Accounting (Basics) - Lecture 11

COMPILATION OF CLOSING ACCOUNTING STATEMENTS – BALANCE SHEET, PROFIT AND LOSS STATEMENT, NOTES TO FINANCIAL STATEMENTS, CASH FLOW STATEMENT AND EQUITY CHANGES STATEMENT.

Content

- Compilation of closing accounting statements
- Balance sheet
- Profit and loss statement
- Notes to the financial statements
- Cash flow statement
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Financial statements

- The **objective of financial statements** is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.
- Financial statements also show the results of the stewardship of management, that is, the accountability of management for the resources entrusted to it.

Qualitative characteristics of information in financial statements

- **Understandability** – the information provided in financial statements should be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

Qualitative characteristics of information in financial statements

- **Relevance** – the information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

Qualitative characteristics of information in financial statements

- **Materiality** – information is material - and therefore has relevance - if its omission or misstatement could influence the economic decisions of users made on the basis of the financial statements.

Qualitative characteristics of information in financial statements

- **Reliability** – the information provided in financial statements must be reliable, that is, it should be free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.

Qualitative characteristics of information in financial statements

- **Substance over form** – transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. This enhances the reliability of financial statements.

Qualitative characteristics of information in financial statements

- **Prudence** – it is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

Qualitative characteristics of information in financial statements

- **Completeness** – to be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Qualitative characteristics of information in financial statements

- **Comparability** – users must be able to compare the financial statements of an entity through time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities to evaluate their relative financial position, performance and cash flows.

Qualitative characteristics of information in financial statements

- **Timeliness** – providing the information within the decision time frame. If there is undue delay in the reporting of information it may lose its relevance.
- **Balance between benefit and cost** – the benefits derived from information should exceed the cost of providing it.

Balance sheet

- **The balance sheet of an entity is the relationship of its assets, liabilities and equity as of a specific date as presented in the statement of financial position**.
- The expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognized.

Balance sheet

- These are defined as follows:
  a) **Asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
  b) **Liability** is a present obligation of the entity arising from past events, settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
  c) **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.

Balance sheet

Assets **Equity + Liabilities**

1. Fixed assets - intangible assets - tangible assets - long-term financial assets **2. Current assets** - inventories - long – term receivables - short – term receivables - short – term financial assets	**1. Owner's equity** - common stocks - capital funds - funds created by net profit - economic results **2. Liabilities** - Reserves (provisions) - long – term debts (liabilities) - short - term debts (liabilities) - bank credits (loans)
Σ Assets	**Σ Equity + Liabillities**

Balance sheet

- An entity shall present **current** and **non-current assets**, and **current** and **non-current liabilities**, as separate classifications in its statement of financial position, except when a presentation based on liquidity provides information that is reliable and more relevant.

Balance sheet

- An entity shall classify **an asset as current** when:
  a) it expects to realize the asset, or intends to sell or consume it, in the entity's **normal operating cycle**;
  b) it holds the asset **primarily for the purpose of trading**;
  c) it expects to realize the asset **within twelve months** after the reporting date; or
  d) the asset is **cash or a cash equivalent**, unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

Balance sheet

- An entity shall classify all **other assets as non-current (fixed)**. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.

Balance sheet

- An entity shall classify a **liability as current (short-term)** when:
  a) it expects to settle the liability in the **entity's normal operating cycle**;
  b) the liability is due to be settled **within twelve months** after the reporting date; or
  c) the entity **does not have an unconditional right to defer settlement of the liability** for at least twelve months after reporting date.
- An entity shall classify all **other liabilities as non-current (long-term)**.

Profit and loss statements (income statement)

- The profit and loss statement provides information about the company performance over an accounting period.
- The attention is paid to the structure of the income statement and dynamism of particular components
- The information from the income statement is a very important source material for evaluation of profitability.

Profit and loss statement

- If the balance sheet enables us to evaluate whether the company is economically stable, the profit and loss statement tells us about its ability to create enough profit
- If you think of the balance sheet as a snapshot, then you can think of the income statement as a video recording covering the period between before and after pictures

Profit and loss statement

- Like the balance sheet, the profit and loss statement is an important source material for analysing the financial management of the company, the objective of which is to evaluate the economics and profitability for a particular period

Revenues – Expenses (Costs) = Economic result

(Profit/loss) or Net income

Profit and loss statement

- The most important component of the statement is “income on operating activities” (EBIT) because it reflects the efficiency of the company to generate positive net income on company’s main operations

Profit and loss statement

- The structure of P/L statement is a little bit more complicated than the structure of the balance sheet.
- The P/L statement is composed gradually with the aim to calculate several partial indicators which represent single parts of economic activity of the enterprise.
- The concrete structure of the P/L statement is as follows:

Profit and loss statement

- Gross profit
- Operating profit (EBIT)
- Financial profit / loss
- Earnings before tax (EBT)
- Non-operating costs and revenues
- Net income

Gross profit

- The difference between net sales and the costs of goods sold.
- It includes total revenues and costs of sales.
- For example:
  - Services ordered by the company, consumption of material, costs of goods sold
  - Revenues from the goods sold, revenues from own products and services

Operating profit

- It includes salaries, rents, utilities, depreciation, advertising expenses, administrative expenses + gross profit.

