# Reading and Understanding Financial Statements

Financial statements are summary of financial transactions of the organizations. Financial statements include balance sheet, statement of profit and loss and cash flow statement. Financial statements communicate wealth of information to users. Balance sheet shows where from business raised funds and how the funds are used. Shareholders and lenders provide capital for business. In addition, suppliers of goods and services also provide funds in the form of goods and services by extending credit period. The sources of funds thus consist of (a) Shareholders Fund (b) Loans and Advances and (c) Suppliers Credit. Shareholders fund includes capital brought by the shareholders and profit retained in the business. The funds are used for buying fixed assets and current assets. Fixed Assets include land, building, machine, furniture and intangible assets like software, trademark and brand. They are used for manufacturing goods or delivering services. Current assets include raw material, unsold finished goods, receivables and cash. The sources and uses are equal and hence the statement is called balance sheet. The statement is nothing but financial equation used for recording accounting transactions.

Assets = Liabilities + Shareholders Equity

The terms used in the balance sheet are slightly different from what we listed earlier. The sources of funds side consist of (a) Shareholders' Fund (b) Non-current Liabilities and (c) Current Liabilities. The uses of funds side consist of (a) Non-current Assets and (b) Current Asses.

The second statement is Statement of Profit and Loss. Business units operate with a goal of generating profit. Though they may pursue various other goals, profit is always bottom line for any business unit and society also recognises the need for firms making profit. The task of deriving the profit or loss figure is really complex in view of number of assumptions to be made in preparing the profit and loss account. Companies normally follow accrual and matching principles in preparing profit and loss account. In addition, there are number of Accounting Standards to ensure some level of uniformity and consistency in preparation of profit and loss account. Profit and Loss Account has three sections. In the first section, we see total revenue and its components. Expenses related to operations are listed in the next section. It consists of raw material consumption, employee cost, power and utility and other operating expenses. The schedules provide details of other operating expenses. It excludes depreciation, interest and taxes. The difference between revenue and operating expenses is called operating profit or Profit Before Interest and Taxes or popularly called EBDITA. The expansion for EBDITA is Earning Before Deprecation, Interest, Taxes and Amortisation. In the last section, we will find profit at different levels and also distribution of profit. Profit Before Depreciation, Interest and Taxes (PBDIT), Profit Before Interest and Taxes (PBIT), Profit Before Taxes (PBT), and Profit After Taxes (PAT) are profit shown at four levels. A part of profit is distributed as dividend, another part is transferred to reserves and balance is surplus part of the profit and loss statement.

Cash flow statement and cash flow analysis have assumed importance, particularly because companies have started adopting creative accounting and earnings management. Realizing the needs of naïve users as well as others, regulating agencies have made reporting of cash flow statements mandatory. Cash flow statement is easy to understand and, to an extent, difficult to fudge. It provides three important pieces of information on cash flow movements of the firm – how much cash is generated through operation, financing and how much cash is spent for investment? It gives a clear and real picture about the internal activities of the firm. There are two methods of preparation of cash flow statements, namely, direct and indirect method. While direct method gives more details on cash flow from operating activities and is also reader-friendly, indirect method is accounting oriented and fails to provide any additional information. Whether the cash flow statement is prepared under direct method or indirect method, the cash flow from operations, investments and financing activities are one and same. Cash flow analysis is typically done by comparing the changes in cash flow from operating activities between one period and another period with the changes in profit levels of the firm during the same two periods. Such comparison is useful to understand the quality of reported profit. Also, the cash flow from operating activities is used to check if there are sufficient funds to meet the liabilities of lenders and contribute to further investments.

**Optional Readings**

Chapter 2, 3 and 4 of the book titled Financial Statements and Analysis by M S Narasimhan (2016) and published by Cengage Learning, New Delhi, India. The paperback edition of the book is available at www.amazon.co.in

E-book at a discounted price of Rupees 299 (equal to USD 5) is available at [http://store.ignitorlearning.com/products/ignitor-book-financial-statements-and-analysis](http://store.ignitorlearning.com/products/ignitor-book-financial-statements-and-analysis)