
FINANCIAL
STATEMENTS
BALANCE SHEET
CASH FLOWS
EQUITY
INCOME STATEMENTS

What is a Financial Statement?

A financial statement shows you where a company's money came from, where it went and where it is now.[1]

Balance Sheet

Income Statement

Cash Flow Statement

TYPES OF FINANCIAL STATEMENTS

Statements	Definition	Important Terms	
Balance Sheet	It is a tabular sheet of balances of assets, liabilities, and equity as on 31st December.	Current Assets Non Current Assets, Property, Plant and Equipment, Long-term Liabilities, Common Stock, Preferred Stock and Retained Earnings etc.	
Income Statement	It is a statement of calculation of the income of a particular period showing Net Sales and all types of expenses.	Sales, Operating Cost, Dep. & Amortization, Interest Cost, Taxes, Preferred Dividends Net Income.	EBITDA EBIT EBT NI
Statement of Cash Flows	A cash flow statement is simply a statement of cash generation and its use categorized under different activities.	Operating Activities, Investing Activities, and Financing Activities.	
Statement of Shareholder's Equity	It is a statement showing the capital investment by stockholders and the retained earnings of the company.	Common Stock, Retained Earnings	
Footnotes to Financial Statements	All other information in annual report other than quantitative statements like above are footnotes.	Inventory valuation method Contingent liability, Disclosures, etc	

THREE STATEMENT MODEL

A three statement model is nothing but the income statement – cash flow statement- the balance sheet of the organization which eventually forms a part of the annual report of the business.

1) Cash Flow Statement Model

Segments of Cash Flow Statement

- Operating Activities
- Investing Activities
- Financing Activities

2) Balance Sheet Model

3) Income Statement Model

UTILITIES

- Stakeholder Confidence
- Check on controls
- Forecasting
- Statutory Requirements

BALANCE SHEET

BALANCE SHEET = STATEMENT OF FINANCIAL POSITION

Balance Sheet gives the financial position of the company. It shows the assets and liabilities of the company. It also shows how the business is being funded.

COMPONENTS

- **Assets** : Resources used by the company in order to run the business
- **Liabilities** : Debts that the company has.
- **Owner's Equity** : Part of assets belongs to owners.

READING

- Reading the Balance Sheet needs clarity and accuracy.
- Investor carry out analysis of Balance Sheet to gauge the performance of the company.

CLASSIFIED BALANCE SHEET

PURPOSE

Classified Balance Sheet shows various information under different subcategories.

OBJECTIVES

- Easily to understand and analyze
- Ascertain the amount and nature of the liabilities easily.
- Easily ascertain the position of assets
- Understand changing trends
- Easily understand profit and Loss
- Understand unpaid

Large organizations and businesses who want their balance sheet to be more detailed go for classified balance sheets.

CLASSIFICATION

- ASSETS :
  - Current Assets
  - Long-term Investments
  - Property, Plant and Equipment
  - Intangible Assets
  - Other Assets
- LIABILITIES :
  - Current Liability
  - Long Term Liability
- EQUITY :
  - Capital Account
  - Partner's Capital Account
  - Share Capital
  - Retained Earnings

MEANING & DIFFERENT TYPES OF ASSETS

MEANING: An asset is a resource or property having a monetary/economic value possessed by an individual or entity, which is capable of producing some future economic benefit.

CLASSIFICATION OF ASSETS

CONVERTIBILITY	• Current Assets • Fixed Assets
PHYSICAL EXISTENCE	• Tangible Assets • Intangible Assets
USAGE	• Operating Assets • Non-operating Assets

UNDERSTANDING TOTAL ASSETS & NET ASSETS:

Total Assets= Total Liabilities + Owner's Equity

Net Assets = Total Assets – Total Liabilities

LIABILITIES

Liability is a legal obligation of an individual or a business entity towards creditors arising out of some transactions.

TYPES OF LIABILITIES

CURRENT LIABILITIES

Current Liabilities are those liabilities which are normally due and payable within one year

LONG TERM LIABILITIES

Long-term Liabilities are those liabilities which don't due immediately but become due after a year or more.

