Entrepreneurship Essentials

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Lecture – 34
Introduction to Financial Statements (Contd.)

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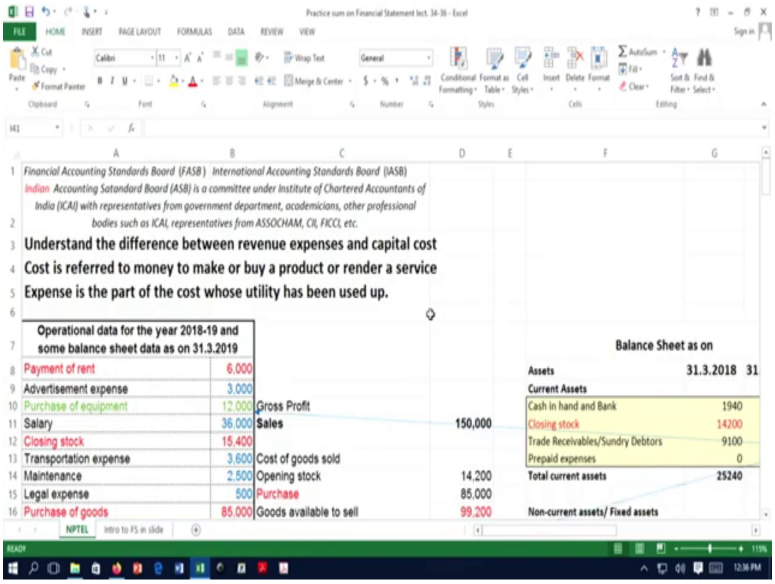

Hello and welcome. So we will continue our discussion from the previous topic that is Introduction to Financial Statements. Now financial statements are prepared based on guidance from 2 international organization or boards, for US companies or USA per se follows the financial accounting, reporting standard, espoused by financial accounting standard board and the other countries across the world, usually follow the international accounting standard board.

So one is Financial Accounting Standard Board that is FASB the other is International Accounting Standard Board that is IASB. India almost or India follows almost the entire IASB policies or guidelines. Not entirely completely, but mostly followed it Indian Standard almost like converse to standards given by IASB.

But then India actually has a separate standard called Accounting Standard Board, they regulate the Financial Accounting reporting which is in-line with International Accounting Financial Accounting the reporting standard. So the Indian India actually came up in 1977 with this standard, this was by committee that is headed by the institutor Institute of Chartered Accountant of India and there are representatives from FICCI from CII from ASSOCHAM then, ICAI, etcetera etcetera.

There are professionals, there are academic academicians why are all these differentiation and why are all this hullabaloo about Accounting Standard is like this that, as I mentioned earlier, all transactions that are made in stock market are based on financial statements, reporting. Whatever information contained in financial standards people make trillions of dollars of investment based on that.

Now there are so much possibility of manipulation in accounting, reporting that the eventual information may not have any bearing with the actual operation of the company. That, shows the gap between the information that is published and the actual information that are diving the accounting, that is that are actually representing the financial finalist financial health of a company.

But then people have to depend on the information which are available and then they make decision, investment decision based on that. But then if the information itself is not right, if it does not represent the actual status of the companies then, there is huge gap and then this information this decisions are made based on fake information. So you can realize that trillions of dollars of investment decisions are made based on information which has lack of reliability.

To bring reliability into this accounting reporting system, the global communities who are interested to promote transparency and reliability of information data, they have been trying to close the loopholes. So that reporting represents the real health of a company. Its almost like impossible, but then people are trying.

So every day, almost every day new policy decisions are coming, new instructions are coming, for compliance. But they still loopholes are means accounting, auditing, people are so smart that they will they are constantly finding loopholes and reporting fake information to serve their best interest. Like suppose a company wants to show more profit to in order to increase the share price they still have lot of levy or lot of opportunities to show higher profit.

