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CSE-07

Financial Reporting and Financial Statements

Businesses communicate accounting information to the external users through a process known as financial reporting. Financial reporting is a process through which companies communicate financial information to the public. Financial statements are the basic means of communicating the information to those who use it. The elements of financial statements provide ".information about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events, and circumstances that change resources and claims to those resources", including ".information about an enterprise's performance provided by measures of earnings and its components". The four general-purpose financial statements are the following:

- Income Statement
- Statement of Changes in Equity
- Balance Sheet
- Statement of Cash Flows

- An **Income Statement** presents revenues and expenses and resulting net income or loss for a period of time. An income statement is also called Statement of Operations, Earnings Statement, or Profit and Loss Statement (P/L).
- A **Statement of Changes in Equity** shows all changes in owner's equity for a period of time. This statement is also called Owners' Equity Statement.
- A **Balance Sheet** presents assets, liabilities and owner's equity at a specific date. A balance sheet is also called Statement of Financial Position.
- A **Cash Flow Statement** summarizes information about cash outflows (payments) and inflows (receipts). This statement may also include certain information not related to actual cash flows.

Objectives of Financial Reporting

The objectives of financial reporting are summarized in the following excerpts:

1. Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
2. Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans.
3. Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change

resources and claims to those resources.

4. Financial reporting should provide information about an enterprise's financial performance during a period. The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components.
5. Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.
6. Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
7. Financial reporting should provide information that is useful to managers and directors in making decisions in the interests of owners.

Elements of Financial Statements of Business Enterprises

Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. The items in financial statements represent in words and number certain enterprise resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims. The Statement of Financial Accounting Concept defines 10 interrelated elements that are directly related to measuring performance and status of an enterprise.

1. **Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. **Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
3. **Equity** is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.
4. **Investments by owners** are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.
5. **Distributions to owners** are decrea. es in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.
6. **Revenues** are inflows or other enhancements of assets of an entity or settlements of its

liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

7. **Expenses** are outflows or other using up of assets or incurrence of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
8. **Gains** are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.
9. **Losses** are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

Closing the Books

For the purpose of closing the accounts at the end of a particular period, accounts are classified into two types e.g., Permanent and Temporary Accounts.

Permanent Accounts are balance sheet accounts (i.e., assets, liabilities, and equity). They are not closed each period. Their balances are carried forward into the next period. Permanent accounts are also called *Real Accounts.* In contrast, revenue, expense, and distribution accounts are Temporary Account. At the end of a period, amounts in **Temporary Accounts** are transferred to Income Statement. Thereby, Temporary Accounts must have zero balances at the end of one accounting period (after closing the books) and at the beginning of the following period. Temporary accounts are also called *Nominal Accounts.*

Temporary Accounts are closed at the end of each period. The process of transferring the balances from the temporary accounts to the Permanent Account and Retained Earnings is referred to as closing the accounts or *closing the books.*

Preparation of Financial Statements

The four General-Purpose Financial Statements are:

- Income Statement
- Statement of Changes in Equity
- Balance Sheet
- Statement of Cash Flows

Exercise: From the following Trial balance prepare Income Statement and Balance Sheet at the end of 2005.

Trial Balance of a Company
as at 31 December, 2005

Accounts	L.F.	Debit (Tk)	Credit (Tk)
Opening Stock		41,000	
Purchases		1,10,000	
Drawings		18,000	
Sales Returns		6,000	
Wages		5,400	
Salaries		9,000	
Traveling		950	
Rent, Rates and Taxes		2,400	
Purchase Returns			1,500
Interest Paid		1,200	
Discount Allowed		800	
Insurance Charges		600	
Bad Debts		600	
Sales			1,80,000
Sundry Debtors		14,000	
Fixed Assets		35,000	
Creditors			62,500
Cash		8,200	
General Expenses		1,200	
Advertisements		900	
Capital			8,750
Investments		3,500	
Bank Overdraft			5,000
Commission Received			1,000
Total		**2,58,750**	**2,58,750**

Note: Closing Stocks are not included in the Trial Balance