Economics, Management and Entrepreneurship

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Lecture - 17
Financial Statements

Good morning. Welcome to the 17th lecture on economics, management and entrepreneurship. Today and tomorrow we shall be discussing on 2 important aspects of any organization. Today's lecture will be devoted to financial statements and tomorrow lecture will be devoted to analysis of these financial statements. Basically as you will see these financial statements answers 2 very important questions about the financial health of an organization.

One how did the organization were in the last one year and as on today what is the financial status of an organization Answers to these questions are normally available in 2 very important financial statements. One is called the balance sheet and the other the income statement or the profit and loss statement. Let us see what these 2 financial statements are all about. So the lecture is entitled financial statements.

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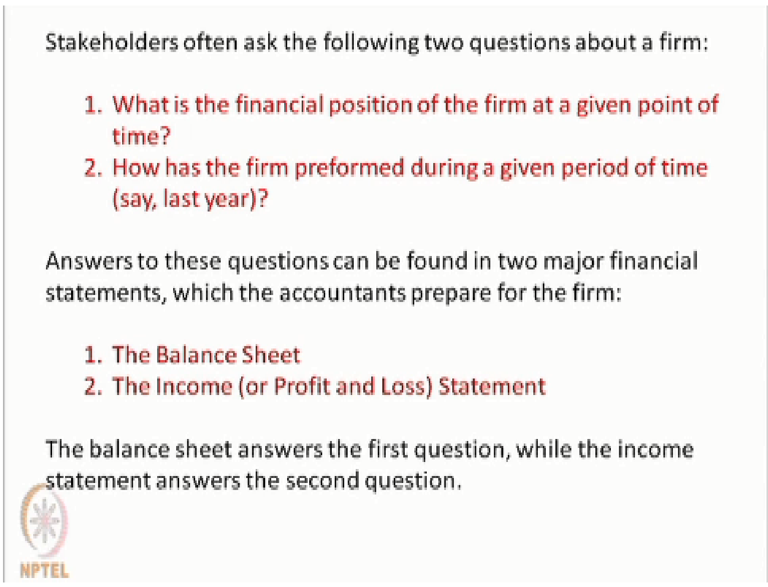

Normally stakeholders of a company are could be customer, could be the financial institutions who pay money, the suppliers, the employee themselves, the owners and so on and so forth and they often ask the following 2 questions about a firm. What is the financial position of the firm at a given point of time, how has the firm performed during a given period of time say last year?

Answers to these questions are normally found in 2 major financial statements which the accounts prepare for a firm the balance sheet and the income or profit and loss statement. The balance sheet answers the first question. First question is what is the financial position of a firm at a given point of time while the income statement answers the second question namely how has the firm performed during a given period of time say last year.

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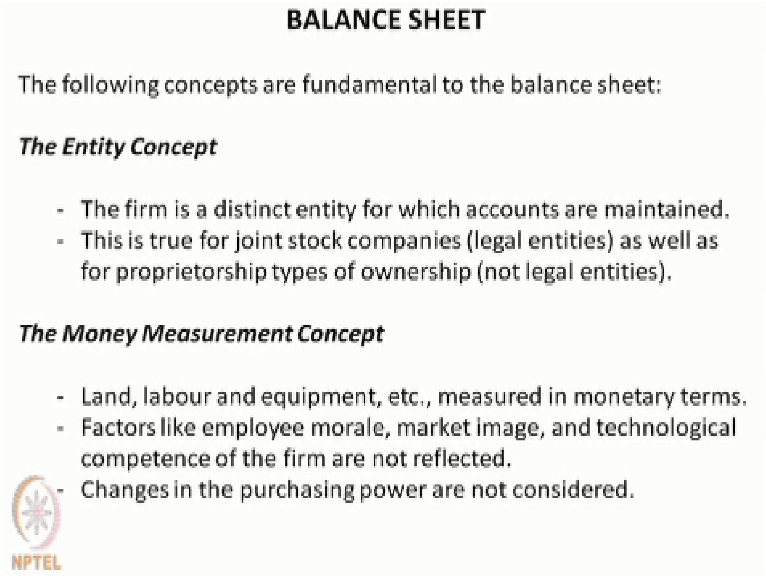

We will look at the balance sheet first. Firstly, let us understand there are certain concepts that are very fundamental to balance sheet. Some of them we have already discussed when we took up double entry book keeping system particularly the concept of a firm being an entity. The first concept is that the firm is a distinct entity for which accounts are maintained. This is true for joint stock companies that are legal entities as well as for proprietorship types of ownerships such as an entrepreneur who may be a non legal entity.

Another concept which is crucial to financial statements is that all the assets and liabilities are measured in monetary terms land, labour, equipment etcetera are measured in monetary terms and therefore the name financial statements. However, there are very important factors like employee morale, market image and technological competence of a firm that are not reflected in financial statements.

So this is a weakness of financial statements so we should know it right from the beginning. Another thing is that as we all know the purchasing power changes as time proceeds because of inflation that takes place whereas in financial statements no consideration of inflation is normally considered are made.

