Entrepreneurship Essentials

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Module - 07
Lecture – 31
Introduction to Financial Statements

Hello and welcome. We are going to discuss about Financial Statements, its introductory knowledge for the day and we will be visiting balance sheet profit loss account, cash flow statements in brief and then gradually we will take up a good example to drive from the points. At the end of the module, I want to make sure that all of you have a good grip on the financial statements knowledge and you should be able to analyze or at least understand the various items that are represented in financial statements.

As an entrepreneur it is very important that you understand everything including finance particularly you need to know whether at the end of the day there is sufficient surplus after meeting all the expenses that goes to the founders, the entrepreneurs. Even before that you need to understand whether you are going you are not going to run out of cash.

We have seen that about 24 percent of the companies fail because they run out of cash unplanned. Meaning that they did not realize well in advance that some point of time, they are going to run out of cash and then close the business. The day you run out of cash, there is no moving forward; you have to really close business because nobody is going to be going to be excusing you. And hard fact is that 24 percent of the companies fail because of that.

These 24 percent of the company many of them would not have failed if they would fore see that such a day is coming when their total inflow of cash is going to be less than the amount of cash that they need to pay. So, it is very important that entrepreneurs understand cash flow statement in particular and then how the cash flow is coming into being out of balance sheet and profit loss account.

So, having some knowledge about all the financial statements make a real meaningful sense. Even if you do not become an entrepreneur suppose you are just in just maybe a housewife, now maybe you make some investment in some companies and time and again you see some balance sheet being published some profit loss account coming up. And then in the pink papers like financial information newspaper they publish some data on some profitability or balance sheet data and then if you cannot make head and tail of that, you are at a loss. You have to ask somebody what is the meaning of this, this company has made this. What does it indicate?

And if some company is making some profit and you see the headline numbers that so and so company made so and so profit. It can be actually highly confusing because headline information may not mean anything whatsoever. You diif, you dive deep inside you will find that there is no profit at all even though headline profit is so, high. Because there may be other factors which are to be taken into account before you really can make some kind of assessment about the realistic profit. So, it is very important that you know a bit of financial statements.

Across the world the stock markets are so vibrant and so much of transactions are happening that the aggregate transaction in stock markets actually are more than the aggregate GDP of the world. So, it has recently exceeded the GDP, the total stock market transaction and these transactions are made based on the inputs that they get from the financial statements because they have no idea what is happening inside the company and nobody actually is supposed to enter inside the company the factory and see how they are operating and what is the situation.

So, all that information that you have access to is the information that is provided by the companies and the major part of the information comes in the form of financial statements: both quarterly, half yearly and annual statements. So, having some knowledge about financial statements makes you a smart guy if kind of a contemporary personal otherwise, you really do not understand anything what whatever is happening in the world.

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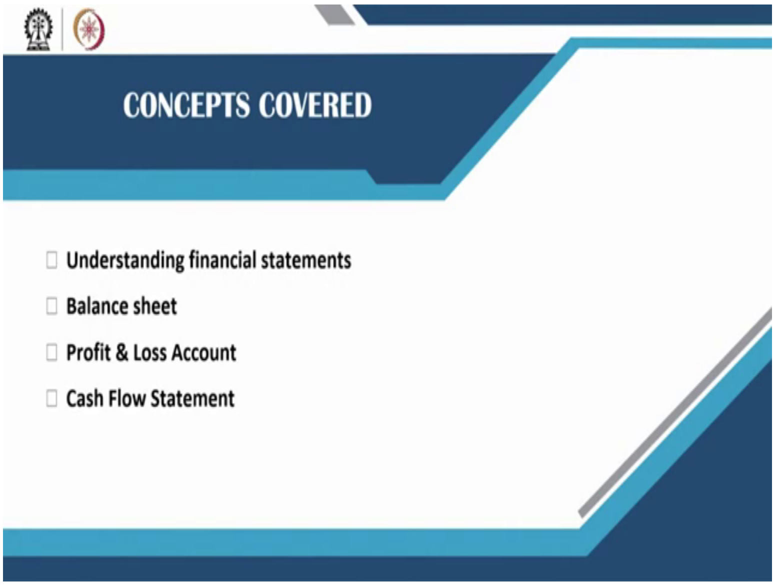

Now, so, there are in major three financial statements. One is balance sheet, profit and loss account, another is cash flow.

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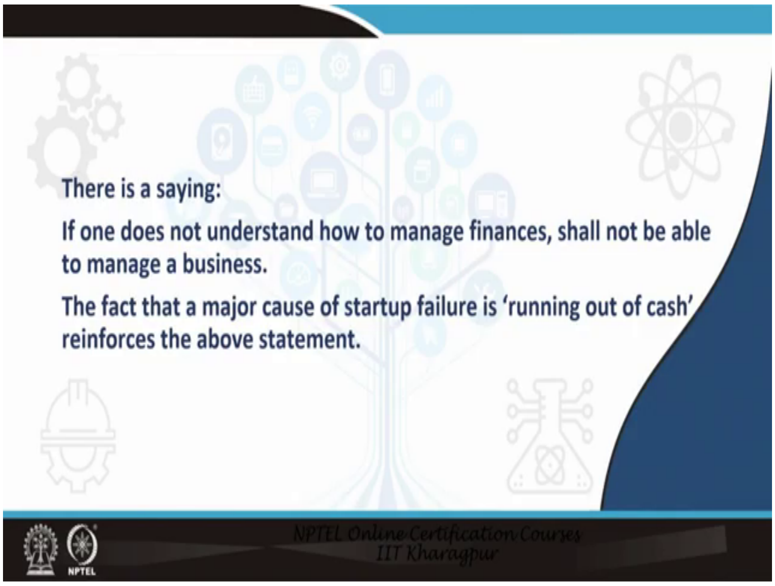

