GOVT. DEGREE COLLEGE FOR MEN

SRIKAKULAM

Dept. of Commerce & Management

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INTRODUCTION

The basic financial statements, i.e, the balance sheet and profit and loss or income statement of business, reveal the net effect of the various transactions on the operational and financial position of the company.

The balance sheet gives a summary of the assets and liabilities of an undertaking at a particular point of time. It reveals the financial status of the company. The assets part of a balance sheet shows the deployment of resources of an undertaking while the liabilities indicate its obligations, ie, the manner in which these resources were obtained.

The profit and loss statement reflects the results of the business operations for a period of time. It contains a summary of expenses ncurred and the revenue realised in an accounting period.

INCOME STATEMENT

SOLUTION

INCOME STATEMENT
for the year ended 31-3-2017

	₹	₹
Sales	10,00,000	
Less : Sales Returns	40,000	
		9,60,000
Less : *Cost of Goods Sold* :		
Opening Stock	1,10,000	
Add : Purchases	7,00,000	
	8,10,000	
Less : Closing Stock	1,40,000	
		6,70,000
Gross Profit		2,90,000
Less : Operating Expenses		
Administration Expenses	38,000	
Selling and Distribution Expenses	30,000	
Depreciation	10,000	
Other Charges	20,000	
Provision for Taxation	70,000	
		1,68,000
Operating Profit		1,22,000
Add : Non-operating Income		18,000
		1,40,000
Less : Non-operating Expenses		3,000
Net Profit		1,37,000

BALANCE SHEET

Balance Sheet

Particulars	₹
I. Equity and Liabilities	
Shareholders' Funds :	
Equity Share Capital	5,00,000
Non-Current Liabilities :	
5% Debentures	2,00,000
Bank Loan	1,50,000
Current Liabilities:	
Trade Payables :	
Sundry Creditors	75,000
Bills Payables	50,000
Others :	
Outstanding Expenses	5,000
Total	9,80,000
II. Assets	
Non-Current Assets :	
Fixed Assets (Tangible) :	
Land and Building	3,50,000
Plant and Machinery	2,50,000
Current Assets :	25,000
Cash in Hand	
Cash at Bank	55,000
Trade Receivables :	
Sundry Debtors	85,000
Bills Receivables	1,05,000
Inventories (Stocks)	1,00,000
Other Current Assets (Prepaid Expenses)	10,000
Total	9,80,000

LIMITATIONS OF INCOME STATEMENT & BALANCE SHEET

- Both the statements provide the essential basic information on the financial activities of a business, but their usefulness is limited for analysis and planning purposes.

- The balance sheet gives a static view of the resources (liabilities) of a business and the uses (assets) to which these resources have been put at a certain point of time. It does not disclose the causes for changes in the assets and liabilities between two different points of time.

- The profit and loss statement, in a general way, indicates the resources provided by operations. But there are many transactions that take place in an undertaking and which do not operate through the statement of profit and loss.

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(A) why were the net working capital lesser in spite of higher profits and vice-versa?

(B) why more dividends could not be declared in spite of available profits?

(C) how was it possible to distribute more dividends than the present earnings?

(D) What happened to the net profit? Where did they go?

(E) what happened to the proceeds of sale of fixed assets or issue of shares, debentures etc.?

(F) what are the sources of the repayment of debt?

(G) how was the increase in working capital financed and how will it be financed in future?

(H) What is the overall credit-worthiness of the enterprise?

(I) How much funds are generated through business?

(J) In what way the management has utilized the funds in the past and possible future bases of such funds?

STATEMENT OF CHANGES IN FINANCIAL POSITION

Therefore, an additional statement is needed to show the changes in assets, liabilities and owners' equity of between dates of two balance sheets. Such a statement is referred to as the statement of changes in financial position.

This statement summarizes.

Changes in assets and liabilities resulting from financial and investment transactions during the period, as well as those changes which resulted due to change in owners' equity, and

the way in which the firm used its financial resources during the period (for example to acquire fixed assets, to pay debts, to pay dividends to shareholders and so on).

Thus, the statement to be prepared to show the changes in assets and liabilities from the end of one period of time to the end of another period statement is called a "Statement of changes in Financial Position."