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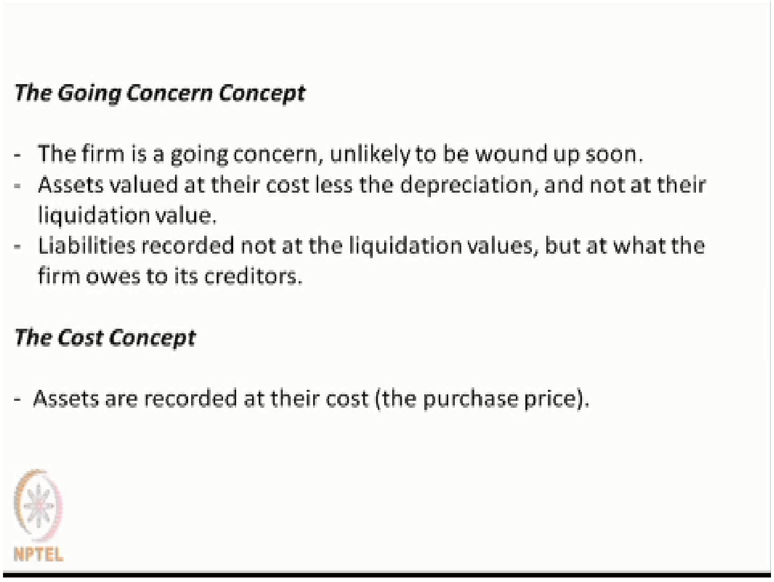

This also we have already taken up when we took up the double entry book keeping system the going concern concept. The firm is a going concern unlikely to be wound up soon. The implication is that assets are valued at their cost less the accumulated depreciation that means assets may have been bought 5 years ago a particular asset may have been bought 5 years ago and we can charge certain amount of depreciation every year.

So depreciation that are calculated every year are added up and subtracted from the purchase price and that is the book value of the asset and the asset value will be shown at the price at which it was purchased less the accumulated depreciation and not at their liquidation value because it is a going concern organization. Therefore, it is assumed that the asset would continue to be retained by the organization.

Similarly, liabilities are recorded not at their liquidation values, but at what the firm owes to its creditors. Another concept that is crucial to financial statements is the cost concepts. Assets are recorded at that cost meaning the purchase price not their resale value or not at their value at which they can be substituted, but at the price at which they were purchased right at the beginning- of course as I said the accumulation depreciation.

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The Dual Aspect Concept

- Assets are resources owned by a firm.
- Equities are claims of various parties against assets owned by a firm.

Equities can be of two types:

- Owners' equity – Claims by the owners of the firm.
- Liabilities – Claims by the creditors of the firm, such as bondholders, commercial banks, suppliers, etc.

The most fundamental concept of accounting is

Assets = Liabilities + Owners' Equity

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The next concept is the Dual Aspect Concept already we have seen those things when we discussed double entry book keeping systems. Assets are resources basically owned by a firm and these assets are normally the value of these assets as on today are= to the liabilities that the company owes to its suppliers and other lenders the outsiders+ the owners equity. So basically assets equal equities and equities can be of 2 types owner's equity that are the claims by the owners of a firm and liabilities that are claims by the creditors of the firm.

Creditors of the firm could be bondholders, commercial banks, suppliers and so on and so forth. Therefore, the most fundamental concept of accounting that we had already discussed is also true when we prepare the financial statements which is assets= liabilities+ owners equity.

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Balance Sheet – An Illustration

Indian Companies Act prescribes following format of the balance sheet:

Liabilities	Assets
Share Capital	Fixed Assets
Resources and Surplus	Investments
Secured Loans	Current Assets, Loans, & Advances
Unsecured Loans	Miscellaneous Expenditures, and Losses
Current Liabilities and Provisions	

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Now we give an illustration of balance sheet. Indian Companies Act prescribes the following format of a balance sheet. The balance sheet will have 2 aspects. One assets and the other liabilities. Liabilities once again has got as we all know one is liabilities to the outsiders these 3 are the liabilities towards the outsiders and these 2 are the liabilities to the owners. We shall discuss these aspects elaborately as we go on today.

On the asset side, we have fixed assets and are also called non-current assets and current assets. So non-current assets are fixed assets and investments and current assets are considered these as the current assets. Now we will take up one by one with the help of an example.

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Balance Sheet of XYZ Company as on March 31, 2000

ASSETS

Fixed Assets (Net Gross Block)		3,200,000
Land	150,000	
Building	3,800,000	
Machinery	950,000	
Office Equipment	100,000	
	5,000,000	
Less: Accumulated Depreciation	1,800,000	
Investments		1,850,000
In Stocks of ABC Company	300,000	
Marketable Securities	1,550,000	

To start with we consider balance sheet. Balance sheet if you recall gives an answer to the first question which was what is the financial status of the company on a particular date. So here we are writing as on March 31, 2000 whatever the year is. So it is at this point of on this date these are the assets and these are the estimated values as the company holds. Now these are the items and this is their value.

This column gives the total values for example fixed assets is known Net Gross Block. Fixed assets are assets also is known as non-current assets= this. This is the sum total of these 4 items. And these are the different components of fixed assets land, building, machinery and office equipment. Now value of land is 150,000 these are all in rupees. Building 3,800,000 machinery 950,000, office equipment 100,000 and this total 5,000,000 less the accumulated depreciation which is 1, 800,000 this get subtracted from this to give a value of 3, 200,000.

In separate class in the future we shall talk about how depreciation is calculated for various fixed assets and how they are accumulated and then subtracted. We will discuss this in detail later. Now we come to another type of long-term asset which is an investment this is something like long-term investment in another company. This company also buys stocks or shares of some other company let say A, B, C this is X, Y, Z company.

It buys stocks of A, B, C company. So this is something like a long-term investment and this is shown separately and this is 300,000 and the company also buys various types of securities, stocks from the stock market which is this particular one is very large therefore it is written separately and these are small stocks, but when they are added up it becomes a very large value which is 1,550,000 written separately.

Marketable securities mean the company purchases stocks of various organizations and it likes to trap them in the secondary market in the stock market whereas this investment the company does not like to sell it in the stock market it continuous to hold them hold these stock for a longer time. It is shown therefore separately. Together they add up to 1, 850,000 rupees.