Financial profit / loss

- Revenues from securities, interest revenues
- Interest expenses, bank account fees, sold securities and ownership interests

Earnings before tax

- The sum of earnings before interest and tax and financial profit / loss

Non-operating costs and revenues

- Costs and revenues from extraordinary activity – not such as the core business activity
- Extraordinary revenues or costs

Profit and loss statement - sample

Profit and loss statement	Thousands of … (currency)
Gross profit	
Operating Costs and Revenues	
Total Operating Profit (EBIT)	
Financial Costs and Revenues	
Earnings before Tax (EBT)	
Non-operating Costs and Revenues	
Total Sum of Costs and Revenues	
Tax (19)%	
Net Income	

Profit and loss statement

- **The P/L statement** is - after the **balance sheet** - the second basic financial statement that must be obligatory compiled to the date of accounting shutter (so called financial statements compilation date).

Notes to Financial Statements

- The notes shall:
  a) present information about the **basis** of preparation of the financial statements and the specific accounting policies used;
  b) disclose the **information required** by law that is not presented elsewhere in the financial statements; and
  c) provide **information** that is not presented elsewhere in the financial statements but is **relevant** to an understanding of any of them.
- An entity shall, as far as practicable, present the notes in a systematic manner. An entity shall cross-reference each item in the financial statements to any related information in the notes.

Notes to Financial Statements

- An entity normally presents the notes in the following **order:**
  a) a statement that the financial statements have been prepared in **compliance with law**;
  b) a summary of significant accounting policies applied, which comprises disclosure of:
     i. the measurement basis (or bases) used in preparing the financial statements.
     ii. the other accounting policies used that are relevant to an understanding of the financial statements.
  iii. supporting information for items presented in the financial statements, in the sequence in which each statement and each line item is presented.

Notes to Financial Statements

- An entity shall disclose in the notes information about **the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date**, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
- In respect of those assets and liabilities, the notes shall include details of their nature and their carrying amount at the end of the reporting period.

Cash Flow Statement

- **Cash equivalents** are **short-term, highly liquid investments held to meet short-term cash commitments** rather than for investment or other purposes.
- Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.
- **Bank overdrafts** are normally considered financing activities similar to borrowings.
- However, if they are repayable on demand and form an integral part of an entity’s cash management, bank overdrafts are a component of cash and cash equivalents.

Cash Flow Statement

- An entity shall present a statement of cash flows that presents cash flows for a reporting period classified by **operating activities**, **investing activities and financing activities**.
- **Operating activities** are the **principal revenue-producing activities of the entity.**
- Therefore, cash flows from operating activities generally result from the transactions and other events and conditions that enter into the determination of profit or loss.

Cash Flow Statement

- Examples of cash flows from operating activities are:
  a) cash receipts from the **sale of goods** and the **rendering of services**.
  b) cash **receipts from royalties, fees, commissions** and other revenue.
  c) cash **payments to suppliers** for goods and services.
  d) cash payments to and on behalf of employees.
  e) cash **payments or refunds of income tax**, unless they can be specifically identified with financing and investing activities.

Cash Flow Statement

- **Investing activities** are the **acquisition and disposal of long-term assets** and other investments not included in cash equivalents. Examples of cash flows arising from investing activities are:
  a) cash payments to **acquire property, plant and equipment, intangible assets and other long-term assets**.
  b) cash receipts from **sales of property, plant and equipment, intangibles and other long-term assets.**
  c) cash payments **to acquire equity or debt instruments of other entities and interests in joint ventures.**
  d) cash receipts from **sales of equity or debt instruments of other entities and interests in joint ventures.**
  e) cash advances and loans made to other parties.
  f) cash receipts from the repayment of advances and loans made to other parties.
  g) cash payments for futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the payments are classified as financing activities.
  h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading, or the receipts are classified as financing activities.