In this session, let us just give introduction as to what they are and how what they mean all of that. There is a saying. So, we will start with an anecdote. If one does not understand how to manage finances, shall not be able to manage a business because at the end of the day unless there is money, there is nothing. Beginning of the day, end of the day you start with money and eventually you have to end up more money with more money than what you started with. The fact that major cause of startup failure is running out of cash that reinforces this statement.

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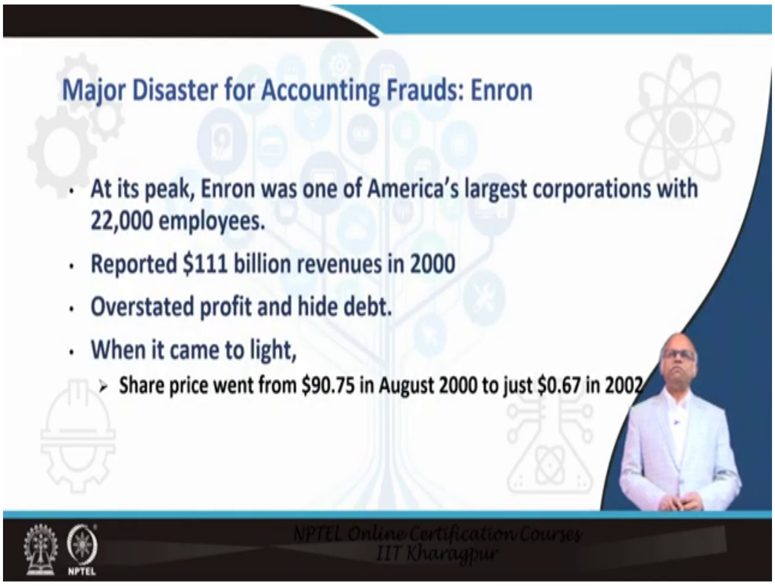

As I said the stock market depends on financial statements. Look at this data Enron was a darling of stock market, their share price was 90 dollar a piece and at peak they had 22000 employees. They reported 111 billion dollars in revenue in 2000, but then they were under stress, they raised huge debt that their company was not able to service.

So, they underreported debt and then in the process, they underreported interest and that where the jacked at the profit. So, stock market thought that they are making lot of profit and because this was a fantastic company, this was a with lot of credentials and all credit rating agencies also overlooked some of the things and then investors trusted on credit rating agencies and they published data.

They did not deep dive deep inside. So, eventually the majority of the investors could not understand, but then at some point of time when it came to light their share price went down from 90 dollar a piece to 0.67, 67 cents in 2002 and then every investor actually lost money. If some investors had something like say 1 million shares, he almost like became bankrupt.

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Major disaster another disaster WorldCom. WorldCom was the second largest telephone company in US and then the same thing happened, they started under reporting or under reporting the cost even that led to over reporting of profit. So, cost was underreported to the tune of 3.8 billion dollar that is 3 billion pound in. So, it filed for bankruptcy, it should be 2010 actually it is not 2020.

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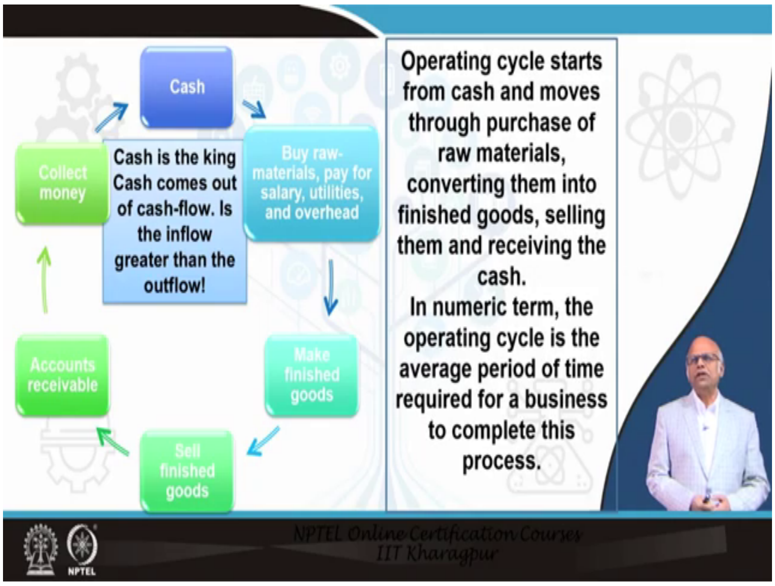

Operating cycle starts from cash and moves through purchases of raw material converting that into finished goods and then eventually you sell it to customers, customers normally do not pay you outright. So, there will be they will be asking for some time to pay. So, your sales is converted into accounts receivables and then someday maybe within a month to month or 2 or 3 or 4 even at times after a year, you are capable of collecting that money and then that gets converted into cash.