CONTINGENT LIABILITES

Contingent Liabilities are liabilities are payable on the occurrence of some event or contingency.

OWNER'S EQUITY

A part of the total value of a company's assets which is claimable by the owners – May be Shareholders in case of company, Proprietors in case of sole proprietorship firm etc.

Accounting Equations

- Owner's Equity = Assets – Liabilities
- Owner's Equity = Available Capital + Retained Earnings
- Owner's Equity = Equity (Previous Year Balance) + Capital Added During the Year+ Retained Earnings + Present Year Net Profit - Withdrawals

Net Worth – How different??

- Difference lies in the use of these terms in personal and business perspectives.
- Owner's equity is strictly a business accounting term, net worth can also be referred to the owner's personal value which may include business equity as well as home equity, investments, bank accounts, valuable items like jewelry and other collections.

STATEMENT OF CHANGES IN EQUITY

STATEMENT OF CHANGES IN EQUITY is a part of financial statements. This shows the changes in value of shareholder's equity

IMPORTANCE

- Information to investors of equity position.
- Helps management in making future decisions.
- Important for outside parties (such as lender)

COMPONENTS OF STATEMENT

SHARE CAPITAL
The amount that company receives due to transaction with owners.

RETAINED EARNINGS
Amount kept aside after paying expenses and dividend

INCOME AND DIVIDEND
Income Inc., Ret Earning Inc. ; Dividend Inc., Ret Earning Dec.

ITEMS AFFECTING STATEMENT

- Issue of share Capital
- Payment of Dividend
- Change in Net Income
- Bonus Share Issue
- Sale of Treasury Stock
- Foreign Exchange
- Fin Stat Restatement
- Fixed Asset Revaluation

	Common Stock	Add. Paid Up Cap.	Retained Earning	Acc. OCI	Treasury Capital	Total
Balance on opening						
Net Income (Loss)						
Common Stock Issue						
Add. Paid up Capital						
Treasury Stock						
Balance on Closing						

CALCULATION OF LIABILITIES FROM BALANCE SHEET

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A **LIABILITY** is something that a business has to pay, either in cash or kind, to its stakeholders & third parties.

FORMULA

Liabilities = Assets – Owner's Equity

USES

- Tells about financial strength.
- Basis for comparison.
- Calculation of financial ratios.
- Serve as yardstick for company to evaluate its financials.

BREAK-UP OF LIABILITIES

1. Short-term liabilities:
Liabilities that are due for maturity or payment under a period of 12 months.

2. Long-term liabilities:
Liabilities that fall due for payment over a period of more than a year or 12 months.

ASSETS vs LIABILITIES

	ASSETS	LIABILITIES
MEANING	Items that a company owns or has the right to use	Obligation that business / individual need to pay in the future
PURPOSE	They help in generating revenue for a company.	They are the financial obligations that a company needs to pay in future.
TYPES	Two types : Fixed assets and current assets.	Two Types : Current Liabilities and non-current liabilities
EXAMPLE	Machines, land, goodwill, accounts receivable	Account payable, loans and more.
DEPRECIATION	Fixed Assets are subject to Depreciation	Liabilities are always non-depreciable.
CALCULATION	Assets = Liabilities + Owner's Equities	Liabilities = Total Assets – Owner's equity
ACCOUNTING	Increase in Asset – Debited Decrease in Asset - Credited	Increase in Liability – Credited Decrease in Liability - Debited
CASH FLOW	Assets results into Inflow of Cash and increases cash balance	Liabilities results into Outflow of cash and decreases cash balance
BAL. SHEET	Assets come on the right side of the Balance Sheet	Liabilities come on the left side of the Balance Sheet

INCOME STAT COMPONENTS

REVENUE FROM OPERATIONS
Money you earned by selling your products and services. It is also known as sales or sales revenue.

COST OF GOODS SOLD
It is the total of all costs incurred to produce the goods. This includes costs pertaining to the purchase of raw materials, shipping costs, wages paid etc.

