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Block 2 - Module 2

Sources of obtaining and financing investments in rural areas

Elaborated by VuS

LECTURE 3: FINANCIAL STATEMENTS

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LEARNING OUTCOMES

- The participants will be able to identify basic financial statements and explain the difference between them.
- The participants will be able to explain the main elements of a basic financial statement.

LEARNING ACTIVITY CONTENT ?

Financial statements

- Users of financial statements,
- Balance sheet,
- Profit and loss account..

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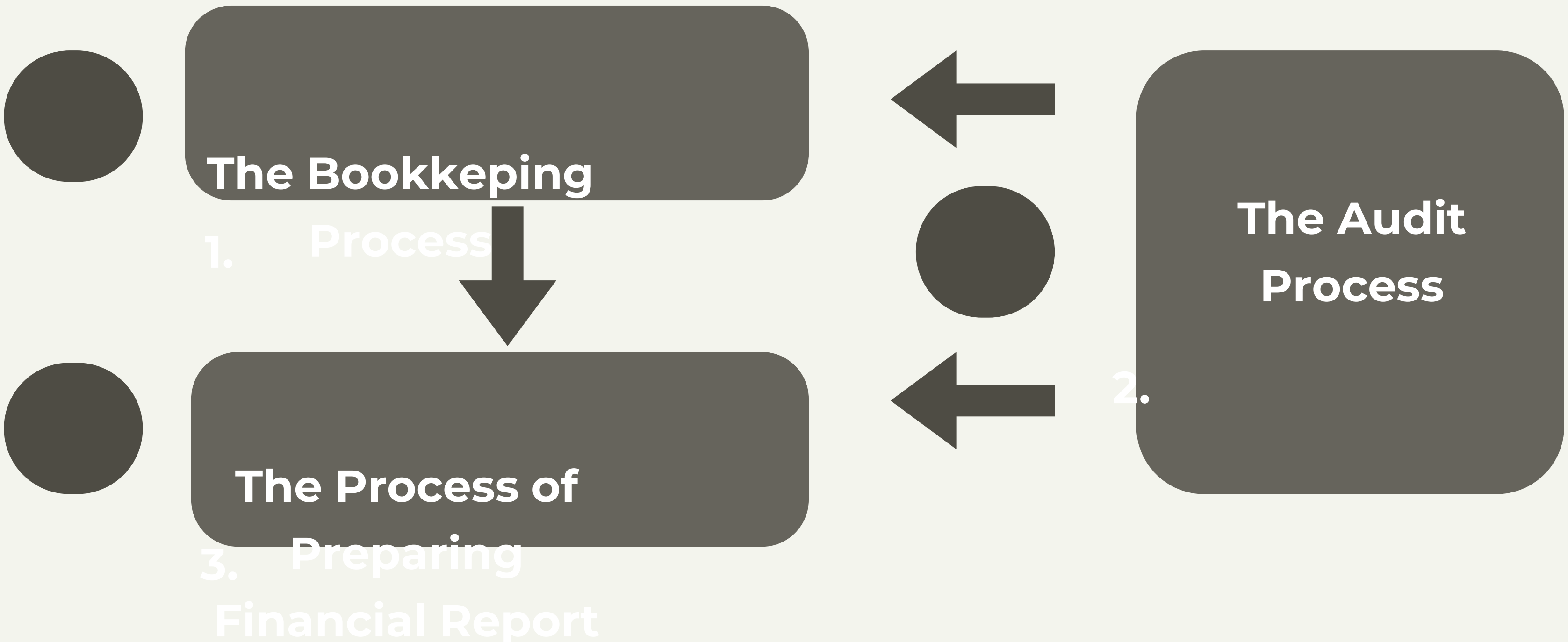
INTRODUCTION..

- An adequate information base is necessary when running a business. A significant part of such information is found in financial statements.
- Companies have to prepare financial statements to monitor the health of their business and provide a true and fair view of their financial position.
- Financial statements are commonly used by banks when making lending decisions.

