Decision making using financial accounting
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Lecture - 03
Two Financial Statements

Yesterday what we talked about? We talked about two basic financial statements. I started with 3 and then only talked about 2. I didn't talk about the 3rd and I am not going to talk about the 3rd today also. We talked about the balance sheet we talked about the profit and loss statement, what we said was, balance sheet is nothing but a list of what you own and what you owe in a way or the other way to pull it is it is just indicative of the sources of your funds out there.

That is what where all you are getting your funds out there, that is what I talked about. I said you get is a capital an entity, you borrow money from a bank, you borrow money from a financial institution that's all what you call it as your source of fund out. I repeat that for example, I said there is what is called as an entity concept. In a entity what I said is, you are an independent person, you file your tax returns independently, the entity or the organization or the company or whatever name you call it that also files it is tax return that is a separate entity.

I start a business I said I start a business Arun Kumar and co I contribute capital to the business, the business owes that money back to me on the day they wind up. So, that is what we talk about as liability plus capital or capital plus liability. Using that capital I can that moment I said capital is there that is I contribute 10 lakhs out there then there is capital out there.

Then what happens? The business or the company owns the 10 lakhs whatever you have actually contributed that whether it is in the form of cash, whether it is in the form of a what we call it is a bankers cheque or whether it is in the form of a whether it is in the kind if you have contributing in the worth 10 lakhs in the form of furniture and building etc. That entire thing is owned by the enterprise or what you call it as it is an asset for the enterprise out there.

Now, beyond that your balance sheet or the statement of what you own and what you owe is an indicative of what is there what you own or what is owe as on a particular day that's all. That is the position can keep changing every minute, your cash position keeps changing every minute it can change, so it is on a particular day.

So, when we talk about a balance sheet we say balance sheet as of 31st first of March, balance sheet as of 30th of the 31st first of the December, balance sheet as of 30th of September, balance sheet as of 15th of that is on that day what is the position. Whereas, when we talked about what we call it as a profit or loss statement or other way to put it is income statement.

It always gives you the resultant revenue and expenditure that is income and expenditure the statement of income and expenditure over a certain period of time. It might be the period of time can be decided by you. It can be 1 day, 1 year, 1 month, 1 quarter and, so on and so forth. So, the resultant; obviously, will be the profit or loss in the process out there, that is what we basically arrived at.

Now, when we talked about capital itself, when I talked about in this particular case when I say capital we look at multiple forms of it. All of us know we would have commonly heard about what is called as equity, there is something else also what we call it as preference, there is a third aspect what we talk about is debt capital. Am I right ok?

Now, when we talk about equity, when we talk about preference, when we talk about debt let me first finish debt out and then let us go to the other two. Debt is nothing but a loan, a borrowing that's all a debt is nothing but a loan, or a borrowing. I with a rate of interest which could be fixed which could be variable depending on the agreement and these part some debts are also what you call it as it could be a secured as well as it could be unsecured also. All that depends on the kind of arrangement you do for getting the debt. The question that might come in now is debenture is a debt yes or no?

Student: Yes.

Some of would will be owning some debentures, I am very sure that many of you would be trading.

Student: Yes because (Refer Time: 05:09).

How many of you trade? Then it should deben.. , when we say debenture if I have to put it a very crudely not a text book definition let me make that also very clear very crudly debenture is nothing, but a borrowing I am collecting from the general public that's all. If I have putting it very crudely, please do not say that it is this is not there in the text book, this is not a textbook definition, this is very crude definition that's all for your understanding.

It's a form of a debt which I am trying to collect from the public, in the sense imagine I need about a crore of money, I can go to the bank and borrow, if bank is ready to give me. I can go to a financial institution and borrow, if they are ready to give me; I can go to you have what you called it as strategic investor and then take money from him etc.

All possibilities or I can also issue what is called as debentures through the public in the sense that I can denominate these 1 crore into 10,000 debentures of what is called as 10,000 debentures of 100 each. 10,000 debentures of 100 rupees each 10,000 into 100 is 1 crore no ..yes?