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Current Assets, Loans, and Advances			4,650,000
Cash and bank		950,000	
Net receivables		2,000,000	
Receivables (Debtors)	2,100,000		
Less: discounts and bad debts	100,000		
Inventories		1,500,000	
Finished Products	600,000		
Work in Process	400,000		
Raw materials & Supplies	500,000		
Prepaid expenses, Loans, & Advances		200,000	
			9,700,000 Rs.

Then we come to current assets. Under current assets loans and advances we have cash and then these receivables then net receivables, inventories and prepaid expenses. Here cash and bank that is amount that we hold in the form of cash and bank and the amount that we are holding in the current account or the saving bank account is 950,000 rupees and net receivables remember that a company who sells its products to its customers quite often the sale takes place in the form of credit.

Therefore, no immediate transaction of cash takes place. So the cash comes at a later date. The amount that the company is expecting to get from its customers is called the account receivables this is what is written as receivables or account receivables also known as debtors is 2, 100,000, but company also can give discounts and sometimes some account receivables are not received they are called bad debts and they are subtracted this is an estimated value/

So this is subtracted from the account receivables and the net receivables is 2,000,000 rupees. Now the next item is inventories next item under current assets. So current assets have got cash, account receivables, inventories and prepaid expenses. Inventories can be in 3 types. Raw materials and supplies, work in process and finished products. Different accounts are maintained for each of them as we already know.

So as on 30th of that month raw material position is 500,000 WIP 400,000 finished product 600,000. Total which are inventories is 1,500,000 rupees. Now prepaid expenses loans and advances often certain amount are paid in advance. For example, rental maybe paid in advance that means for the month of April rental maybe paid in March. Similarly, insurance maybe paid 1 year in advance.

So these advances are basically assets they are not yet expenses. So these are called prepaid expenses or advances that amount of 200,000. We will give definition of almost each one of these items later just now let this be 200,000. These 4 together meaning cash, account receivables, inventories and prepaid expenses and advances these 4 add up to 4, 650,000 and then previously these 2 were there under fixed assets and investment they add up to 9,700,000 rupees.

So this is the asset position total assets of the company as on 31st of March 2000 is 9,700,000 rupees.

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LIABILITIES

Share Capital		2,800,000
Equity Capital	2,000,000	
Preference Capital	800,000	
Reserves & Surplus		1,700,000
Revenue Reserves	1,700,000	
(Accumulated Retained Earrings)		

Now what is the position of the liabilities. Liability on the owner's equity side we have 2 items one the share capital is the stock holder's owner's capital. One there are 2 types of capital normally equity capital. We will discuss about equity and preference capital just now. The equity capital is 2,000,000 rupees and preference capital is 800,000 total share capital is 2,800,000 rupees this is also known as paid in capital total paid in capital is 2, 800,000 rupees.

Then as time proceeds certain profits there is a mistake here in the spelling this should be earnings. Every year there is certain earning that is retained and not given away as dividends to the customers. So if you add all of this earnings that becomes accumulated retained earnings and in this case this is 1,700,000 rupees. The owners are also owners of these accumulated retained earnings. This I already have told you in one of my past lectures. So here this company owes it to the owners.

Therefore, this is also included here under liabilities this comes as 1,700,000 rupees that is posted here.

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Secured Loans		2,000,000
Debentures	1,500,000	
Loans from Financial Institutions	500,000	
Unsecured Loans		700,000
Fixed Deposits with XYZ	500,000	
Loans from Promoters	200,000	
Current Liabilities and Provisions		2,500,000
Accounts Payable (Creditors)	1,000,000	
Loans Payable	850,000	
Accrued Expenses Payable	200,000	
Provisions for Pension and Gratuity	100,000	
Income Taxes Payable	350,000	
		9,700,000 Rs.

Then apart from these owner's equity there are liabilities that the company owes to outsiders this is the loans that has company has taken from financial institution and from general public in the form of bonds and debenture so that could be 1,500,000 loans from financial institutions could be 500,000 rupees totaling 2,000,000 rupees. Loans also could be in the form of these 2 are secured loan meaning that the company has probably mortgaged some of their assets or some such thing therefore it is called secured loans/

That is certain securities against the loan taken which means that if the loan is not paid back then the lending institutions adds the power to sue and then sell the items against which the loans were taken to get back the amount from the company. Whereas these are loans of not that nature so the company may also owe to outsiders for the loan that they have taken. So this is a fixed deposit 500,000 loan from promoters 200,000 totaling 700,000 rupees.

Apart from the loans taken from outsiders there are other liabilities that the company owe to its creditors and others. One is account payable meaning that the company has purchased goods from suppliers on credit so they are liable to pay the amount back to the suppliers. It comes to 1,000,000 rupees, loans payable could be 850,000 rupees, accrued expenses payable means the company is supposed to have paid let say rent or taxes or other expenses.

But it has not yet made the payment that is accrued expenses payable is 200,000 then the company may keep certain amount for pension and gratuity. They are normally called provisions. So company keep this amount separately it has to be paid so it is mentioned in the liability in the balance sheet as 100,000 and income tax is payable could be shown separately and not with the expenses.

It could be shown separately as 350,000. Now all this add up to 2,500,000. So total liability is 2,800,000 for share capital, reserves and surpluses 1,700,000 secured loans and unsecured loans and current liabilities together they are= 9,700,000 rupees. This is the total liability including the owner's equity which is same as the total assets. And this is our accounting balance equation 9,700,000 total assets.

We know therefore what are the dues of the company to whom to how much extent the company owes and where the money is presently invested.

