

Chapter No. 3

Understanding Financial Statements

3.1 Introduction

Financial statements are records that outline the financial activities of a business, an individual or any other entity. Financial statements are meant to present the financial information of the entity in question as clearly and concisely as possible for both the entity and for readers. Financial statements for businesses usually include: Income statement, Balance sheet, statements of retained earnings and cash flows, as well as other possible statements. Financial Statements represent a formal record of the financial activities of an entity. These are written reports that quantify the financial strength, performance and liquidity of a company. Financial Statements reflect the financial effects of business transactions and events on the entity.

3.2 Accounting Mechanism

Before understanding various financial statements, it is necessary to have an idea of accounting procedures. Accounting, in order to communicate the results of the operations of a business; records business transactions, classifies them, summarizes and presents them in manner useful for interpretation. Various steps involved in the accounting procedures are briefly described as under:

3.2.1 Transaction: The starting point for accounting is a business transaction, say, the purchase of raw material. Such a transaction is evidenced by a document called 'voucher', say in this case, purchase bill. It gives the details of the material purchased, the name of the party from whom goods purchased either on credit, or if purchased for cash, the fact that

payment has been made. Similarly, 'receipt' for the payment of a rent is the voucher for the transaction of 'payment of rent'.

3.2.2 Recording: Transactions are recorded in various books of accounts on the basis of vouchers. Such books of accounts include cashbook, and journal. The transaction of purchase of raw material on credit will be recorded in the purchase book; similarly the payment of rent will be recorded in the cashbook. Transactions relating to credit sales will be recorded in the sales book. The journal is a book to record all those transactions, which are not recorded in any specific book.

3.2.3 Classification: The next step in the accounting procedure is to classify the transactions under appropriate heads like salaries, rent payments, raw material. This is done by analyzing the transaction recorded in the books of accounts and posting transactions of a similar nature under one head, called the 'ledger account'. The account book containing various account heads is called, the ledger. For example, all transaction relating to 'salaries' may be posted in 'salaries account' or those relating to rent paid may be posted in rent payment account.

3.2.4 Summarization: The art of summarization relates to periodical presentation of the classified data in the form of ledger accounts balances in a statement called the trial balance. All ledger accounts are balanced periodically, say, at the end of a month, and the account balances are placed together in the form of a trial balance. In the trial balance, the total of debit balances equals the total of credit balances and this is one way to check the accuracy of the accounts books.

3.2.5 Financial statements: The trial balance is normally the basis for the preparation of financial statements called Profit & Loss statement and Balance Sheet.

3.3 Accounting Principles

3.3.1 Money Measurement Concept

Accounting records state only those facts about a business firm, which can be expressed in monetary terms. In other words, business events and facts that cannot be expressed in monetary terms, howsoever important they may be, are excluded. The operational implication of the Money Measurement Concept is that financial statements do not provide all information about the business.

3.3.2 Business Entity Concept

Business transactions of a sole proprietorship are separate from the business owner's personal transactions. For legal purposes, a sole proprietorship and its owner are considered to be one entity, but for accounting purposes they are considered to be two separate entities.

3.3.3 Going Concern Concept

The Going Concern Concept implies that the firm will continue to operate in the foreseeable future. The operational implication of this assumption is that assets are not shown in Balance Sheet at their realisable market value, which implies liquidation value. Instead, evaluation of assets is with reference to the value of goods and services they are likely to produce in future years to come.

3.3.4 Cost Concept

Assets/resources owned by the firm are shown at their acquisition cost and not at current market value/current worth. The rationale for this assumption is that it provides objective

and verifiable basis for accounting records. Market valuation of assets in use is not only difficult to be made but also is related to subjectivity. Besides, market values may be constantly subject to change.