Student: 1 lakh.

1 lakh then make it 1 lakh debentures into 100 fine, I am very bad at zeros anyway, so 1 lakh debentures of 100 rupees each. So, I issue this 1 lakh debentures of 100 rupees each and anybody can buy the debenture out there by paying 100 rupees out there. Imagine you buy 10 debentures 10 into 100 you buy it for about 1000 rupees you buy 10 debentures out there.

These debentures will also have a fixed rate of interest, I would say it is a 8 percent debenture, it is a 10 percent debenture, it is a 6 percent debenture etc. That means, a year on year on your investment of 1000 rupees or part debenture is 100 rupees, you will get an interest of about 6 percent out there. And it also as a life it is redeemable at the end of 5 years, or 7 years or whatever it is.

Redeemable means at the end of 5 years, 7 years the debentures ceases to exist the company takes back to the debentures and gives you the money, money is whatever you have invested initially that is debenture. It is a form of what you call it as a, a debt collected by the company from the public, very crude definition. Now, there can be various differences in that secured, unsecured.

Student: Is not like a fixed deposit.

No fixed deposit slightly difference sir, I will come to fixed deposit also.

Student: Sir it similar to bond.

Yes, we will come to that also sure, normally we say bond. Bond if it is a little long term out there, it is 8 years, 10 years etc we term it as one there are legal differences in that let us not even get in to that. There are legal differences in that let us not even get into that. Fixed deposit, he said, fixed deposit I don't denominate in units, fixed deposit becomes difficult for me to trade whereas, debentures I can trade in the market sir, I can trade in the market. Fixed deposits, is basically a lump sum money what you put in and then it is like you having your fixed deposit in a bank slightly different from that.

Now, when we talk about debentures it can be secured, unsecured, convertible, nonconvertible oh god ! you go, I mean various possible combinations out there. Secured, all of you know what is that? It is secured against a particular asset of a company that is in the event of the company defaulting. Then what happens, you can go and take over the particular asset sell it recover your money and come out, no questions now because I am expecting some.

Student: Who will do that sir?

That is that is what exactly I was expecting, who will do that? How can everybody get together and do it, etc? Now, there are processes for that, there is a trustee who is appointed by the company who is expected to act on the behalf of the investors. So, in the event of the company defaulting the trustee goes take over takes over the assets sells it and distribute the money whatever he gets into the investors are out there.

If he is able to clear of all the investors and excess money is there that will go back to the company, if there is what is called as if he is not able to dispose the asset for the value of what he has to pay the investors the investors take the hit out there. Unsecured, no security that's all simple no security on your investment out there. Then, why should everybody going for unsecured debenture people will go only for secured debenture. Am I with you?

Student: (Refer Time: 10:00) high interest should be like. High interest.

Risk return that's all, higher the risk.

Student: The returns (Refer Time: 10:06).

How many of you say higher the return?

Student: (Refer Time: 10:11).

What is the risk in the market sir? Risk in the market stock market, risk in the stock market higher or risk in the stock market compare to the risk of investing in a fixed deposit in state bank of India?

Student: Higher.

Higher, so you are assured of higher return?

Student: No assure no.

Then, we also said no, you said somebody said higher risk, higher return.

Student: Probably.

Sir higher expected return that is use the word, the word expected is very important there with higher the risk accepted higher the expected return that is it. Even here in debenture when I am doing an unsecured debenture I am expecting higher return I may get it, I may not get it if I do not get it I lose that's all .With you on this. So, there are various forms of what is called as just close the door, there are various forms of what we call it as your debt out there.

When I talk about various forms of debt, one is what we talked about this debenture secured, unsecured. I can take a loan from a bank, I can take a loan from a foreign what we call a financial institution, I can take a loan from a foreign bank with a forward cover also, that is I can raise a loan in Japan. If you know the interest rates what is happening, what is the interest rates out there in Japan; any idea?