GROSS PROFIT
When you subtract Cost of Goods Sold from Total revenue, you get Gross Profit.

MARKETING / PROMOTIONAL EXPENSES
The expenses incurred in such marketing and promotional activities are put under this head.

GENERAL AND ADMIN EXPENSES
It includes all other expenses which do not belong an individual product in general but they are incurred to run the business in general.

EBITDA
The full form of EBITDA is Earnings Before Interest, Tax, Depreciation, and Amortization.

DEPRECIATION EXPENSE
Depreciation and Amortization expenses are non-cash expenses to spread out the cost of machinery and equipment across all the years of service.

EBIT or OPERATING INCOME
The full form of EBIT is Earnings before Interest and Tax.

INTEREST
Interest expense is the amount of money which it has to pay on its borrowings.

EBT
EBT stands for Earnings before Tax. To calculate EBT, deduct Interest Expense from Operating Income

EXPENSES

Expenses can be defined as "Any cost that a company bears in an attempt to maximize its revenues, and thereby its profits".

TYPES OF EXPENSES

- **Cost of Goods sold (COGS)** - Expenses directly related to generating sales revenues
- **Indirect Expenses** – These are the operating expenses
- **Non Operating Expenses** - those expenses which are not related to "revenue generation for the core business activity"

EXPENSES IN P&L A/C

- Salaries
- Raw Material
- Electricity Bills
- Depreciation
- Advertisement
- Insurance
- Fuel Expenses
- License Cost
- Bad Debt Loss
- Interest
- Tax Expenses
- Other Misc Exp.

COST OF GOODS SOLD

ACCOUNTING METHODS

- **FIFO (First In First Out)** : Here one assumes that the products first in are also the first to be sold to the end customer.
- **LIFO (Last In First Out)** : Here the stock that comes in the last is sold first.
- **Weighted Average** : Under this, one has to divide the total cost of goods available for sale by the total units available for sale and then and multiplying it by the actual number of units sold gives the cost of goods sold.
- **Specific identification** : Under this, costs are specially assigned to the specific unit sold.
- **Other methods** : Perpetual and Periodic Method

MEANING

COGS refers to the cost of producing goods and services. COGS helps the company will in determining – Pricing and the Gross Profit

Formulae : COGS = Opening Stock + Purchases – Closing Stock

SHORTCOMINGS

It becomes easier to manipulate and report wrong numbers. A company can falsely report the number by overstating the discounts, returns to the suppliers, along with overestimating inventory at hand and so on.

OPERATING EXPENSES

Operating Expenses or OPEX are those that a company incurs to keep the business running, or in the normal course of business.

CALCULATION

Operating Expense = Office expense + insurance+ license fees+ salaries and wages + accounting expenses + supplies + utilities + maintenance and repairs+ property taxes+ license fees.

CATEGORIZATION

One can categorize the operating expenses into Selling, Administrative and General Expenses which can be further classified into Compensation related, Office related and Sales and Marketing Expenses.

INCLUSION OF COST OF GOODS SOLD

- Sometimes the definition of operating expense may include the cost of goods sold as well.
- Examples include : Freight Outward Cost, Rental Cost, Product Cost, Depreciation Expense

NET SALES

Net sales are the income earned by a company after deducting its returns and discounts. The incentive of the sales personnel depends upon the net sales.

CALCULATION

- Before Net Sales, there is Gross Sales. It is the base revenue figure.
- **Net Sales = Gross Revenue/Sales – Sales Returns – Allowances – Discounts**

REPORTING

- Net sales do not account for items such as cost of goods sold, general expenses, and administrative expenses.
- Net Sales considers : Gross Revenue / Sales, Sales Return, Allowances and Discounts

FACTORS

- Net Sales include both cash and credit sales.
- Cash Accounting is a method wherein receipts for a certain period in cash are recorded.
- Accrual Accounting is a procedure wherein sales are accounted for when earned, instead of when the payment is received.

NET SALES RATIOS

- **Return on Sales, Price-to-sales ratios, and profit margin ratio** - all denote various measures when compared to net sales.