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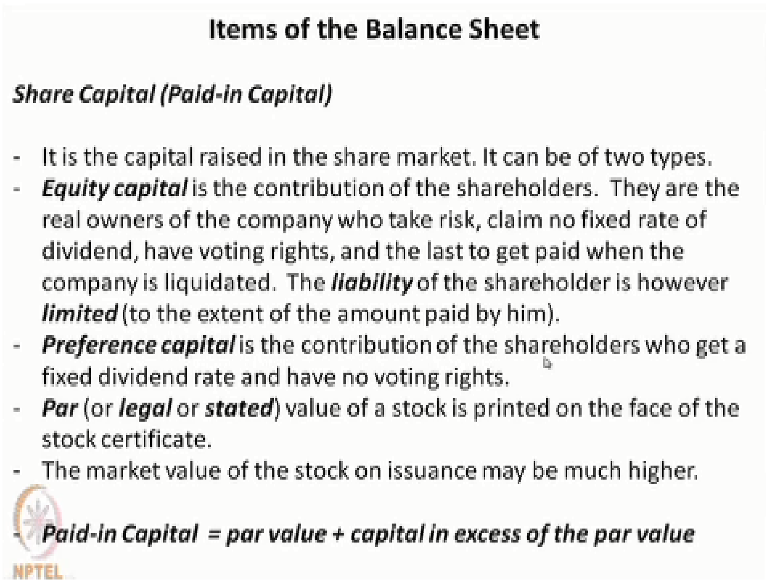

Now we shall discuss in detail various items that appear in the balance sheet and in the income statement. Firstly, their share capital the share capital is the amount raised in the share market. Normally there are 2 types of share capital. One is the equity capital the other is the preference capital. The equity capital is the real contribution of the shareholders or stockholders.

They are the real owners of the company would take risk because there is no fixed rate of dividend when the company is doing well probably the dividend will be paid at a very high rate and if the company is not doing so well they may be getting less dividends. They have voting rights and or rather but they will be the last to get paid when the company is liquidated.

If for some reason the company's financial position is not bad and it is very bad and is liquidated, then the other people get paid first for example the outside liabilities will be paid first and the stock holders of equity capital will be paid last. Their liabilities of course is limited to the extent of the amount they have paid. So this is a limited liability case. So this is what is equity capital contrast this to preference capital. The preference capital shareholders get only a fixed dividend rate and they have no voting rights.

So if is 9% they always get 9% of the amount that they pay every year whether or not the company makes a profit, but they have no voting rights and the equity capital people may be getting 50% dividend on one day or in one year and may be only 5% in another year. Nothing maybe in still another year. So these are the differences between equity capital and preference capital.

Equity capital the shareholders are actually the real owners of the organization. Normally on the certificate a value is written value of the stock is written the stock certificate is called par value or legal value or stated value. Company actually pays or actually charges not at this par value all the time. It may add certain premium to it. The par value maybe only rupees 10 for a particular stock the company maybe charging 110 rupees and this 100 rupees is called in capital in excess of the par value.

Par value could be just 10 rupees and the total paid in capital for one stock will therefore be 10 rupes+100 rupees, 110 rupees that is the paid in capital. So this is what is called share capital.

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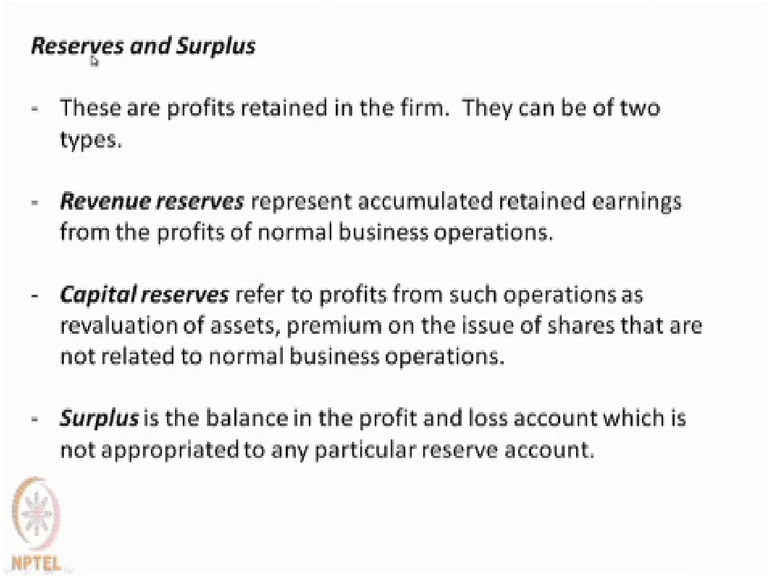

The next item that we had mentioned was Reserve and Surplus. These are profits retained in the firm. If you recall it is something like this from out of the net profit taxes and interest are paid and the amount that is retained after payment of interest and taxes from out of that dividends are paid to the shareholders and after paying the dividend what is retained is actually called earnings.

These earnings are retained by the firm. Now these profits can be of 2 types revenue reserves that is what I just now said accumulated retained earnings from the profits of the normal business operations after paying the dividend. Whereas capital reserves referred to profit from such operations as reevaluation of assets premium on the issue of shares that are not related to normal business operations.

And surplus is normally the balance in the profit and loss account which is not appropriated to any particular reserve account. You will realize that although we say that assets and liabilities must equal there are accounting errors and because of that this equality sometimes is not achieved. So whenever we see up to 5% any mismatch of the values of assets and liabilities is usually tolerated.

And if assets are more than the liabilities the more amount is called the surplus and that is written down here as surplus.

