

Financial Accounting
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Lecture – 40
Revision of Course

Namaste. To all of you, I am very happy that we have reached the last 40th lecture of this course. So, we were meeting regularly for last 2 months, I am hoping that you would have found the lectures as well as the assignments very much useful for your learning process. Now, this being a last lecture we will take a brief recap of whatever we have discussed whatever you have learnt in the course, we would also think of what can be done further for strengthening the learning and also what are the avenues for future learning.

I know it is a mix of variety of students or participants of different type, because this course has registration of students from different faculties; there are engineering students, there are management students, there are non-commerce students like art or sciences, there are also few commerce students, there are some entrepreneurs or housewives and so on. So, it is going to be useful for almost everybody in the society if you have a basic knowledge of accounting, which we have tried to discuss in the class. So, we started with discussion on what is meant by accounting.

If you remember we discussed that accounting is a language of business. So, we come out with financial statements based on transactions. First we record transactions then we summarize and the reports which are available are known as financial transactions giving us the financial reports. It is not only restricted to business entities it is equally useful for non-profit organizations, for government organizations. In fact, they are also useful for households. Just to know the expenses and income of a household also if proper financial statements are prepared then that that becomes advantageous. Then we went on to discuss three important financial statements we started with balance sheet.

So, balance sheet is a statement which gives the financial position as at a particular date. We can make balance sheet as on any date, but normally it is prepared at the end of the quarter may be at the end of 3 months or sometimes at the end of 1 year. There is a specific format for the balance sheet. So, you have got assets and liabilities; assets

represents the resources which we use for business like cash, like land and building, like patents like software or hardware and so, on they are required to be funded by somebody those are the sources of funds which we call them as liabilities.

There are two major types of liabilities in the category of NCL that is noncurrent liabilities or long term liabilities and then there are current liabilities. The non-current liabilities in turn can be of two types you have owners funds which is also known as equity or net worth and then you will have variety of other non-current liabilities which mainly consist of borrowings of debt. So, we discussed about the balance sheet.

Now, analysis of balance sheet is very much useful because we come to know the strengths and the weaknesses of the business in the form of assets and liabilities. Though I am using the term business it is not just for business entities, if you study the balance sheet for a new organization say a trust or a school or for government organizations also, you come to know: what are the resources which are being used for running those activities and who are funding those resources. So, we have seen first the basic formats, we have also seen the format of balance sheet as per company law.

Next we moved to profit and loss account. We all know profit and loss account or income statement is an important statement because it list out all the incomes. So, the revenues generated from where the money is coming and then we relate it with the expenses; in the expenses all category of expenses will be listed. So, first you will have operating expenses like purchases, like manufacturing expenses, then you may have something like rent, advertising, marketing expenses, you will also have finance cost, then non-cash cost like depreciation, that give you the first level of profit which can be called as a operating profit.

If you do not consider finance cost, then from operating profit you deduct finance cost then what operating profit you is also known as PBIT. After you deduct finance cost you get PBT. From PBT or Profit Before Tax you deduct taxes to get PAT, this is the profit available to the owners from that some profit may be distributed to the owners in the form of dividends and then the remaining profits are called as retained earnings which are transferred to balance sheet. Because they get added to the owners funds normally we show it under the category as reserves and surplus in the balance sheet.

Then we move to the third important statement that is known as cash flow statement. Cash flow statement as the name suggest talks about the flows of cash. Now the cash flow statement evolved because though profit and loss account makes us to understand the profitability of the business, it may not tell us what is the cash coming in and in what way the cash is being utilized that is why a cash flow statement was developed. And, all the cash flows are categorized under three heads so, that users of the statement understand purposes for which the cash is being raised and is being utilized.

So, there are three headings. Do you remember the headings? The first one is operating cash flows. So, this is the normal business activity of the entity or the day to day activities of the entity. All the money is coming in and out for normal course of activities are listed under the cash flow from operating activities, usually we use indirect method for the same. So, we start with profit before tax and we make adjustments for those items which are non-cash in nature. So, what are those non-cash items? We will add depreciation, we will add any particular amounts which are written off which are non cash in nature. Now why do we add depreciation? I think you all know, but I am just revising because here is where many get confused.

On one hand when we prepare P and L account we deduct depreciation, but in cash flow we add depreciation. What is the reason? Because it is a non cash expense and we have not paid any cash for the same, but it has been deducted for calculating profits or PBT. So, here what we do is, we take PBT we add depreciation, we also make adjustment for non operating items. For example, if there is any profit on sale of shares we will take in cash flow statement, will we add this profit or deduct the profit? Just think over most of you are right we will deduct the profit. Again a point of confusion because many times when the word profit comes we feel it should be added, but in reality it should be deducted because it has already been considered for calculation of profit and it is not an operating item. So, we need to remove it that is why we deduct it.