Student: Negative. 0.Negative, 0, I mean they had a zero balance account that is what we call it as no charge in saving account couple of 1 or 2 years back and everybody was so happy about it. Because, earlier they were charge, they were being charge to keep money in the account out there. If you raise loan in Japan out there you will raise it at a (Refer Time: 11:48) percent or percent and half, one and half percent out there.

Then you get a forward cover, forward cover for the currency fluctuation with one of your banks in India which will charge about 5 or 6 percent out there and then your landing cost will still be about 7 percent which will be far cheaper than their raising the loan in here itself. Then why cannot everybody go abroad and raise loan, well they also make an evaluation and then your company should basically be evaluated by one of these Japanese financial institutions, it should be worked out and then they found it otherwise they don't.

So, there are various forms of loan. Now, all these debt very importantly if I had put it most of them carry fixed rate of interest some of them carry variable rate of interest. Debt as such the debt holders as such does not have or do not have any voting right number one in the company. Number 2 are not eligible for a share in the profits of the enterprise also, all they are eligible is basically to get their interest on the amount. They invested as well as that is the refund of the principle and the interest, or what we call it in a simple term like debt service that's all what they are eligible for and nothing beyond that right?

Now, I move to the next set of guys out there what we call it as the preference share fellows. A glorified form of debt, again very crude definition please note again very crude definition; a glorified, again preference shares, fixed rate of interest, no voting rights only thing is denominated in the form of shares out there.

Again I raise about 10 crores, I need to rise from the market in the form of preference share I can issue 1 crore preference shares at 10 rupees each to the public.

Again with a specified interest rate upfront itself I will indicate the interest rate, peoples subscribed away it every year on year they get that interest. And at the end of what you call it as 20 years, now their stipulated time is 20 years extendable up to 30 years out there. At the end of 20 year, 30 years, these preference share is redeemed that is the company takes back and then gives the money out there.

Now, is preference share tradable? Yes preference share is also tradable. Now, when the company buys back from me, what is the price they will give? Will they give the market price, or will they give the price at which I invested that is 10 rupees out there. When on the date of redemption both will actually be the same whether the market price under the on the face value call so called face value of the shares. Face value is the only value at which it is denominated both of it will basically be the same out there at whatever price there be one of the pardon me.

Student: Only a price interest.

Only interest you are getting, interest is what you get during a period, more or less a debt concept as of now not very active. Am I right? Not very active out there more or less a debt concept it was very active in the 80s and early 90s etc more or less dead now. Because now, why should people going for a preference share when they can going for a debt I will come to you.

Simple risk return right, in the event of a dissolution of the company the debt holders are settled first, if at all money is remaining then it will go to the equity preference holders. If at all money is remaining after settlement of the preference shareholders it will go to the equity holders, so risk return variable what we call it as your interest rate.

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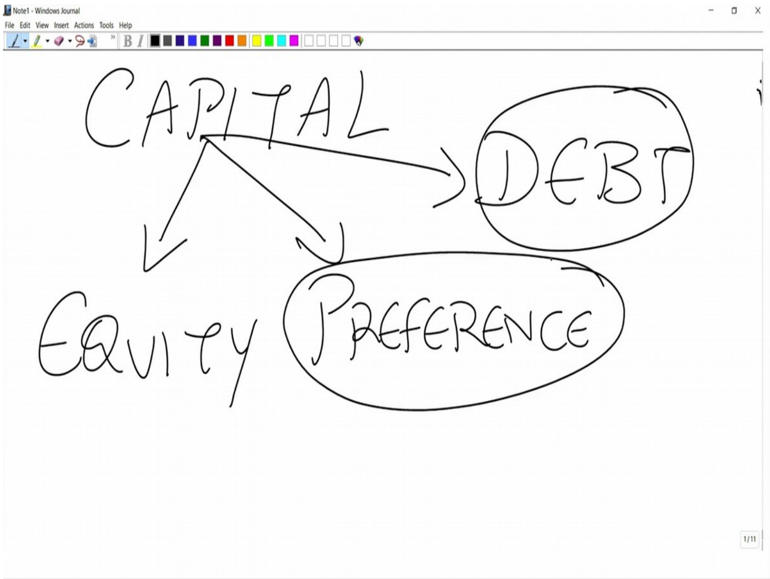