So, we start with raw material and then you hold some raw material because it is not a just in time kind of purses for everybody. So, you most of the people buy for a month o. so, on an average. Maybe it is a month’s requirement because you want to make sure that you do not run out of stock and then you always are capable of producing and meeting the demand from the market. So, you keep some buffer. So, maybe you maintain 1 month's consumption equivalent of stock.

So, that there you block some money and then you put some stock in the shop floor. If you are a manufacturing company, you need at least a week's stock in the shop floor because you cannot run from shop flow to the inventory or to wherever you put the inventory bring them on a daily basis. So, you will be putting some stock in the shop floor maybe 7 days or something.

So, anything requires money wherever you put some stock, you need money to buy that. So, that is money actually and as I mentioned earlier also that money is costly money requires money. It force you to incur cost like suppose you maintain rather than 7 days a stock in the shop floor, you maintain 10 days stock in the shop floor or maybe 14 days stock in the shop floor.

Suppose 7 days stock requires 1 lakh rupees. So, for maintaining 14 days a stock, you require 2 lakh rupees. So, that additional 1 lakh rupee has to come from somewhere mostly people borrow in the form of working capital for this kind of moving stock. So, you borrow 1 lakh extra money for maintaining additional stock in a shop floor. So, you end up paying interest on 1 lakh rupees for a entire year because every time you are maintaining 7 days extra of raw material. So, 7 days extra more raw material is worth on 1 lakh rupees. So, every day you have 7 lakh 1 lakh extra worth of raw material.

So, end of the year, it is not seven days interest that you pay; you actually pay interest on 1 lakh rupees which is equivalent to 7 days worth of stock. So, if the interest rate is 15 percent, you pay 15000 rupees for nothing just for maintaining additional stock in the shop floor maybe for reducing risk or anything.

But if you cannot maintain if you cannot manage your inventory at every places like raw material stock, finished good stock, then stock in goods in process or shop floor and then receivable stock unless you are efficient capable of efficiently managing them, you will end up paying more and more interest in the process.

So, your objective whether you are entrepreneur or an executive wherever you work your object is to reduce this time of this cycle from cash to cash conversion cycle. If it takes 1 year that is something; if it takes 6 months that is exactly half or double efficiency with which you are managing the inventory.

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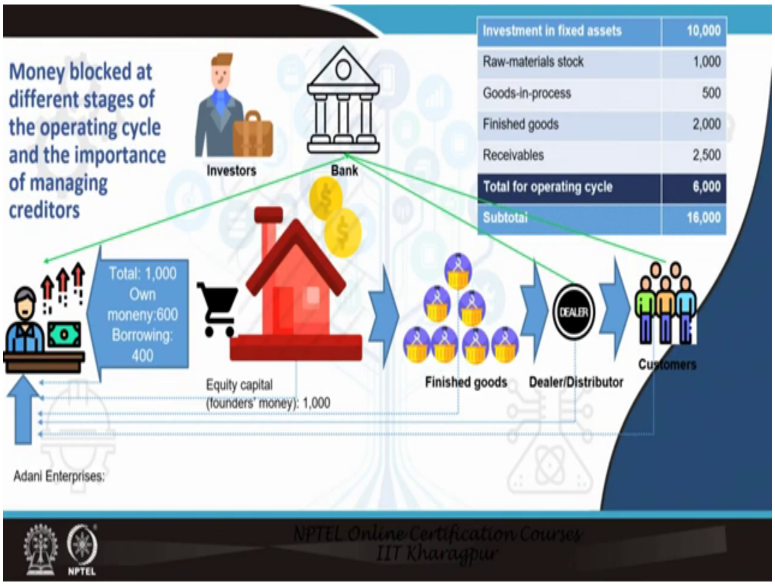

So, your objective should always be to efficiently manage inventory. So, that your requirement of money for maintaining the cycle is much less. So, you end up paying less interest initially or even now you might think that this is not so important to manage inventory and then managing money. But take it from me many many companies fail because they cannot service their interest.

For example say a SRS steel, they borrowed heavily from banks to the extent of 55000 crore rupees or maybe 1 lakh crore rupees and then eventually they could not service interest because steel prices somewhat down, but our central bank maintained a higher interest rate regime and in the process all borrowers particularly big business houses like SR like name any other company like JP group, Bhushan steel in particular or Aloak industries.

All these are default to the tune of tens of thousands of crores. Like Bhushan steel was defaulted to the tune of 55000 crore rupees without latest interest if you charge interest after that, it will be 1 lakh crore rupees. So, 1 lakh crore rupees and say interest rate is 15 percent, it is 15; 1 lakh multiple.

So, is this 15000 crore rupees of interest that you pay annually on 1 lakh crore rupees; 15000 crore rupees a hell lot of money that it is not so easy to make by selling steel in a downward market. When particularly when the world was following something like 0 interest rate regime like Japan like US like Europe even in China, the interest rate is much less compared to India.