3.3.5 Dual aspect

Every business transaction has a dual effect, one receiving of a benefit and the other giving of a benefit. For example, when a firm acquires an asset (receiving of a benefit), it has to pay cash (giving of a benefit). Therefore, two accounts are to be opened in the books of account, one for receiving the benefit and the other for giving the benefit. Thus, there will be a double entry for every transaction. For each and every debit, there should be a corresponding credit and vice-versa. This is nothing but the principle of double entry system of accounting which, in other words, is known as dual aspect concept. Another accounting implication of the dual aspect concept is that the initial amount is contributed by the owner. If additional funds are required, bank loans are taken. As per the dual aspect concept, all these receipts create corresponding obligations for their repayment. In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets) but also its obligations (liabilities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities should be equal. This equality is called "balance sheet equation" or "accounting equation."

Liabilities = Assets or,

Capital + Liabilities = Assets or,

Assets - Liabilities = Capital

3.3.6 Conservative Concept

As the name suggests, Conservative Concept warrants use of conservatism in business records. In relation to Income Statement, the principle is, "anticipate no profits unless realised but provide for all probable future losses". Stock of finished goods is valued at the cost price or current market price whichever is lower. Likewise, it is normal for the firms to provide for likely irrecoverable sum from debtors by creating provisions for bad and doubtful debts at the end of accounting year. This assumption safeguards over-estimation of profits.

3.3.7 Accrual (Realization) Concept

Accrual Concept is a fall-out of accounting period concept. This concept requires that expenses incurred for a particular accounting period should be reckoned in the same period, irrespective of the fact whether these expenses have been paid in cash or not in that year. The same holds true for revenues, i.e., revenues earned in a specific accounting period are construed as incomes of the same period, irrespective of their receipts. In the absence of accrual accounting, the Income Statement may indicate more profit in one year at the cost of the profits of some other year, which is entirely inappropriate and illogical.

3.3.8 Materiality

It states that if the value of any asset is very low, it might be expensed in the year of purchase itself rather than amortizing over its useful life (through depreciation).

3.4 Balance Sheet or Statement of Financial Position

Statement of Financial Position, also known as the Balance Sheet, presents the financial position of an entity at a given date. It is comprised of three main components: assets, liabilities and equity.

Balance Sheet helps users of financial statements to assess the financial soundness of an entity in terms of liquidity risk, financial risk, credit risk and business risk.

3.4.1 Classification of Components

Balance Sheet consists of the following key elements:

3.4.1.1 Assets

An asset is something that an entity owns or controls in order to derive economic benefits from its use. Assets must be classified in the balance sheet as current or non-current depending on the duration over which the reporting entity expects to derive economic benefit from its use. An asset which will deliver economic benefits to the entity over the long term is classified as non-current whereas those assets that are expected to be realized within one year from the reporting date are classified as current assets.

Assets are also classified in the balance sheet on the basis of their nature:

Tangible & intangible: Non-current assets with physical substance are classified as tangible assets like property, plant and equipment whereas assets without any physical substance are classified as intangible assets. Goodwill is a type of an intangible asset.

Inventories includes goods that are held for sale in the ordinary course of the business. Inventories may include raw materials, finished goods and works in progress.

Current Assets: Current assets include cash and other assets that in the normal course of events are converted into cash within the operating cycle. Several operating cycles may be completed in a year, or it may take more than a year to complete one operating cycle. The time required to complete an operating cycle depends upon the nature of the business. It is conceivable that almost all of the assets that are used to conduct business, such as

buildings, machinery, and equipment, can be converted into cash within the time required to complete an operating cycle.

However, current assets are only those that will be converted into cash within the normal course of business. The other assets are only held because they provide useful services and are excluded from the current asset classification. Current assets are usually listed in the order of their liquidity and frequently consist of cash, temporary investments, accounts receivable, inventories and prepaid expenses.

Prepaid expenses: These expenses are payments made for services that will be received in the near future. Often insurance premiums or rentals are paid in advance.

Investments: Investments are cash funds or securities held for a designated purpose for an indefinite period of time. Investments include stocks or the bonds, real estate or mortgages that are held for income-producing purposes.

Marketable Securities: These investments are temporary and are made from excess funds that business do not immediately need to conduct operations so as to earn a return. These investments are made in securities that can be converted into cash easily; usually short-term government obligations.

Accounts Receivable: Simply stated, accounts receivables are the amounts owed to business entity. Accounts receivable are the amounts billed to customers and owed to business entity on the balance sheet's date. If these other amounts are currently collectible, they may be classified as current assets.

