Decision making using financial accounting

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Lecture - 04
Two Financial Statement

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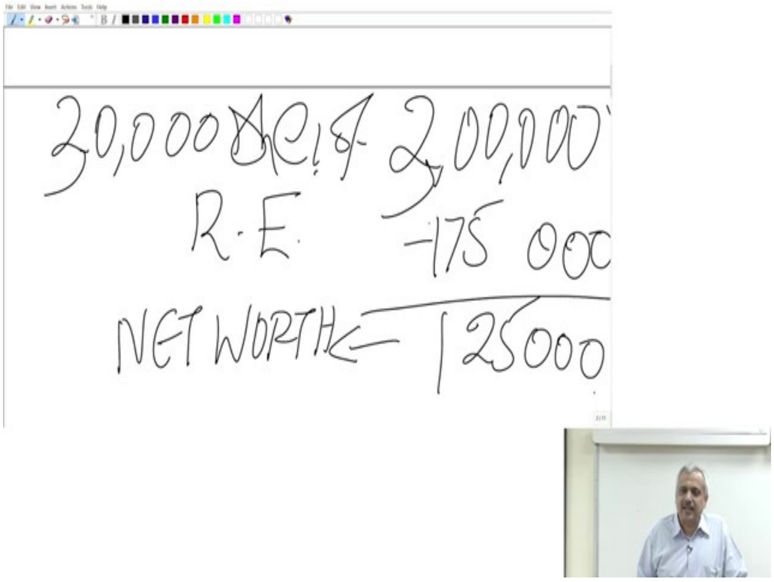

Now, what does the company; what the company do, the company says there are 10,000 shares out here which is a 10 rupees face value and the value is 1,00,000. Retained earnings so far, I have retained about 2,50,000 out there so, this money belongs to the equity shareholders. So, what do I do let me say that I am issuing a one is to one bonus that is, for every 1 share you are holding I am going to issue 1 more share.

So, what happens the number of shares become 20,000 and; that means, if it becomes 20,000 face value is 10 rupees; that means, what is the value of the share? Value of the share is 2,00,000. Does not mean that I am collecting the other 10 rupees per share from the public; what do I do, I will say whatever is the retain earning which has 2,50,000 I just make this 1,50,000. I move 1,00,000 from retained earnings out here sorry retained earnings out here to basically what is called as in this, I move this 1,00,000 from the retained earnings out here.

So, what happens for every 1 share what you are holding you are getting 1 more share from the company. They can even issue not 1 is to 1 bonus they can issue 1 is to 2 also or it can be any ratio. If they issue 1 is 2 what happens a 20,000 becomes 30,000, out here this becomes 3,00,000 and then this retain earnings at the company is only 50,000; your net worth of the company does not change. So, for every 1 share you are holding you are getting 2 more shares from the company out there. So, totally you have 3 shares; what is the advantage for you? You go to the market and sell it whenever you want not that the company is thrusting cash on you, whenever you want it you liquidate it. Number two what is the advantage for the company.

Student: Tax.

Profit.

Tax profit.

Student: Profit.

Student: The net worth falling down.

Nothing no profit simple, no cash outflow all that happens is.

Student: Paper

One code are there not even paper today DMAT, one code on the computer and thats it nothing no cash outflow; understand, there is no cash outflow happening for the company. The company is also benefited in the process. So, when the market move; the prices in the market moves it is in anticipation of these kind of performances that is there so, what happens?

First 5 year the market is just moving, why market is just moving? Because they know that eventually somewhere are the other somehow are the other you are going to get the money whether it is a form of cash or in the form of stock dividends out there and then you sell it and make money. That is what is the crude way I have explained what do you call it as how do you get what is called as bonus shares and stock dividends.

