**LESSON 2: FINANCIAL STATEMENTS**

1. **Introduction**

The general purpose information provided by financial accounting is summarized in the **financial statements**: the balance sheet, income statement, and statement of cash flows.

**2.1 International Accounting Standard 1 (IAS1): Presentation of Financial Statements**

IAS1 prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity’s financial statements of previous periods and with the financial statements of other entities.

**2.2 Purpose of Financial Statements**

The objective of the financial statements is to provide information about the financial position, financial performance, and cash flows for decision making.

**2.3 Fair Presentation**

Financial statements shall present fairly the financial position, financial performance, and cash flows of an entity.

**2.4 Three Primary Financial Statements**

The three primary Financial Statements that companies use to convey their financial situation to investors, creditors, and other interested parties are:

1. **Statement of Financial Position** (formerly known as Balance Sheet) – reveals what a company owns and what it owes;
2. **Statement of Financial Performance** (formerly known as Income Statement[[1]](#footnote-1)) – measures the economic performance of a company; and
3. **Statement of Cash Flows** – outlines where a company gets its cash and how it spends that cash.

**2.5 Statement of Financial Position**

A **Statement of Financial Position** presents the financial position of a company at a particular point in time. It shows the financial resources the company owns or controls and the claims on those resources.

**2.5.1 Balance sheet layout:**

**Assets**

Assets are shown under two headings: **non-current assets** and **current assets**.

**Non – current assets** are assets that:

1. were not bought primarily to be sold; but
2. are to be used in the business; and
3. are expected to be of use to the business for a long time.

Examples: buildings, machinery, motor vehicles, fixtures and fittings

Non-current assets are listed first in the balance sheet starting with those the business will keep the longest, down to those which will not be kept so long. For instance:

**Non-current assets**

* 1. land and buildings
  2. Fixtures and fittings
  3. Machinery
  4. Motor vehicles

**Current assets**

**Current assets** are assets that are likely to change in the short term and certainly within 12 months of the balance sheet date. They are listed in the increasing order of liquidity.

**Current Assets**

1. Inventory
2. Accounts receivable
3. Cash at bank
4. Cash in hand

**Liabilities**

There are two categories of liabilities: current liabilities and non-current liabilities.

**Current liabilities**

**Current liabilities** are items that have to be paid within a year of the balance sheet date. Examples: bank overdrafts, accounts payable resulting from the purchase on credit of goods for resale.

**Non-current liabilities**

**Non-current liabilities** are items that have to be paid more than a year after the balance sheet date. Examples: bank loans, loans from other businesses, mortgages.

**Shareholders' Equity**

Shareholders' equity is the initial amount of money invested into a business. If, at the end of the fiscal year, a company decides to reinvest its net earnings into the company (after taxes), these retained earnings will be transferred from the income statement onto the balance sheet into the shareholder’s equity account. This account represents a company's total net worth.

**2.5.2 How the Balance Sheet Works**

The balance sheet is divided into two parts that, based on the following equation, must equal each other, or balance each other out. The main formula behind balance sheets is:

|  |
| --- |
| **Assets = Liabilities + Shareholders' Equity** |

**2.6 Income Statement**

The income statement describes a company’s financial performance for a specific period of time. It reports the amount of net income earned by a company during a period. It measures the economic performance of a company.

**2.6.1 Income Statement Format**

The format of the income statement will have the following elements:

**A. Revenues and Gains**

1. Revenues from primary activities
2. Revenues or income from secondary activities
3. Gains (e.g., gain on the sale of long-term assets, gain on lawsuits)

**B. Expenses and Losses**

1. Expenses involved in primary activities
2. Expenses from secondary activities
3. Losses (e.g., loss on the sale of long-term assets, loss on lawsuits)

**2.7 Statement of Cash Flows**

In addition to net income, investors and creditors also want to know how much cash a company’s operations actually generate during a certain period and how that cash is used. In the statement of cash flows, individual cash flow items are classified according to three main activities: **operating**, **investing** and **financing**

* + 1. **International Accounting Standard 7** (IAS7)

The IAS7provides the meaning to the following terms:

1. *Cash* – comprises cash on hand and demand deposits.
2. *Cash equivalent* – are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
3. *Cash flows* – are inflows and outflows of cash and cash equivalents.
   * 1. **Operating activities**

These are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

**Examples**:

1. cash receipts from the sale of goods and the rendering of services,
2. cash receipts from royalties, fees, commissions, and other revenues,
3. cash payments to suppliers for goods and services,
4. cash payments to and on behalf of employees,
5. cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits,
6. cash payments or refunds of income taxes
7. cash receipts and payments from contracts held for dealing or trading purposes

**2.7.3 Investing activities**

They involve the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

**Examples**:

1. cash payments to acquire property, plant and equipment, intangibles and other long-term assets,
2. cash receipts from sale of plant and equipment, intangibles and other long-term assets,
3. cash payments to acquire equity or debt instruments of other entities,
4. cash receipts from sales of equity or debt instruments of other entities,
5. cash advances and loans made to other parties (other than advances and loans made by a financial institution),
6. cash receipts from the repayments of advances and loans made to other parties (other than advances and loans made by a financial institution),
7. cash payments for futures contracts, forward contracts, etc,
8. cash receipts from futures contracts, forward contracts, etc.