The most commonly used forms of the statement of changes in financial position are:

Funds flow statement and

Cash flow statement.

FINANCIAL ANALYSIS THROUGH FUNDS FLOW STATEMENT

The Funds Flow Statement is a statement which shows the movement of funds and is a report of the financial operations of the business undertaking. It indicates various means by which funds were obtained during a particular period and the ways in which these funds were employed. In simple words, it is a statement of sources and applications of funds.

FUND:

The term funds has been defined in a number of ways

In a narrow sense, it means cash only and a funds flow statement prepared on this basis called a cash Bow statement, Such a statement enumerates net effects of the various business transactions on cash and takes into account receipts and disbursements of cash

In a broader sense, the term funds refers to money values in whatever form it may exist. Here funds' means all financial resources, used in business whether in the form of men, material, money, machinery and others

in a popular sense, the term funds, means working capital, Le, the excess of current o current liabilities. The working capital concept of funds has emerged due to the fact the total resources of a business are invested partly in fixed assets in the form of fixed capital and partly kept in form of liquid or near liquid form as working capital

Fund = Working Capital (Net)

Gross Working Capital = Current Assets

Net Working Capital = Current Assets – Current liabilities

FLOW OF FUNDS: The term flow means movement and includes both inflow and outflow.

The term 'flow of funds means transfer of economic values from one asset of equity to another.

Flow of funds is said to have taken place when any transaction makes changes in the amount of funds available before happening of the transaction.
If the effect of transaction results in the increase of funds, it is called as source of funds and if it results on the decrease of funds, it is known as an application of funds.

Further, in case the transaction does not change funds, it is said to have not resulted in the flow of funds.

According to the working capital concept of funds, the term flow of funds refers to the movement of funds in the working capital. If any transaction results in the increase in working capital, it is said to be a source or inflow of funds and if it results in the decrease of working capital it is said to be an application or out-flow of funds

CURRENT AND NON-CURRENT ACCOUNTS:

To understand flow of funds, it is essential to classify various accounts and balance sheet items into current and non-current categories.

Current Accounts can either be current assets or current liabilities.

Current assets are those assets which in the ordinary course of business can be or will be converted into cash within a short period of normally one accounting year.

Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of the current assets or to the income of the business.

CURRENT ACCOUNTS

LIST OF CURRENT OR WORKING CAPITAL ACCOUNTS

Current Liabilities	Current Assets
1. Trade Payables :	1. Cash in hand
(a) Bills Payable	2. Cash at bank
(b) Sundry Creditors or Accounts Payable	3. Trade Receivables :
2. Accrued or Outstanding Expenses	(a) Bills Receivable
3. Dividends Payable and Unpaid Dividend	(b) Sundry Debtors or Accounts Receivable
4. Bank Overdraft	4. Short-term Loans & Advances
5. Short-term Loans, Advances & Deposits	5. Short-term or Marketable Investments
Provision against Current Assets	6. Inventories or Stocks such as
Other Current Liabilities	(a) Raw Materials
	(b) Work-in-process
	(c) Stores and Spares
	(d) Finished Goods
	7. Prepaid Expenses
	8. Accrued Incomes
	9. Other Current Assets

NON- CURRENT ACCOUNTS

LIST OF NON-CURRENT OR PERMANENT CAPITAL ACCOUNTS

Non-Current or Permanent Liabilities	Non-Current or Permanent Assets
1. Equity Share Capital	1. Goodwill (Intangible Assets)
2. Preference Share Capital	2. Land
3. Redeemable Preference Share Capital.	3. Building
4. Debentures	4. Plant and Machinery
5. Long-term Loans	5. Furniture and Fittings
6. Share Forfeited Account	6. Trade Marks
7. Balance of Statement of Profit and Loss	7. Patent Rights
8. Capital Reserve	8. Long-term Investment
9. Securities Premium Reserve	9. Discount on Issue of Shares
10. Capital Redemption Reserve	10. Discount on Issue of Debentures
11. Provision for Depreciation against fixed assets.	11. Preliminary Expenses
12. Appropriation of Profits :	12. Other Deferred Expenses
(a) General Reserve	
(b) Dividend Equalisation Fund	
(c) Insurance Fund	
(d) Compensation Fund	
(e) Sinking Fund	
(f) Investment Fluctuation Fund	
(g) Reserve for Taxation	