Then international communities are also trying to restrict inside a trading, even that is also almost impossible to implement. But then the entire financial system is based on reporting and based on people who are who are privy to information. So they depend on their reporting. So they will always have some kind of access to information and some ways to make this information selectively public so that some people can exploit this information for their personal benefit.

That will continue, but then this also in tries to drive home the point that financial statements are very important both for existing companies, for investors for anybody who are interested in the economy of a nation of the world.

I mentioned that earlier aside from all of that start for founders of start-ups, when I understanding financial statements is very important particularly, cash- statement, you must understand when the cash flow is likely to be negative so that you can prepare well in advance, number 1.

Number 2, unless you understand profit-loss quite authoritatively, you would not be able to have a handle on controlling the cost, increasing revenue trying to define new or and newer streams of revenue so that your cash inflow is more than your cash outflow and eventually you remain cash positive.

So my objective is to give you the foundational knowledge about preparing who have financial statements and have a grip on this topic. So we already discussed the introduction part. Today we are taking a an example that will start from basic information and then eventually, we will prepare the profit-loss account then we will prepare a balance sheet, partial balance sheet, then we shall prepare the cash flow statements and bring the net cash position to the balance sheet to complete the balance sheet.

Now we will start with general ledger balances. There will be a lot of general ledgers in a company, every major accounting head has a general ledger. And the close of the business, you have the actual net position of general ledgers. That information is used to prepare profit-loss account, balance sheet and cash-flow statement.

Now on our left, we have the balance in some of the general ledgers that are prevalent in a trading company. So there may be even more number of heads, there may be more number of more number of expense heads, but we have taken not so simple but not so complex example so that it drives home the point, it helps you to understand, appreciate the various types of entries and then how to treat them.

Before we dive deep into the thing which we would like to highlight major conceptual implication of these entries. Particularly, it is very important to understand out of all these entries which are profit-loss account entries and which are balance sheet entries.

Even if something most of the things will look like their expense either expense or their income or revenue. But it is actually not so there are some balance sheet item, there are profit loss account item, the income item expense item.

Now, when you buy something suppose you buy a calculator, you pay 500 rupees to the shopkeeper to buy that calculator or to a vendor. Whether this is an expense or this is a cost is important to understand. Now before that what is the difference between expense and cost? Cost is something when you that you incur to build something or to buy something.

Now it becomes expense when you use it up in a particular year or a particular period. Suppose, you buy a battery that you consume in 3 months. So the battery is consumed, it does not remain with you. At the end of the year it is not it does not remain. So that is an expense. But when you buy a calculator which needs the battery or you already have a calculator that is not meant for consumption during the year. That is meant to be there in the company for number of years the longer, the better.

So, even though the battery also the longer it remains, the batter suppose the battery remains there for say 5 years then the battery will not be expensed off or used up. So if something is used up during the year, that is an expense, you incur expense. So that is a revenue expense. Whereas, if you incur some cost to create an asset, that is not supposed to be used up in a short period of time particularly, within a year we normally call it cost.

So cost of a calculator this is this also is expensed in the form of depreciation. Every year, calculator will allow some depreciation for the calculator so the cost of the calculator that will be expensed in the as operating expense every year in the form of depreciation. So anything, that you consume like say raw material like salary, like rent, like power, fuel, telephone expenses, transportation expenses, these are paid and used up. But many of the things are not used up. They are used over their life and the life is long.

So whatever proportion that you use during a particular year, you expense only to that extent. Cost has another implication. Suppose you are manufacturing something, so we try to understand what is the cost of production? What is the cost of producing a particular good? Particular product? So we identify the elements of cost and then we add them up to understand cost of individual product so that we can make some kind of a pricing decisions.

Suppose manufacturing cost of a product is 50 rupees so, if we price it as following the cost plus pricing strategy, then we add some 10 percent or 5 percent or 20 percent over the cost of production to determine the selling price, if we have depending on the comfort level. Like suppose, competing products are selling for 80 rupees. So we might very well add 30 percent to our cost of production and decide the price of the product. Of course, we have to add GST and all that. That is always there.