Please note here at the stage preference shares are that is interest on preference shares I am sorry, interest on preference shares are not tax deductible. Because, the interest on the preference share or dividend on the preference share is paid after the tax is deducted for the company. Crowd sourcing, later as after a what is called as you can source it, but how are you sourcing is a very simple word.

But finally, as an accountant I am looking at how is it denominated, you can do crowd sourcing and denominate as debt it will sit as debt. You can do crowd sourcing denominated it as equity; yes it will sit as equity that's all I'm worried only about these three terms nothing beyond that, yes sir.

Student: Where this ECP concept (Refer Time: 16:21) in concept in the external (Refer Time: 16:22).

External.

Student: External commercial.

External commercial, all that borrowing will be debt sir, that is a beautiful that's all. It is a simple 4 letter that's all debt, DEBT it will all sit there, any borrowing sit there. It can be external commercial borrowing, it will when we FCRA what is call Foreign Currency Borrowing out there, anything it can be all borrowing is debt.

Student: Then you have to pay rate of interest that's all.

If that that depends on your agreement, that depends on kind of agreement under which you are entering into debt. For example, somebody can you can get a debt for the 5 year moratorium and after that a very high rate of interest also yes, possible that's all depends on your agreement with which you enter (Refer Time: 17:04) taking that, yes sir.

Student: The difference between debt debenture and preference is the time period.

One the time period, second is the risk more is the risk; for example, if I dissolve the company what do I do? I sell what I own all my assets, I pay of whatever I owe. When I pay off whatever I owe I cannot pay everybody at one shot. I will there is a process right I first claim somebody else has it. So, debt holders have a claim which is which is higher than what is called is a preference, preference holders gets it.

Student: Debenture holders gets the priority.

Pardon me?

Student: The debenture holder he gets.

Debenture holder gets a priority; of course, there are others also who will get priority even before the debenture holders we will come to that a little later. But among these two debenture holder gets a priority.

Student: How this forward cover mechanism, what you mention that if rate is crore.

Sir, very simple if I have to put it in a very simple terms I am not going to get too deeper into it, simple I borrow yen . A million yen out there. When I borrow a million yen please note the million yen is not converted to INR and it doesn't come to me. Million yen is converted into X amount of dollars, the dollars again gets reconverted to INR and that is what I get.

When I have to pay the interest on that one million yen, dollar and rupee INR can fluctuate, dollar and yen Japanese yen also can fluctuate. Now, I will have to allow to forgo, so many INR which for example, the interest rate of interest is 2 percent on that one million yen. Now, I will have to lot of 4 goes, so many INR that if converted to dollar and the dollar again converted to yen will result in exactly 2 percent of that one million yen.

It might be higher, it might be lower; there is a fluctuation there. And this more so happens is firstly, when you have to return that kind of a debt, most of these kind of debts are also there for what do you call it as an infrastructure projects and so on and so forth out there. So, the borrowing is huge, the repayment is huge. So, a small variation a the current kind of current prices of the dollar etc can really through your entire finances out of gear out there very simple and crude definition, yes ma'am.

Student: who decides that who tends a priority at the time of repayment like if you dissolving your company and you are repaying like you said the debt holders get the first repayment and then a preference shareholder. So, is this like a standard?

This is a standard.

Student: Company.

This is a standard and if at all what happens is the same debt holder can have what is called as a same asset can be pledged to multiple debt holders also, if the asset value is huge. In that case you specify who is a primary what we call it as how was the primary security on that asset, who has a subordinate debt. Then there is a subordinate that is we comes in second etc that is specified among that debt holders.

Student: Ok.

