**Final Accounts Interpretation**

**UNIT-II** **Understanding Financial Statements**

**Syllabus:** Structure of financial statements -Introduction, statements of Financial Position (Balance Sheet) - Statement of Earnings (Profit and Loss Statement) - Cash Flow Statement AS-3 (components and preparation) and Fund Flow Statement(benefits and process in preparation).

**Structures of Key Financial Statements**

There are four basic financial statements: the Income Statement, the Statement of Owners’ Equity, the Balance Sheet, and the Statement of Cash Flows.

1. **Income Statement / Statements of Earnings:**

The income statement shows revenues less expenses, also known as net income. In accounting, the word “net” means the combined total of both negative and positive amounts. For financial statement purposes, accountants don’t identify account balances by debit and credit—that’s part of the internal process of accounting and bookkeeping that has to do with the double-entry system you studied earlier.

1. **Statement of Owners’ Equity:**

The statement of owners’ equity, or owner’s equity if the company is a sole proprietorship, shows beginning owner capital, additions and subtractions to capital, including net income from the Income Statement. This gives the total owners’ capital at the end of the same specific time period as the Income Statement. This amount will be the beginning capital for the next Statement of Owners’ Equity. Both of the Income Statement and the Statement of Owners’ Equity, as well as the Statement of Cash Flows, show activities over a period of time, such as a year.

Equity = Owner Contributions – Owner Withdrawals + Revenues – Expenses.

1. **Balance Sheet:**

The balance sheet, unlike the previous two statements, shows a snapshot of the business at a moment in time. Notice that the Income Statement and the Statement of Owners’ Equity both identify the period of time covered, but the Balance Sheet indicates a specific date that is always the last day of the time period covered by the prior two statements. The balance sheet is based on the accounting equation and show total assets, total liabilities, and owners’ equity, and shows as well how they balance.

1. **Cash Flow Statements:**

Cash flow statements report a company’s inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you whether a company made a profit, a cash flow statement can tell you whether the company generated cash.

A cash flow statement shows changes over time rather than absolute dollar amounts at a point in time. It uses and reorders the information from a company’s balance sheet and income statement. The bottom line of the cash flow statement shows the net increase or decrease in cash for the period. Generally, cash flow statements are divided into three main parts. Each part reviews the cash flow from one of three types of activities: (1) operating activities; (2) investing activities; and (3) financing activities.

* **Operating Activities**

The first part of a cash flow statement analyzes a company’s cash flow from net income or losses. For most companies, this section of the cash flow statement reconciles the net income (as shown on the income statement) to the actual cash the company received from or used in its operating activities. To do this, it adjusts net income for any non-cash items (such as adding back depreciation expenses) and adjusts for any cash that was used or provided by other operating assets and liabilities.

* **Investing Activities**

The second part of a cash flow statement shows the cash flow from all investing activities, which generally include purchases or sales of long-term assets, such as property, plant and equipment, as well as investment securities. If a company buys a piece of machinery, the cash flow statement would reflect this activity as a cash outflow from investing activities because it used cash. If the company decided to sell off some investments from an investment portfolio, the proceeds from the sales would show up as a cash inflow from investing activities because it provided cash.

* **Financing Activities**

The third part of a cash flow statement shows the cash flow from all financing activities. Typical sources of cash flow include cash raised by selling stocks and bonds or borrowing from banks. Likewise, paying back a bank loan would show up as a use of cash flow.

1. **Fund Flow Statements:**

A funds flow statement is a statement that comprises the inflows and outflows of funds. It includes the sources of funds and application of funds for the particular period. Therefore, you can analyse the reasons behind the change in a company’s financial position. This article explains the funds flow statement, its components, importance and limitations.

A funds flow statement explains the changes in a company’s working capital. It considers the inflows and outflow of funds (source of funds and application of funds) for a particular period. The statement helps in analysing the changes in a company’s financial position between two balance sheet periods.

The statement helps in determining how the funds are being used. As a result, analysts can assess the company’s fund flow in the future.

