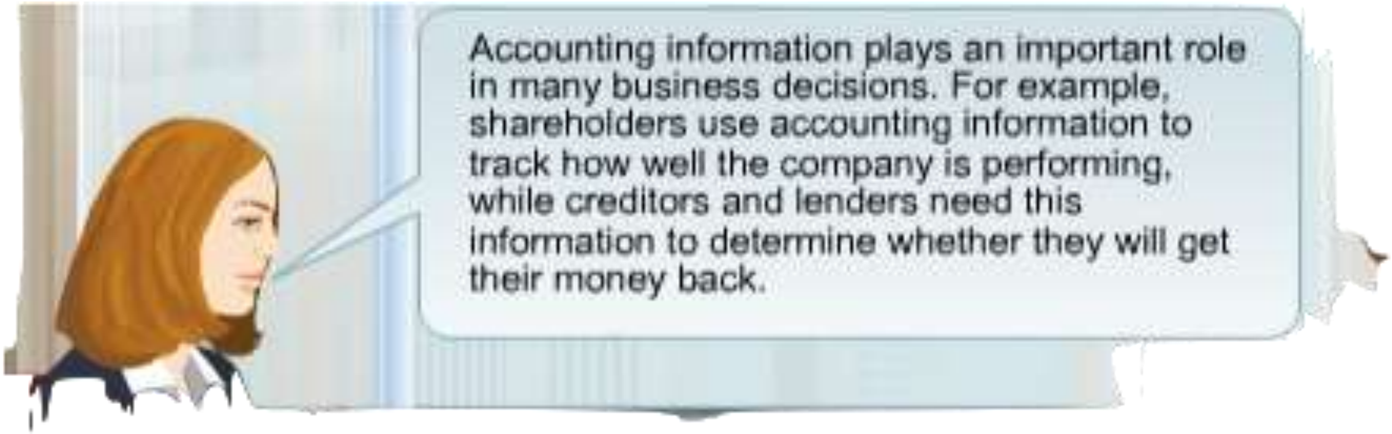
Introduction to Financial Statements

Agenda

In this session, you will learn about:

- Understanding Financial Statements
- The Accounting Process
- Accounting & Book-Keeping
- Financial Terminologies
- Accounting Concepts
- Qualities of Accounting Information
- Accounting Equations
- Financial Statements

Why We Should Know About Financial Statements?



- Most financial models use historical financial statements to understand the trend and behavior of financial variables
- Thus, understanding financial statements is critical
- However, it is enough to understand what the numbers mean and how they go there

You need to understand the language of Accounting and the tools required to interpret, build and forecast financial accounting data.

The Accounting Process

Identification

Select Economic Events/Transactions

Analyze & Interpret for Users

Recording

Record, Classify, and Summarize

Communication

Preparation of Accounting Reports

Questions Asked by Internal Users

Internal Users

Questions Asked by External Users

Will the company be able to pay its debts as they come due?

How does the company compare in size and profitability with its competitors?

Is the company earning satisfactory income?

What do we do if they catch us?

External Users

Accounting and Book-Keeping

Accounting

Focused on appropriate treatment and presentation of economic transactions and events

Book-keeping

Focused on recording of economic transactions and events

Financial Terminologies

Definitions for **financial terms** that you may come across when you are dealing with financial statements.

Making Sense Out of Financial Terms (1/3)

Sales / Revenue

- Used to refer to the total value of products/service sold by the company
- Companies may also add income earned from passive sources (example: royalty) to sales and may refer it as total 'income'

Overheads

Ongoing expenditure incurred for the purpose of running a business operation; overheads can be fixed or variable.

Profit

- Profit refers to the surplus of income over expenditure; if expenditure is greater, it is referred as loss
- Profits are categorized at multiple levels to aid better analysis of financial performance

Making Sense Out of Financial Terms (2/3)

Value

It represents the profit a company is generating adjusted for the underlying risk it takes

Assets

Refers to properties, financial investment and other financial claims that a company has

Liabilities

Amount of money that a company owes to third party

Making Sense Out of Financial Terms (3/3)

Debt

It represents liabilities that are interest bearing

Equity

Equity represents the amount of assets that belong to the shareholders after paying off third party debt.
Equity = Assets – Liability

Capital Expenditure

Expenditure such purchases of fixed asset etc that produces benefits for a period beyond the normal operating cycle of a company.