Otherwise there are these are basic standards out there with you on this.

Student: But a can the preference always have a higher rate of interest than debt how.

Normally expected to expected to , but if it is a very stable company then unsecured secured will itself will not have any difference right that's all very stable.

Student: Why will they given offer a preference?

Which are, that is why I said more or less nonexistent very it is almost debt at this stage. Because see all your when transparency was slow, then what happens is and people would wanted to be secure today with the kind of training trading and marketing growing etc more or less not very popular as of now.

Student: Let us the oil infrastructure want it is government of India it should with oil.

Sir, if oil infrastructure bond government of India issues etc that is basically it is all borrowing that's all, this is I am talking about it from the point of view of the company. For a for if an oil company issues a bond that bond is also part of your debt only. Debt is very big term multiple forms of debt we will revisit all that as we go along confused in terms of.

Student: See what do I get out of preference share.

Preference share gets fixed rate of interest you are it is reading, but the end of 20 year, 30 years. Debt normally debenture redeem at the end of 5 years, 7 years right, debentures also get a fixed rate of interest could be. Debentures holders have a first claim in the time of dissolution, preference holder preference share holders get in next after that.

Student: So, we differences saying is the time period.

Time period and the risk.

Student: Preference tradable also.

Preference say, debenture is also tradable.

Student: (Refer Time: 21:57).

Debentures also tradable, how it gets traded, what is the price we will worry about it after couple of classes.

Student: You mention that preferences should have period of 20 year.

Yeah.

Student: Should be a 4 year back there was a infrastructure bonds there will last year all the bonds issued which would I have been 20 year 30 year keeping.

That's a bond.

Student: That's a bond.

That is a bond, Mohan they say bond it is a bond.

Student: Present bond.

No not preference share.

Student: I have one more question.

Sure.

Student: (Refer Time: 22:25) dependent on following follow this which is like you said company when the company dissolves trustee with the pointed with the.

Not when the company dissolves, when some of these are issued itself trustee is appointed.

Student: I will then like they will sell asset and (Refer Time: 22:40) debentures I am looking at the perspective of the equation.

Student: (Refer Time: 22:45).

Process is on they are trying to sell the asset nobody's buying it that is only problem the process is on.

Student: That you will first go to the banks.

I don't know the kind of debt what he has on his books, I am not really un realize this balance sheet. So, if somebody has a claim which is higher than the banks then they will get it first, they are all the process is on; whether it will be done in your life time I really do not know that's all yes Prathish yes sir.

Student: Sir, in case company does not able to pay the company have to amount the debt.

Student: Company has no money.

Student: Do the equity holder or the preference holder has the digital claim.

Which are, the company is dissolved all assets sold, where is the equity share holder I hold equity I hold equity shares of kingfisher fine I cannot go and take over an aircraft nothing over. That is become what is called as after our [FL] vada tissue paper that's all if it is a certificate now it is a Demat form nothing else nothing over gone.

Student: So, what role security expense what we assume that does not matter is the.

That is in the next class sir next subsequent course; there is a role of SEBI and other thing we will come to that.

Student: Can debentures be converted into equity?

Debentures can be converted equity, that is what I said it can be secured, unsecured convertible, non convertible. Convertible debentures, they would have indicated that these debentures are will be converted to equity shares at the end of whatever is the time period they would have indicated 5 years, 7 years etc. Now, what is the price that they can convert yes? The price range price range also they would have indicated as of now.

Today what happens is your equity shares is 10 rupee equity, share face value 10 rupee face value or per value whatever you call it I also issue 100 rupee debenture. Then I would also put a rider out there saying that these debentures would be converted at the end of 5 years into equity shares at a price range of say 60 to 100 supposing I have anticipated as a company share, so you have bought it.