Cash Flow Statement

- **Financing activities** are activities that result in **changes in the size and composition of the contributed equity and borrowings of an entity.** Examples of cash flows arising from financing activities are:
  a) cash proceeds from **issuing shares or other equity instruments.**
  b) cash payments to owners **to acquire or redeem the entity's shares.**
  c) cash proceeds from **issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings**.
  d) cash **repayments of amounts borrowed**

Cash Flow Statement

- An entity shall present **cash flows from operating activities** using either:
  a) **indirect method**, whereby the net cash flow from operating activities is determined **by adjusting profit or loss** for the effects of:
     i. changes during the period in **inventories and operating receivables and payables**;
     ii. **non-cash items** such as depreciation, provisions, deferred tax, accrued income (expenses) not yet received (paid) in cash, unrealized foreign currency gains and losses, undistributed profits of associates, and non-controlling interests; and
     iii. all other items for which the cash effects relate to investing or financing.

Cash Flow Statement

b) **the direct method**, whereby **net cash flow** from operating activities is presented by disclosing information about major classes of gross cash receipts and gross cash payments. Such information may be obtained either:

   i. from the **accounting records** of the entity; or

   ii. **by adjusting sales, cost of sales and other items in the statement of comprehensive income** (or the income statement, if presented) for:

      - changes during the period in inventories and operating receivables and payables;
      - other non-cash items; and
      - other items for which the cash effects are investing or financing cash flows.

Cash Flow Statement

- An entity shall present **separately major classes of gross cash receipts and gross cash payments** arising **from investing and financing activities.**
- An entity shall record cash flows arising from transactions in a **foreign currency** in the **entity's functional currency by applying to the foreign currency amount the exchange rate** between the functional currency and the foreign currency **at the date of the cash flow.**

Cash Flow Statement

- The entity shall translate **cash flows of a foreign subsidiary at the exchange rates** between the entity's functional currency and the foreign currency **at the dates of the cash flows**.
- **Unrealized gains and losses** arising from changes in **foreign currency exchange rates are not cash flows**.
- The entity shall remeasure cash and cash equivalents held during the reporting period at period-end exchange rates.
- **The entity shall present the resulting unrealized gain or loss separately from cash flows from operating, investing and financing activities**

Cash Flow Statement

- An entity shall **present separately cash flows from interest and dividends received and paid**, and classify them as cash flows from **operating, investing or financing activities**.
- An entity shall **present separately cash flows arising from income tax** and shall classify them as cash flows from **operating activities** unless they can be specifically identified with financing and investing activities.

Cash Flow Statement

- Many investing and financing activities do not have a direct impact on current cash flows even though they affect the capital and asset structure of an entity.
- **An entity shall exclude from the statement of cash flows investing and financing transactions that do not require the use of cash or cash equivalents.**

Cash Flow Statement

- The most simple form of cash-flow statement is following:

Cash-flow statement (in thousand of currency)	
Opening balance of cash	
Increase of cash (incomes)	
Decrease of cash (expenditures)	
Final balance of cash	

Cash Flow Statement

- The statement of cash flows is used for evaluation of company’s financial stability, short-term planning of cash receipts and cash payments, long-term compiling of a financial plan and evaluation of cost-effectiveness of investment variants.

Equity changes statement

- **Equity changes statement** presents an entity's profit or loss for a reporting period, items of income and expenditures recognized in other comprehensive income for the period, the effects of changes in accounting policies and corrections of errors recognized in the period, and the amounts of investments by, and dividends and other distributions to, equity investors during the period.

Equity changes statement

- An entity shall present a statement of changes in equity showing in the statement:
  a) **total comprehensive income** for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests.
  b) **for each component of equity** – the effects of **retrospective application** or retrospective restatement recognized.

Equity changes statement

c) **for each component of equity** – a **reconciliation** between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:

   i. profit or loss.

   ii. each item of other comprehensive income.

   iii. the amounts of investments by, and dividends and other distributions to, owners, showing separately issues of shares, treasury share transactions, dividends and other distributions to owners, and changes in ownership interests in subsidiaries that do not result in a loss of control.

Equity changes statement

- **The statement of income and retained earnings** presents an entity's profit or loss and changes in retained earnings for a reporting period.

Equity changes statement

- An entity shall present, in the statement of income and retained earnings, the following items in addition to the information required by statement of comprehensive income and income statement:
  a) **retained earnings** at the **beginning of the reporting period**.
  b) **dividends** declared and paid or payable during the period.
  c) **restatements** of retained earnings for **corrections of prior period errors**.
  d) restatements of retained earnings for **changes in accounting policy.**
  e) **retained earnings** at the **end of the reporting period**.