Generally Accepted Principles of Accounts

Standard framework of guidelines for financial accounting

Institutes of Chartered Accountants, India

Major Accounting Concepts

Going Concern

Assumes Organization will continue into foreseeable future

Income and Expense must be recognized in the accounting periods to which the relate rather than on cash basis

Accrual Concept

Monetary Unit

Only transaction data that can be expressed in terms of money is included in the accounting records.

Includes any organization or unit in society

Economic Entity

Major Accounting Concepts

Periodic Concept	Financial results are ascertained every year/every period
Cost Concept	The cost of the asset is considered for recording purposes and not the realisable value
Dual Aspect Concept	Every business transaction has a dual effect.

Accounting Conventions

Which of the following illustrates the accruals concept?

a) A company is in the second year of trading.
It applied straight-line depreciation to its fleet of motor vehicles in its first year and is applying the same method again this year.

b) Assets are carried in the books at what the entity paid for them (less depreciation where appropriate).

c) Prepaid rent at the end of the accounting period is treated as an asset, and carried over to the following period.

Basic Accounting Equation

ASSETS EQUITY	Liabilities + Owner's Fund
Fixed Assets + Net Working Capital	1. Interest- Bearing Debt (whether Long-Term or Short-Tem) 2. Employee Benefits 3. Other Liabilities (Deferred Tax, etc.)

NET WORKING CAPITAL	Current Assets (-) Current Liabilities

Increase and Decrease in Owner's Equity

Review Question

SHAREHOLDER"S EQUITY	Assets (-) Liabilities

Shareholders' EquityA company has the following assets and liabilities:

- Fixed assets: 70
- Current assets: 50
- Current liabilities: 30
- Long-term liabilities: 10

Calculate shareholders' equity.

Shareholder's Equity = (70+50-30) - (10)

80

Financial Statements

IMARTICUS LEARNING

After transactions are identified, recorded, and summarized,
four financial statements are prepared from the summarized accounting data:

Income Statement	Balance Sheet	Cash Flow Statement	Statement of Owner's Equity
It presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.	It reports the assets, liabilities, and owner's equity of a business enterprise at a specific date.	It summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.	It summarizes the changes in owner's equity for a specific period of time.

Financial statements also include notes, which are an integral part of the financial statements.

Standalone v/s Consolidated Financial Statements

Huge corporations organize their business as several different companies

Each of the individual company is controlled by a parent company

Parent company present stand alone financial statements and consolidated financial statements

Standalone financial statement reflect only the transactions of parent company and ignore the transactions of subsidiaries

Consolidated financial statement treat the entire group as one

The Profit and Loss Account

Adam Wesley's
Trading and Profit & Loss Account
for the Year ended December 31, 2010

	$	$	$
Sales		104520	
less Return Inwards		2950	
Net Sales			101570
Cost of goods sold:			
Purchases	91040		
less Return Outwards	5080		
Net Purchases		85960	
less Closing Stock		20180	65780
Gross Profit			35790
Add Revenue:			
Discount Received		11442	
Commission Received	4500		
Commission Received owing	1500	6000	17442
			53232
less Expenses:			
Electricity	1500		
less Electricity Prepaid	100	1400	
Telephone owing		1200	
Depreciation (fixture)[1]		96	
Discount Allowed		4510	
Rent		5000	
Wages		16000	28206
Net Profit			25026

Notes:
1. Depreciation per annum is pro-rated and hence the statements reflect depreciation for one month only.

The Profit and Loss account is an account where Revenues and Expenses are Netted Off

The difference between Revenues and Expenses i.e. Profit or Loss is transferred to the Balance Sheet

Revenues and Expenses by themselves DO NOT RESULT in CHANGES IN OWNERS' EQUITY

These changes happen through the Profit and Loss account

Key Financial Statement Items: Revenues

Revenues may result from sale of merchandise, performance of services, rental of property, or lending of money.

Operating Revenues	Non-Operating Revenues
Revenues from the main activity of a company [eg: Sale of Aluminium for Hindalco]	Revenues which are not related to the main activity of a company [eg: Interest Income for Hindalco, Sale of Assets, etc.]