Cash and cash equivalents include cash in hand along with any short term investments that are readily convertible into known amounts of cash.

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3.4.1.2 Liabilities

A liability is an obligation that a business owes to someone and its settlement involves the transfer of cash or other resources. Liabilities must be classified in the balance sheet as current or non-current depending on the duration over which the entity intends to settle the liability. A liability which will be settled over the long term is classified as non-current whereas those liabilities that are expected to be settled within one year from the reporting date are classified as current liabilities.

Liabilities are also classified in the balance sheet on the basis of their nature:

Current Liabilities: Current liabilities are obligations that are required to be discharged within the normal operating cycle of business. In most circumstances, current liabilities will be paid within the next year by using the assets classified as current. The amount under current liabilities often arises as a result of acquiring current assets such as inventory or services that will be used in current operations. It also include the amounts owed to trade creditors that arise from the purchase of materials or merchandise as accounts payable. Other current liabilities may include the estimated amount payable for income taxes and the various amounts owed for wages and salaries of employees, utility bills, payroll taxes, local property taxes and other services.

Accounts and other payables primarily include liabilities due to suppliers and contractors for credit purchases. Sundry payables which are too insignificant to be presented separately on the face of the balance sheet are also classified in this category.

Short term borrowings typically include bank overdrafts and short term bank loans with a repayment schedule of less than 12 months.

Long-term borrowings comprise of loans which are to be repaid over a period that exceeds one year. Notes, bonds and mortgages are often listed under this heading. Current

portion of long-term borrowings include the installments of long term borrowings that are due within one year of the reporting date.

Current Tax Payable is usually presented as a separate line item in the balance sheet due to the materiality of the amount.

Deferred Revenues: Customers may make advance payments for merchandise or services. The obligation to the customer will, as a general rule, be settled by delivery of the products or services and not by cash payment. Advance collections received from customers are classified as deferred revenues, pending delivery of the products or services.

3.4.1.3 Equity

Equity is what the business owes to its owners. Equity is derived by deducting total liabilities from the total assets. It therefore represents the residual interest in the business that belongs to the owners.

Equity is usually presented in the balance sheet under the following categories:

Share capital represents the amount invested by the owners in the entity

Retained Earnings comprises the total net profit or loss retained in the business after distribution to the owners in the form of dividends.

Revaluation Reserve contains the net surplus of any upward revaluation of property, plant and equipment recognized directly in equity.

3.4.2 The balancing characteristics of the Balance Sheet

The balance sheet is structured in a manner that the total assets of an entity equal to the sum of liabilities and equity. Assets of an entity may be financed from internal sources (i.e. share capital and profits) or from external credit (e.g. bank loan, trade creditors, etc.). Since the total assets of a business must be equal to the amount of capital invested by the

owners (i.e. in the form of share capital and profits not withdrawn) and any borrowings, the total assets of a business must equal to the sum of equity and liabilities.

This leads to the Accounting Equation: $\text{Assets} = \text{Liabilities} + \text{Equity}$

3.4.3 Importance of Balance Sheet

Balance sheet helps users of financial statements to assess the financial health of an entity. When analyzed over several accounting periods, balance sheets may assist in identifying underlying trends in the financial position of the entity. It is particularly helpful in determining the state of the entity's liquidity risk, financial risk, credit risk and business risk. When used in conjunction with other financial statements of the entity and the financial statements of its competitors, balance sheet may help to identify relationships and trends which are indicative of potential problems or areas for further improvement. Analysis of the statement of financial position could therefore assist the users of financial statements to predict the amount, timing and volatility of entity's future earnings.

3.5 Income Statement or statement of Profit & Loss

Income statement, also known as statement of Profit & Loss, is a report of income, expenses and the resulting profit or loss earned during an accounting period.

3.5.1 Basis of preparation

Income statement is prepared on the accruals basis of accounting. This means that income (including revenue) is recognized when it is earned rather than when receipts are realized (although in many instances income may be earned and received in the same accounting period). Conversely, expenses are recognized in the income statement when they are incurred even if they are paid for in the previous or subsequent accounting periods.