So, managing your money and then managing interest is so very important. SRS steel become bankrupt, Bhushan steel become bankrupt, Alok is already bankrupt and Bhushan has been taken over by Tata Steel. SR has been taken over by Mithal. So, the founders or the entrepreneurs they lost their asset, they lost their investment and entrepreneurs are not born overnight

So, whatever reason they could not manage their money, they could not service their interest eventually they failed and entrepreneurs failed. So, it is important that you make estimate well in advance that how much you can service, what is the sensitivity of your business on interest rate if interest rate goes up by 1 percent. How your profit is affected? If you see that profit is affected drastically then it is not wise to start a business under that kind of a capital structure where you need to borrow so much of money.

So, this actually this image explains, how money or how the whole working capital or this operating cycle moves. There are raw material supplier so, you have to pay money to buy raw materials, you buy some raw material on cash, buy some raw material on credit. So, eventually raw material comes in the shop floor, then you convert that into finished goods; finished goods goes to dealer distributors who sells them. So, after selling this started sending back the money; money comes to the bank from bank. You make payment to the supplier.

Now why this big image after discussing all of that in the previous slide is like this? Here I am trying to focus on one particular aspect that is you buy on credit to some extent on credit, to some extent you pay cash. Similarly you sell sometimes on cash sometimes on credit. If you can; if you can sell on credit which is equivalent to the entire purchase that you make meaning that you can purchase the whole amount on credit, you can sell maybe little bit on cash and little bit on credit, but on a shorter period of credit meaning that suppose you was you pay to your suppliers after a month.

Whereas, you recover your sales proceeds within maybe 20 days, then managing of business becomes very easy because you are getting the money in 20 days. And once you get the money, you can make the payment to your suppliers.

But much depends on many many things, most importantly the sustainability of your business. If your suppliers are in some kind of a buyer's market meaning that you can command you have a competitive advantage and you can command make a bargain with your suppliers, then suppliers will be eager to supply you on credit. But if you are in a seller's market meaning that there are less number of sellers and more number of buyers, then you may not be able to bargain on the credit terms or on the price terms sometimes people compromise on price, they negotiate on a higher credit term.

In the process they save interest. So, they see what is the trade off between the two and then they manage their fund this way. So, suppose your investment is 10000 say 10000 rupees and then raw material stock is 1000 rupees, goods in process is maybe 500, finished goods 2000, receivable is 2500. So, total for operating cycle is 6000.

Now suppose you get a credit of 6000, then there is no problem at all; you do not have to borrow any money from the bank for working capital per se. You have to borrow money maybe for capital investment to create fixed assets, but here you may not have to borrow. So, going will be very easy.

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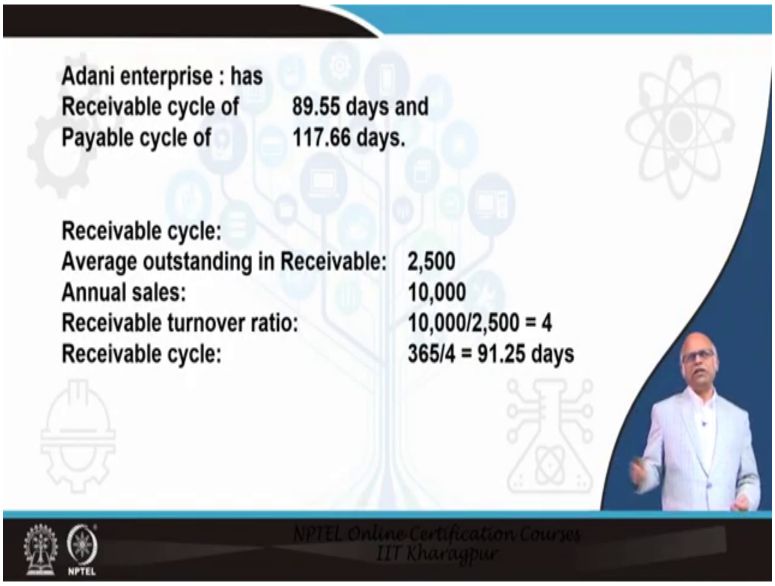

Here is a live example. Adani enterprise as per a recent report has a receivable cycle of 89 days meaning that they have they get their payment back within roughly 90 days of their sales. They sales to they sale today and receive the payment after 90 days whereas, they have a payable cycle of 117 days meaning that they buy raw material and then they make payment after 117 days within which time they actually sell the goods and then receive back the payment and then make the payment to the suppliers.

So, they do not have to borrow money from the bank. Not only they do not have to borrow money from the bank, they can actually enjoy some money; some difference this difference between 89 days and 179 days is about 30 days.

So, about 30 days of worth of sales, they are able to hold for a while maybe they put it in the bank earn some interest or maybe they actually reduce some of their loans or maybe some working capital loans for a (Refer Time: 19:33) concerned, they may they maybe give the money to some kind of a corporate borrower or something.