Hold it for one more minute; now, what we talked about equity share, we talked about retain earning, we talked about net worth. Supposing after the 5th year, after they have done the bonus shares, something happens to the company and the company subsequent year pose a loss of 75,000. So, what happens the company pose a loss of 75,000 then what happens in this particular case out here, it is basically negative 75,000 out here yeah. It is basically negative 75,000 in this particular case then what happens is total out here then it is 2,25,000 that is what happens. 3rd year huge loss of 1,00,000 then what happens, further loss of 1,00,000 that is total loss of 1,75,000 then what does it become 3,00,000 minus 1,75,000 is 1,25,000 that is what it becomes. 4th year further loss of 2,00,000 then what happens in this case, 2 plus 3; 2 plus 1.75 3,75,000 out here negative 3,50,000.

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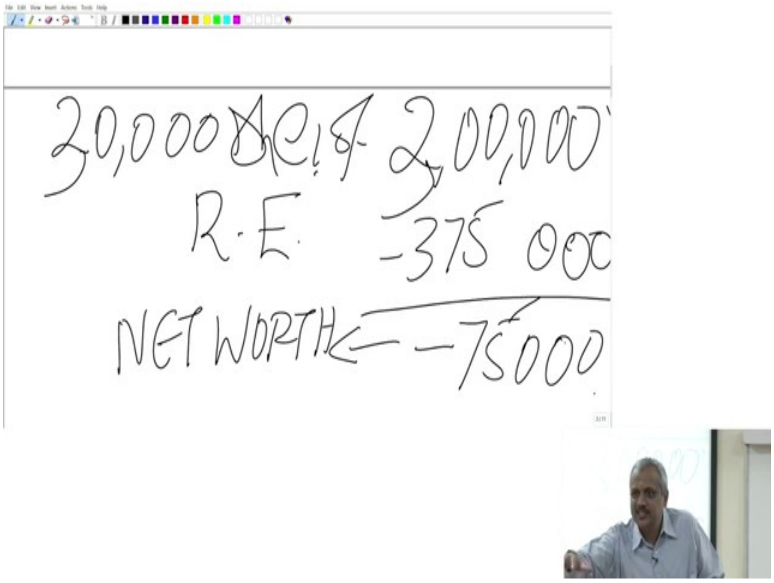


Then what happens in this particular case out here is basically net worth becomes negative that is why net worth gets eroded, when net worth gets eroded value of the equity is negative. So, the company ceases to exist at that stage. Am I with you on this; now all questions first.

Student: This is how the stock will increase or decrease.

No this is not this is how what happens in the company's stock price, decrease is independent sir do not even bring that here.

Student: Because that is that is go it is reflecting on the market.

Stock prices is expected to reflect the performance of the company which is one attribute, which is one of the attribute.

Student: That is what I am asking this is the with.

It is this attribute depending on the performance as this negative keep increasing.

Student: Yeah.

It keeps tanking, positive keeps increasing company is expected to do well for example, there might be huge amount of retained earnings. The company can have a corporate governance issue, then prices will never move up right.

Student: Um.

So, that is one of the attributes, there are hundreds of attributes around which will decide the movement to the market.

Student: (Refer Time: 05:31) of earlier (Refer Time: 05:33); (Refer Time: 05:34) earlier (Refer Time: 05:35).

Whatever it can be anything; that is why I said it can be hundreds, may not even be a priority sector as of today, expected to now values increase; addition shares.

Student: No, so, I (Refer Time; 05:46) one is to one know as you 1 is to 2 the number of shares of value increase. So, I am just wondering with the company's value will decrease.

Value will decrease, how will the value decrease.

Student: It get more diluted.

It can, that is in the market though it can get more diluted; see theoretically what happens a share is 100 rupees as of today in the market, a 10 rupee share is selling it 100 rupees in the market. Now, I issue 1 is to 1 bonus then what happened theoretically the price should come down to 50 for the value it will remain the same, the price will come down to 60 or 75 value is always higher. So, 75 into number of shares is double right. So, the value will not necessarily decrease.

Student: (Refer Time: 06:26) understand the ratio of bonus share, apart from the sentiments values that distributed any shareholders, may be promoters can sell his shares what is unit for company.

Promoters selling the shares and all it is independent.

Student: They are also shareholders.