So, at the end of 5 years I decide the price based on the market condition, the average price there is a process for that then I arrive it a price and then it is converted. You have to only one debenture, the conversion rate is 75. Then you get one equity share of which has a face value of 10 rupees market value as 75 rupees plus 25 rupees back in cash out there that's all that can happen. Again if it is to be all debentures are not converted, if it is a convertible debenture it is mentioned, it is indicated right at the time of issue yes Prathista you had a question.

Student: (Refer Time: 25:31).

Now, I move from here to all these are minor [chota], the major part is equity that is what all of you trade in that is what all of you buy etc. Equity shares are nothing but equity shareholders are basically nothing but the owners of the company. You own 100 shares of reliance and each share is denominated at one rupee face value; that means, you are owner to the extent of 100 rupees of Reliance Company. Whatever, supposing it has 100 million shares value of 100 million equity value of 100 million, you are 100 million into whatever is your holding 100 rupee is your holding to that extent or that percent is basically the holding.

Supposing I have a company which has 10,000 equity shares of 10 rupees each and then the capital is 100,000. You hold 1,000 shares in my company, you are one tenth owner of my company that's all what we have is. When I say the views the word owner in my company what are my indicating here? You have that decision making right in the company that is you have what is called as the voting right in the company.

You have the voting right on all major decision not the day to day operations on all the major decisions of the company number one. Number two, you are eligible for what we call it as a share in the profits of the enterprise and that is what gets declared as dividends out there. Now, the immediate question is are all the profits of the firm distributed to the equity holders well yes and no.

Student: No.

Student: Tell me the percentage of the preference holder.

It can be the percentage, it can be the entire money or the company need not distributed and the company can keep flowing it back into the company itself.

Student: Based on the business.

For example, based on the business Microsoft for the first time declare the dividend couple of years back till then they had never declared dividend. So, what happens in the first year imagine I have what is called as, now imagine I have 10000 shares at 10 rupees each, value is 1 lakh or 100 thousand whatever you might call it. Year 1, I make a profit of about 25000, year 1 I make a profit of 25000.

That means, each of the 10,000 shareholders what are the eligible to get, the 25,000 is divided by 10,000; that means, each one is eligible to get about 2.5 rupees as dividends. Now, I do not pay this dividend to the public, I say that I need to expand my business, I need to buy one more machinery, I need to do what I do is I flow back this money back into the business.

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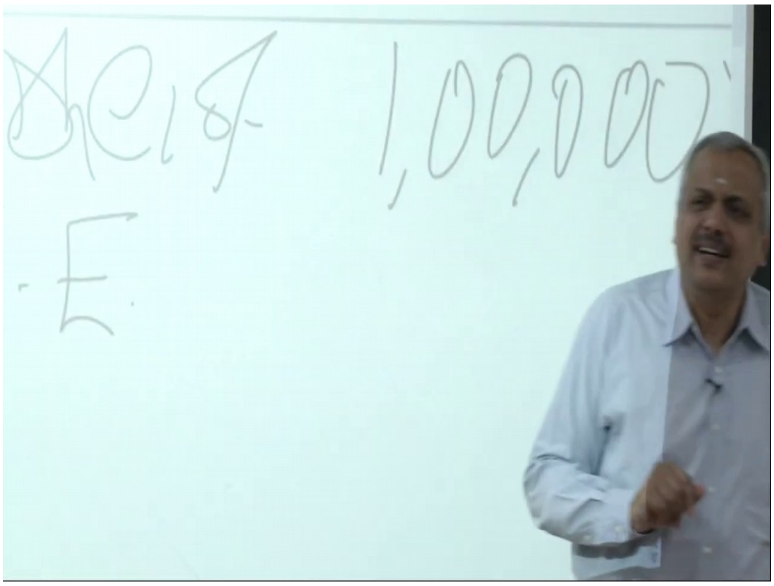

So, what I do the profit out there which is what is called as belongs to the equity holders I retain it that is or here indicates retained, retained earnings. I retained this profit retained earnings, I retained this profit in the business and then say now what I say is how much I have retained I have retained about 25,000 out there.