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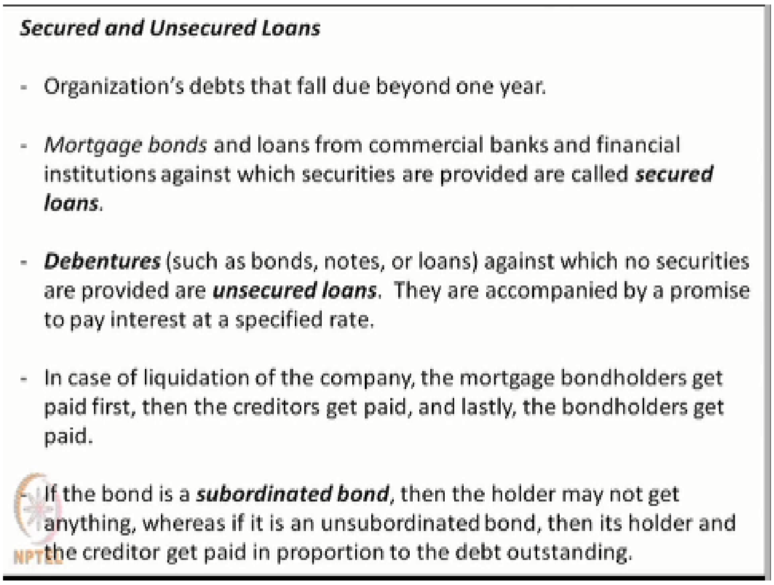

Then we talk about secured loans and unsecured loans. Normally organization debts that fall due beyond one year are covered under secured and unsecured loans. We have mortgaged bonds and loans from commercial banks and financial institution against which securities are provided are called secured loans whereas debentures such as bonds, notes or loans against which no securities are provided are unsecured loans.

Normally they are accompanied by a promise to pay interest at a specified rate. So sometimes they are called promissory notes. And sometimes instead of writing unsecured loans we also write as notes payable. Now in case of liquidation of the company the mortgage bond holders get paid first because there is mortgage signed. It is a secured loan they are first set of people who get paid then the creditors get paid and lastly the bondholders get paid that is the unsecured loans.

And if still some money is available the equity shareholders get that money. If the bond is a subordinated bond, then the holders may not get anything at all whereas it is an unsubordinated bond then the holder of such an unsubordinated bond and the creditors get paid in proportion to the debt outstanding so these are some details about secured and unsecured loans.

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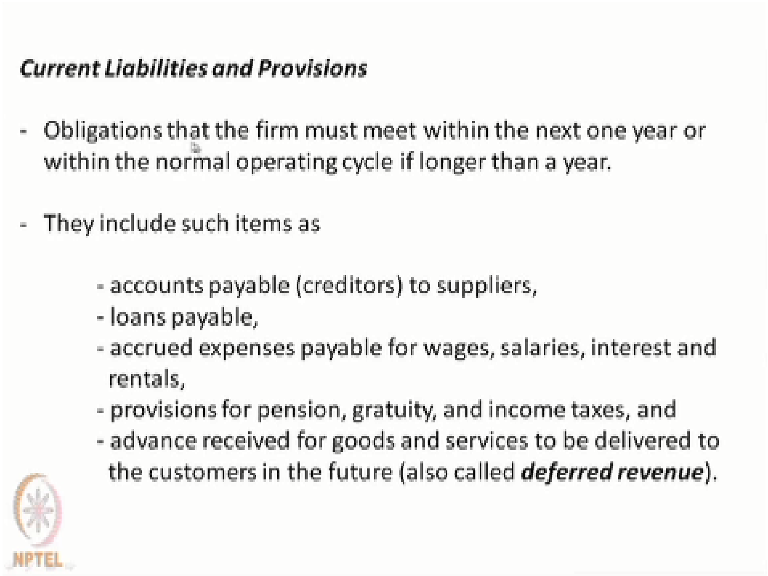

Then we talk about current liabilities and provisions. Under current liabilities these are obligations that the firm must meet within the next one year or within the normal operating cycle if it is longer than a year. Next slide we will talk about the meaning of operating cycle. They include such items as accounts payable which is also known as creditors to suppliers, loans payable, accrued expenses payable for wages, salaries, interests and rentals, provisions for pension, gratuity and income taxes.

Advanced received for goods and services from customers for delivery of these things to them in the future that means the amount is received in advance from the customers, but the goods and services have not been delivered to them. So these are advanced received also known as deferred revenue so this is also a liability. So basically one when we say current it means within one year or within the normal operating cycle if the cycle is longer than a year.

Now what is this operating cycle? We will talk about it just hold on.

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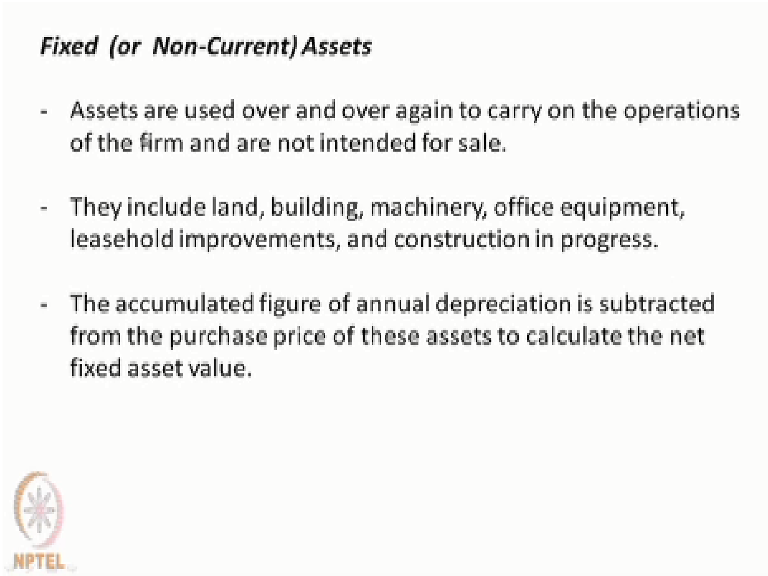

Next is non-current assets or fixed assets. They are used over and over again to carry on the operations of the firm and are not intended for sale. They include land, building, machinery, office equipment, lease hold improvements. We shall talk about leasehold improvements just now and construction in progress. The accumulated figure of annual depreciation is subtracted from the purchase price of these assets to calculate the net fixed asset value this already we have discussed.