There are also have bonus shares everybody gets it.

Student: What is unit for (Refer Time: 06:48).

What is in it for the entity; entity is basically run basically because of the investors. Entity is (Refer Time; 06:53) all the money not distributing to the investors, then the price in the market will never go up right; that people would be just trying to get rid of it.

Student: They can sell the original equity also.

Which one?

Student: They can sell the original equity share.

No, original anything that is there is, no everything is original share. Bonus share is also original there is nothing denominating, everything is original.

Student: Enough before you have, before get the bonus share.

Before you get the bonus share you can sell it.

Student: Because you.

You sell it for a simple, as she asked share price is 100 before there is what is called as cum bonus there is ex-bonus, book closure date that is if the share is registered there is a book closure date which is indicated by the company. On this particular date who is ever name is the shares registered they are the ones who are getting the bonus. So, naturally if the trading activity, before the closure day book closure date the price of the share will always be higher because who are buys it is going to get one more share.

After the book closure date if you are buying it, you are buying only that equally share the bonus is not going to come to you the bonus is go to the previous owner so; obviously, the price will be.

Student: Low.

Less that is all, yeah.

Student: Net worth.

One second sorry I am coming in order so that I do not want to miss anybody yeah.

Student: Sir Face value is what I purchase a share.

Not you purchase a share, I never said that face value is at what the price the share is denominated, you buy it at the purchase it at a price which could be far higher or far lower. Let us not worry about that, it is at which it is denominated.

Student: Face value is what they say that is the company declares and then.

Company's if the share is denominated, that is all.

Student: The market value is what I sale and I sale.

Market value is independent.

Student: What is the book value?

Book value is what we are arrived, what is the book value of the share now negative.

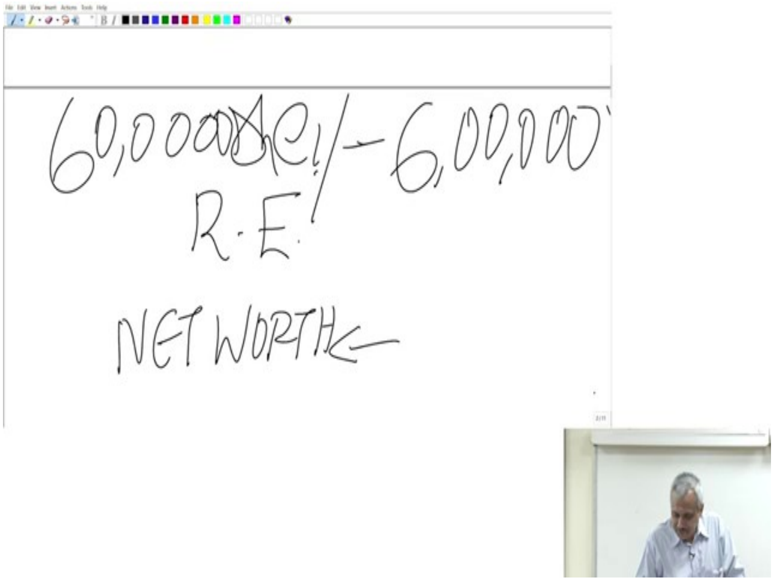
Student: Book value is only in books.

Book value is only in books, yes that is why it is book value.

Student: It does not have any significant.

It has a lot of significance when you do the analysis. At the stage that is the book value is what is the share worth based on the performance the real worth; what do you call it is an intrinsic real worth of the share based on the performance. That is the company decides tomorrow to sell all their assets, clear of all their liabilities that is what you are expected to get.

IPO is there is an additional share, that is what when I issue the shares that is an IPO. I issued 10,000 shares at 10 rupees each and that is what I have issued and that is what comes out here. Now, today I decide my company decides, I have 3,00,000 share 30,000 shares out there imagine forget about the loss part of it imagine that making a profit, I will for the benefit; let me just erase this part of it.