Income statement does not report transactions with the owners of an entity.

Hence, dividends paid to ordinary shareholders are not presented as an expense in the income statement and proceeds from the issuance of shares is not recognized as an income.

Transactions between the entity and its owners are accounted for separately in the statement of changes in the equity.

3.5.2 Components

Income statement comprises of the following main elements:

Revenue

Revenue includes income earned from the principal activities of an entity. On the other hand, if the same entity earns interest on its savings in a bank account, it shall not be classified as revenue but as other income.

Cost of Sales

Cost of sales represents the cost of goods sold or services rendered during an accounting period.

Other Income

Other income consists of income earned from activities that are not related to the entity's main business.

Distribution Cost

Distribution cost includes expenses incurred in delivering goods from the business premises to customers.

Administrative Expenses

Administrative expenses generally comprise of costs relating to the management and support functions within an organization that are not directly involved in the production

and supply of goods and services offered by the entity. Examples are employee benefits, administrative expenses etc.

Other Expenses

This is essentially a residual category in which any expenses that are not suitably classifiable elsewhere are included.

Finance Charges

Finance charges usually comprise of interest expense on loans and debentures.

Income tax

Income tax expense recognized during a period is generally comprised of the following three elements:

Current period's estimated tax

Prior period tax adjustments

Deferred tax expense

Prior Period Comparatives

Prior period financial information is presented along side current period's financial results to facilitate comparison of performance over a period.

3.5.3 Use of Income statement or statement of Profit & Loss

Income Statement provides the basis for measuring performance of an entity over the course of an accounting period.

Performance can be assessed from the income statement in terms of the following:

- Change in sales revenue over the period and in comparison to industry growth
- Change in gross profit margin, operating profit margin and net profit margin over the period
- Increase or decrease in net profit, operating profit and gross profit over the period

- Comparison of the entity's profitability with other organizations operating in similar industries or sectors

Income statement also forms the basis of important financial evaluation of an entity when it is analyzed in conjunction with information contained in other financial statements such as:

- Change in earnings per share over the period
- Analysis of working capital in comparison to similar income statement elements

3.6 Statement of Cash Flows

Statement of Cash Flows, also known as Cash Flow Statement, presents the movement in cash flows over the period as classified under operating, investing and financing activities.

3.6.1 Basis of Preparation

Statement of Cash Flows presents the movement in cash and cash equivalents over the period. Cash and cash equivalents generally consist of the following:

- Cash in hand
- Cash at bank
- Short term investments that are highly liquid and involve very low risk of change in value (therefore usually excludes investments in equity instruments)
- Bank overdrafts in cases where they comprise an integral element of the organization's treasury

As income statement and balance sheet are prepared under the accrual basis of accounting, it is necessary to adjust the amounts extracted from these financial statements (e.g. in

respect of non cash expenses) in order to present only the movement in cash inflows and outflows during a period.

All cash flows are classified under operating, investing and financing activities.

3.6.2 Operating Activities

Cash flow from operating activities presents the movement in cash during an accounting period from the primary revenue generating activities of the entity.

Profit before tax as presented in the income statement could be used as a starting point to calculate the cash flows from operating activities.

Following adjustments are required to be made to the profit before tax to arrive at the cash flow from operations:

- Elimination of non cash expenses (e.g. depreciation, amortization, impairment losses, bad debts written off, etc)
- Removal of expenses to be classified elsewhere in the cash flow statement (e.g. interest expense should be classified under financing activities)
- Elimination of non cash income (e.g. gain on revaluation of investments)
- Removal of income to be presented elsewhere in the cash flow statement (e.g. dividend income and interest income should be classified under investing activities)
- Working capital changes (e.g. an increase in trade receivables must be deducted to arrive at sales revenue that actually resulted in cash inflow during the period)

3.6.3 Investing Activities

Cash flow from investing activities includes the movement in cash flow as a result of the purchase and sale of assets other than those which the entity primarily trades in (e.g. inventory).