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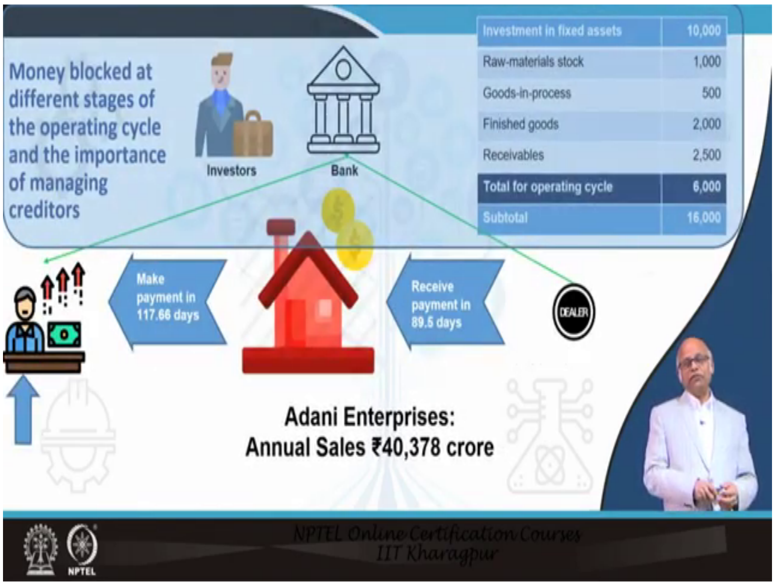

So, eventually they like say the same example Adani actually annual sales is 40000 crore rupees, 30 days equivalent will be something like 3500 crore rupees. So, Adani enterprise sit is on 3500 crore rupees every day meaning that money is always surplus with them. So, they do not have to borrow.

So, their interest cost will be will be very very low meaning all the interest that they have to pay is on capital investment, long term investment or maybe they actually invest money in some of the form at a higher rate of interest and borrow money from somewhere else.

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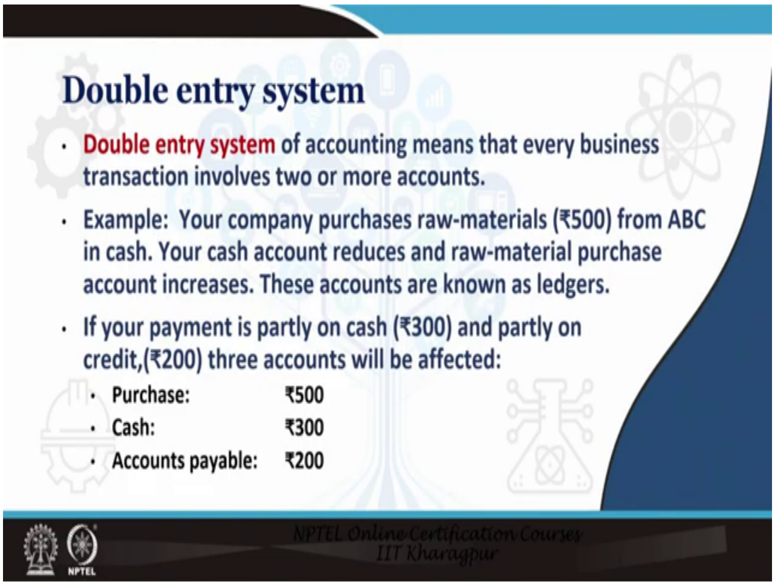

So, that in a nutshell also explained that there are so much that can be done to make your business more profitable. Like suppose you have some surplus money by managing your receivable and payable. Well, you can actually make some money look at Reliance Industries balance sheet. They are their treasury operation is so, high meaning they borrow money and then they lend money. They borrow money at a very low rate because they are credit rate is high. So, they can borrow at liver plus maybe 1 percent and then they can lend it maybe 5 percent above lever.

So, in the process they make a clean 3-4 percent of interest income and if you see if we look at the balance sheet and profit and loss account of reliance industries, you will see a significant amount substantial amount of their profit comes from treasury operation. Treasury operation is this financial transaction this is borrowing and lending business. So, just by managing your balance sheet, you can actually make more profit; significant profit compared to your profit from operation now.

So, let us talk about just a very brief discussion about the origin of the accounting not origin the fundamentals about accounting without any detail. Present system of accounting is a double entry system. It is called accrued method of accounting. Earlier it was a cash method of accounting cash method of accounting recognizes a transaction only when cash is received.

Suppose on 31st of March, you sell goods worth of 100 rupees and the payment comes on 1st of April because the payment does not come on 31st of March. You do not recognize that sells as a sells for the year because your year closes on 31st of March that is called cash system of accounting. Meaning any transaction will be recognized if cash is either received or paid.

Suppose you pay a salary or say you have to pay insurance for the next year or for the current year on 31 st of March, but you pay you give a cheque; the cheque is encashed some other time maybe may be in April. So; obviously, same day they cannot encash the cheque. So, this expense also will not be accounted for in this year. So, that is what is cash system of account.

In accrual system of accounting whenever you raise a bill or somebody else raises a bill or you, this transaction is recognized. So, whenever you make a sales you raise a bill on somebody, he accepts the bill and it becomes a transaction and you enter in your laser that sales has been made even though goods are yet to reach to the premises of the buyer and payment is yet to be received. That is the difference between accrual system and of accounting and cash system of accounting.

Accounting with a single entry system becomes very difficult meaning that suppose you sell something say or maybe you buy say 500 rupees worth of goods and you just write that goods bought for 500 rupees and you do not write anything else, it becomes very confusing. There will be multiplication there will be redundancy of accounting, you will be writing either too many times, you will not be able to manage. So, came double entry system.

