

Financial Statements Analysis & Reporting
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Lecture - 01
Introduction

Hi, this is Dr. Anil K Sharma; I am from department of management studies, IIT, Roorkee. And I am offering this course Financial Statement Analysis and Reporting, financial statement analysis and reporting is a very interesting area especially for the students who are interested in the business management, and learning about the business management or the management of any business undertaking without accounting is incomplete. So, in accounting the major part is the preparation of financial statements, analyzing the statements, and then reporting these this information which is given in these statements to the different stake holders, they may be shareholders, they may be lenders who provide us long-term finance, they may be auditing companies or they may be government authorities. So, reporting is again a very important component of financial statements.

Now, when we are talking about financial statement analysis and reporting, in this particular area, we will discuss three things. First part is to learn how to prepare the financial statements, second part is how to analyze these statements because information in these statements is not self-explanatory, and we will have to analyze it by using certain tools and techniques of accounting analysis, and then reporting. So, first I will discuss with you, how to prepare the financial statements. We will discuss for both type of organizations - public and private firms. And accounting is a little bit different for public and private firms including sole proprietorship and partnership firms.

So, in this process as I told you that first we will be learning how to prepare the financial statements. So, we will start with the process of learning to prepare the financial statements. And in this process of preparing the financial statements, there is some background. If you do not know the background, you cannot prepare any financial statement.

When I am talking about the financial statement what do I mean, we have normally three financial statements, which are statutorily required in a day. First part is the trading and

profit and loss account, second part is the balance sheet, and third part is the cash flow statement. When we talk about the profit and loss account or trading and profit and loss account, while preparing this statement, we are learning how to calculate the profit or loss in the business. Because ultimate purpose of any business is to earn the profits and maximize it and that is objective of all the stakeholders, who provide finance, who provide other inputs they want maximum return on their investment. And if you talk in nutshell, the ultimate objective of any business is to ensure the security of your funds and growth of the invested funds.

Now, by security when we talk about we make sure that the funds invested in the business are secured largely with the help of balance sheet. We can make sure that firm is doing a good job. And when we talk about the growth of your funds, I would say that in terms of ROI - return on investment, we try to measure the growth. And for working out the return on investment, we need a statement called as profit and loss statement or trading and profit and loss statement. So, we will prepare, we will learn how to prepare these three statements, and then how to draw the meaningful inference out of it. Now, as I told you that if you want to prepare the statements there is some background process which we must be knowing. If you have heard about little bit about accounting, you must have heard about the term called GAAP - G A A P, GAAP.

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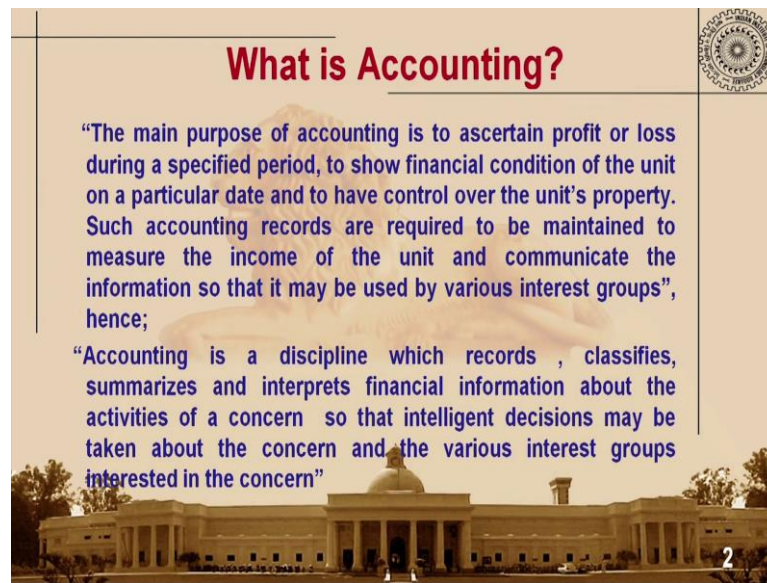


Now when we talk about the GAAP we say that I am talking to you about a term, which is called as GAAP. GAAP is generally accepted accounting principles. And if you want to know about the preparation of these statements financial statements, we must aware about the GAAP. You must have heard about that we have different type of GAAPs, Indian GAAP, US GAAP or every different country has its own GAAP. Because businesses is are different, business processes are different, sources of finance to the business are different, and their utilization in the business and the methods of utilization of these sources is also different. So, in every country means every country has devised some generally accepted or generally agreed accounting principles. And on the basis of these principles, we prepare the financial statements and report this financial information to the different stake holders in the industry.