Cash flow from investing activities consists primarily of the following:

- Cash outflow expended on the purchase of investments and fixed assets
- Cash inflow from income from investments
- Cash inflow from disposal of investments and fixed assets

3.6.4 Financing activities

Cash flow from financing activities includes the movement in cash flow resulting from the following:

- Proceeds from issuance of share capital, debentures & bank loans
- Cash outflow expended on the cost of finance (i.e. dividends and interest expense)
- Cash outflow on the repurchase of share capital and repayment of debentures & loans

3.6.5 Importance of cash flow statement

Statement of cash flows provides important insights about the liquidity and solvency of a company which are vital for survival and growth of any organization. It also enables analysts to use the information about historic cash flows to form projections of future cash flows of an entity (e.g. in NPV analysis) on which to base their economic decisions. By summarizing key changes in financial position during a period, cash flow statement serves to highlight priorities of management. For example, increase in capital expenditure and development costs may indicate a higher increase in future revenue streams whereas a trend of excessive investment in short term investments may suggest lack of viable long term investment opportunities. Furthermore, comparison of the cash flows of different entities may better reveal the relative quality of their earnings since cash flow information is more objective as opposed to the financial performance reflected in

income statement which is susceptible to significant variations caused by the adoption of different accounting policies.

3.7 Statement of Changes in Equity

Statement of Changes in Equity, often referred to as Statement of Retained Earnings, details the change in owners' equity over an accounting period by presenting the movement in reserves comprising the shareholders' equity.

Movement in shareholders' equity over an accounting period comprises the following elements:

- Net profit or loss during the accounting period attributable to shareholders
- Increase or decrease in share capital reserves
- Dividend payments to shareholders
- Gains and losses recognized directly in equity
- Effect of changes in accounting policies etc.

3.7.1 Components

Following are the main elements of statement of changes in equity:

Opening Balance

This represents the balance of shareholders' equity reserves at the start of the comparative reporting period as reflected in the prior period's statement of financial position.

Effect of Changes in Accounting Policies

Since changes in accounting policies are applied retrospectively, an adjustment is required in stockholders' reserves at the start of the comparative reporting period to restate the opening equity to the amount that would be arrived if the new accounting policy had always been applied.

Effect of Correction of Prior Period Error

The effect of correction of prior period errors must be presented separately in the statement of changes in equity as an adjustment to opening reserves. The effect of the corrections may not be netted off against the opening balance of the equity reserves so that the amounts presented in current period statement might be easily reconciled and traced from prior period financial statements.

Restated Balance

This represents the equity attributable to stockholders at the start of the comparative period after the adjustments in respect of changes in accounting policies and correction of prior period errors as explained above.

Changes in Share Capital

Issue of further share capital during the period must be added in the statement of changes in equity whereas redemption of shares must be deducted there from. The effects of issue and redemption of shares must be presented separately for share capital reserve and share premium reserve.

Dividends

Dividend payments issued or announced during the period must be deducted from shareholder equity as they represent distribution of wealth attributable to stockholders.

Income / Loss for the period

This represents the profit or loss attributable to shareholders during the period as reported in the income statement.

Changes in Revaluation Reserve

Revaluation gains and losses recognized during the period must be presented in the statement of changes in equity to the extent that they are recognized outside the income

statement. Revaluation gains recognized in income statement due to reversal of previous impairment losses however shall not be presented separately in the statement of changes in equity as they would already be incorporated in the profit or loss for the period.

Other Gains & Losses

Any other gains and losses not recognized in the income statement may be presented in the statement of changes in equity such as actuarial gains and losses.

Closing Balance

This represents the balance of shareholders' equity reserves at the end of the reporting period as reflected in the statement of financial position.

3.7.2 Importance

Statement of changes in equity helps users of financial statement to identify the factors that cause a change in the owners' equity over the accounting periods. Whereas movement in shareholder reserves can be observed from the balance sheet, statement of changes in equity discloses significant information about equity reserves that is not presented separately elsewhere in the financial statements which may be useful in understanding the nature of change in equity reserves.

3.8 Relationship between Financial Statements

Financial Statements reflect the effects of business transactions and events on the entity. The different types of financial statements are not isolated from one another but are closely related to one another.

3.8.1 Balance Sheet

The Balance Sheet or Statement of Financial Position, is directly related to the income statement, cash flow statement and statement of changes in equity.