EBITDA MARGIN

EBITDA MARGIN calculates the company's earnings before interest, tax, depreciation, and amortization as a percentage of total revenue.

EBITDA MARGIN = EBIT + D + A / Total Revenue

Where, EBIT= Earnings Before Interest & Tax, D = Depreciation & A = Amortization.

FEATURES

- ❑ Always higher than the profit margin.
- ❑ Not regulated by GAAP.
- ❑ Higher the EBITDA margin, lower are a company's operating expenses.

GOOD EBITDA

A "good" margin varies. But, a higher one is preferable. To determine a "good" margin, one must calculate the metric for several years & then use average of those.

It is **USED BY ANALYSTS** to compare companies of different sizes in different industries as it's shown as a % of revenue. So, it helps in analyzing how much operating cash a co. is generating with each $ of revenue earned.

IMPORTANCE

- Tells the cash profit of the year.
- Effective measure to minimize risks.
- Evaluates cost cutting efforts.
- Useful in inflating financial performance.

DRAWBACKS

- Doesn't reveal proper profits.
- Doesn't give a clear picture of cash flows & neglects WC changes.
- Doesn't come under GAAP.
- Shows biased figures.

HOW ITS DIFFERENT FROM OTHER PROFIT MARGINS?

- ✓ Basically there are 3 profit margins to calculate. Gross Profit Margin, Net Profit Margin, Operating Profit Margin. The calculation of these profit margins is standardized, whereas, cos. use their own rules to calculate EBITDA.
- ✓ Net profit margin takes into account all the expenses & EBITDA doesn't & hence, net profit margin is widely used.

DEPRECIATION

DEPRECATION refers to allocation of the cost of the asset over time.
It is a non cash expense. Capitalized cost of an asset is allocated through depreciation.

TYPES

- ✓ **STRAIGHT LINE METHOD** : Depreciation = (Original cost - Salvage value) / Useful Life
- ✓ **ACCELERATED** : More depreciation is reported in the initial years of the life of the asset and less in the later years.
- ✓ **DOUBLE DECLINING BALANCE** : DDB Depreciation = (2 / depreciable life in years) % * Book value at beginning of period
- ✓ **UNIT OF PRODUCTION METHOD** : Depreciation = ((original cost – salvage value) / life in no. of units) * no. of units in the year.

Effects of Depreciati on

It affects the pre tax income and tax expense and also the income tax expense (in case of accelerated method)

Useful Life & Salvage Value

Higher useful life and salvage value reduces depreciation and thus increases profits.

EARNINGS BEFORE INTEREST & TAX

EBIT Is the Earnings earned from the business operations including Direct Expenses, Interest and Tax & excluding one-time or extraordinary items, like the cost of a lawsuit or revenue from the sale of an asset also non-operating income, like interest from investment.

CALCULATION

1. Sales – (COGS + Direct Expenses) = EBIT.
2. Net Income + Tax + Interest = EBIT.

➢ Wherein, COGS = Cost Of Goods Sold, Direct Expenses are those that are directly related to co.'s core business.

IMPORTANCE

- Useful Business Metric even for Creditors.
- Comparison of Different Co.'s of same sector.
- Input for Calculating Ratio Analysis, etc.
- Proxy for the FCF (Free Cash Flow).

EBIT MARGIN

- EBIT Margin = (EBIT / Net Revenue)
- It is measure of a co.'s earnings ability. Higher EBIT Margin is better because it indicates more efficient cost management & better sales.

EBIT OR EBITDA?

- EBITDA = Overestimates profit, more closely tied to operations of business, used for highly capital-intensive & leveraged co's.
- EBIT = Important measure of a co.'s profitability, focuses primarily on co.'s ability to earn from its operations

NET OPERATING INCOME

The net difference between the revenue generated by the core operations and the expenses directly incurred to generate this revenue is called the **NET OPERATING INCOME.**

COMMON OPERATING EXP.

- ✓ Cost of Goods Sold (COGS
- ✓ Selling, Distribution and Administration Expenses (SG&A)
- ✓ Depreciation / Amortization

IMPORTANCE

It is an important measure of operating efficiency as it excludes the effect of financial leverage and taxes

FORMULAE !!