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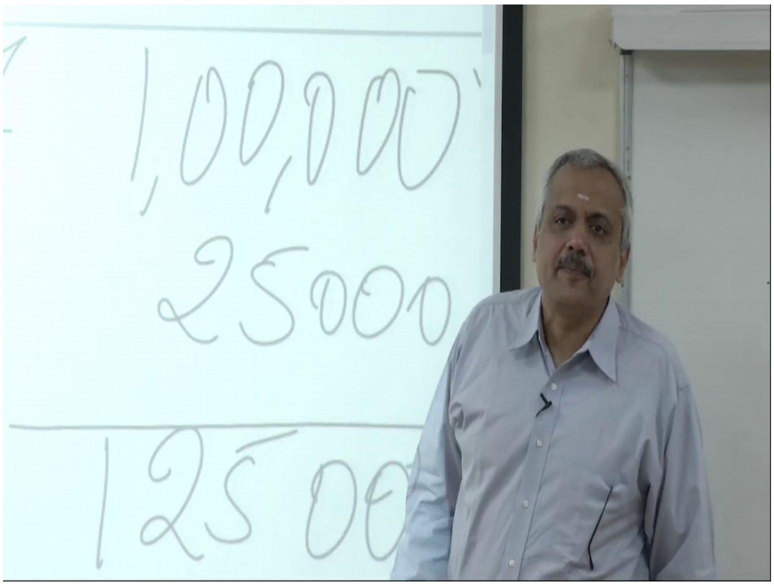

So, now what is the value of your shares? Total equity; the value of equity is 125,000 because, 1 lakh is what you have invested as equity shares, 25000 is the profit that you have earned which also with the company has earned which belongs to you. So, the value of your equity is 125,000.

Now, what is the value of your equity share now? The value of equity share is nothing but this 125,000 /10,000 out there that is 12.5 is the value of your equity now. That value is what we call it as book value of the equity, please note that value is what we call it as a book value of the equity. So, now, I need to go to the board this 10 rupees at which it is denominated is what we call it as a face value of that equity.

This 12 rupees 50 paisa what you are getting out of there is what we call it as the book value of the equity; this face value will never change. I cannot change never change will normally not change unless what is called as there is a stock split or a reverse split, unless there is a stock split or a reverse split. What is the stock spilt? What is the reverse split? Hold it for a sometime we will we will sort of explain that also, that is what we call it as the face value and what you get out here is what we call it as a book value.

Now, moving on further from here please hold your questions and note down I will address all that. Now, what happens in this particular case out here over a period of time over a period of time first year you are accumulated 25,000. Over a period of time you keep on accumulating the profit for a couple of years out there you are not distributing the profits you are not distributing the profit you are accumulating the profits out there.

And to at some stage I see the balance sheet may be after 5 years, or 4 years, or 6 years or 10 years whatever is the number of years you can decide and I see the balance sheet and I will see equity capital is the same thing. But the retained earnings what is there as actually become 250,000 in the process.

So, now what happens? My total out here what we call it out in this particular case is 3,50,000 or 350.000 the value of each equity share book value of each equity share is 35 rupees out here, am I with you on this. This is what we call it normally as net worth of the company this is what I call it as net worth of the company.

When I say net worth is eroded, they would you all very use a word called as you would have certainly read in the papers that is net worth is eroded we will come to that out here in a couple of minutes from now. At this stage the company now all these money belongs to whom? Belongs to the equity holders that is the shareholder that 10,000 shareholders. Imagine everybody is holding only one share, let us say everybody's holding only one share 10,000 shareholders.

Now, they are eligible to get the money, (Refer Time: 32:28) 5 years a company has not paid anything why are we invested at this stage what the company could possibly do is issue what is call it as the bonus share or what is called as stock dividend. The other names for it is stock dividends or issue what is called as bonus shares, again I am putting all these things in the simplest form right.

I mean if you actually go back and talk to a company secretary or charted accounted work in company they can complicate it . But this is the basic principal behind the whole thing that's all what do you have to understand.