So, we deduct profit from operation something like profit from sale of shares, if there is any loss due to some non operating item let us say loss on sale of old machinery, then because it is a loss we will add it. So, we after making the adjustments for non-cash and non operating items, we get a figure which is known as funds from operations. Now in funds from operations we will make adjustment for working capital items.

So, any moment in inventory, any moment in debtors, any moment in creditors will be adjusted in cash flow statement because, it affects the availability of cash to me. For example, if the amount of debtors or receivables has gone down during the year, it means that our collection efforts were good and debtors have paid more amount from their last years outstanding they have reduced their outstanding, they have paid that amount to us.

So, decreasing debtors is a plus item in the cash flow statement ok. So, I think keep only this in mind that decrease in debtor is a addition to cash, automatically the same rule will be applicable to inventory. When it comes to creditors it will be exactly opposite because, for a current asset decrease is going to be added, but for a current liability decrease will be deducted getting it. So, we will adjust working capital items at this stage we will get cash flow from operating activities before tax, then we will deduct the taxes paid, then we will get the cash flow from operating activities. This is the first part of cash flow statement which is comparatively complicated to calculate and it is a lengthier part.

After that there are two more headings; the second one is cash from investing activities as the name suggests it includes long term investments, it also includes any other NCA like fixed assets. So, if you have purchased or sold these items, any cash going out or coming in would be shown under cash from investing activities. The third one is cash from financing activities; so, any money which we have raised for the business or if you have gone for repayment, then that will be included under this. For example, issue of shares or buy back of shares, issue of debentures or redemption of debenture, taking loan returning or repaying loan all these transactions would be in the financing item.

There is some special need to note about interest and dividend. Whenever interest is received because it is received from investments, it will be categorized as investing item same thing is true for dividend received. Whenever interest is paid or dividend it paid it will be categorized as a financing item. So, we will make total of operating plus investing plus financing, that will be the total cash generated by the company or entity during the year, we will add opening balance and that will be matching with the closing balance of cash.

In the note we will show any non cash transactions which we have not included in the cash flow statement. What are such non-cash transactions? For example, if there is a share swap. Now what is a share swap? Suppose we have acquired other company, for

acquiring other company we have issued our shares and in return we have got shares of that company from their shareholders, then it is called as a share swap deal; no cash payment is involved. So, it is not coming in the cash flow statement it will be shown as a note or as a footnote.

Like that there can be more transactions for example, if we have some outstanding loan which is payable to the bank, but instead of paying the loan amount we issued shares. So, our capital balance has increased and the loan balance has decreased without involvement of any cash, then again it becomes a non cash transaction. So, we will not show it in the cash flow, but we will show it as a footnote. So, have you got it? I have just gone a little in detail because cash flow statement is one important statement and many times the participants get confused in that.

So, we discussed about all the three financial statements. At this point of time I had told you in the sessions earlier and again I am repeating that it is very important for you to have a hands on view of the actual statements, just what we discussed in the class is not enough. So, you were asked in the first 2-3 sessions itself, that you need to choose your company, download the annual report read the annual report carefully particularly the financial statement part of it.

I hope you have completed that assignment and you have submitted the required details, but going beyond required details I will request you to many times read their P and L, balance sheet, cash flows. And, you can also check with the other companies financial statements so, that you know the peculiarities how different financial statements are prepared by different companies.

Apart from financial statements there will be many other useful information in the annual report, that also we have discussed in the class and by now you would have seen it in the annual report do you remember what else is there? There will be corporate governance report, there will be sustainability report, there will be list of employees which are who are getting high level of salary, there would be directors report, there will be auditor's report like that a variety of information about that company and sometimes about that industry is available. So, please go through that information also. In the class particularly after discussing the financial statements, we have gone into some of the conceptual parts.

Now, many times in the traditional system the accounting is taught from journal entries then we go to ledger account. From ledger we come to trial balance, from trial balance students are taught to prepare P and L and balance sheet. But I have gone in a reverse way first we have learnt: what is the output in the form of balance sheet, then income statement, then cash flow and then you have been introduced to the steps which are taken for preparation of those statements. Because this is not a hard core class meant for accounting students, this is mainly meant for non accounting professionals who have lesser time.

So, we have tried to cover the whole course in 20 hours to discuss important part of accounting ok. Now, at this stage we had discussed two important topics one was depreciation, methods of depreciation, how the depreciation is provided, next was inventory methods like FIFO or method like weighted average we had discussed, then we went to some conceptual discussion in conceptual discussion we have learnt about corporate governance; what is corporate governance, what are the important principles of governance, what happens due to failure of governance it leads to variety of frauds malpractices.