FINANCIAL REPORTING



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FINANCIAL STATEMENTS

- Financial statements are a picture of a company's financial health, a record of financial activity that has happened over a certain period, and an overview of the financial operations.
- Financial statements are essential since they provide information about a company's assets, debt, revenue, expenses, and profitability.
- Types of financial statements:
  - balance sheet
  - profit and loss account
  - cash flow statement
  - equity statement
  - notes to the financial statements.
- Financial statements are generally prepared annually.

USERS OF FINANCIAL STATEMENTS AND THEIR INTEREST

MANAGEMENT OF THE COMPANY

information to make financing decisions and day-to-day operational activities.

INVESTORS

to evaluate a company's financial health and earnings potential.

CREDITORS

the security of the company's operations.

EMPLOYEES

to increase their understanding of the business.

USERS OF FINANCIAL STATEMENTS AND THEIR INTEREST

CUSTOMERS

quality and timely delivery of products and services they buy from the company.

SUPPLIERS

want to do business with "healthy" companies.

GOVERNMENT

to ensure accuracy for tax purposes.

PUBLIC

employment, job security, doing business following environmental requirements.

EU RULES ON FINANCIAL REPORTING

- When prepared for external users, **financial statements should follow regulations and relevant accounting standards.**
- Directive 2013/34/EU aka the "accounting directive" instructs that:
- All limited liability companies doing business in the EU, whatever their size, have to prepare annual financial statements and file them with the relevant national business register to monitor the health of their business and provide a true and fair view of their financial position.
  - Listed companies (those whose securities are traded on a regulated market) must prepare their consolidated financial statements following a single set of international standards called International Financial Reporting Standards.
  - **Small and medium-sized enterprises apply a simplified reporting regime**, and micro-companies (those with less than 10 employees) use the so-called super simplified regime - they prepare the balance sheet, the profit and loss account, and the notes.

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BALANCE SHEET

A balance sheet is a financial report that systematically displays the state of assets, liabilities and owner's equity at a certain point in time – much like a snapshot.

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BALANCE SHEET INFORMATION

FINANCIAL STRENGTH

company's ability to generate revenue and to have a sufficient cash flow.

LIQUIDITY

company's ability to use its current assets to meet its current liabilities.

SOURCES OF FINANCE

in what proportion the company used its own and other sources of financing.

COMPANY`S POSITION

compared with the previous period, and with similar companies in the industry.

THE ELEMENTS OF BALANCE SHEET

An asset is a present economic resource controlled by the company as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Those rights apply the right to use, sell, or pledge the object, as well as other undefined rights.

A **liability** is a present obligation of the company to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that a company has no practical ability to avoid.

Equity is the residual interest in the assets of the company after deducting all its liabilities.

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ASSETS

- An asset is a resource with economic value that company owns or controls with the expectation that it will provide a future benefit.
- They are bought or created to increase a business's value or benefit the business's operations.
- An asset can be thought of as something that, in the future, can generate cash flow, reduce expenses, or improve sales, regardless of whether it's manufacturing equipment or a patent.
- In the statement of financial position (balance sheet), assets are required to be classified as current or non-current (fixed) assets.

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NON-CURRENT ASSETS

are intended for use on a continuing basis for the company's activities.

- Examples of non-current assets include
  - trademarks,
  - land, property, plant, and equipment, and
  - long-term

- INTANGIBLE ASSETS
- TANGIBLE ASSETS
- FINANCIAL ASSETS

CURRENT ASSETS

assets that can be converted to cash within one year.