So the expense is the part of the cost whose utility has been used up. The portion the either entirety or the portion of the cost that has been used up. As I said, depreciation is one of that. Let us move forward.

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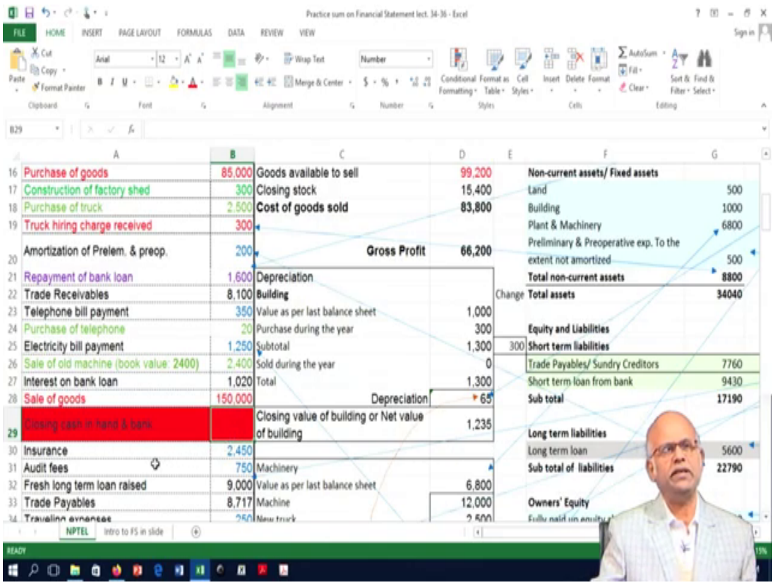

So suppose, on this left side, we have operational data for the year 201-19, that means, the year that is started on first of April 2018 and it ended on 31 st March 2019, it has operational data meaning, your sales, your purchase, your incurring of cost of various revenue, expenses, at the same time, it has some capital expenses as well; which are not revenue in nature, but capital in nature meaning that if you buy something and that remains with you for more than a year normally, these are capital asset.

Like suppose you construct a building, you buy a machine, these are all capital asset and the money that you invest to procure them is long-term cost and is a capital cost. So we have to accurately identify out of all these items which one is revenue expense and which one is capital cost. If we make a mistake doing it then the entire financial statements, balance sheet, profit-loss account and cash-flow statements are going to be wrong. So, we have to be careful about that part and we should be very accurately make a distinction.

So try to understand the difference and we will initially discuss and then we will try to put them at one place and then move forward. Suppose these are a expenses these are the item. Say payment of rent, rent you pay and it does not remain. You have used a premises for a month, at the end of the month or before the month if you pay in advance, then at the beginning of the month if you pay after the month, so you pay it off and the space is used up for the month and you pay.

So this is a revenue expense because nothing remains. Suppose, you just get out of the room go to another premises nothing remains. So neither a residual value nor you possess that. Advertisement expense, same thing, you advertise, you pay up and its gone. Of course, there is another argument and say very valid argument that if you advertise the impact may remain for a long time. Not the impact that you create in the minds of people, minds of your potential customers that will remain for a long time.

For that reason and for reasons that advertisement expenses may be very high and if you allow that expense in a year, then you may actually go into deep into red. Red means you may incur a lot of cash loss or net loss with that view sometime or in a if you incur a major expenses under advertisement, then you do not allow all the expenses in the same year, you allow only a portion of the expense. Suppose in a particular year, you incur 10 crore rupees for advertisement.

So, you may decide that out of the 10 crore let us take only 1 crore each year as advertisement expense and carry forward the 9 rest remaining 9 crore in the next few years to be incurred. Meaning, every year you allocate only 10 percent of the cost then this is called amortization.

Is almost like depreciation, we will discuss that later this session itself, but its called amortization.