Now, you may you wondering about that who prepared this GAAP. So, I would like to share with you that in every country, there is a one institute which is called as Institute of Chartered Accountants of that country or Institute of Certified Public Accountants in may be other country; in India, we have ICAI. In India, we have ICAI - Institute of Chartered Accountants of India, and this institute is entrusted with the task of initially long back preparing the GAAP, ensuring the proper implementation of the GAAP, and effecting changes if any from time to time.

So, these generally accepted accounting principles are must to be known by every person who is interested in the financial statements of the business; without GAAP, you cannot proceed further, you cannot learn how to prepare these financial statements. So, let us proceed further and learn about the GAAP. When we talk about the GAAP, before GAAP, I would tell you how we define accounting.

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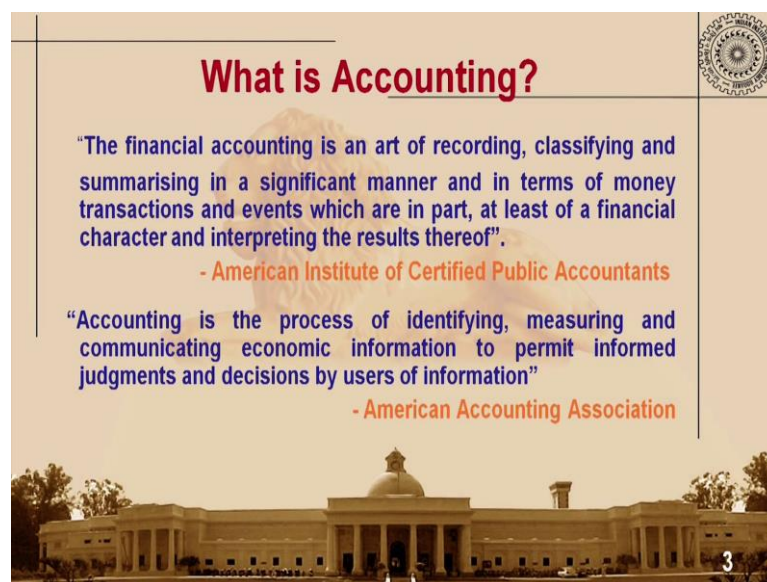
So, on other way around you can say what is accounting. Accounting is as I have written here; it is basically just focus about the lower part first. Accounting is a discipline which classifies summarizes and interprets the financial information about the activities of a concern means a business so that the intelligent decision making may be done or intelligent decisions may be taken about the concern or that particular firm and the various interest groups interested in the concern. So, who are the means what are the sources of finance, what is the asset composition of that particular firm, what is the equity and debt position of the firm, what is the overall profitability position of the firm everything can be known with the help of accounting which helps us to prepare the important financial statements.

So, I would say that the main purpose of accounting is to ascertain profit or loss, during a specified period to show financial condition of the unit on a particular date and to have control over the unit's property. Such accounting records are required to be maintained to ensure the income of the unit and communicate the information, so that it may be used by various interest groups. So, now, what is the meaning of these different things given here in this definition I said here that say for example, we talk about the profit and loss. So, we would learn how to calculate the profit and loss. During a specified period, so what is that specified period we will discuss about that. Financial condition or the financial position what is this and how to measure it, we will learn about it. And why on

a particular date, there is a reason for that; and ultimately how to exercise the control over the financial performance of a firm.

So, now we have learnt something about accounting that basically it is a discipline which facilitates the recording classification and summarizes and interprets financial information about the activities of a concern so that intelligent decisions may be taken about the concern and the various interest groups interested in the concern. As I told you that different countries have different GAAPs; and they have specialized institutes; in case of India, I told you we have ICAI; in US, we have institute called as American Institute of Certified Public Accountants.

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So, how American Institute of Certified Public Accountants interpreted accounting? We say that financial accounting is an art of recording classifying and summarizing in a significant manner and in terms of money transactions and events which are in part, or at least of a financial character and interpreting the results thereof. So, it means one thing is very clear that in accounting or when we talk about accounting, we talk about only those operations of the business where finance is involved. Anything happening in the firm in any business where finance is not involved, how important it may be we are not concerned about that information. So, ultimately means everything we are talking about finance and financial performance of the firms.

Similarly, American accounting association have also said that accounting is a process of identifying measuring and communicating economic information is financial information to permit informed judgments and decisions by the users of that information. Now, what accounting does, why we use accounting in the businesses, and how it is important for different stakeholders. If you look at these five points - first five points, they made the objectives of accounting, purpose of accounting, they define the purpose of accounting. And in that purpose of accounting, first objective of accounting is making decisions concerning use of limited resources. So, because finance is limited, it is a scarce resource, it is not unlimited.