- These items business uses in its day-to-day operations to generate cash flow.
- They can be turned to cash quickly to fund the existing operations and cover

RIES

- **ACCOUNTS RECEIVABLE**
- **SHORT-TERM INVESTMENTS**
- **CASH**

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BALANCE SHEET LAYOUT - ASSETS

- The assets are listed in according to their relative degree of **liquidity** (i.e. their closeness to cash - how easily they can be converted into cash).
- Ascending order of liquidity.
- Cash is the ultimate in liquidity, thus appears last in balance sheet. The further an asset is removed from cash, the less liquid it is.

Assets	Explanation
Non-current assets	Long-term asset, not expected to be used or sold within a year.
Intangible assets	Concessions, patents, licenses, trade marks, software and similar rights.
Tangible assets	Land, buildings, plant, machinery, other fixtures and fittings, tools and equipment.
Financial assets	Shares and loans to affiliated undertakings, investments held as fixed assets.
Current assets	Cash and items likely convertible to cash within 1 year.
Stocks (Inventories)	Raw materials, work-in-process, and finished goods.
Debtors (Accounts receivable)	Amounts owed to company by customers.
Cash	Cash at bank and in hand.
Total assets	Assets = liabilities + owners' equity.

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BALANCE SHEET LAYOUT - ASSETS

- Shows where the money to buy the assets came from.
- Capital is the business's own source of financing the assets and represents the rest of the assets after settling liabilities.
- Liabilities - the money owed by the company (provisions and creditors).

Equity and liabilities	Explanation
Capital and reserves	Subscribed capital, Reserves, Profit or loss brought forward, Profit or loss for the financial year.
Provisions	Provisions for pensions and similar obligations. Provisions for taxation.
Creditors	Amounts owed to credit institutions, Payments received on account of order, Trade creditors, Bills of exchange payable, Other creditors, including tax and social security authorities.
Long-term debt	Debt becoming due and payable after more than one year.
Current liabilities	Debts becoming due and payable within one year.
Total equity and liabilities	The sum of equity and liabilities equals assets.

OWNER'S EQUITY

- Owners' equity aka *net worth* or *net assets*, consists of two basic parts: the part that was invested and the part that was earned (generated) in business operations.
- In other words, equity consists of: invested capital and earned capital.

INCREASE

- Retained profits
- Additional investment

DECREASE

- Loss
- Distribution to owners

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THE ACCOUNTING EQUATION

ASSETS = OWNER'S EQUITY + LIABILITIES

What the company owns

The sources of company's assets

- The balance sheet is based on the accounting equation. This equation states that company's assets are equal to the sum of its equity and liabilities.
- For example, if a company takes out a five-year, €4,000 loan from a bank, its assets (specifically, the cash account) will increase by €4,000. Its liabilities (specifically, the long-term debt account) will also increase by €4,000, balancing the two sides of the equation.

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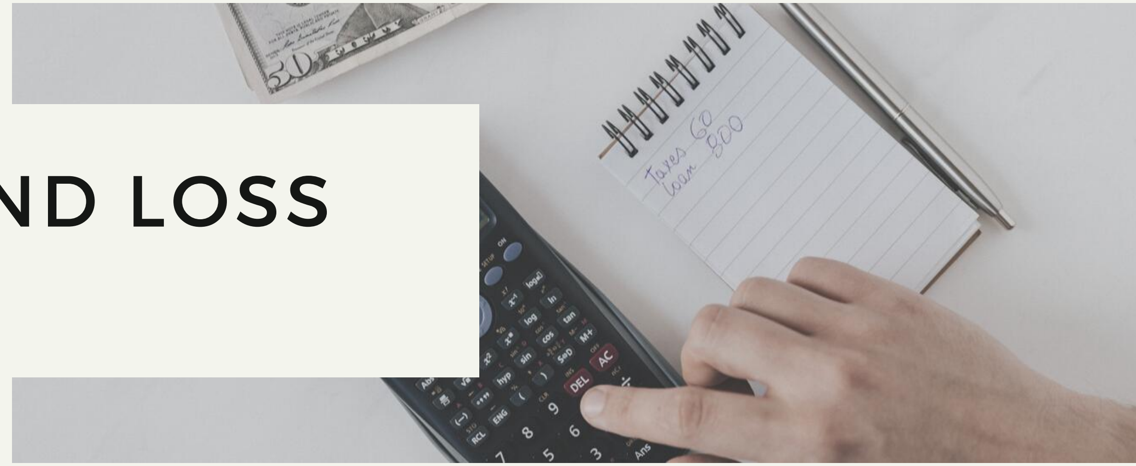
BALANCE SHEET LAYOUT