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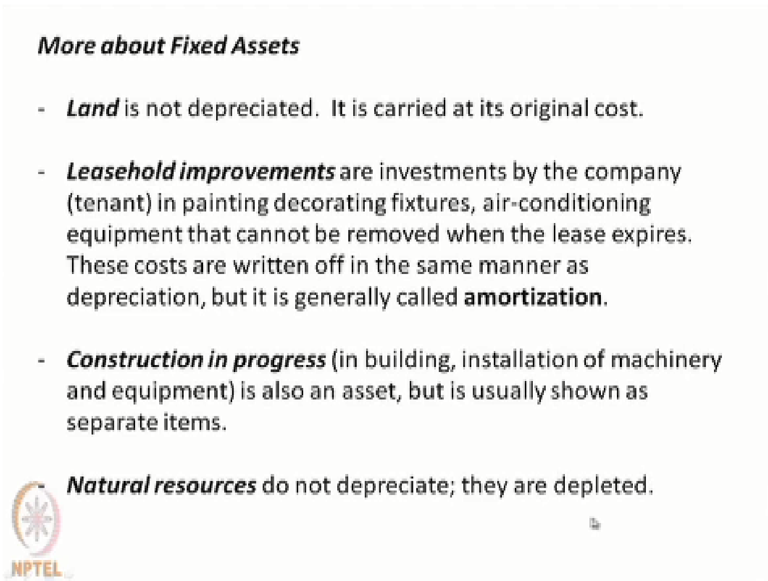

Land normally unlike equipment building and machinery land is not depreciated. It is carried at its original cost. Leasehold improvements are investments by the company in painting or decorating fixtures, air-conditioning equipment that cannot be removed when the lease expires. These are examples of leasehold improvements it means that suppose the company has taken a building on lease for 5 years.

Naturally during the lease period, it might spend certain amount to make the building habitable and usable by them and when the lease expires these amounts, fixtures and air conditioning or painting that is done they cannot undo it. So this is the amount they had invested in the leasehold improvements activity so they are taken as fixed assets and like a machinery they are also depreciated in 5-year time and this is generally called amortization instead of depreciation.

And the amount they invest in making the building habitable by them or usable by them is called the leasehold improvements. Now while making building or installing machinery and equipment it might take quite a long time and lot of money maybe invested in the process that is called construction in progress. That is also an asset, but usually not soon as a separate item.

Under fixed assets also a company may have particularly mining companies may have natural resources like mines normally no depreciation is calculated for such resources, but as and when mines are used or ores are mined out there is a depletion that takes place and this depletion is amount in terms of money depleted is subtracted from the estimated reserves of the natural resources to show the asset position on a particular debt.

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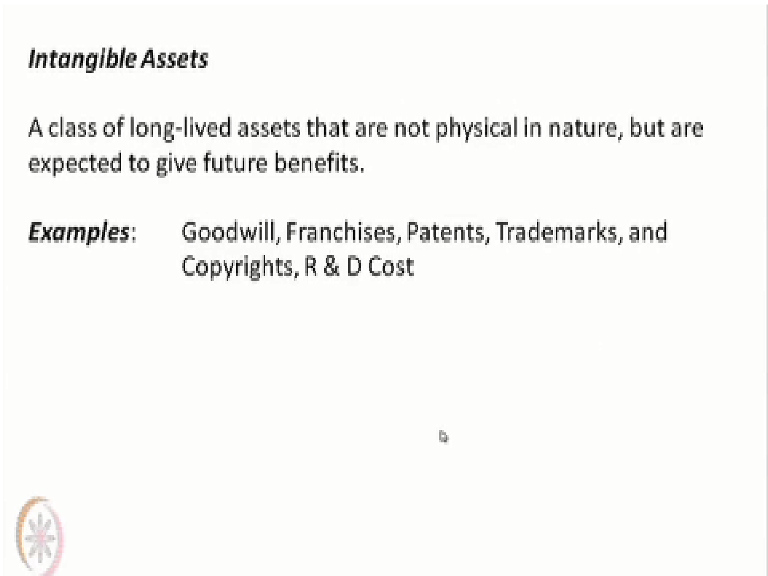

We also in addition to have tangible assets like fixed assets we also have what is called intangible assets that we cannot see, feel or touch and their examples of such non physical or intangible assets like goodwill, franchises, patents, trademarks, copyrights and R&D

investments these are all intangible assets. There are different types of rules in every country that suggest or that gives guidelines as to how to account for these intangible assets.

For example, R&D maybe taken as an expense and can be expensed off not in one year, but over a period of time because R&D investment gives rise to certain future benefits so it is investments it is an asset. Therefore, it is amortized over a period of time. Similarly, patents, trademarks and copyrights. Similarly franchises now what is goodwill often times goodwill is shown as an item in the balance sheet.