Revenues usually result in an increase in an assets

- If goods are sold on cash: Increase in Cash
- If goods are sold on credit: Increase in Receivables

Key Financial Statement Items: Expenses

Expenses are the cost of assets consumed or services used in the process of earning revenue.

Expenses can be typically divided into:

Cost of Production / Cost of Goods Sold
[Direct Costs]

Selling, Distribution and Marketing Costs
Indirect Costs

General and Administration
Costs Office Stationery, Audit Expenses

Non-Cash Costs
Depreciation
Amortization

Financial Costs **Interest Expenses**

Taxes
Income Taxes

Capital Expenditure v/s Current Expenditure

Capital Expenditure

Capital Expenditure is an expense which is expected to result in a benefit over several years

Eg: Purchase of Fixed Assets

This expenditure is not expensed (i.e. not taken to P&L Account)

Current Expenditure

Current Expenditure is an expense which is expected to result in a benefit in the current year or pertains only for the current year

Eg: Purchase of Raw Materials for Production

This expenditure is expensed (i.e. taken to P&L Account)

The Profit and Loss Account

Profits
Profits result in an **increase** in

Assets
[Through Cash and Other Items]

Equity
[Through Increase in
Retained Earnings/Net Worth]

Losses
Loss results in a **decrease** in

Assets
[Through Cash and Other Items]

Equity
[Through Decrease in
Retained Earnings/Net Worth]

Income Statement: Special Line Items

Depreciation & Amortization

Permanent reduction in value of fixed assets on account of wear and tear, obsolescence etc.

Deferred tax income represent future tax benefit expected to arise on account of transactions carried out during the year

Deferred tax expense represent future tax obligation expected to arise on account of transactions carried out during the year

Deferred Tax

Income from associates

Represents share of profits earned by strategic investees

Typically, associates are those entities in which the parent company holds between 20-50% of investments

Minority interest in the income statement refers to a share of profit/loss of a subsidiary company that belong to external shareholders

Minority interest

Profit Metrics

GROSS PROIT	Sales(-) Cost of Production
EBITDA	Gross Profit (-) Cash Operating Cost
Earnings before interest tax, depreciation and amortization	It shows the cash profit from core business operations of a company
EBIT	EBITDA (-) Depreciation & Amortization
Earnings before interest tax,	Also referred as operating profit It shows the profit from core business operations of the company

Single Step v/s Multi-Step Financial Statement

Particulars	Figures for current year	Figures for previous year
I. Revenue		
II. Other Income		
III. Total Income (I + II)		
IV. Expenses		
Cost of raw materials		
Employee benefit expenses		
Finance costs		
Depreciation and amortization expenses		
Other expenses		
Total expenses		
V. Profit before one-off expenses and taxes (III - IV)		
VI. One-off expenses/(income)		
VII. Profit before taxes (V - VI)		
VIII. Tax expenses		
Current tax		
Deferred tax		
IX. Profit for the period from continuing operations		
X. Profit before from discontinued operations		
XI. Tax on profit from discontinued operations		
XII. Net Profit (IX + X - X1)		
XIII. Minority Interest		
XIV. Net profit attributable to equity shareholders (XII - XIII)		

Particulars	Figures for current year	Figures for previous year
I. Revenue		
II. Other Income		
III. Total Income (I + II)		
IV. Expenses		
Cost of raw materials		
Employee benefit expenses		
Other expenses		
V. EBITDA (III - IV)		
VI. Depreciation and amortization expenses		
VII. Operating profit (EBIT) (V - VI)		
VIII. Finance cost		
IX. Profit before one-off expenses and taxes VII - VIII)		
X. One-off expenses/(income)		
XI. Profit before taxes (IX - X)		
XII. Tax expenses		
Current tax		
Deferred tax		
XIII. Profit for the period from continuing operations		
XIV. Profit before from discontinued operations		
XV. Tax on profit from discontinued operations		
XVI. Net Profit (XIII + XIV - XV)		
XVII. Minority Interest		
XVIII. Net profit attributable to equity shareholders (XII - XIII)		

- Multi-step financial statement shows several additional profit metrics

Cost Category v/s Cost Center Approach

Most developed markets prepare income statement based on cost centers rather than cost category; later is considered more helpful to analysts