**Components of a Fund Flow Statement**

The statement comprises the following 2 components:

* **Sources of Funds**: Includes where the funds have come from and their source.
* **Application of Funds**: Denotes the usage of funds for short term and long-term needs.

**Importance of a Funds Flow Statement:**

* **Financial Position**: A profit and loss statement or balance sheet does not explain the reasons for the change in a company’s financial position. The statement will give information about where the funds have come (Source of Funds) and where the funds have been used (Application of Funds).
* **Company Analysis**: Often, companies that are making profits end up in cash crunch scenarios. In such scenarios, the funds flow statement offers a clear picture of the source and usage of funds.
* **Management**: The funds flow statement assists management in determining its future course of action and also serves as a management control tool.
* **Changes in Assets and Liabilities**: The statement shows the reason behind the change in assets and liabilities between two balance sheet dates. As a result, you can conduct an in-depth analysis of the balance sheet.
* **Creditworthiness**: Lending institutions use this statement of a company to analyse creditworthiness. They compare the statement over the years before approving a loan. Therefore, the statement depicts a company’s credibility in terms of fund management.

**Limitations of Funds Flow Statement:**

Despite its importance in analyzing the financial position of a firm, the statement has the following limitations:

* The statement focuses only on the movement of funds. It doesn’t consider other parameters that are part of the Balance Sheet and Profit and Loss Account. Therefore, it has to be analyzed alongside the Balance Sheet and Profit and Loss Account.
* The funds flow statement doesn’t depict the cash position of a company. Hence, a separate cash flow statement has to be made for analyzing the cash position.

**Difference between a Cash Flow Statement and a Fund Flow Statement:**

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| **Point of Difference** | **Cash Flow Statement** | **Fund Flow Statement** |
| 1. **Basis of Analysis**
 | The cash flow statement is based only on cash and is one of the elements of working capital. | The fund flow statement is based on a broader concept – working capital. |
| 1. **Source**
 | Shows the opening balance of cash and reaches the closing balance after accounting for inflows and outflows. | Determines the various inflows and outflows of funds. |
| 1. **Usage**
 | Useful in analysing the short term effects of liquidity of the business. | Useful in analysing long term financial health. |
| 1. **Changes in Working Capital**
 | Changes in current assets and current liabilities are part of the cash flow statement itself. | The changes in current assets and current liabilities are part of the schedule of changes in working capital. |
| 1. **Components**
 | Cash flow from operating activities, Cash flow from investing activities and Cash flow from financing activities | Statement of changes in working capital, and Statement of funds from operations |
| 1. **Result**
 | Determines the factors that cause changes in cash. | Determines the factors that cause changes in net working capital. |
| 1. **Principal of Accounting**
 | CFS data obtained on an accrual basis are converted into a cash basis. | Follows accrual basis of accounting. |

**Role of Income statement or Statements of Earnings in Financial Reporting:**

An income statement is a financial statement that shows you the company’s income and expenditures. It also shows whether a company is making profit or loss for a given period. The income statement, along with balance sheet and cash flow statement, helps you understand the financial health of your business.

The income statement is also known as a profit and loss statement, statement of operation, statement of financial result or income, or earnings statement.

**Importance of an Income statement:**

An income statement helps business owners decide whether they can generate profit by increasing revenues, by decreasing costs, or both. It also shows the effectiveness of the strategies that the business set at the beginning of a financial period. The business owners can refer to this document to see if the strategies have paid off. Based on their analysis, they can come up with the best solutions to yield more profit.

Following are the few other things that an income statement informs.

1. **Frequent reports:** While other financial statements are published annually, the income statement is generated either quarterly or monthly. Due to this, business owners and investors can track the performance of the business closely and make informed decisions. This also enables them to find and fix small business problems before they become large and expensive.
2. **Pinpointing expenses:** This statement highlights the future expenses or any unexpected expenditures which are incurred by the company, and any areas which are over or under budget. Expenses include building rent, salaries and other overhead costs. As a small business begins to grow, it may find its expenses soaring. These expenditures may involve hiring workers, buying supplies and promoting the business.
3. **Overall analysis of the company:** This statement gives investors an overview of the business in which they are planning to invest. Banks and other financial institutions can also analyze this document to decide whether the business is loan-worthy.