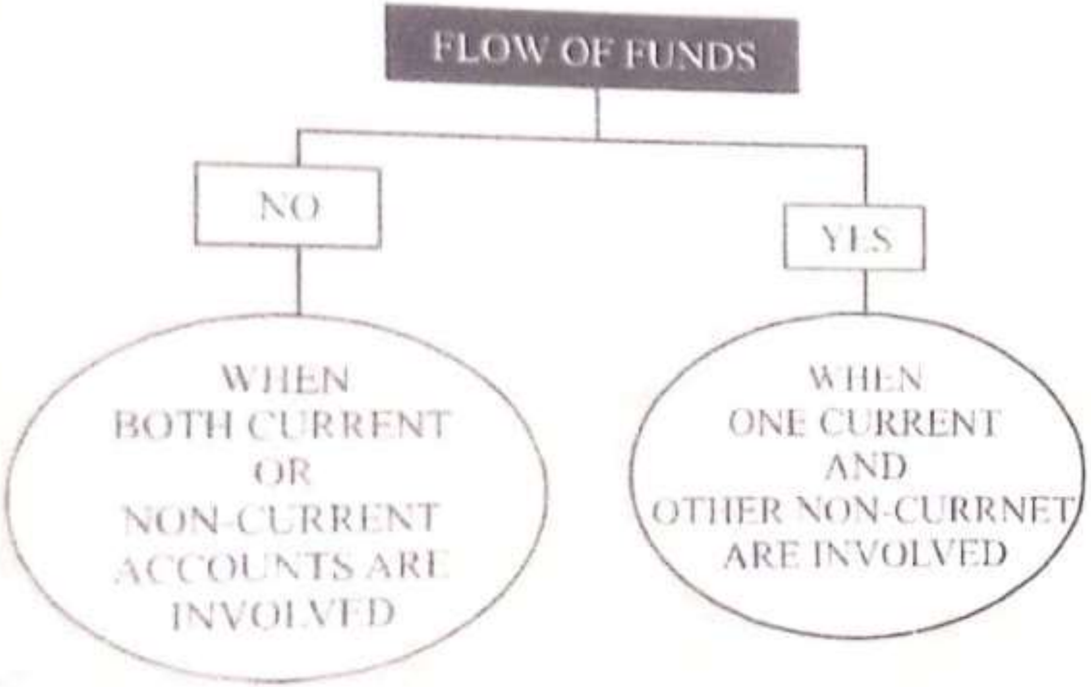
FUNDS MOVED/FLOOD OR NOT ?

- The flow of funds occurs when a transaction changes on the one hand a non-current Account and on the other a current account .
- When a change in a non-current account ég fixed assets, long-term liabilities, reserves and surplus, fictitious assets, etc is followed by a change in another non-current account, it does not amount to flow of funds. This is because of the fact that in such cases neither the working capital increases nor decreases.
- Similarly, when a change in one current account results in a change in another current account, it does not affect funds. Funds move from non-current to current transactions or vice-versa only.
- In simple language funds move when a transaction affects
- (i) a current asset and a non-current asset, or
- (ii) a non-current and a current liability, or
- (iii) a current asset and a non-current liability, or
- (iv) a non-current liability and current liability;