Particulars	Figures for current year	Figures for previous year
I. Revenue		
II. Other Income		
III. Total Income (I + II)		
IV. Expenses		
Cost of raw materials		
Employee benefit expenses		
Other expenses		
V. EBITDA (III - IV)		
VI. Depreciation and amortization expenses		
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VIII. Finance cost		
IX. Profit before one-off expenses and taxes VII - VIII)		
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XV. Tax on profit from discontinued operations		
XVI. Net Profit (XIII + XIV - XV)		
XVII. Minority Interest		
XVIII. Net profit attributable to equity shareholders (XII - XIII)		

Particulars	Figures for currency year	Figures for previous year
Revenue		
Cost of goods sold		
Gross Profit		
Sales and marketing expenses		
Research and development expenses		
General and administrative expenses		
Operating profit		
Financial expenses		
Profit before tax		
Tax expenses		
Profit after tax from continuing operations		
Profit from discontinued operations		
Net Profit		
Miniority interest		
Net profit attributable to equity shareholders		

The Balance Sheet

Balance Sheet for Wal-Mart

As of Jan 31, 2006

Assets		**Liabilities and Shareholders' Equity**	
Current Assets:		*Current Liabilities:*	
Cash and Cash Equivalents	6,414	Commercial Paper	3,754
Receivables	2,662	Accounts Payable	25,373
Inventories	32,191	Accrued Liabilities	13,465
Prepaid Expenses and Other	2,557	Accrued Income Taxes	1,340
Total Current Assets	43,824	Long-term Debt, due within one year	4,595
		Obligations Under Capital Leases, due within one year	299
Property and Equipment, at cost:		**Total Current Liabilities**	48,826
Land	16,643		
Buildings and Improvements	56,163	Long-term Debt	26,429
[illegible]	[illegible]	[illegible]	[illegible]
Goodwill	12,188		
Other Assets and Deferred Charges	2,885	**Total Shareholders' Equity**	53,171
Total Assets	138,187	**Total Liabilities and Shareholders' Equity**	138,187

Balance Sheet is the statement of Assets and Liabilities of a business **AT A POINT OF TIME**

The Total of Assets and Liabilities is always equal i.e. the Balance Sheet always tallies

Key Balance Sheet Items: Assets

Assets are **resources owned by a business** which help in **generating economic benefits** for the firm or which **can be converted into cash** in the short term (less than a year).

Which of the following is an asset for a company?

a) Bank Overdraft
b) Receivables
c) Sales

Can you name a few assets?

Key Balance Sheet Items: Liabilities

Liabilities are claims against assets.

They are existing debts and obligations.

Key Balance Sheet Items: Owners' Equity

OWNER'S EQUITY	Total Assets (-) Total Liabilities

Owner's Equity represents the ownership claim on total assets.

Subdivisions of Owner's Equity

- **Capital**
- **Drawings**
- **Revenues**
- **Expenses**

Key Balance Sheet Items: Investments

Investments by owner are the assets put into the business by the owner. These investments in the business increase owner's equity.

Pop Quiz: Classify Balance Sheet Items

The Balance Sheet

Smoothtonze is a manufacturer of electronics equipment. The information displayed has been extracted from Smoothtonze's balance sheet.

	Millions	Asset	Liability	Equity
Accounts payable	82	☐	☐	☐
Inventory	173	☐	☐	☐
Common stock	48	☐	☐	☐
Equipment	32	☐	☐	☐
Accounts receivable	55	☐	☐	☐
Wages payable	11	☐	☐	☐
Buildings	47	☐	☐	☐
Retained earnings	155	☐	☐	☐
Loans payable	72	☐	☐	☐
Cash	61	☐	☐	☐