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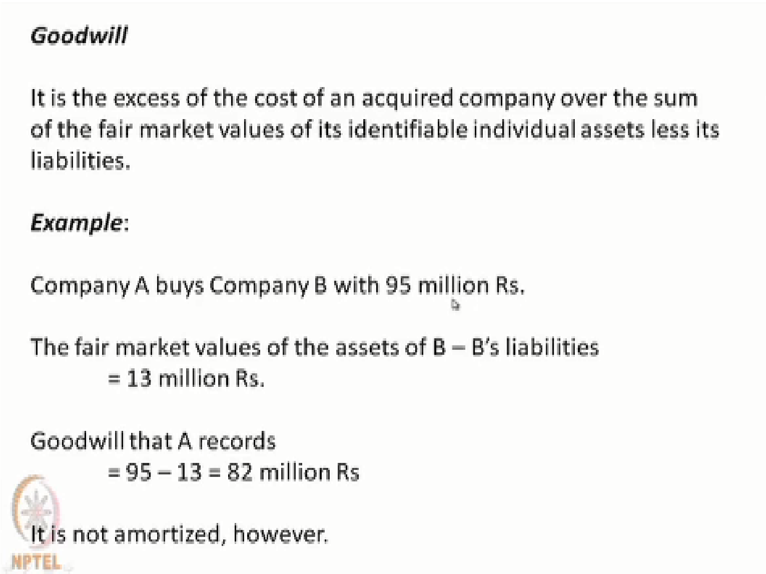

Now what is goodwill? This is an example of what goodwill means. It is the excess of the cost of an acquired company that means if the company acquires another company in that case only goodwill is meaningful. It is the excess of the cost of an acquired company over this sum of the fair market values of its identifiable individual assets less its liability. Now what is the meaning?

This is explained in this example. Let say that company A buys company B by paying 95 million rupees. Now the financial statements the balance sheet in particular of company B shows that it has certain assets and it has certain liabilities, but the market value of the assets and-the liabilities one sees that it is only 13 million rupees. The company has paid however 95 million rupees.

That means if it sales the assets of B it can pays the liabilities then it only has 13 million rupees' surplus. So which means that the company A has invested 95-13 82 million rupees more than the actual net assets of company B. These amount this amount excess amount that it has invested over the fair market values of the indefinable assets less the liabilities is known as goodwill that is an investment made.

And this is shown as an asset and it is not amortized not depreciated it remains as an investment.

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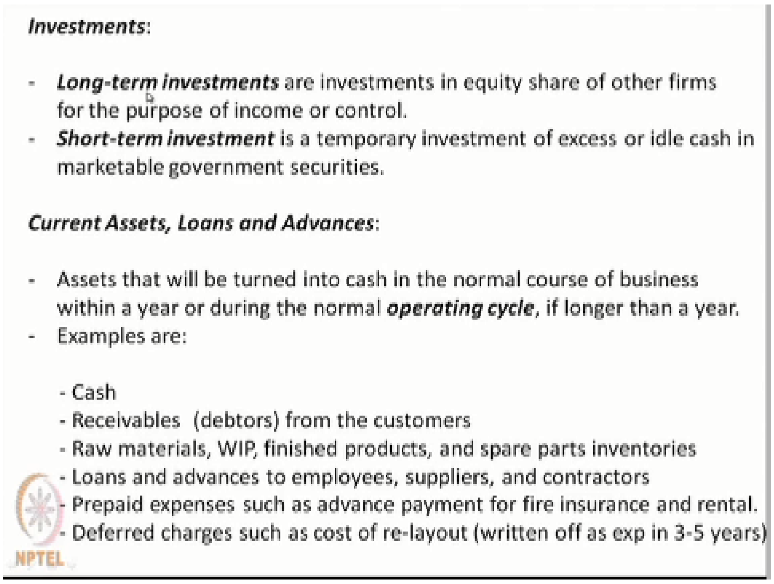

Now investment can be of 2 types long-term and short-term. Long-term investments are equity shares in other firms for the purpose of income or even controlling the other firms the operations of the other firms whereas short-term investments is a temporary investment of excess or idle gas in particularly government securities such as treasury bills and all that. Now current assets. Current assets we already mentioned as cash receivable, raw materials, work in process, finished products and spare parts.

Advances paid to the employees, suppliers and contractors, advance payment for fire insurance and rental, prepaid expenses paid and deferred charges such as cost of re-layout written off as expense in 3 to 5 years. So these are examples of current assets normally they will be turned into cash in the normal course of business within a year or during the normal operating cycle if normal than a year.

So this is what I was telling you little earlier and we shall now say what is the meaning of an operating cycle is?

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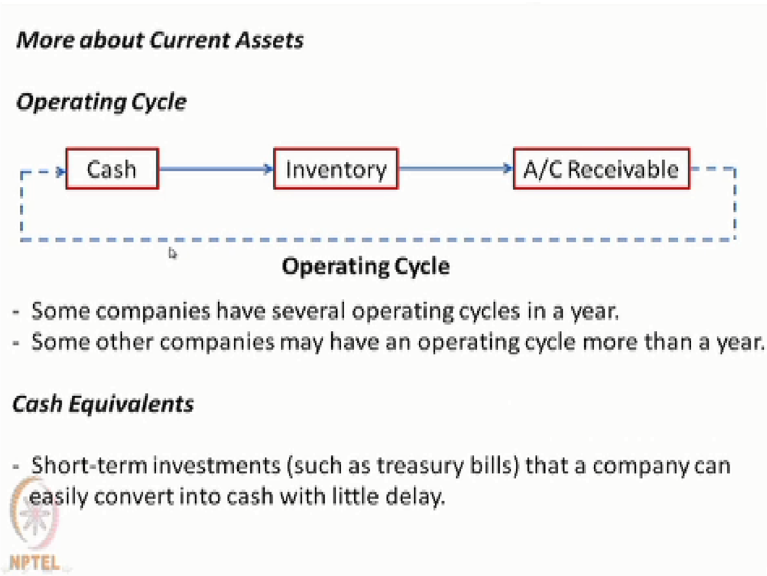

This is the operating cycle normally cash is the most liquid that is used to buy inventory, raw material inventory and then the company adds value to it to make into work in process and then finished product inventory and then this finished product inventory is sold to the customers if it is on credit then it remains as account receivable. And then when it is paid by the customers it is turned into cash.