Assets	Liabilities
Fixed Assets	Equity
Intangible fixed assets	Common stock
Tangible fixed assets	Other shareholder funds
Other fixed assets	Non-current Liabilities
Current Assets	Long-term debt
Stocks	Other non-current liabilities
Debtors	thereof: Provisions
Other current assets	Current Liabilities
thereof: Cash	Loans
	Creditors
	Other current liabilities
Total Assets	Equity + Liabilities

PROFIT AND LOSS ACCOUNT



- Financial statement that shows how much income and expenses were incurred over a specific period.
- It is a statement of financial performance that provides information about income, expenses and profit or loss.
- These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both.

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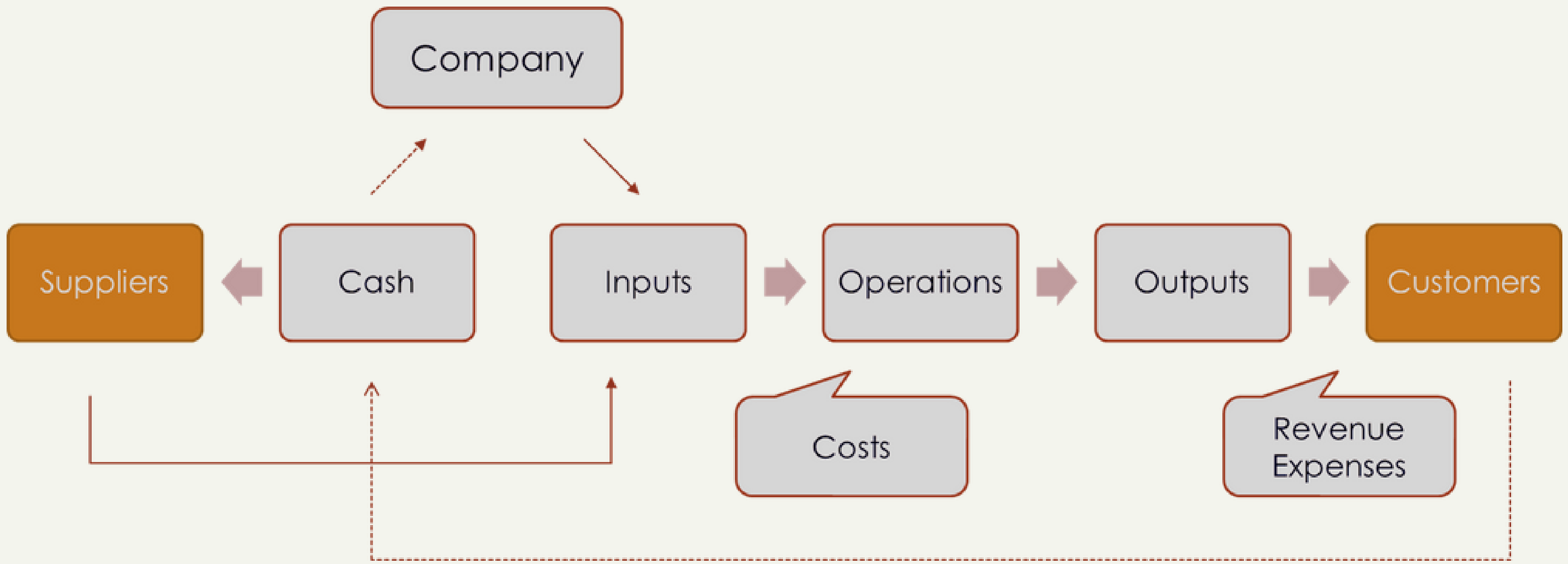

BUSINESS PROCESS

Income and expenses arise related to the development of business processes, i.e. related to changes in assets and sources of assets.