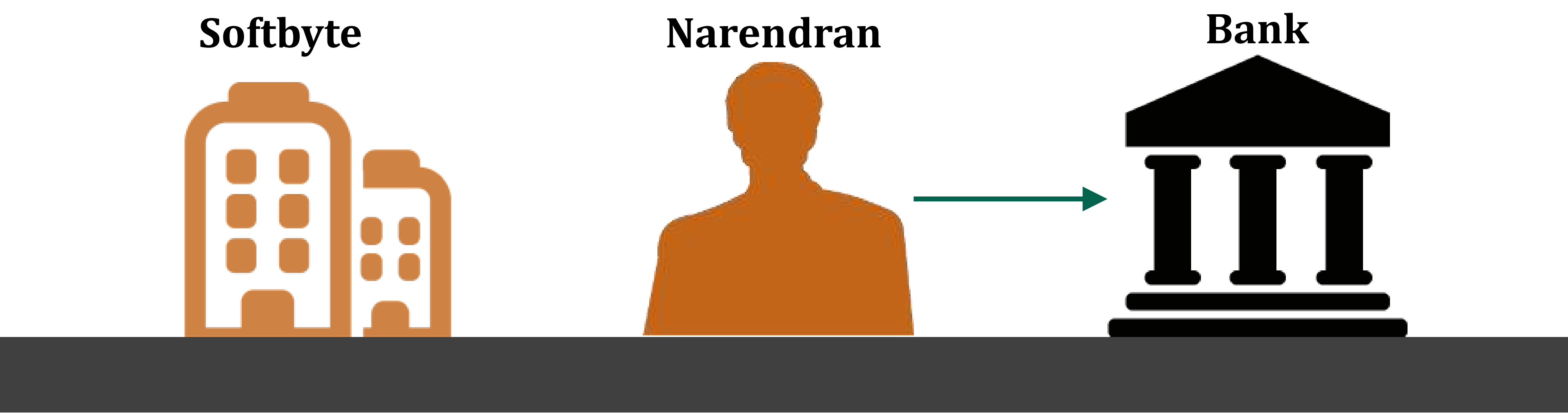
Categorize each item in the balance sheet as an asset, a liability, or equity by selecting the appropriate box. When you have finished, click submit.

submit

Balance Sheet: Special Line Items

Goodwill	Permanent reduction in value of fixed assets on account of wear and tear, obsolescence etc.
Deferred tax asset represents accumulated value of deferred tax income that will be utilized in future Deferred tax liability represents accumulated value of deferred tax expense	**Deferred Tax Asset/Liability**
Investment in associates	Refers to the share of net assets of an associate that belongs to the parent company
Minority interest in the balance sheet refers to the share of assets of subsidiary company that belong to external shareholders	**Minority interest (Balance Sheet)**

Transaction Analysis



Narendran decides to open a computer programming service.

Financial Statements and their Interrelationships

SOFTBYTE Income Statement For the Month Ended September 30, 2002		
Revenues	(Rs.)	(Rs.)
Service revenue		4700
Expenses		
Salaries expense	900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1950
Net income		2750

Net income of Rs.2,750 shown on the income statement is added to the beginning balance of owner's capital in the statement of owner's equity.

Financial Statements and their Interrelationships

Owner's capital of` Rs.16,450 at the end of the reporting period – shown in the statement of owner's equity – is also shown on the balance sheet. Cash of Rs.8,050 on the balance sheet is reported on the cash flow statement.

Balance Sheet
September 30, 2002

Assets	(Rs)
Cash	8050
Accounts receivable	1400
Supplies	1600
Equipment	7000
Total assets	18050
Liabilities and Owner's Equity	
Liabilities	
Accounts payable	1600
Owner's Equity	
M. Doucet, Capital	16450
Total liabilities and owner's equity	18050

Transaction 1

On September 1, he invests Rs.15,000 cash in the business, which he names Softbyte.

Trans. #	Assets			=	Liabilities	+	Owner's Equity	
	Cash	Supplies	Equipment		Accounts Payable		M. Doucet, Capital	
(1)	15,000			=			15,000	Investment

There is an increase in the asset Cash, Rs.15,000, and an equal increase in the owner's equity, Narendran, Capital, Rs.15,000.

Transaction 2

Softbyte purchases computer equipment for Rs.7,000 cash.

Trans. #	Assets			=	Liabilities	+	Owner's Equity	
	Cash	Supplies	Equipment		Accounts Payable		Narendran, Capital	
	15,000						15,000	Investment
(2)	-7,000		7,000					
Balance	8,000 +		7,000	=			15,000	

Cash is decreased Rs.7,000, and the asset Equipment is increased Rs.7,000.

Transaction 3

Softbyte purchases computer paper and supplies expected to last several months from ABC Supply Company for Rs.1,600 on account.

Trans. #	Assets			=	Liabilities	+	Owner's Equity
	Cash	Supplies	Equipment		Accounts Payable		Narendran, Capital
Balance	8,000		7,000				15,000
(3)		1,600			1,600		
Balance	8,000 +	1,600 +	7,000	=	1,600	+	15,000

The asset Supplies is increased Rs.1,600, and the liability Accounts Payable is increased by the same amount.