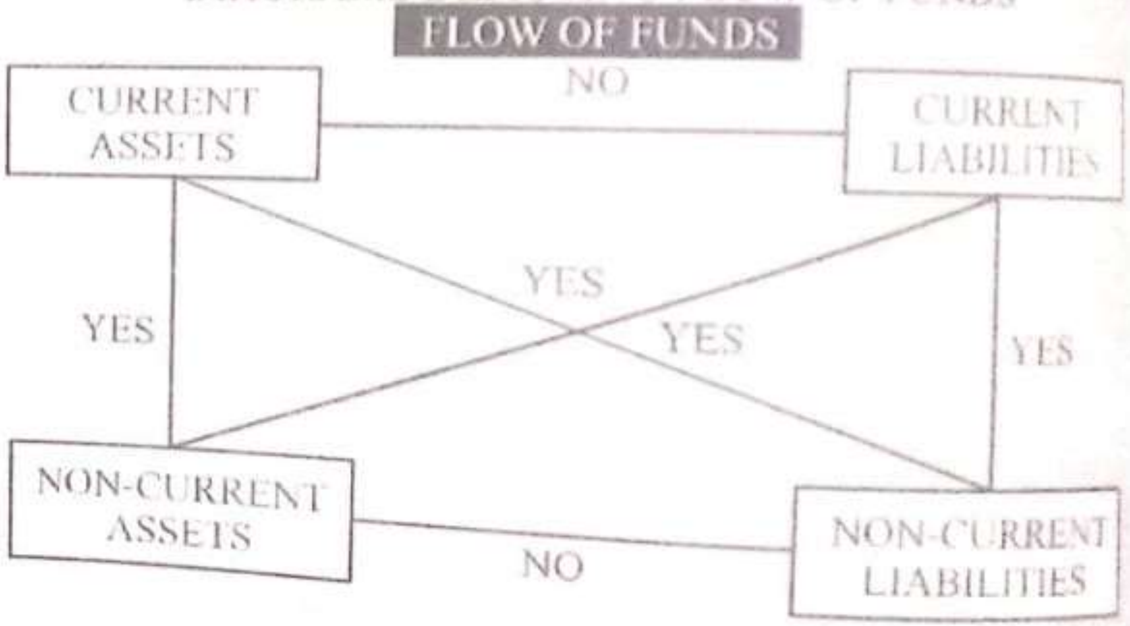
Funds do not move when the transaction affects fixed assets and fixed liability or current sets and current liabilities.

PROCEDURE FOR KNOWING WHETHER A TRANSACTION RESULTS IN THE FLOW OF FUNDS OR NOT

- (1) Analyze the transaction and find out the two accounts involved.
- (2) Make Journal Entry of the transaction.
- (3) Determine whether the accounts involved in the transaction are current or non-current
- (4) If both the accounts involved are current , either current assets or current liabilities, does not result in the flow of funds.
- (5) If both the account involved are non-current, either permanent assets or permanent liabilities, it still does not result in the flow of funds.
- (6) If the accounts involved are such that one is a current account while the other is a non current that results in flow of funds.



DIAGRAMS DEPICTING FLOW OF FUNDS



FOLLOWING TRANSACTIONS WILL BRING THE CHANGE IN THE WORKING CAPITAL)

(1) Current Assets and Non-current Assets:

- Whenever in any transaction one affects the current assets and the ether non current assets, there is flow in the working capital.

For example, when building is purchased for cash, non-current assets will increase and current will reduce without any corresponding change in current liabilities. So working capital decrease. Similarly, if any fixed asset is sold, there is increase in current assets (without corresponding change in current liabilities) and reduction in non current assets, so it will increase the working capital.

(2) Current Assets and Non-current Liabilities.:

- If in any transaction, one aspect affects the current assets and the other non current liabilities, there will be flow in the working capital

For example, if equity shares are issued for cash, it will increase the cash current asset) with out any corresponding increase in current liabilities and also increase the equity share capital, there is increase in working capital. On the other hand, if long term liabilities debentures are paid in cash, it will decrease the current assets and decrease the non current liabilities without any change in current liabilities so it will reduce the working capital.

(3) Current Liabilities and Non-current Liabilities.

If in any transaction, one aspect affects the current liabilities and the other non current liabilities, there will be flow in the working capital. For example, if debentures are issued to the creditors it will increase the non-current liabilities and decrease the current libilities without any change in current assets, as there will be increase in the working capital

(4) Current Liabilities and Non-current Assets.

If in any transaction, one aspect affects the current liabilities and the other non-current assets, there is flow in the working capital. For example, if building is purchased on credit, it will increase the non-current assets and also current liabilities (without any change in current assets, so there will be decrease in the working capital.