And if you are in the business our ultimate objective is maximum and the best utilization of this scarce resource. If you are an entrepreneur or you would be like to be entrepreneur tomorrow, many things will come in your mind many projects may come in your mind. I should start this business, I should start that business, I should go into manufacturing sector, I should go into services sector. So, you cannot go to all those areas where you are interested in you have to move in the phase manner. And when you have to move in the phase manner, you have to choose at least one business in the beginning. And when you choose that business in the beginning, the cost entry is only finance, you not have unlimited resources with you, you have limited resources.

So, first invest those resources in a business which ensures the two objectives as I first told you the security of your funds you are investing, and second thing is the growth of the funds. And once you are successful in one business, you can move to the second, you can move to the third may be in the same area or maybe you can diversify means after that sky is the limit, but not everything altogether. So, our first objective is and with the help of accounting, we achieve this objective that we make important decisions, because now how do we make important decisions.

If you would like to entrepreneur tomorrow, and you have some money with you or in your pocket, but that is not sufficient to establish a firm. So, you would like to raise additional resources, for that you have number of sources, you can go to banks for seeking loan, you can go to the stock market raising the funds by selling the stocks of your firm, but all these things are not possible for the new businesses, because nobody knows the track record of that business. So, banks will be reluctant to give you money, why should they give you money because you have not any provement track record.

Stock market if you go to and you come out with an IPU - initial public offer people may not be interested to subscribe to the shares of your company, because they do not know what is going to be the fate of this company how much return is going to be there.

So, we have no alternative. So, either you run the business with your own capital or you go to the other source which is called as the bench capitalist, who provide you the risk capital. And they not only provide you the capital, they provide you the business guidance also, and they help you in different aspects of running a firm, but the problem is the rate of interest they charge is very, very high. So, we sometime cannot afford to go to the bench capitalist. So, ultimately means purpose is that our resources are limited and we have to make the best use and accounting helps you in guiding you that how to invest in the business, how to expect returns, how much returns and how to maintain a proper prudent financial position of your business.

Second objective is identification of the crucial decision areas and deciding objectives and goals. What are the critical areas of your business? For example, you are going to establish a manufacturing firm is raw material available for the product which you want to manufacture; technology is available which is within your reach, sufficient manpower will be available. And what about the market of the product, the finished product, which will come in the market and you have to sell it in the market. So, many crucial areas are there. And when we talk about these crucial areas, we have to identify those areas and convert them into financial terms, so that we can get to know that what is going to be the end result of the business.

Third - effective directing and controlling of units resources where to invest, how much to invest, how to make sure that whatever you invested that has been successfully utilized in the business. There is no pillage leakage of your funds and there is a complete effective control means I would say more appropriately financial control and that financial control is again ensured by the accounting.

Next is maintaining a reporting on the custodianship of the resources. Say ultimately, when we talk about the reporting of the financial results, apart from many stakeholders, government is the one important stakeholder because government is the custodian of public faith. So, when you go to stock market, borrow money by selling your company's shares in the market, government always will make sure that money goes to the right

concerns, people investment is safe and a right kind of the activity is taking place. So, as a custodian of public faith, government knows how to do it, but they require information. So, with the help of financial statements, we keep on informing the government from time to time that how the business is going, and how the funds provided by the business by the people different stakeholders are being utilized in the business. So, custodianship is very, very important; government is the best custodian, shareholders are the other custodians, financial institutions who have provided you long-term loans are the other custodians. So, every custodian requires your information or the information about your business.

Facilitating social functions and control. So, apart from the business, we need to inform the society as a whole, what is happening in this firm, how this firm is doing and overall performance. So, we have to tell to the general public, shareholders, government, suppliers, financial institutions, so everybody is interested in the firms affairs who is directly or indirectly affected. So, all these objectives are there which are performed by financial accounting.

Now I was talking to you that if you want to analyze the financial statements, we have to learn how to prepare the financial statements that is three financial statements, trading and profit and loss account, two - balance sheet, and three - cash flow statement, these are the three statutory statements required to be prepared and used for reporting purpose. Now, for preparing these statements, we have two different systems; one system is cash system of accounting and the other system is mercantile or accrual system of accounting.

Now, what is the basic difference in these two systems. Under cash system of accounting, we record only those transactions in the business or transactions of the business are recorded only and only if there is a movement of the cash. For example, firm purchased raw material, and made the payment in cash then that statement is important to be recorded; otherwise it will not be. Similarly, firms sold the finish product in the market and total sales are on cash, no credit sales. So, on the one hand, finish goods are going to the buyers; and on the other cash is flowing into the firm from the buyers, no credit transactions, no due and only those transactions will be recorded in the profit and loss account and balance sheet, where or which are affecting your cash. If there is no movement of the cash, there is no effect of the cash their transaction is not important for the business.

