000 rupees from the sale be recorded in the financial statement for FY 22-23?

Now, the question arises: Will this sale be included in the revenue for the financial year 22-23, or will it be considered as part of revenue for the next financial year since the cash will be received in the next financial year, specifically on April 14, 2023, which falls under FY 23-24?

According to the accrual principle, revenue is recognized when it is earned, regardless of when cash is received. Therefore, since the sale has occurred and ownership of the goods has been transferred to the buyer on March 15, 2023, the revenue of 50,000 will be included in the financial statements for FY 22-23.

It's important to note that the accrual concept is not based on actual cash inflow or outflow but on the recognition of revenue when it is earned. In short it is determined based on transfer of ownership. Even if the buyer fails to pay or declares insolvency later on, it will be accounted for as a loss in the subsequent financial year (FY 23-24). However, for FY 22-23, the sale is considered revenue as it has accrued or been earned, regardless of the actual receipt of cash.

Transaction 2:

The next transaction. On March 18, 2023, I purchased raw materials for 25,000 on a 45-day credit basis. This means I am obligated to pay the 25,000 rupees only on May 2, 2023, which is in the financial year 23-24. However, the purchase occurred in the financial year 22-23.

The minute I buy the goods the ownership or the responsibility of the goods rests with me and I am liable to pay for them. In the event of damage to the goods, returning them and receiving a refund would constitute a separate transaction. As of now, the transaction involves the sale and purchase of goods, with me acquiring ownership.

Therefore, the purchase of raw materials has accrued in the financial year 22-23. Irrespective of whether the raw materials are utilized in the same year or next FY the purchase is recognised in the FY 22-23. If the raw materials are not used immediately, they would be considered as assets.

So, to clarify, if the raw materials are both purchased and used within the financial year, the goods have been received, ownership has transferred, and the expenditure has accrued for FY 22-23.

There could be arguments that suppose I have paid for the purchase of goods but the vendor has not delivered and delivers it in the next financial year then how do we recognise the expenditure. Please note the expenditure or revenue is recognised only when ownership transfers. In this case when money is paid but the ownership is not transferred it is recognised as an "advance" provided and not as an expenditure or revenue as the case may be until the ownership transfers. The minute ownership transfers the expenditure or revenue is recognised and is recorded in the FY of the ownership transfer.

In accounting terms, the profit and loss statement or income statement is not based on cash transactions unless specifically stated. It operates on an accrual basis, indicating income and expenditure are recognized as they accrue, regardless of the actual cash flow.

For instance, consider interest certificates on FD issued by banks for tax filing purposes. Even if the bank pays interest only twice a year, such as on June 30th and December 31st, the interest accrued throughout the financial year is reported. If you request an interest certificate for the financial year 22-23 in March, the certificate will include both the interest paid and the interest accrued during that period.

Transaction 3:

Now, let's consider the third example, which involves a different scenario.

On April 10, 2022, I received cash amounting to 100,000 for a sale made in the financial year 21-22. The sale occurred during FY 21-22, and although I receive cash in FY 22-23, it does not constitute revenue for financial year, FY 22-23.

This 100,000 does not relate to any transaction in FY 22-23; instead, it is associated with a sale made in FY 21-22. Therefore, it will not be recorded in the profit and loss or income statement for FY 22-23. However, it will still be recorded in the cash flow statement of FY 22-23 as receipt of cash.

Transaction 4:

Similarly, if we consider the next transaction where cash is paid for purchases made in FY 21-22, while the cash has been expended, it does not pertain to the financial year 22-23. Therefore, this expenditure will not be included in the profit and loss statement for FY 22-23.

In summary, the accrual concept dictates that any income or expenditure accrued during a specific financial year irrespective of cash receipt or payment should be recorded in that financial year. Therefore, transactions related to FY 21-22 will not be reflected in the profit and loss statement for FY 22-23, as they do not pertain to that specific financial year.

The preparation of both the income statement (profit and loss statement) and the balance sheet

The income statement, which is also known as the profit and loss statement, is prepared for a specific period, which can vary. It can be for a financial year (FY), a quarter (e.g., Q1, Q2, Q3, Q4), or even for a half-year period. For example, "FY 22-23" refers to the financial year from April 1, 2022, to March 31, 2023. "Q1 of 22-23" refers to the period from April to June of FY 22-23, while "Q2 of 22-23" refers to the period from July to September of FY 22-23. Similarly, "half year 22-23" refers to the period from April 1, 2022, to September 30, 2022.

Regardless of the specified time period chosen, the income statement records all revenues and expenditures that have accrued during that period. This means that both earned revenues and incurred expenses are included in the income statement, irrespective of whether the cash transactions have occurred during the same period.

In summary, the income statement reflects the financial performance of a business over a specific period, detailing all revenues earned and expenses incurred during that time, based on accrual accounting principles.