Now, it has 3,00,000; 30,000 shares out there now, I decide to increase my share capital. I decide to issue new shares to the public, guess then what happens. My number of shares instead of 30,000 becomes what happens I decide to issue 30 more thousand shares, my number of shares becomes what is called as 60,000 shares. What is the value out here, value is 10 rupees. So, what happens this becomes 6,00,000 out there, face value will not change, but they will not issue at 10 rupees what they will issue they will issue it at a.

Student: Premium.

Premium they will charge you a little more, how do they calculate the premium we will come to that a little later ok. Next row yeah, I am just going one by one row sir, definite definitely hold it I will definitely come to you.

Student: What is the intrinsic value from the balance sheet.

Balance sheet that is what it said after equity, after equity capital there is a balance sheet which is there as part of the manual what I have given of Maruti Udyog , you can just look at it, it will come under the heading called as reserves and surplus immediately after share capital. Some people will show it as retain earnings some will represent it as profit and loss account balance, both being the same, yep.

Student: Sir. So, net worth is the book value right.

Net worth is not a book value; net worth is net worth of the company. Net worth divided by the number of shares is the book value.

Student: Ok.

Net worth divided by number of shares is the book value per share.

Student: Oh, yes one more doubt actually the retain and earning I mean (Refer Time: 11:21) profit in.

Yeah it is earning which you are retain.

Student: But the real (Refer Time: 11:24).

It's an earning of the company belonging to the shareholders, which the company has retained that is where retained earnings.

Student: So, thus we not anybody who has invested you being knowing a so and so amount along with retained.

Of courses yes. Public limited company, any company which is listed please understand, any company which is listed is supposed to put it in the public domain the balance sheet P and L and cash flow statement all the three statements at the end of every year. It is in public domain, how well it is window dressed that is up to you normally from retained earnings yeah normally only from retained earnings there are reserves and surplus has lot of things in addition to retained earnings will come to all that in a few minutes; few in a not today's class maybe subsequent classes. On the interest there is no tax company does not pay only on the dividend it is tax, we have to hold it you have to hold it sir till one more class.

Student: No, I am talking about the individuals who are actually.

Individuals what you are get on hand is your income. A company has declared hundred rupees as a interest to you, you are getting a hundred rupee dividend warrant or interest warrant you pay tax on the dividend is not tax interest is taxed in India.

Student: Yeah, but it is mine is it TDS they have to.

Which one?

Student:(Refer Time: 12:37).

The company will not do any TDS; they will just give it to you, beyond that you will have do it.

Student: So, the decision of retaining the earnings in the company is made by the shareholder.

Is by the board; board has a representative of the shareholder. If you are the answer is yes to your question.

Student: Sir, if the company does not have the general retained earning it is present, it is a it is 0 the company want to the issue some more shares.

The company can issue shares that is it is not bonus share, it is what we call it as at that stage we call it as not as an IPO, we call it as a seasoned offering; that is the company is again coming to the market and issuing shares to the public and collecting money. In a bonus share they do not collect money, in an equity share they can collect money. First time they issue IPO initial I is initial public offering first time issue subsequent issue seasoned offering.

Student: Dividend in case of seasoned offer they given from the face value.

Face value will never change, if face value changes face value changes for everything existing as well as new. Otherwise face value does not change, face value can be 10 rupee, 1 rupee. At this stage the company can say I am going to do a stock split, I am going to do a stock split I am not going to value my shares at 10 rupees, I am going to my value my shares at 1 rupee. If I decide I am going to value my shares at 1 rupee what happens out here it becomes 1 and then all that happens is one more 0 gets added there, that is all the one more get 0 added out here, I have added a 0; this does not change. This remains the same with you on this sir.

Student:(Refer Time: 14:20).

Pardon me the I am talking only about equity maam for the last 20 minutes I am talking only about equity. I never talked about anybody else. It was earlier you had 10,000 shares, now for example, out of 10,000 shares you had 1,000 shares. Now I issued a 1 is to 2 bonus for every 1 share I am giving you 2 shares. So, what are you getting you are getting 2 more 1000 shares 33,000 shares is what you have. Total number of shares in the books is 30,000 shares it is still the same 10 percent.