• TRANSACTIONS THAT WILL NOT AFFECT THE FLOW OF FUNDS FOLLOWING TRANSACTIONS WILL NOT BRING ANY CHANGE IN THE WORKING CAPITAL

(1) Current Assets and Current Liabilities. When in any transaction one aspect affects the current assets and other current liabilities, there is no flow in funds. For example, if goods sold on credit, it will increase the debtors (current assets) and will reduce the stock of goods. So there will be no change in the working capital, similarly, if cash is paid to creditors, it will decrease the note and decrease the current liabilities, there will be no change in the working capital

(2) Non-current Assets and Non-current Liabilities If any transaction, one aspect is the no current assets and the other non current liabilities, there will not be any change in de working capital.
For example, if building is purchased by the issue of equity shares, it will the non-current assets and non-current liabilities, but there will not be any change in working capital, Similarly, if debentures are redeemed out of the amount received from the sale of machinery, it will reduce the non-current assets and non-current liabilities. But there will be no changes in working capital

3)Non-current Liabilities or Non-current Assets:
If there is any transaction both aspects of which affect non current liabilities (or non current assets), it will not affect the working capital. For example, if debentures are converted into share capital it will on one hand increase the non-current liabilities and on other hand decrease the non current liability.

PREPARATION OF FUNDS FLOW STATEMENT:

Preparation of funds flow statement includes:

1. SCHEDULE OF CHANGES IN WORKING CAPITAL

2. CALCULATION OF FUNDS FROM OPERATIONS

3. FUNDS FLOW STATEMENT

INPUTS FOR PREPARATION OF FUNDS FLOW STATEMENT

- BALANCE SHEETS OF TWO PERIODS
- INCOME STATEMENT/ PROFIT AND LOSS ACCOUNT/ SURPLUS STATEMENT
- ADDITIONAL INFORMATION

- **1. SCHEDULE / STATEMENT OF CHANGES IN WORKING CAPITAL**

Working Capital = Current Assets - Current Liabilities.

So,

(i) An increase in current assets increases working capital;

(ii) A decrease in current assets decreases, working capital;

(iii) An increase in current liabilities decreases working capital; and

(iv) A decrease in current liabilities increases working capital

STATEMENT OF CHANGES IN WORKING CAPITAL

Particulars	Previous Year	Current Year	Working Capital Changes	
			Increase	Decrease
Current Assets:	(₹)	(₹)	(₹)	(₹)
Cash in Hand				
Cash at Bank				
Short-term Investment (Marketable Securities)				
Sundry Debtors				
Bills Receivable				
Accrued Income				
Prepaid Expenses				
Stock-in-trade				
Other Current Assets				
(A)	xxxx	xxxx		
Current Liabilities:				
Sundry Creditors				
Bills Payable				
Outstanding Expenses				
Income received in advance				
Bank Overdraft				
Other Current Liabilities				
(B)	xxxx	xxxx		
Working Capital (A - B)				
Increase/Decrease in Working Capital			xxxxxx	xxxxxx

ILLUSTRATION 11. **(Sole Proprietor)** From the following Balance Sheet of Mr. A, prepare a schedule of changes in working capital and a funds flow statement :

Liabilities	2020 ₹	2021 ₹	Assets	2020 ₹	2021 ₹
Capital	63,000	1,00,000	Cash	15,000	20,000
Long-term Borrowings	50,000	60,000	Debtors	30,000	28,000
Trade Creditors	42,000	39,000	Stock-in-trade	55,000	72,000
Bank Overdraft	35,000	25,000	Land and Buildings	80,000	1,00,000
Outstanding Expenses	5,000	6,000	Furniture	15,000	10,000
	1,95,000	2,30,000		1,95,000	2,30,000

SOLUTION :