Net Operating Income = Revenue – COGS – SG&A – Depreciation – Amortization

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NET INCOME

NET INCOME refers to the income that is left after business expenses are deducted from revenue. It may be positive and negative.

CALCULATION & FORMULAE

It can be found by subtracting cost of goods sold and business expenses from total revenue.

GROSS INCOME = REVENUE – COGS
NET INCOME = GROSS INCOME - EXP

FINANCIAL RECORDING /EFFECT

- Total revenues, cost of goods sold, gross income, expenses, taxes, and net income are all line items on the income statement.
- Positive Value of Net income would increase the retained earning in Balance Sheet and vice versa.

RELEVANCE / USES

- **It is used by analysts, investors and shareholders for making investment decisions.**
- Amount of dividend payment depends on net income earned.
- **This includes not only cash items but also non cash items such as depreciation/amortization etc.**
- Net income varies depending upon company's size and industries
- **Other affecting factors : growth factors in industries, debt levels or even government taxes.**

PROFIT AND LOSS STATEMENT

PROFIT & LOSS STATEMENT is an important financial statements that reflect company's performance and financial standing over a period of time

This statement summarizes all the incomes and expenditures over the desired time period. It gives the result as Net Loss or Net Profit.

It can be prepared, monthly, quarterly as well as annually.

IMPORTANCE OF THIS STATEMENT

- **Enables Decision Making** : A profit and loss statement is extremely important for a business for making decisions.
- **Meeting Statutory Obligations** : This statement helps in arriving at figures required for filing statutory tax returns.
- **Funding Requirement Formalities** : This statement helps the company to borrow funds as it help lender to gauge earning potential of the borrower.

STRUCTURE OF P&L

Particulars	Amount	Amount
Sales or Revenue (A)		X
Less : Cost of Goods Sold (B)		(X)
Gross Profit (A-B) = (C)		X
Less : Selling, General & Admin Exp (D)	X	
Less : Depreciation and Amortization (E)	X	
Less : Interest Expenses (F)	X	
Less : Taxes Paid (G)	X	(X)
Net Income (C) – (D+E+F+G) = (H)		X

CASH FLOW STATEMENT

CASH FLOW STATEMENT is a report that gives the movement of cash during the period under consideration. It gives an idea about the inflow and outflow of cash from operating, investing and financing activities.

COMPONENTS OF A CASH FLOW STATEMENT

OPERATING ACTIVITIES

It refers to the main activities of a business of purchase or sale of goods, providing of services, etc.
For Ex.: Purchase or sale of goods, trading P/L expenses, depreciation, etc.

INVESTING ACTIVITIES

It shows the investment a business does in either a property, security or particular asset, etc.
For Ex.: purchase/sale of a building, purchase of an investment, etc.

FINANCING ACTIVITIES

When a business needs of finance, it looks for various sources like raising funds through shares or debts, etc. For Ex.: Issuance of equity or preference shares, redemption of the same, payment of dividend, etc.

INTERPRETATION

Normally, the higher and positive the cash flow, the better it is! As positive cash flow indicates the co. has sufficient funds to meet its debts & liabilities, fund its day to da y cash requirements. It is taken as a positive signal by investors.

CFS VS IS

CFS= Cash Flow Statement, IS= Income Statement. Generally, there are the differences we find between these 2:

1. IS follows cash accounting whereas CFS doesn't.
2. IS records non-cash transactions also. While CFS records cash ones only.

CASH FLOW FROM OPERATING ACTIVITIES

OPERATING CASH FLOW shows quantum of cash movement and the net positive cash flow generation by company from its operating activities.

FORMULAS

- **Operating Cash Flow** = Net Income + Non-cash expenses – taxes +/- Working capital changes
- **Operating Cash Flow** = Net Income + Depreciation & Amortization expenses + any other non-cash items + non-operating losses – non operating gains + decrease in current assets – increase in current assets + increase in current liabilities - decrease in current liabilities – decrease in taxes + increase in taxes

NET INCOME is the amount derived before Interest and Taxes (EBIT).