Student: Is there any norms for fixing this face value.

There are norms sir, it has to be in multiples of 1.

Student: Multiples of.

It cannot be in decimal.

Student: That is, but there is any upper limit.

Nothing, there are shares which are, which are even, even now there are some shares which are face values 100 rupees. Earlier 100 rupees was a norm then it became 10 then it became 5, 2, now it is now only 1 rupee.

Student: Sir if I issue additional share. To raise money at the same face value for example, 10 rupees, but it is sold at hundred rupees.

Sold at 100 rupees to.

Student: In their to the investors.

Agreed.

Student: Where is the 90 rupees accounted.

Where is a 90 rupees accounted fine. Now, that is what we call it as the premium now I will come to that. Now that you have raised that question, I am moving to the next aspect. I am sorry this sheet I think we may not be able to do it today we will do it in next class we are going slightly slow. But I hope it is ok, but I want to ensure that all of you get the basics right then it becomes easier. Now, why is premium charge and how is premium charged. Let us look at it.

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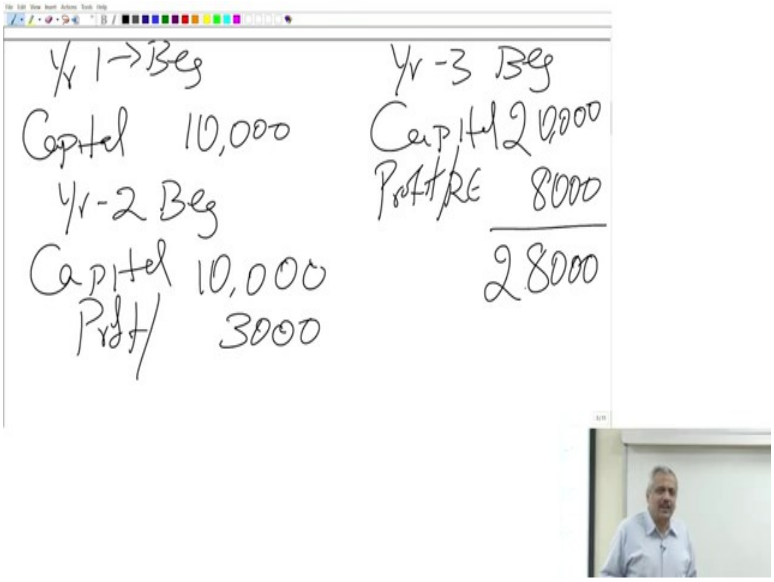

Supposing I say, suppose I say that I start a business. Let me say year 1, I started a business I have not done anything, I have contributed a capital of let us say 10,000. Year 1 I make a profit; I make a profit of about what is called as this is at the beginning of year 1. Now I will say year 2 at the beginning out there at the end of year 1 I have made a profit let me also talk about the profit out there I have the capital remains the same. I am at a profit which I have retained in the company,I have made a profit or what we call it as retain earnings of about let us say about 3,000; what is the net worth of the company.

Student: 13,000.

13,000; now, let us even say that this capital of 10,000 ok, let us retain the you will is not even divided in equity fine. Now I move at the end of year 2 what is called as I move to what is called as year 3 again beginning of year 3; we see beginning of year 3 our end of year 2. There is a capital of 10,000, there is a profit which is there or retained earnings or whatever name you would call it. First year I had retained 3,000 second year I made more profit; now I have made a profit of 5,000 now what happens is my retained earning is 8,000. Now, what is the worth of the company the worth of the company is 18,000.

Now, I decide now he decides to become my partner what he called as he decides not even a party, he decides to invest in my business. He says I will contribute another what is called let us say, you have contributed a capital of 10,000 I will also contribute another 10,000 become a 50 percent what is called as owner of the business. Now, when he contributes 50, 10,000 if I am an idiot what I will do is I will say yes says I will give you a 50 percent share you come and contribute 10,000 out there in the business then I what happens is at the beginning of the 3rd year if he contributes what is called as 10,000 out there then the capital becomes 20,000 and this also what happens is becomes 28,000 net worth. The same evening he decides to fight with me and he decides to leave the business he says what is the business net worth, net worth of the business is.