So advertisement expense whatever amount you think that we have used are used up you can allocate that portion also. But here it is only 3000 compared to rent of 6000 this is not much. So we allocate the entire expense of advertisement in this year. Purchase of equipment: equipment will remain with us for a long time. So this is not a revenue expense even though we incur cost to acquire equipment, but we do not allocate this as operational expense.

We allocate only the depreciation part meaning that we allocate proportional to the life of the equipment whatever should be allocated for a particular year. Suppose the depending on the life of the asset. Suppose expected life of an asset is 5 years, so we may decide that we will allocate proportionally in 5 years all the cost that we have incurred.

So if we purchase something for 1,00,000 rupees and if we think that the assets life should be 5 years, then we will allocate 20,000 rupees every year as expense for the equipment in the form of depreciation. So as of now we are not talking about depreciation. So equipment is a capital asset and we have incurred costs that will go to the balance sheet. In that sense this is a balance sheet item. Advertisement usually is a profit-loss account item, rent is a profit-loss account item.

In same, when salary also is a revenue item, and it is part of the profit-loss account and not balance sheet. So this is a profit-loss account item closing stock is an asset.

Assets and liabilities is a balance sheet item. They are not cost in under any circumstances. Maybe we have procured something incurring cost, but still if something is an asset or something is a liability, outstanding at the end of the year that will represent in the balance sheet either as a liability or as an asset that is balance sheet item. Closing stock is a balance sheet item. So this is not part of the profit-loss account.

Transportation expense, transportation once incurred it is gone. Unless it is an outstanding expenses even if it is outstanding expenses normally transportation does not remain for a long time it is an expense revenue expense. So this is part of the profit-loss account, maintenance is part of profit-loss account. Legal expense is expense is part of profit-loss account, revenue type, purchase of goods you incur money to purchase goods, but then you do not consume or you do not use up all the goods that you purchase. Some of the goods remain as closing stock.

So the in entirety purchase of goods may not be or is not revenue expense. Whatever amount you consume that is called cost of goods sold. That is what you use up and that remains as revenue expense. Construction of factory shed its a fixed asset created paying incurring cost, but it remains for a long time its a balance sheet item. Purchase of truck is a balance sheet item, truck hiring charge on the other hand truck hiring just received meaning that you have purchased a truck and you have rent it once in a while and you have earned some money.

So that is again part of your revenue, but this is not your regular business. Maybe you have rented out on a very unsystematic, unplanned manner, this is not your regular business. So this is regarded as other income. Income from other sources not from your core business.

Amortization is a part of the cost that you have incurred to create intangible asset or something. Like advertisement, you create some brand equity or research and development expenses that you incur to create intellectual property like technology. So part of the expenses is allocated in the form of operating operational expense that only that part is called amortization of that expense and that comes here as amortization.

In this particular case, it is amortization of preliminary and preoperative expense which means that before starting the business, you have incurred some expenses which you do not want to allocate as operating operational expense immediately you want to allocate only a portion of it rest of the part you want to carry forward. So every year, moving forward for a certain years you want to allocate. So that is regarded as amortization.

Repayment of bank loan is not related to your operation at all. So obviously, this is not something related to cost or anything. It is just you have borrowed some money and you have repaid something out of your cash flow that is different, but then it does not affect your profit-loss account. Whether you pay to the bank or you do not pay to the bank, does not affect your profit-loss account. What affects your profit-loss account is the interest on the bank loan that you pay to the bank.

Interest is different than repayment. Suppose, you have borrowed 1,00,000 rupees and the interest annual interest rate is suppose 10 percent. So every year you are going to pay interest of 10,000 rupees on 1,00,000 rupees that is different. Whereas, if you repay suppose, 20,000 rupees each year you are repaying against a loan of 1,00,000 rupees then this repayment has nothing to do with your profit-loss account, you are repaying the principal amount of the loan that is just a repayment.