DEPRECIATION/AMORTIZATION is measurement of the wear and tear of assets

WORKING CAPITAL is difference between current assets and current liabilities

METHODS

DIRECT METHOD - records all the cash receipts on one side and expenses on other side. The difference shows net positive cash flow or net negative cash flow from operating activities.

INDIRECT METHOD – wherein net income reflecting in the income statement is adjusted with the changes in current assets, current liabilities, and fixed assets for a given period.

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CASH FLOW FROM INVESTING ACTIVITIES

- ❑ Gives an idea of entity's investment-related expenditures
- ❑ Shows entity's spends on non-current asset

ITEMS INCLUDED

- Buying & Selling of
  - ➢ Property, plant & equipment
  - ➢ Shares, bonds & other marketable securities
- Acquiring and selling other entities/businesses

IMPORTANCE

- ❖ Spending on PPE
- ❖ Future growth idea
- ❖ Cash allocation for long term

FORMULA

CapEx (Capital Expenditure) + (Purchase of Long-Term Investments) + (Business Acquisitions) - Divestitures

INTERPRETATION

- ❖ Continuous **–ve** cash flow mean company is in growth state and can give **+ve** returns in future
- ❖ Drop in fixed asset investments could mean entity is no more profitable

CASH FLOWS FROM FINANCING ACTIVITIES

- These are part of cash flow statement
  Transaction regarding long term funds

ITEMS INCLUDED	
	▪ Debt Issuance ▪ Equity Issuance ▪ Share Buybacks ▪ Debt Repayment ▪ Dividends

FORMULA

Cash from Financing Activities = Debt Issuances + Equity Issuances - (Share Buybacks plus Debt Repayment + Dividends payment + Dividend Distribution Tax + Financial Lease Repayment)

INTERPRETATION

- Low or negative amount it as positive sign
- Three components used for interpretation:
  - Frequency of cash inflows
  - Capital financing options
  - Share buyback & dividend

CASH FLOW FORMULA

CASH FLOW FROM

Operating Activities
Shows inflows, outflows & cash from operations

Investing Activities
Shows capital expansion & long-term investments undertaken by entity

Financing Activities
Changes to be made in permanent capital structure

LIQUIDITY RATIOS

Defense Interval Ratio = Quick Assets/Daily Cash Expenses

Current Ratio = Current assets/Current Liabilities

COVERAGE RATIOS

Cash Coverage Ratio = Cash Balance/ Interest Expense

Debt Service Coverage Ratio = (PAT+ Interest+ Lease Rental+ Non Cash Expenses)/(Installment+ Lease Rental)

SOLVENCY RATIOS

Solvency Ratio = Net Profit (After Tax) + Depreciation/ Short Term + Long Term Liabilities

LIST OF NOTES

- ✓ Basis of Presentation
- ✓ Accounting Policies
- ✓ Changes in Accounting Policies
- ✓ Depreciation of Assets
- ✓ Valuation of Inventory
- ✓ Subsequent Events
- ✓ Related Parties
- ✓ Intangible Assets
- ✓ Consolidation of Financial Statements
- ✓ Benefits to Employees
- ✓ Contingencies
- ✓ Debt Reporting
- ✓ Risk and Uncertainties
- ✓ Other Notes and Disclosures

Adv. & Disadvantages

ADVANTAGES

- ❖ Ease of Accessibility
- ❖ Helps Auditors
- ❖ Helps Financial Analysts

Helps Shareholders

DISADVANTAGES

- ❖ Complexity
- ❖ Real Information Misplaced


LIMITATIONS OF FINANCIAL STATEMENTS
Indifferent to Market Values
Inflation
Specific Time Period
Not Comparable
Intangible Assets
Prone to Frauds
Ignores Non-Financial Matters
Unaudited Financial Statements
Not Futuristic
Errors and Omissions
Qualitative Information
Not Self Explanatory
Real Profits Hidden
Valuation of Closing Stock
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