Balance Sheet

The next financial statement we discuss is the balance sheet. The key difference between the income statement (profit and loss statement) and the balance sheet lies in their focus and purpose.

While the income statement provides a detailed account of a company's revenues and expenses over a specific period, the balance sheet presents a snapshot of a company's financial position at a particular point in time. Essentially, the balance sheet tells you two fundamental things: what the company owns (assets) and what it owes (liabilities) as of that specific date.

In other words, the balance sheet provides a summary of the company's resources (assets) and its obligations (liabilities) as of the balance sheet date. This snapshot remains the same regardless of whether you are considering the current day, tomorrow, or even yesterday. For example, if a company's financial year is from April 1, 2022, to March 31, 2023, the balance sheet would be prepared as on March 31, 2023.

On the contrary, the income statement (profit and loss statement) covers a specified time period, such as a financial year or a quarter. For instance, the profit and loss statement for the financial year 22-23 would cover the entire period from April 1, 2022, to March 31, 2023. Unlike the balance sheet, which provides a snapshot of financial position at a specific date, the income statement summarizes the company's financial performance over the specified time period, detailing revenues, expenses, and net income (or loss).

Entity Concept

Regarding the concept of ownership, it's essential to understand the distinction between person who has the business ownership and the business entity. When you start a company, what you "own" personally may differ from what the business "owns." This leads to the next concept we will discuss, which is called the entity concept. The entity concept emphasizes the separation of the business entity from its owners, recognizing the business as a distinct legal and economic entity with its assets and liabilities separate from those of its owners.

The entity concept, also known as the business entity concept or separate entity concept, is a fundamental accounting principle that emphasizes the distinction between a business or organization and its owners or shareholders. According to this concept, the business is considered a separate legal and economic entity from its owners, meaning it has its own assets, liabilities, and financial responsibilities independent of its owners.

For example, if Arun Kumar starts a business named Arun Kumar and Co, Arun Kumar himself is a separate entity from the business entity Arun Kumar and Co. This means that the assets owned by Arun Kumar are distinct from the assets owned by the business entity. Similarly, the liabilities incurred by Arun Kumar are separate from the liabilities incurred by the business entity.

When preparing financial statements such as the profit and loss statement (income statement) and the balance sheet, it's crucial to adhere to the entity concept. The profit and loss statement reflects the revenues and expenses accrued by the business entity, not by the individual owners. Similarly, the balance sheet presents the assets owned and the liabilities owed by the business entity, not by its owners.

In practical terms, this means that any financial transactions or obligations of the business entity are recorded separately from those of its owners. For instance, if the business entity takes out a loan from a bank, it is the responsibility of the business entity to repay the loan, not the individual owner and the person who is operating the business is responsible for adhering to the obligations of the entity. Conversely, if the individual owner takes out a personal loan, it is their personal responsibility to repay it, unrelated to the business entity's finances.

Interaction between Income Statement and Balance Sheet

Let's discuss the interaction between the income statement and the balance sheet in the context of some transactions:

1. **Purchase of Raw Materials for Cash:**
    - When you purchase raw materials for cash, your cash balance decreases, resulting in a reduction in the asset (cash) on the balance sheet.
    - Simultaneously, the raw materials (inventory) acquired become an asset on the balance sheet, increasing your total assets.
2. **Sale of Finished Goods for Cash:**
    - When you sell finished goods for cash, the finished goods (inventory) on the balance sheet decrease, as they are now sold.
    - The cash received from the sale increases your cash balance, increasing the asset (cash) on the balance sheet.

These transactions impact both the balance sheet and the income statement:

- **Balance Sheet:** The balance sheet reflects the changes in assets and liabilities resulting from these transactions. For instance, the purchase of raw materials increases the assets of the balance sheet if bought on credit, while the sale of finished goods decreases the inventory assets, but increases the cash asset if cash is received or increases the receivables asset if the receipt is due.
- **Income Statement:** The income statement reflects the financial performance of the business over a specific period, including revenues and expenses. In the case of sale of

finished goods for cash, the revenue generated from the sale increases the revenue (or sales) on the income statement, contributing to the net income.

In summary, every business transaction affects both the balance sheet and/or the income statement, as they impact the company's financial position (assets, liabilities, equity) and its financial performance (revenues, expenses, net income). Understanding these interactions is crucial for accurately assessing a company's financial health and performance. There are some transactions which can affect only the balance sheet and not the income statement. Suppose you use cash of the business to buy an asset then one asset that is cash reduces and another asset increases impacting only the balance sheet and not the income statement.

In our next session, we will delve deeper into the interactions between the balance sheet and the income statement. We'll explore examples and discuss how transactions affect both financial statements. Additionally, we'll formally analyse a set of transactions to understand how they impact the income statement and the balance sheet. We will revisit these topics when we begin working with financial statements in the next lecture.