ACCOUNTING THEORY
2nd Semester (HONOURS)
UNIT : 6 FINANCIAL STATEMENTS

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Meaning OF Financial Statements : A financial statement may be defined as an organised collection of accounting information in a systematic , logic and consistent manner with the basic objective of meeting the need of the users of accounting information .

Nature Of Financial Statements :

1. **Recorded Facts : financialsatements** contain the facts relating to the business transactions already recorded in the books of accounts . the unrecorded facts , whatever importance they might have are not included in financial statements .
2. **Accounting conventions :** they refer to the arguments or usages and customary practices in social and economic life of human being which have been generally accepted in building up the accounting techniques . the examples are the convention of conservatism and consistency .
3. **Accounting assumption or concepts :** the generally accepted fundamental assumptions which build the premise of practical accounting and do not require to be proved are known as accounting assumptions or concepts .
4. **Personal judgement:** it is true that generally accepted accounting conventions and concepts are followed in preparing finamcial statements , but their application in most of the cases depend on personal judgement of accountants .

Importance or Uses or Purposes of financial statements :

1. **To the management :** the management of a concern is interested in financial statements to know whether the operatimg activities carried on by it is profitable or not . these statement also help the management is assessing the efficiency of different responsibility centres ,exercising cost control and deciding future courses of action.
2. **To the owners :** as the supplier of capital the owners of the business are interested to know the fate of their investment . they want to know whether the business is being carried on efficiently and the capital of the business has been employed in such a manner so that it ensures a steady flow of return.
3. **To the creditors :** the creditors of the business intend to know the financial strebgth and repayment capacity of the concern before allowing credit facilities . they can judge the profitability , current solvency and future prosperity of the business on the basis of information supplied by financial statements.
4. **To the investors :** the prospective investors , willing to invest either short term or long term fund in the firm are interested to assess the security and repayment aspect of their investment .they are also curious enough to have an idea about the profitability of the concern for being sure about regular payment of interest .
5. **To the bankers :** like the creditors , the bankers are also interested to know whether the short term and long term credit they intend to sanction to the firm will be secured or earned steady return .

6. **To the government :** the tax liability of the business houses to the government are assessed on the basis of financial statements . so , the financial statements also helps the government to know the true income of the concern.
7. **To the employees :** the demand of the employees for wage rise , higher bonus and better working conditions ,etc. are dependent on the profitability of the concern .
8. **To the consumers :** this group is interested to get better goods at reduced price. For this purpose they may be willing to know the true cost of production , profit margin etc. financial statement are the only source to get such information .

Limitations of financial statements :

1. **only interim reports :**financial statements do not give a final picture of the profit or loss and financial position of the concern . information supplied by these statements is only approximate and not exact . the exact position can only br known when the business is closed down.
2. **Fail to reveal the real value of assets** : in financial statements assets are expressed in monetary terms . the value at which all fixed asstes are shown in the balancesheet , neither presents the value at which they can be sold nor the amount that may be required for their replacement .
3. **Dependence on historical cost** : in preparing the financial statements the historical cost method is used and it is assumed that the value of monetary unit always remains constant . so these statements do not reflect the current price changes .
4. **Non disclosures of non monetary factors** : Non-monetary factors even if they have good effect on the financial position and operating results of the firm are not recorded in financial statements. Only the items that can be measured in terms of money are shown here.
5. **Exhibition of pre-conceived figures**: Accounting techniques are based on certain assumptions and conventions. The use of these concepts and conventions .the use of these concepts and conventions makes the financial statements the suppliers of pre conceived figures.
6. **Influence of personal judgement** : in maintaining accounts and preparing financial statements accountants are given the liberty of making choice from a wide range of alternative methods . there is no single hard and fast rule . for example –the option of selecting the method of depreciation , method of valuation stock ,means of amortisation etc. from many alternatives are enjoyed by the accountants .the exercise of such option is mostly depends on personal judgement .
7. **Emphasis on quantity** : financial statements express only quantitative figures . they cannot indicate anything relating to quality of the information .
8. **Difficulty in comparative analysis :** if accountants of different firms of the same country of different countries adopt the same accounting policy and follow the uniform accounting principles the comparative analysis on the basis of information disclosed by financial statements would become much easier .

Different financial statements :

in any business organisation generally two basic financial statements are prepared . they are :
1 the income statement or profit and loss account
2 the balance sheet or the statement of financial position
Profit and loss account : the statement that is prepared usually at the end of an accounting period for finding out the net result of all the operating transactions taken place during that period by

means of matching expired costs against revenue earned is known as the income statement or profit and loss account .

Elements of profit and loss account are manufacturing account , trading account , profit and loss account , and profit and loss appropriation account .

Balancesheet : Balancesheet is a statement through which the financial position i.e. the assets and liabilities of a firm on a particular point of time is expressed . it represents the assets under the possession of a firm at a particular point of time and the claims of the owners and outsiders against those assets at a time.

Relation between profit and loss account and Balance sheet :

1. **complementary financial statements :** The Profit and Loss Account is prepared to ascertain the net income by transferring the nominal account balances at the end of the accounting period to this Account. In the balance sheet this net income i.e. net profit or net loss and the personal and real account balances are shown. It signifises that a balance sheet cannot be prepared without preparing a profit and loss account .
2. **Stock and flow relation :** there exists a stock and flow relation between a profit and loss account and balance sheet . capital and net assets is the stock of resources of an entity and income is the flow arising from the use of that stock . capital which is in fact the difference between the gross assets and gross liabilities is measured through the balance sheet and the flow from the capital or income is measured in the profit and loss account .
3. **Interim report :** both the profit & loss account and balance sheet are interim reports prepared for the same accounting period . The indefinite life span of an entity is assumed to be divided into small segments , each segment being identified as one accounting period. So, each accounting period is basically an interim period .
4. **Increase or decrease of assets :** both the statements indicate the increase or decrease of assets . the net income shown in the profit and loss account indicates internal generation or depletion of assets through operating activities during a particular accounting period . On the other hand the increase or decrease of all assets in the same period is reflected in the balance sheet .
5. **Profit and equity :** profit indicate increase in owners’ or shareholders’ claim or equity . So unless fresh capital is invested change in equity is effected by net incomes. Net income relate the profit and loss account and the balance sheet by increasing or decreasing equity .