In double entry system, for any transaction there is at least two accounts that are affected meaning you enter any transaction in two separate books; two or more separate books. Here is an example. Suppose you buy raw material for 500 rupees; now suppose you pay 300 rupees of cash and you tell the suppliers that you take 200 rupees later maybe after 5 days 10 days or whatever. So, there are so understand the transaction. You purchase raw material of 300 rupees and you pay 500 rupees. You pay 300 rupees of cash and 200 rupees is to be paid later.

So, how the accounts are affected? First thing is when you buy raw material it is an expense account raw material or purchase account. So, your purchase accounts get affected; purchase account gets affected meaning that you write that purchase of raw material 500 rupees. Then you pay cash. So, cash gets reduced because from cash account you are paying some money to the suppliers. So, cash accounts account gets affected.

Similarly your payable account also gets affected because your accounts payable meaning that you want to pay some 200 rupees later. So, that is to be written somewhere. So, wherever you are writing accounts payable that is a ledger. So, you add another two 200 rupees there. So, that completes the transaction meaning 500 rupees is gone 500 rupees worth of goods have come. Your cash has been reduced by 300 rupees, your accounts payable has gone up by 200 rupees your purchases account has gone up by 200 rupees.

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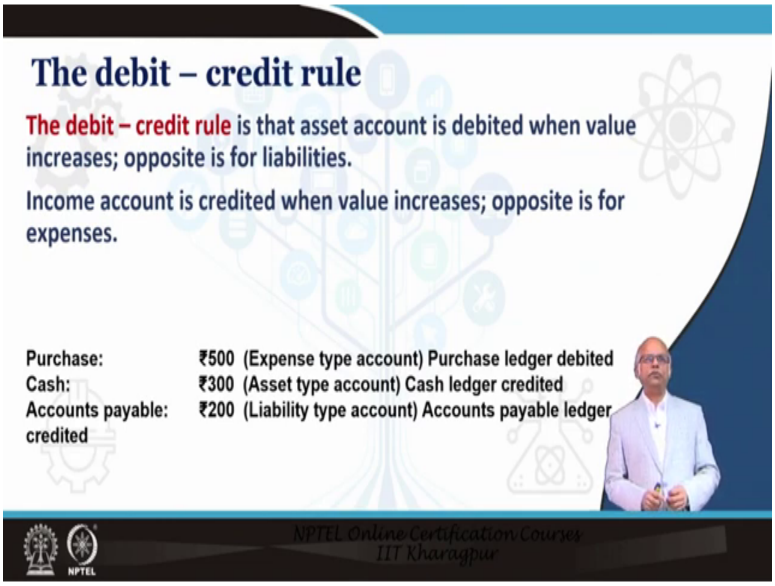

Now, the debit credit rule. I am not going into details there are so much a formula, but just the shortcut of this is like this the. If asset goes up meanings asset going up meaning that you are buying some asset and suppose you buy computer. So, your computer asset or total fixed asset goes up. When asset goes up account is debited and the opposite is about liability. When the liabilities go up, account is credited.

Suppose as an example suppose you say buy a computer on credit. So, computer is an asset; asset goes up. So, your asset ledger will be debited you add it there, but the debit balance goes up; one side of the transaction. As I said it is double entry system. So, what should be the contra? Your suppose you are not paying any money at this point of time, you are selling on credit sorry you are buying on credit, you will pay later.

So, your payable account will also go up when your asset account goes up, you debited the account now payable is a liability because you have to pay the amount at some point of time. So, the other guy the suppliers are supposed to get money. So, for it for the company, it is a liability. Now liability also has gone up, it is just the just the opposite of asset convention. When asset goes up, you debit; when the liabilities go up, you credit. So, your accounts payable ledger will be credited.

Now, going back to the same example, you purchase 500 rupees worth of material. So, your purchase ledger has gone up purchase actually is an expense. So, there is another rule from asset and liability one rule, for income and expenses there is another rule. Income account will be credited whenever some income goes out. Something you sell or in any format if you think that if it actually increases the income, then the income ledger will be credited. These books are called ledger where you enter the major enter items in major heads of either income expenses or assets and liabilities.

So, you purchase 500 worth of goods and your raw material is an expense. So, expense is going up. So, this is debited because sales going up is credited, expense going up is debited. Now you pay cash. So, cash goes down cash is an asset. Asset going out is credited asset reducing is credited. So, asset ledger will be credited accounts payable; accounts payable again is a liability; liability going because it is increasing

So, it is liability going up is credited. So, cash is credited, accounts payable is credited whereas, purchase is debited so, debit credit balances. So, suppose any transaction debit and credit must balance.