**2.7.4 Financing activities**

These are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

**Examples**:

1. cash proceeds from issuing shares or other equity instruments,
2. cash payments to owners to acquire or redeem the entity’s shares,
3. cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings,
4. cash repayments of amounts borrowed, and
5. cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities.

**2.7.5 Exceptions**

1. Short-term marketable securities are treated as long-term investments and appear in cash flow from investing activities
2. Short-term debt is treated as long-term debt and appears in cash flow from financing activities
3. Although dividends are handled as a cash outflow in the cash flow from financing activities section, interest payments are considered as an operating outflow, despite the fact that both are payments to outsiders for using their money.

**2.7.6 Taxes on income**

Cash flows arising from taxes on income shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

**2.7.7 Non – cash transactions**

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Examples of non-cash transactions are:

1. the acquisition of assets either by assuming directly related liabilities or by means of a finance lease,
2. the acquisition of an entity by means of an equity issue, and
3. the conversion of debt to equity.

**2.7.8 Operating Activities**: **Presentation Format**

The cash flow from operating activities section of a cash flow statement can be presented using the direct format or the indirect format. The bottom line is the same, but the two begin at different points. Companies are free to use either format. Below is an example of both formats.

1. **Direct method**: shows how much cash came in for sales and how much cash went out for inventory and other operating expenditures.
2. **Indirect method**: starts with net income as a figure that summarizes most of the cash transactions for operating activities in a firm.

**2.7.8.1 Adjustments to net profit**

When preparing statement of cash flows, net profit has to be adjusted to take account of items included which do not involve a movement of cash. These are depreciation, allowances for doubtful debts, and book profits and losses on the sale or disposal of non-current assets. An allowance for doubtful debts is similar to a provision for depreciation. The cash flow occurs when a debt is paid, not when provisions are made in case there may be bad debts in the future. As a result, the allowance for doubtful debts needed to be added back to net profit whenever there is an increase and vice versa.

If a non-current asset with a book value (after depreciation) of 50,000/= is sold for 64,000/= cash, the flow of cash is 64,000/=. The fact that there has been a book profit of 14,000/= does not provide any more cash above the figure of 64,000/=.

**2.7.9 Direct and Indirect Methods**

**2.7.9.1 Direct Method**

The method reports directly the major classes of operating cash receipts and payments of an entity during a period.

**Illustration**: Cash from Operating Activities: **Direct Method**

**Cash Flows from Operating Activities**:

Collections from customers XX

Payments for inventory purchases (XX)

Payments for miscellaneous expenses (XX)

Payments for interest (XX)

Net cash provided by operating activities XXX

**2.7.9.2 Indirect Method**

The method starts with net income, adds depreciation, adds/(deducts) loss/(gain) on disposal of fixed assets.

**Illustration**: Cash from Operating Activities: **Indirect Method**

**Cash Flows from operating activities**:

Net Income XX

Add: Depreciation XX

Add/(deduct): Loss/loss on disposal XX(XX)

Decrease in Current Assets XX

Increase in Current Liabilities XX

Increase in Current Assets (XX)

Decrease in Current Liabilities (XX)

Net cash provided by operating activities XXX

Regardless the method, the same amount of cash flow from operating activities should be reported. After all, cash flow is cash flow – it shouldn’t matter how you count it, there is still the same amount of cash.

**2.7.9.3 Advantages of the Two Methods**

**Direct Method**

* is easy to understand;

**Indirect Method**

* is relatively easy to construct from existing balance sheet and income statement data;
* highlights the reasons for the difference between net income and cash from operations.

**Note:** IFRS permits companies to use either method. However, many companies use the Direct Method.

**Example** (Discussion will be done in the class)

**ABC CO. Ltd**

**Trial Balance January 1, 2005**

(in million of currency units)

|  |  |  |
| --- | --- | --- |
| **Items** | **Assets** | **Liabilities and Equity** |
| Cash | 300 |  |
| Accounts receivable | 2,500 |  |
| Inventory | 1,900 |  |
| PP&E | 4,000 |  |
| Accumulated depreciation | (1,200) |  |
| Accounts payable |  | 1,700 |
| Taxes payable |  | 40 |
| LT debt |  | 2,200 |
| Common |  | 1,000 |
| Retained earnings |  | 2,560 |
| **Total** | **7,500** | **7,500** |

The following transactions were conducted by the company during 2005 (figures in million of currency units):

1. Sales on account, 13,500.
2. Collections on account, 14,000.
3. Purchased inventory on account, 7,900.
4. Cost of goods sold, 8,000.
5. Paid accounts payable, 8,100.
6. Purchased PP&E for cash, 1,700.
7. Sold PP&E for cash, 500 (original cost, 1,200, accumulated depreciation, 800.
8. Repaid long-term debt, 200.
9. Issued stock for cash, 450.
10. Recorded depreciation expense, 500.
11. Paid interest on debt, 180.
12. Recorded interest owed (accrued) but not paid, 20.
13. Paid miscellaneous expenses (e.g., wages, supplies, etc.) for the period, 3,200.
14. Recorded income tax expense for the period, 450.
15. Paid income taxes during the period, 440.

*Use the above information to prepare Balance Sheet, Income Statement, and Statement of Cash Flows* (use both methods).

* 1. **Interpretation of Financial Statements**

Interpretation of financial statements will be done under Lesson 5.

1. Similar to Trading, Profit and Loss A/C [↑](#footnote-ref-1)