Whereas the 10,000 rupees of interest that you have paid to the bank is part of the expense. It has a separate flavor. This is not part of operational expense. So you estimate operating profit. From operating profit, you deduct bank loan interest. Interest on bank loan to get profit before tax. We are going to discuss that moving forward. Then trade receivable, you have sold something, the vendor is yet to make payment to you. So you show that remains outstanding.

So whatever amount is outstanding with the customer or dealer or distributor, who received your goods and they are yet to make payment back to you, that remains as receivable. This has nothing to do with expenses. So, that remains as a balance sheet item that is an asset because you are going to realize that money. Telephone bill payment is a revenue expense because once you pay is gone. Purchase of telephone on the other hand, is a capital item. I have put that abutting each other because I just wanted to show the difference.

Telephone bill payment is the payment that you make that you make for using telecom service. Whereas, telephone is a fixed asset is an equipment that you buy and keep it on your table that it remains for a long time with the company. Electricity bill payment is a revenue expense, sale of old machine it is related to balance sheet item because the machine was in the balance sheet. Now we do not need the machine for whatever reason and you are selling it back to somebody, not back you are selling it to somebody.

So whatever money you get, you get that a cash flow happens. It has nothing to do with profit-loss account provided, you sell it at the book value. Book value means whatever value that is there in your books of accounts. What is the book value? Book value is the value as of the previous end of previous year minus depreciation is the book value.

Why book value? Book value means you have procured an asset with something and every year you are using a part of the asset and you are allowing that as depreciation. So every year, you are allowing some depreciation. So suppose, the you are talking you are at present you are in the year 3. So whatever depreciation you have allowed up to year 3, first second and third year, that is the amount of the value of the asset that is used up. So you deduct that and whatever remains that remains as a book value.

Now if you sell them asset at book value, then you do not in you do not incur any loss neither you make profit by selling the asset. Now suppose you bought the asset for say, something. Now the book value is 2,400. If you sell the asset at for 2,400, there is no profit, no loss. So if there is meaning that there is you have sold the machine at its book value.

So there is if the if you sell the machine at say two instead of 2,400, if you sell it at 2500; that means, you are selling the asset at 100 rupees in excess of the book value. This excess amount is called capital gains because you are making a profit on capital asset. So it is called capital gains.

That 100 rupees is added to your income, total income in the year sales, any other income and this also becomes a part of other income because selling a machine is not your main business, it is just a one of case when you your some of your machine went kaput or you just decided that decided to upgrade the machine. So you sold off the old machine, but sometimes you recover more money than the book value.

So if you recover say, instead of book value is 2,400 and you sold the machine at 2,500. So 100 rupees of extra that you have recover that you have recovered by selling the machine, so that 100 rupees is a profit it is termed as capital gains. So that capital gains is added to the total income as other income.

So that is added there. Suppose you sell this machine for 2,000 instead of 2,400 which is the book value. So you are actually incurring 400 rupees of loss. May be your machine has become bad and nobody is interested to buy the machine at 2,400. So, these 400 rupees that the value the reduction of value from book value is a capital loss, regarded as a capital loss. And that is shown as expense in your profit-loss account. If you sell it at a capital gains, that is shown as additional income in your profit-loss account. Whereas, if you incur capital loss, you show it as expense in your profit-loss account.

So then, electricity bill payment is gone, interest on bank loan is an expense of revenue in nature, but this is not part of operational expense. Remember clearly that interest on bank loan is not part of operational expense even if this is a revenue expense. There may be a question that what is that item which is a part of which is regarded as a regular revenue expense? But you do not show it as part of operational expense. Interest is the answer, interest on bank loan. Now sale of goods is the total revenue that you earn so obviously, this is not an expense.

Closing cash in hand and bank should come from cash flow statement. So if it is given somewhere, this is actually a miss it should not be there, this should not be given. That should you get this data from your bank account whatever, is the balance in the bank and there may be some loose cash in your cash box so add them together actually is the closing cash in hand.