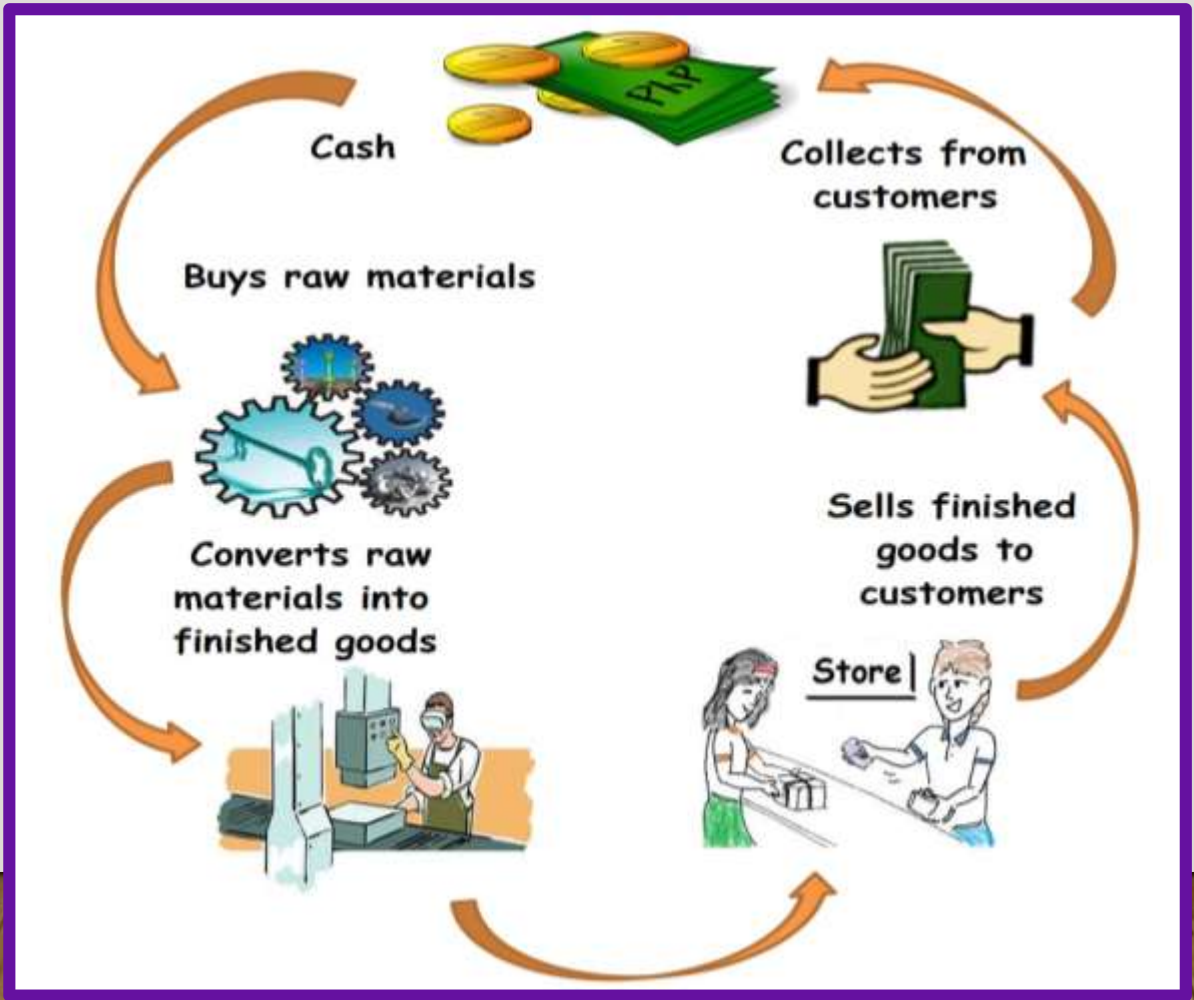
Schedule of Changes in Working Capital

	2020	2021	*Effect on Working Capital*	
	₹	₹	*Increase* ₹	*Decrease* ₹
Current Assets				
Cash	15,000	20,000	5,000	
Debtors	30,000	28,000		2,000
Stock-in-Trade	55,000	72,000	17,000	
	1,00,000	1,20,000		
Current Liabilities				
Trade Creditors	42,000	39,000	3,000	
Bank overdraft	35,000	25,000	10,000	
Outstanding Expenses	5,000	6,000		1,000
	82,000	70,000		
Working Capital (C.A.–C.L.)	18,000	50,000		
Net Increase in Working Capital	32,000			32,000
	50,000	50,000	35,000	35,000

FUNDS FROM OPERATIONS

As the name suggests, Funds From Operations (FFO) is the fund or cash generated from the operating activities of the business. The operating activities mean the core business activities.

OPERATING CYCLE



Funds from non-operations:
(funds from Financing and Investing activities)

- Examples:
  - Sale of Assets
  - Issue of shares/debt
  - Receipt of interest and dividends
  - Etc