Again the cash is used to buy inventory, add value to it, make finished products, sell it to the customers again it remains as account receivables and again when amount is account receivables is converted into cash so this continues. We say cash is the most liquid account, receivables is little less liquid, inventory is the least liquid. Least liquid because inventory to be converted into cash usually goes through account receivables.

First it has to be sold. If it is account receivable that means already inventory has been sold. So most liquid, least liquid, less liquid this cycle is called operating cycle and how long an inventory takes time to be converted into cash is called the operating time. Normally it is within a year, but some companies have several operating cycles in a year. Some companies maybe very lucky in 2 months' time they may be able to convert inventory into cash and then to inventory, but some companies may take longer than one year.

So that is the meaning of operating cycle. We also sometimes talk about cash equivalents as short-term investments such as in treasury bills. Now we come to the second statement the income statement. Now in the balance sheet we showed as on a particular date what the company is owed to the others to the owners and to the non-owners and what it possesses in the form of assets.

And what are the components of assets and what are the components of liabilities that we showed in the balance sheet as on a particular date.

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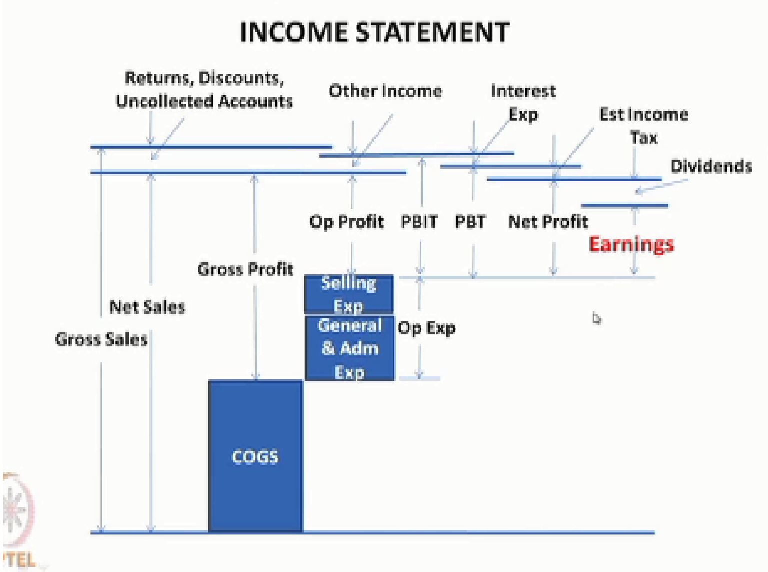

Now the second financial statement is income statement. Now income statement is I have shown in a graphical manner. Let us say that is the (()) (47:09) and that the gross sales after selling the goods to the customers the revenue is the gross sales, but from the gross sales certain amount will be returned as bad quality products or something they are returns or there are defects or the company may give certain discounts or as I wrote earlier uncollected accounts or bad debts.

So by that amount the sales will be reduced so if we subtract estimated value of discounts, returns and uncollected accounts then our net sales are only this much that is gross sales-this is the net sales. Now out of these net sales we subtract the cost of goods sold. Cost good sold is labor cost and material cost and power cost and other overhead expenses that are charged to the products that are sold that is cost of goods sold.

If we subtract from the net sales the cost of goods sold, we have gross profit. Now from the gross profit if we subtract the general and administrative expenses and the selling expenses then we get the operating profit recall that gross profit is calculated by subtracting COGS from net sales. COGS has the material cost, labor cost and factory overhead expenses. The other expenses are written separately as general and administrative expenses.

And selling expenses these 2 types of expenses are read together is called operating expense. And if we subtract from the gross profit the operating expenses then we get operating profit. The company may have certain other income from various investments that it might have made, certain investments in other companies or in certain bonds or short term investment it might have made that are not basically the operations its own operation, it is some other operation, but not central or crucial to the company itself therefore it is shown separately.

So gross profits mean net sales-factory cost or cost of production. Operating profit basically means not only factory cost, but also companies other expenses that are required to sell the product and if we add to it other income what we have is called profit before interest and taxes. From out of profit before interest and taxes if we subtract the interest expense then we get profit before tax.

Profit before tax-estimated tax income tax is called net profit. Look that net profit is what net is used only here and not anywhere with profit not anywhere before. So net profit is calculated only after all expenses including interest and income tax are paid that is a net profit. So net profit therefore is the operating profit+ other income-interest expenses-estimated income tax.

Now from net profit the company now decides how much to give dividends to its owners. And if they decide to pay these dividends what remains is the earnings in that particular year. These earnings over different years are added up to give what is called accumulated retained earnings. So today we discussed in detail balance sheet it has got 2 basic divisions assets and liabilities. Under assets we had fixed assets and current assets.

We gave different components of fixed and current assets we discussed them in detail. Under liabilities we had long-term investments and different other short-term investment and account payable type of components of liabilities and then we had just introduced income statement where we said that from the gross profit made when the goods are sold there are different types of expenses. One is a factory cost nest the general and administrative expenses.

And the selling expenses are subtracted and then from there we subtract or rather we add first of all any other income from other sources before we subtract interest and taxes. Once we subtract the interest and taxes we get what is called net profit and then based on that we decide how much to pay dividends. If dividends are subtracted, then what we get is earnings. So in our next lecture we shall discuss in detail the various components of income statement.

And then later we shall show how the numerical values given in the financial statements can be used to get to know the financial health of a company. Thank you very much.