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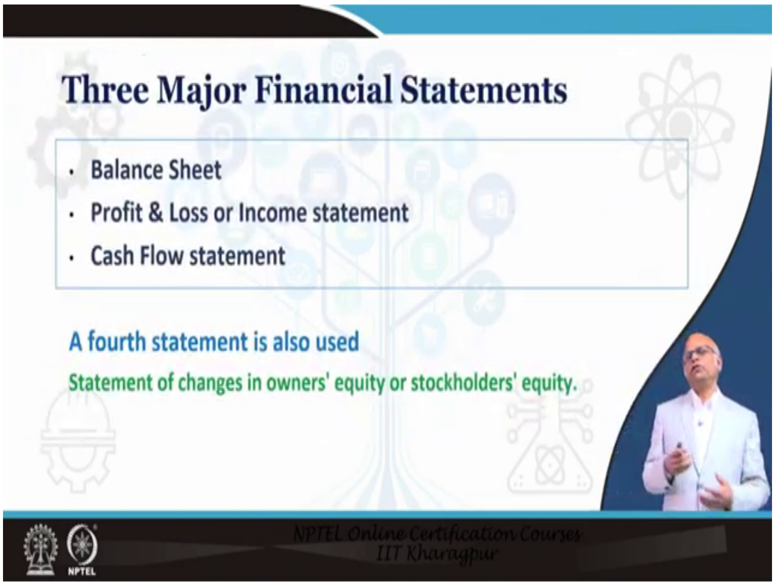

And in the process you can avoid lot of accounting anomalies, you can balance the book. Well now there are three financial statements as I said balance sheet profit and loss or income statement sometimes it is referred to as income statement, then cash flow statements. These three statements together are financial statements. Sometimes we have usually in textbooks you will find there are four elementary or basic accounting statements. The fourth one is capital account or equity account; owner's equity account.

So, statement of changes in owner's equity; equity will be another account, but normally it is subsumed in balance sheet unless the company is big. Normally it is included in balance sheet how the owners equity actually is going up and down.

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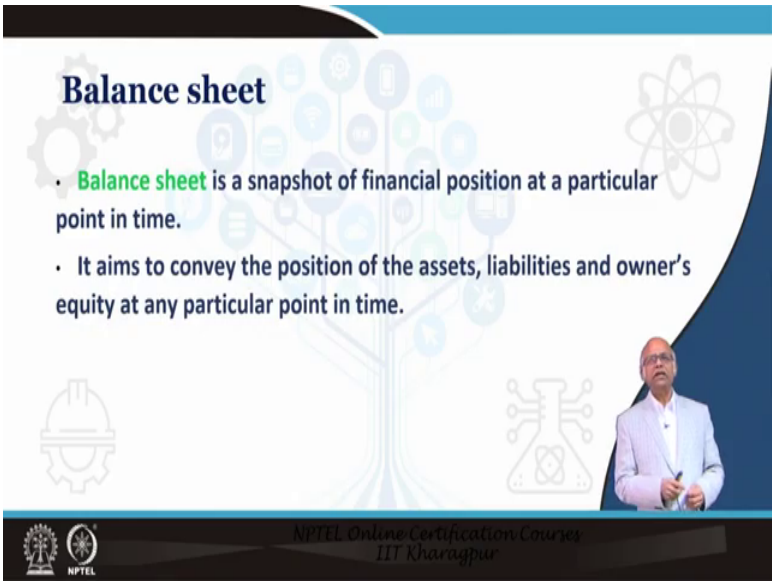

So, let us talk about balance sheet a bit. Balance sheet is refers to your position of assets and liabilities at a particular point in time. Like suppose just an extreme example suppose a guy enters into your office and he tells you that I would like to buy your company, but I would like to know what is your assets and liabilities as of now. So, you can actually by the click of a button in your computer, you can prepare a balance sheet as on the same moment not even day.

So, if you are managing the accounting through computerized accounting system, you will be able to prepare a balance sheet as at that point of time. So, balance sheet refers to a particular point in time. It is a snapshot of financial position meaning that when the guy enters into your office and he demands a balance sheet at that point of time, it is almost like you are taking a photograph of the entire system and then you are telling him look I have this here and here. I have so much of assets here; so, much of liabilities and the net amount is my equity and that is this amount at this point of time.

So, any point of time you can create a balance sheet, but traditionally balance sheets are prepared either as at the end of the financial year or as at the end of half year sometime end of a quarter. So, quarter means 3 months half year or year. Balance sheet is prepared on this on at the end of these periods. So, that is how it is called a snapshot of financials financial position at particular point in time. It aims to convey the position of the assets liabilities and owner's equity at any particular point in time.

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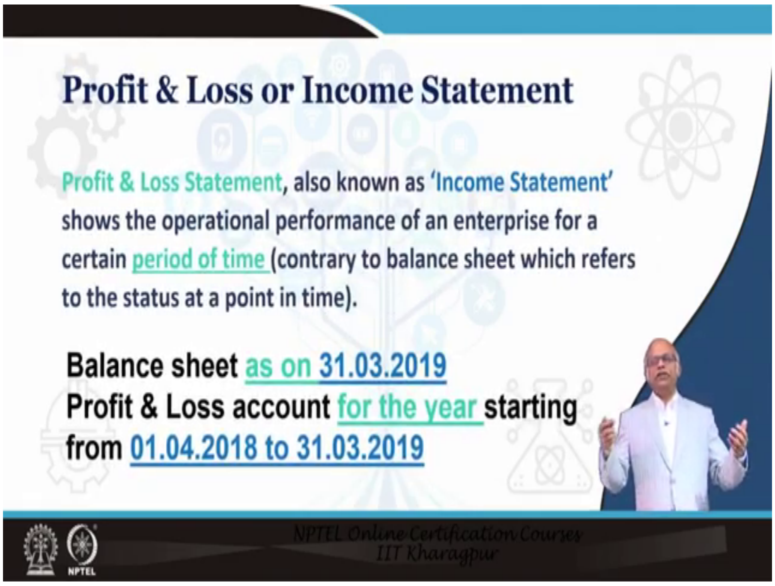

As I said that when you take a snapshot, you give the person who has entered into your chamber what is your assets what is your liability and rest of it is equity. Now profit loss account on the other hand refers to a period of time meaning that if you are thinking of quarterly performance, then you are preparing total sells during a quarter and total expenses during the quarter and whatever is the surplus after meeting all the expenses is the profit during the quarter.