But this data should come from cash flow statement and previous balance sheet, balance closing balance of cash that is shown in previous balance sheet you add them together to get cash balance. And incidentally, it is different in this year. Then insurance; insurance also you if you are paying on an annual basis, this is a revenue expense. But if you pay for a long term that is a different audit fee if you pay on an annual basis, and that is used up so this is also revenue expense.

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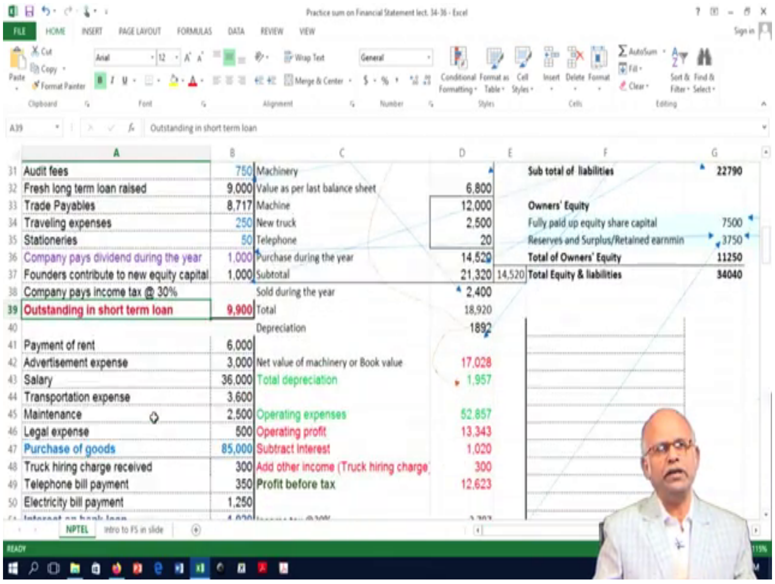

Fresh long term loan raised, loan there is no relation with loan and revenue expense or capital expense or anything, capital cost or anything. So loan is absolutely different it is a balance sheet item. So new loan comes it is a balance sheet item and a cash flow statement item. This is a cash flow, because you get some loan means some money is coming in. So this is a cash inflow.

Cash inflow that is your financial activity, cash flow from financial activity. We will show that in the cash flow statement. Trade payable again, a balance sheet item. Trade payable arises when you buy some raw material, but you do not pay it pay against that immediately. So that remains outstanding as long as it remains outstanding, you will show it that you show it in the balance sheet as trade payable. So, its a balance sheet item.

There is nothing to do with cost. Even though, it is arising out of purchase. Traveling expense is a revenue expense, stationeries that you incurred during the year is a revenues a revenue expense. Company pays dividend, it has nothing to do with cost, it has nothing to do with income, this is something that happens after you estimate profit before tax, then you pay income tax whatever remains is called net profit.

So you this whole net profit belongs to the founders. So out of this money, you pay something to the founders dividend. So this is the founders understanding founders comfort a prerogative of the founder how much money they should take back for maintenance of their family or other purposes. Whatever they take out as dividend that goes away from the company, the remaining amount of net profit goes to the balance sheet as retained profit or reserves and surplus.

So dividend has nothing to do with profit-loss account, at least till the time you are estimating net profit. Then founders contribution to equity capital: the founders are making new investment fresh investment in their equity, that is also not related to either cost or income. This is not an income even the money is coming in this will reflect in balance sheet, this will reflect in cash flow statement because money is coming in. Company pays income tax. This money is given to the government out of profit before tax.

So government is has to get their cut money from whatever profit you make. So you pay whatever is the tax rate. If you are a proprietary company, proprietorship company, the tax rate is 30 percent, but as per new rule, government has reduced the tax rate to 17 percent with surcharge and other charges it may go up to 22 percent, but its not 30 percent, but for proprietorship company it is a still 30 percent until the next budget, it may actually change.