Assets, liabilities and equity balances reported in the Balance Sheet at the period end consist of:

- Balances at the start of the period;
- The increase (or decrease) in net assets as a result of the net profit (or loss) reported in the income statement;
- The increase (or decrease) in net assets as a result of the net gains (or losses) recognized outside the income statement and directly in the statement of changes in equity (e.g. revaluation surplus);
- The increase in net assets and equity arising from the issue of share capital as reported in the statement of changes in equity;
- The decrease in net assets and equity arising from the payment of dividends as presented in the statement of changes in equity;
- The change in composition of balances arising from inter balance sheet transactions not included above (e.g. purchase of fixed assets, receipt of bank loan, etc).
- Accruals and Prepayments
- Receivables and Payables

3.8.2 Income Statement

Income statement, or Profit and Loss Statement, is directly linked to balance sheet, cash flow statement and statement of changes in equity.

The increase or decrease in net assets of an entity arising from the profit or loss reported in the income statement is incorporated in the balances reported in the balance sheet at the period end.

The profit and loss recognized in income statement is included in the cash flow statement under the segment of cash flows from operation after adjustment of non-cash transactions.

Net profit or loss during the year is also presented in the statement of changes in equity.

3.8.3 Statement of Changes in Equity

Statement of changes in equity is directly related to balance sheet and income statement.

Statement of changes in equity shows the movement in equity reserves as reported in the entity's balance sheet at the start of the period and the end of the period. The statement therefore includes the change in equity reserves arising from share capital issues and redemptions, the payments of dividends, net profit or loss reported in the income statement along with any gains or losses recognized directly in equity (e.g. revaluation surplus).

3.8.4 Cash Flow Statement

Statement of cash flows is primarily linked to balance sheet as it explains the effects of change in cash and cash equivalents balance at the beginning and end of the reporting period in terms of the cash flow impact of changes in the components of balance sheet including assets, liabilities and equity reserves.

Cash flow statement therefore reflects the increase or decrease in cash flow arising from:

- Change in share capital reserves arising from share capital issues and redemption;
- Change in retained earnings as a result of net profit or loss recognized in the income statement (after adjusting non-cash items) and dividend payments;

- Change in long term loans due to receipt or repayment of loans;
- Working capital changes as reflected in the increase or decrease in net current assets recognized in the balance sheet;
- Change in non current assets due to receipts and payments upon the acquisitions and disposals of assets (i.e. investing activities)

3.9 Use of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions .

Financial Statements provide useful information to a wide range of users:

Managers require Financial Statements to manage the affairs of the company by assessing its financial performance and position and taking important business decisions.

Shareholders use Financial Statements to assess the risk and return of their investment in the company and take investment decisions based on their analysis.

Prospective Investors need Financial Statements to assess the viability of investing in a company. Investors may predict future dividends based on the profits disclosed in the Financial Statements. Furthermore, risks associated with the investment may be gauged from the Financial Statements. For instance, fluctuating profits indicate higher risk. Therefore, Financial Statements provide a basis for the investment decisions of potential investors.

Financial Institutions (e.g. banks) use Financial Statements to decide whether to grant a loan or credit to a business. Financial institutions assess the financial health of a business to determine the probability of a bad loan. Any decision to lend must be supported by a sufficient asset base and liquidity.

Suppliers need Financial Statements to assess the credit worthiness of a business and ascertain whether to supply goods on credit. Suppliers need to know if they will be repaid.

Terms of credit are set according to the assessment of their customers' financial health.

Customers use Financial Statements to assess whether a supplier has the resources to ensure the steady supply of goods in the future. This is especially vital where a customer is dependant on a supplier for a specialized component.

Employees use Financial Statements for assessing the company's profitability and its consequence on their future remuneration and job security.

Competitors compare their performance with rival companies to learn and develop strategies to improve their competitiveness.

General Public may be interested in the effects of a company on the economy, environment and the local community.

Governments require Financial Statements to determine the correctness of tax declared in the tax returns. Government also keeps track of economic progress through analysis of Financial Statements of businesses from different sectors of the economy.