So, we discussed an example of Enron which is one of the biggest global fraud, then we also discussed global models of corporate governance the Anglo US model which is very much dependent on CEO and on the capital markets, then the banking dominated model of Japan and Germany, government dominated model in China and ethical model in India.

We have also discussed various ethical aspects or moral aspects which we get from Indian culture (Bharateeya Sanskriti) and which are very important for proper functioning of any organization. Then from corporate governance we have also discussed about evolution of accounting, how accounting is related to Deewali, how various Shreni types of organizations existed in ancient India. So, we have learnt about the history of accounting, then again we went to statements because by now I had hope that you would have familiarized yourself about the financial statements. So, we have may we have then gone for 2-3 exercises or cases taking real life companies and we had made in the class various financial statements like P and L balance sheet and cash flow.

From that if you remember we had done a case of Hindalco and in detail all the three statements were made after that we went to analysis of financial statements in the analysis we take ready statements sometimes we take some extra data and study the statements so, that we can analyze it and we can draw some interpretations from the statement. We saw that from a portfolio management angle this is a part of fundamental analysis.

In fundamental analysis there are three components company analysis, economy analysis and industry analysis we had focused on company analysis which is related to what we are learning that is financial statements. So, varieties of ratios were calculated. Do you remember important categories of ratios? From the balance sheet we started with liquidity ratios like current ratio then financial statement stability related ratios like debt equity or capital gearing ratio, then from income statement we can calculate profitability ratio like net profit or operating profit ratio, we can also calculate expense ratios like cost of good sales, to sales or material consumed to revenue these types of ratios.

Then we can calculate variety of return ratios. So, in return ratios we link the profitability to amount invested. The most important return ratio is ROI Return On Investment or sometimes it is called as return on invested capital; it can be calculated for the whole company, it can also be calculated for a particular project or for a particular SBU or division of the company it becomes a very important criteria for evaluation of projects.

There can also be return on equity share holders funds known as ROE or return on owners fund, then there can be other type of ratios which are known as turnover or activity ratios or efficiency ratios. For example, total asset turnover or inventory turnover or debtors turnover or fixed asset turnover these ratios measure the efficiency in use of that asset, we have also seen that inventory turnover you can convert it into number of days. So, we know that how many days of inventory or how many days of receivables are in the balance sheet.

So, we these were the ratios related to financial statements there can be other ratios which are useful for stock market like earning per share or dividend yield or for example, PE ratio this becomes very important for stock market investors. You can also have other ratios for example, for employees important ratio can be revenue per employee or profit

per employee. So, like that you can also take some outside data and link it to financial statements to calculate other types of ratios.

So, this was the almost the last part of our discussion. Now going ahead there can be a few concepts which we have not discussed, but those who have developed interest now in accounting or in finance, I would request you to study them further. One of them is environmental accounting or green accounting as it is known as where we try to measure the environmental impact for a particular project or for a company.

So, you can have environment accounting, there is another concept called as inflation accounting which tries to measure the impact of inflation, another important aspect of accounting is human resources accounting. We have seen that human resources are one of the most important assets for the business, but we cannot show it in the balance sheet because they are not owned by the organization.

But now there are concepts like HRA or Human Resource Accounting where some efforts are made to evaluate and value the human resources and put them in the form of a particular figure. So, there are variety of contemporary or new concepts which are coming in accounting. In our major discussion we have also discussed about accounting standards or GAAP, but we have discussed it in short you can go more in detail about various financial standards or accounting standards which are issued by various bodies why they are issued and how they are applied by variety of companies.

So, there are number of aspects which can be studied in accounting. I hope you have developed now more and more interest. There are a few more concepts like investment accounting, departmental accounting, branch accounting. So, what I would request you is, now if you have developed some basic understanding go for a detail accounting book or some other web courses in accounting, wherein more aspects would be detailed would be discussed and you can learn more and more aspects of accounting.

As far as our course is concerned various sheets have been shared with you they include first was about our assignment on annual report, there are variety of cases, there are also some conceptual aspects which have been shared with you. If you have not downloaded a few of them I would request you to download go through them and for any queries which you have, our discussion forums are always active and research scholars and professors from IIT are also participating in it to respond to your queries. So, keep on

raising the queries discuss it amongst the peer group also discuss it with our research scholars and that will help continuous learning for you and we are also of course, going to have a proctored exam.

And, I hope you are preparing well for the exam, and best wishes to all of you not only for the exam, but also for grasping the learning which would have happen. You would have learned many things and I hope they would be very much useful for your day to day life. It can be for your corporate life, for your career because you will be evaluated on financial performance, it will be also useful for entrepreneurs. If you are doing business the knowledge of finance is very important; if you are wanting to study further let us say wanting to do MBA or PhD or wanting to learn further some more aspects of accounting or finance for that also this course is very going to be very much useful.

So, all the best for exam as well as for further learning keep in touch. Namaste.