So, it is quarterly statement or maybe half yearly statement or maybe annual statement. If you are making estimate from 1st of April to 30 of this year to 31 March of next year, then it is annual profit and loss statement. So, it refers to a period. So, there will be two dates mentioned for profit loss account; only one date will be mentioned for balance sheet something like balance sheet as on 31 03 2019. Whereas profit loss account will be from 1st of April 2018 to 31st of March 2019 profit loss account is for the period balance sheet for a particular point in time.

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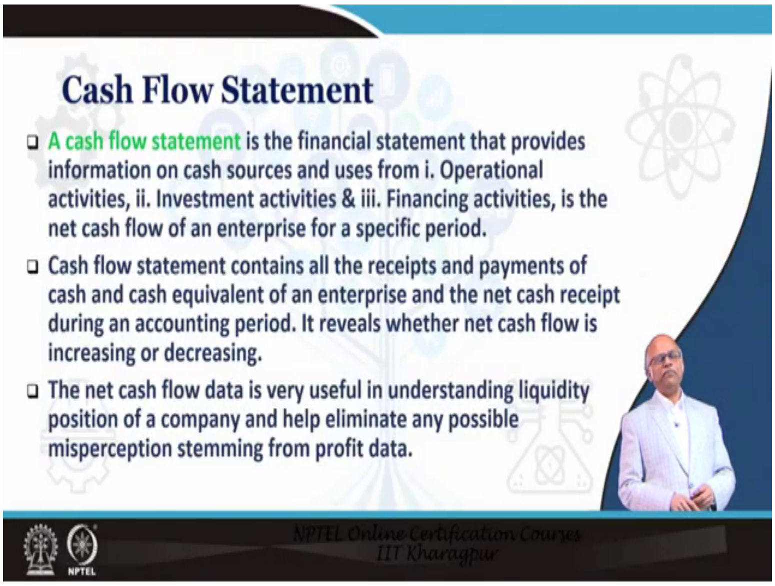

Now, cash flow statement on the other hand or I should not say other hand cash flow statement is the net of total cash that is coming in cash that is going out and the net effect. This is diminished this is mentioned in the cash flow statement.

So, you mention the sources from whatever sources cash is coming or whatever streams of cash that is coming in and whatever streams of cash that is going out and you draw a net to understand what is the net cash flow during the year. And then you add that to the cash position of the previous year which will be mentioned in the balance sheet.

So, this aggregate amount that is the previous year's cash previous years closing cash and current years closing cash current years cash net cash flow will be added together and that will be reported in the balance sheet as on the date of end of this financial year. Suppose we are in 2020. So, on 31st of March 2020, you are going to prepare a balance sheet that balance sheet will have the cash that will be equal to the net cash flow during the year 2019-2020 plus the previous years closing cash.

So, cash flows happens from or cash flow is categorized to be happening from three different sources. One is operating activities or operational activities, you operate meaning that your sales and purchase and sales etcetera that is one kind of activity that is your main business activities. Whatever cash flow is happening there that is cash flow from operational activities.

Now we have some borrowing happening meaning you invest money in fixed asset and working capital. So, we have some borrowing and some repayment etcetera happening. So, these are investment activities meaning how much of the money you invested in creating fixed assets and then there are financing activities like borrowing or maybe you invest in equity, you bring in fresh money and then maybe you paid dividend also. All these are subsumed in financing activities and the net becomes net cash flow.

Cash flow contains all the receipts and payments cash and cash equivalent of an enterprise and net cash received during accounting period it reveals whether net cash flow is increasing or decreasing. If the net cash flow is decreasing, it is alarming not always, but definitely one of the diagnosis is that it is alarming. The net cash flow data is very useful in understanding liquidity position.

Suppose cash flow is increasing every year that is a wonderful liquidity of the company it indicates wonderful liquidity. It eliminates any possible misperception stemming from profit data. If you understand the cash flow and then combine that with profit loss account, you will have a better grip on real profitability. If you see that there are lot of profit happening whereas, cash flow is going negative; that means, this profit is artificial.

Artificial in the sense that from because it is accrual system of accounting so, company is selling a lot of things. So, suppose company sales for 100 rupees and then company purchase for 500 rupees. So, company will show a profit of 1000 minus 500 is equal to 500 rupees. Now suppose this 1000 rupees is yet to be recovered. So, there is no cash flow at all.

So, the company actually is moving towards death. So, the health of the company is not so, good many of the receivables; that means, many of the sales process may not come. So, any sales process which is more than 6 months old are doubtful receivables. So, you may actually write it off and then there is no profit. So, we will close here this session and then we will restart the discussion in the next session.

Thank you very much.