Student: 28,000.

28000, so, what you have to give me, you have to give me 50 percent of it, he will just take 14,000 and go away from me. So, I will just simply a loser in the process, now you understand. So, what I tell him I tell him that when you join this business itself, I tell him boss you have to get me 10,000 as equity or capital.

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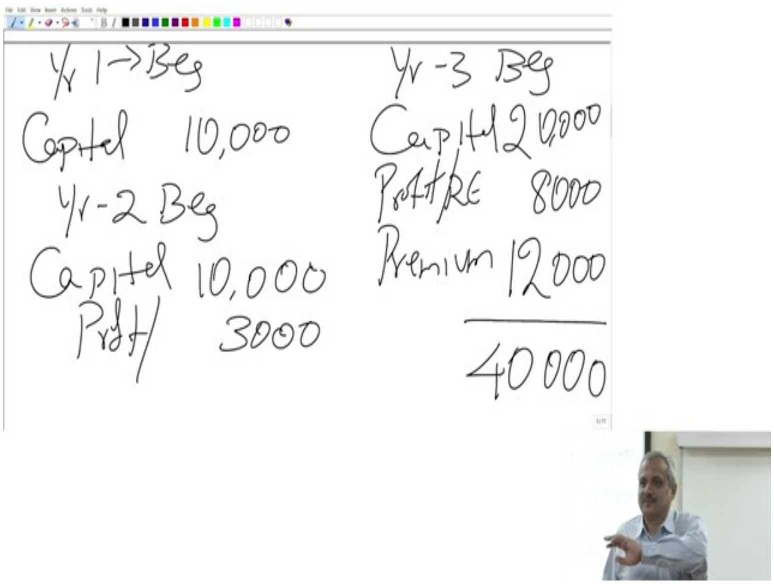

Another 8,000 as what I call it as premium in the business. I will say you have to get me, please do not write, you have to get me another 8,000 as premium that is what makes it 50 percent in the business. So, now, the business is 20 plus 16 that is 36,000 rupees out there. So, if you fight in the same evening and go you take your 18,000 and go I do not stand to lose anything that is a base minimum even to do that I should be an idiot, but normally I will not do that I will tell him first 2 years the risk of the business is very high I have taken the risk.

Now, 3rd year when you are coming in the risk of the business is low and already there is a 8,000 retain earning that is there in the company out there, I should also be compensated. So, when you come in as a partner you bring in 10,000 as equity; I saw 10,000 as capital or equity and bring in another 12,000 as premium. So, what happens out here I will tell him the premium what you are paying is 12,000. So, now, what is the value of this 20 plus 30 that is what is this becomes what is called as 40,000 out there. So, he has totally brought in 22,000 into the business.

Now, what is his share in the business, his share in the business is only 50 percent, 20,000 out there. What have I gained, I have gained another 20,000 that is basically my entire effort is compensated; that is what is the premium. This is the crude way again how premium is arrived at. Now I think I have answered many questions out there how is the premium calculated etcetera; am I with you on this.

Student: Yes sir, why do we agree to the breakup (Refer Time: 21:05).

Let him not agree, then he will not invest, if you have invest in my company he has to agree. Sir, when companies issue shares at a premium nobody forces you to apply, nobody is forcing you. You get greedy because your neighbor is investing and making money you also want to invest that is of we all invest.

Student: Ok, but I have an investor provides stand to benefit of a.

You because you see value because in the first two years itself with the 10,000 capital I made a 8,000 profit out there; you feel there is a huge potential to invest and grow what kind of return what you see in the return right, almost very high return then, he will sort of he decides because of that.

Student: I am asking he says add everything to the capital.

Everything cannot be added to the capital. I will say there a capital is only 50 percent capital if I add the entire 18,000 to the capital, then what is his ownership in the company, larger and what am I getting, nothing; with you on this sir.