**Who uses an income statement?**

There are two main groups of people who use this financial statement: internal and external users. Internal users include company management and the board of directors, who use this information to analyze the business’s standing and make decisions in order to turn a profit. They can also act on any concerns regarding cash flow. External users comprise investors, creditors, and competitors. Investors check whether the company is positioned to grow and be profitable in the future, so they can decide whether to invest in the business. Creditors use the income statement to check whether the company has enough cash flow to pay off its loans or take out a new loan. Competitors use them to get details about the success parameters of a business and get to know about areas where the business is spending an extra bit, for example, R&D spends.

**Income statement format with the major components:**

The following information is covered in an income statement. The format for this document may vary depending on the regulatory requirements, the diverse business needs and the associated operating activities.

* **Revenue or sales:** This is the first section on the income statement, and it gives you a summary of gross sales made by the company. Revenue can be classified into two types: operating and non-operating. Operating revenue refers to the revenue gained by a company by performing primary activities like manufacturing a product or providing a service. Non-operating revenue is gained by performing non-core business activities such as installation, operation, or maintenance of a system.
* **Cost of goods sold (COGS):** This is the total cost of sales or services, also referred to as the cost incurred to manufacture goods or services. Keep in mind that it only includes the cost of products which you sell. COGS does not usually include indirect costs, like overhead.
* **Gross profit:**Gross profit is defined as net sales minus the total cost of goods sold in your business. Net sales is the amount of money you brought in for the goods sold, while COGS is the money you spent to produce those goods.
* **Gains:**Gain is a result of a positive event that causes an organization’s income to increase.  Gains indicate the amount of money realized by the company from various business activities like the sale of an operating segment. Likewise, the profits from one time non-business activities are also included as gains for the business. For example, company selling off old vehicles or unused lands etc.  Although gain is considered secondary type of revenue, the two terms are different. Revenue is the money received by a company regularly while gain can be accounted for the sale of fixed assets, which is counted as a rare activity for a company.
* **Expenses:**Expenses are the costs that the company has to pay in order to generate revenue. Some examples of common expenses are equipment depreciation, employee wages, and supplier payments. There are two main categories for business expenses: operating and non-operating expenses. Expenses generated by company’s core business activities are operating expenses, while the ones which are not generated by core business activities are known as non-operating expenses.  Sales commission, pension contributions, payroll account for operating expenses while examples of non operating expenses include obsolete inventory charges or settlement of lawsuit.
* **Advertising expenses:**These expenses are simply the marketing costs required to expand the client base. They include advertisements in print and online media as well as radio and video ads. Advertising costs are generally considered part of Sales, General & Administrative (SG&A) expenses.
* **Administrative expenses:**It can be defined as the expenditure incurred by a business or company as a whole rather than being the ones associated with specific departments of the same company. Some of the examples of administrative expenses are salaries, rent, office supplies, and travel expenses. Administrative expenses are fixed in nature and tend to exist irrespective of the level of sales.
* **Depreciation:**Depreciation refers to the practice of distributing the cost of a long-term asset over its life span. It is a management accord to write off a company’s asset value but it is considered a non-cash transaction. Depreciation mainly shows the asset value used up by the business over a period of time.
* **Earnings before tax (EBT):**This is a measure of a company’s financial performance. EBT is calculated by subtracting expenses from income, before taxes. It is one of the line items on a multi-step income statement.
* **Net income:**Net profit can be defined as the amount of money you earn after deducting allowable business expenses. It is calculated by subtracting total expenses from total revenue. While net income is a company’s earnings, gross profit can be defined as the money earned by a company after deducting the cost of goods sold.