But under mercantile system of accounting, cash is not important. For recording any transaction whether it has happened or not happened or it is of use to the business or not it does not depend upon the movement of the cash. For example, we are buying the raw material, and we are buying it on credit, the payment will be made by the firm to the supplier after 2 months, yes, under mercantile system of accounting it is important. Similarly, we are selling the finish product in the market. So, does not mean that every time you have to sell it on cash, it can be sold on credit. As you are buying raw material on credit, you are about to sell it on credit in the market sometimes because all the times the cash sales are not possible.

So, you are not concerned with sales means sales whether it is on cash or it is on credit whether cash moves in or cash does not move in its not important for us. For us sales have taken place, and they have gone out of the concern or concerns warehouse and they have reached to the buyer. So, this system which is not requiring the movement of the cash in every transaction or every time is called as the mercantile system of accounting or the accrual system of accounting.

Now, you would ask a question that which system is used in the businesses, and in what kind of the businesses. So, I would say cash system of accounting is in practice, it is in vogue only in the banking sector in a day. Other than banking sector, for financial reporting purpose, we follow the mercantile or accrual system of accounting reason being that in the business everything happening on the basis of the cash is not possible. Otherwise, the size of the business the growth of the business will be affected. So, you cannot do everything in cash you have to sell it on credit also buy it on credit also.

Now for example, when we talk about the employees when somebody is working in the firm; day one, when he comes and he works for the whole day 8 hours a day, we not pay him same day, we pay him after 30days. It means, he is still giving you services. So, accrual system and cash system of accounting the main basic difference between these two systems is cash system will take into account to only those transactions where the cash is affected. And accrual system of accounting will not require any movement of the cash if the cash moves fine; if the cash does not move no need. In the banking sector, we have the cash system of accounting. Earlier, we had mercantile system accrual system in the banking also, but that system failed to report the true results of the bank's performance.

You must have heard about a one term which is called as NPAs nonperforming assets. Now, what is a nonperforming asset? What is asset for the bank first; let us learn. Asset means the loan which the bank has given to somebody when the bank borrows means when the people deposit your money in the bank that deposit is a liability on the bank because it has to be paid back. And when bank gives this money converts that into the loan it becomes the asset for the bank.

So, then we have or sometime back, when we had accrual system of accounting in the banking sector, so what we were doing say for example, there is one loan account. He borrowed one million rupees from Punjab National Bank, he paid and then he had to start repaying it. For one year, he paid his all installments regularly, but after that he stopped paying it. So, if it is a accrual system of accounting in Punjab National Bank, what will happen that branch which has given that loan to that borrower, he has stopped paying it back to the bank, but that branch will not recognize this fact. And every month, quarter, day, day, month, quarter or six months or annually they will keep on showing in their profit and loss account that this much interest we earned from this loan. And that loan will be continued to be shown in the balance sheet as an asset, but you see this asset has become nonperforming after one year.

So, after one year neither, we are receiving back the principle amount nor any interest on that, but the bank is reporting its financial statements that yes on all the loans we earned this much of the interest, this is our interest income which will be the part of profit and loss account of that branch. And finally, the bank and the total loan portfolio will be shown as the assets of the bank whereas some of the assets have become nonperforming because borrower has stopped paying. So, then we shift it from mercantile system of accounting to the cash system of accounting, because NPAs started raising nonperforming assets. When any loans stops coming or any return on that loan may be the interest or the principle stops coming back to the bank that asset becomes the or that loan becomes the nonperforming asset.

So, when these extents started rising, the nonperforming assets contempt started rising, we realized that we have to now convert from the system that is from the accrual system of accounting in the banking industry to the cash system in this industry. And under the cash system only those assets will be considered as assets, who are really good assets, performing assets means that loan whose principle amount is when it is due it is being

paid by the borrower and the interest component also when it is due to be paid by the borrower back to the bank it is coming. It means movement of the cash.

When the bank will receive that interest in cash or when the bank will receive that principle amount in cash only then it will be considered as the receipt of that interest and the receipt of the principle component. Otherwise, it will not be received treated as receipt means no credit or no recording of those assets who have become NPAs nonperforming assets. Because if you follow the accrual system, many loans will become nonperforming, but we are assuming that this is the interest income of the bank this is the principle amount coming back. But at the end of the year your profit and loss account is showing a different profit, but actually cash profit is different. Cash profit will be much low as compared to the book profit or the profit being shown by the profit and loss statement so that will create the problem for the bank. And sometimes some banks become even means are affected to the extent that they even become sick banks because of the nonperforming loans or because of the nonperforming assets.

So, finally, I would conclude that out of this two systems of accounting in the businesses other than banking, we use mercantile or accrual system of accounting; and only in the banking industry in India for the reasons just I explained to you we follow the cash system of accounting. Now, I will take you to the next step that what is the mercantile system of accounting and how to follow it for preparing the financial statements. Remaining part of discussion we will do in the next class.

Thank you very much.