Transaction 4

Softbyte receives Rs.1,200 cash from customers for programming services it has provided.

Trans. #	Assets			=	Liabilities	+	Owner's Equity	
	Cash	Supplies	Equipment		Accounts Payable		M. Doucet, Capital	
Balance	8,000	1,600	7,000		1,600		15,000	
(4)	1,200						1,200	Service Revenue
Balance	9,200 +	1,600 +	7,000	=	1,600	+	16,200	

Cash is increased Rs.1,200, and M. Doucet, Capital is increased Rs.1,200.

Transaction 5

Softbyte receives a bill for Rs.250 for advertising its business but pays the bill on a later date.

Trans. #	Assets					=	Liabilities	+	Owner's Equity	
	Cash		Supplies		Equipment		Accounts Payable		M. Doucet, Capital	
Balance	9,200	+	1,600	+	7,000	=	1,600	+	16,200	
(5)							250		(250)	Advertising Expense
Balance	9,200		1,600		7,000		1,850		15,950	

Accounts Payable is increased Rs.250, and M. Doucet, Capital is decreased Rs.250.

Transaction 6

Softbyte provides programming services of Rs.3,500 for customers and receives cash of Rs.1,500, with the balance payable on account.

Trans. #	Assets					=	Liabilities	+	Owner's Equity	
	Cash		Account Receivable		Supplies		Equipment		Accounts Payable	M. Doucet, Capital
Balance	9,200	+	0	+	1,600	+	7,000	=	1,850	15,950
(6)	1,500		2,000							3,500 Service Revenue
Balance	10,700		2,000		1,600		7,000		1,850	19,450

Cash is increased Rs.1,500; Accounts Receivable is increased Rs.2,000; and M. Doucet, Capital is increased Rs.3,500.

Transaction 7

Expenses paid in cash for September are store rent, Rs.600, salaries of employees, Rs.900, and utilities, Rs.200.

Trans. #	Assets				=	Liabilities	+	Owner's Equity	
	Cash	Account Receivable	Supplies	Equipment		Accounts Payable		M. Doucet, Capital	
Balance	10,700	2,000	1,600	7,000		1,850		19,450	
(7)	(600)							(600)	Rent Exp.
	(900)							(900)	Salaries Exp.
	(200)							(200)	Utilities Exp.
Balance	9,000 +	2,000 +	1,600 +	7,000	=	1,850	+	17,750	

Cash is decreased Rs.1,700 and M. Doucet, Capital is decreased the same amount.

Transaction 8

Softbyte pays its advertising bill of Rs.250 in cash.

Trans. #	Assets				=	Liabilities	+	Owner's Equity
	Cash	Account Receivable	Supplies	Equipment		Accounts Payable		M. Doucet, Capital
Balance	9,000	2,000	1,600	7,000		1,850		17,750
(8)	(250)					(250)		
Balance	8,750 +	2,000 +	1,600 +	7,000	=	1,600	+	17,750

Cash is decreased Rs.250 and Accounts Payable is decreased the same amount.

Transaction 9

The sum of Rs.600 in cash is received from customers who have previously been billed for services in Transaction 6.

Trans. #	Cash		Account Receivable		Supplies		Equipment		Accounts Payable		M. Doucet, Capital
	Assets							=	Liabilities	+	Owner's Equity
Balance	8,750		2,000		1,600		7,000		1,600		17,750
(9)	600		(600)								
Balance	9,350	+	1,400	+	1,600	+	7,000	=	1,600	+	17,750

Cash is increased Rs.600 and Accounts Receivable is decreased by the same amount.

Transaction 10

Marc Doucet withdraws Rs.1,300 in cash from the business for his personal use.

Trans. #	Assets				=	Liabilities	+	Owner's Equity	
	Cash	Account Receivable	Supplies	Equipment		Accounts Payable		M. Doucet, Capital	
Balance	9,350	1,400	1,600	7,000		1,600		17,750	
(10)	(1,300)							(1,300)	Doucet, Drawings
Balance	8,050 +	1,400 +	1,600 +	7,000	=	1,600	+	16,450	

Cash is decreased Rs.1,300 and M. Doucet, Capital is decreased by the same amount.