Student: How does the premium grow?

Premium does not grow. Premium stays like that, premium stays like that. Premium does not grow, unless I collect premium, it does not grow. Well, you guys have to go on collecting money.

Student: Premium value suppose after 3rd year I am missing this make share, I issued at the 5 year or 10 years I will definitely will be increase.

I of yeah of course, you join at the end of 6 years I have by then my retained earnings has grown to some 50,000 with a 20,000 capital then I will charge at least a bomb from you. When you dissolve the company this is net worth of the company, there is no division between premium equity etcetera. Whatever money is left that is at this stage divided by number of equity holders that is all.

Premium is part of your net worth; part of your net worth of course, that is all the money net worth is nothing, but all the money that belongs to the equity shareholders. All the money that basically belongs to the equity shareholders is what is called as net worth. When I say, all the money that belongs to the equity shareholders, it could be share capital which belongs to the equity share holder, retained earning belongs to the equity share holder, premium belongs to the equity share holder.

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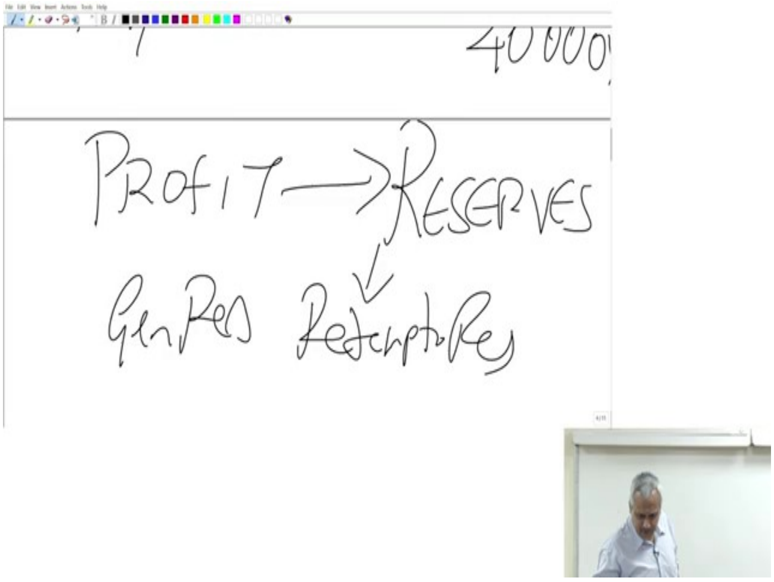

In addition to that having said this now, I have to move further slightly on this before I take more questions on out here; what happens is normally from the profit what I have, I cull out some part of the profit for some kind of what I call it as reserves. It could be what is called as general reserve. It could be redemption reserve. Reserve is nothing, but what you call, you know what it is a reserve redemption reserve capital redemption reserve, it can be debenture redemption reserve, it can be preference capital in share is a redemption reserve, it is all what is called as redemption reserve.

When I say redemption, redemption means what, at the end of the period payback; for that I create a reserve that is; all what you got all these money is culled out of what culled out of profit not utilized. This will also come and sit somewhere out here along with your what is called as your net worth; before your net worth is arrived at equity, retain earning, premium, all reserves that is in short, all money belonging to the equity holders.

Entire, that entire bundle is what we call it as net worth, and that is what other than equity all these are go under a heading called as reserves and surplus. All the other aspects premium, your retained earnings, your kinds of reserves all this go under a heading called as reserves and surplus in the balance sheet. In this particular case if I were to move up out here yeah, I am back here.

Student: If given.

What I said, he has brought in 10,000 as capital, he has brought in 12,000 as premium, my net worth is 40,000. Same evening he decides to fight with me and leave what is eligible he is eligible for 50 percent of his net worth. What is 50 percent of his net worth; 20,000 what did he contribute he contributed.

Student: 22.

22 he has lost 2,000 in value, there is no question of dilution here. Because at this stage if you have an investor at work then there should be something else that it should be going on behind the scenes.