Out standing a short term loan account again, is a balance sheet item, it has nothing to do with cost. Then so let us quickly identify which are the revenue item? Which should be part of the profit-loss account quickly? So look at this and we separate them. So whenever there is a sum like that, the first job one should do, you should practice it to have a grip on the subject of preparing profit-loss account that once you get this data immediately what you do is you identify the revenue item.

Payment of rent is a revenue item, advertisement expenses is a revenue item, purchase of equipment is not a revenue item. Salary is a revenue item, closing stock is not a revenue item, its a balance sheet item. Transportation expense is an expense and a revenue item because this is used up. Then maintenance also is a revenue item. Legal expense is incurred once for all and then its a revenue item.

Purchase of goods revenue, but then not the entire purchase. So we will discuss that later. Construction of factory shed is capital in nature and its a balance sheet item. Purchase of truck remains with truck remains with us for a long time is not a revenue item, its a balance sheet item. Truck hiring charge received its revenue, but other income. Amortization is an operational expense and the revenue item, repayment of bank loan has nothing to do with neither revenue nor expense.

So forget about this, this is a balance sheet item. Trade receivable is a balance sheet item, telephone bill payment is a revenue item and an operation operational expense, purchase of telephone is a capital item and balance sheet item. Electricity bill payment, revenue and profit-loss account item sale of old machine has nothing to do with your profit-loss account.

Interest on bank loan, interest on bank loan is a revenue item, but not part of operational expense. Sale of goods is your income or revenue, so its not an expense. Then insurance is a revenue item and operational expense, audit fee same thing. Fresh long term loan raised has nothing to do with revenue or operational expense. Trade payable is a balance sheet item. Traveling expense is revenue as well as is a operational expense stationeries is a revenue and operational expense.

Dividend is not has nothing to do with expense or income or even balance sheet, it is just outside your financial statements. Founders contribute that is a balance sheet item and a cash flow item, company pays income tax it goes to the government it has nothing to do with either profit-loss account or balance sheet, you pay it up and whatever is whatever remains after payment of that is the net profit a part of that is paid to the founders as dividend, the other part goes to the balance sheet as retained earning added to the reserves and surplus.

Outstanding short term loan is a balance sheet item that is it. So here, we have jotted down that items that we consider as revenue item.

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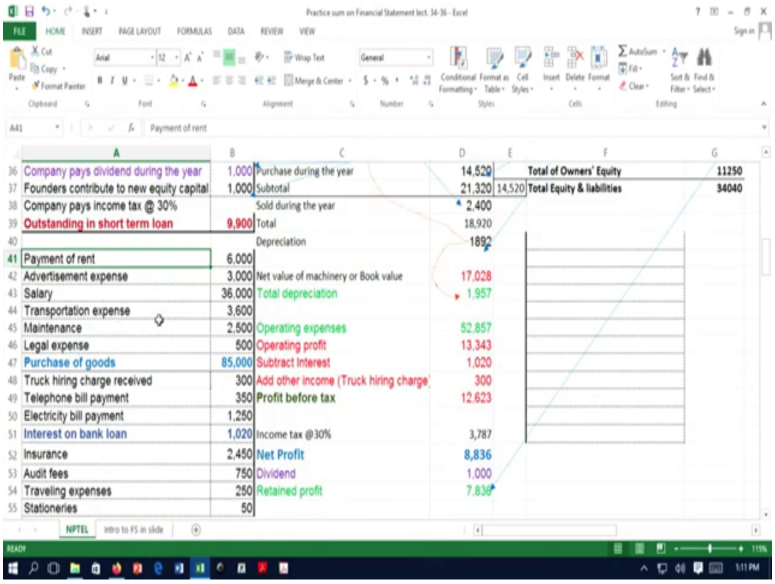

Look at this from row 41 till 55, these are all revenue items. In the next section, we will show how to add them together and then estimate gross profit margin then operating sorry gross profit, gross profit margin, operating profit, operating profit margin, net profit, net profit margin and then we will estimate retained earning then we will start preparing the balance sheet.

Thank you very much for the session.