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THE ELEMENTS OF PROFIT AND LOSS ACCOUNT

INCOME

Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

EXPENSES

Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

FINANCIAL RESULT

Income – Expenses

Income > Expenses

Expenses > Income = loss

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PROFIT AND LOSS ACCOUNT - ELEMENTS

Net sales (net turnover)	**Amount received, or receivable, from customers.**
- Cost of goods sold	Directly related to operating levels: wages, raw materials, supplies, and manufacturing overhead.
= Gross profit	Profit after subtracting all the costs directly related to manufacturing and selling of products or services.
- Selling, general, and administrative expenses	Salesmen's commissions, advertising, officers' salaries, etc.
= Operating profit/loss	Reflects the residual income that remains after accounting for all the costs of doing business.
+ Financial revenue	The differences from exchange rate, etc.
- Interest paid	Cost of borrowed funds.
- Other financial expenses	Losses from sales of financial assets, etc.
= Profit/loss before tax	Taxable income.
- Taxes	Tax on profit or loss. Corporate income tax.
= Profit/loss after tax	Net income. Amount earned for owners.

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TWO LAYOUTS OF THE PROFIT AND LOSS ACCOUNT

by nature of expense	by function of expense
Revenue	Revenue
Other income	Cost of sales
Changes in inventories of finished goods and work in progress	Gross profit
Raw materials and consumables used	Other income
Employee benefits expense	Distribution costs
Depreciation and amortisation expense	Administrative expenses
Other expenses	Other expenses
Total expenses	Profit before tax
Profit before tax	

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LAYOUT BY NATURE OF EXPENSE

1. Net turnover.
2. Variation in stocks of finished goods and in work in progress.
3. Work performed by the undertaking for its own purposes and capitalised.
4. Other operating income.
5. (a) Raw materials and consumables.
(b) Other external expenses.
6. Staff costs:
(a) wages and salaries;
(b) social security costs, with a separate indication of those relating to pensions.
7.(a) Value adjustments in respect of formation expenses and of tangible and intangible fixed assets. concerned.
(b) Value adjustments in respect of current assets, to the extent that they exceed the amount of value adjustments which are normal in the undertaking
8. Other operating expenses.
9. Income from participating interests, with a separate indication of that derived from affiliated undertakings.
10. Income from other investments and loans forming part of the fixed assets, with a separate indication of that derived from affiliated undertakings.
11. Other interest receivable and similar income, with a separate indication of that derived from affiliated undertakings.
12. Value adjustments in respect of financial assets and of investments held as current assets.
13. Interest payable and similar expenses, with a separate indication of amounts payable to affiliated undertakings.
14. Tax on profit or loss.
15. Profit or loss after taxation.
16. Other taxes not shown under items 1 to 15.
17. Profit or loss for the financial year.

LAYOUT BY FUNCTION OF EXPENSE

1. Net turnover.
2. Cost of sales (including value adjustments).
3. Gross profit or loss.
4. Distribution costs (including value adjustments).
5. Administrative expenses (including value adjustments).
6. Other operating income.
7. Income from participating interests, with a separate indication of that derived from affiliated undertakings.
8. Income from other investments and loans forming part of the fixed assets, with a separate indication of that derived from affiliated undertakings.
9. Other interest receivable and similar income, with a separate indication of that derived from affiliated undertakings.
10. Value adjustments in respect of financial assets and of investments held as current assets.
11. Interest payable and similar expenses, with a separate indication of amounts payable to affiliated undertakings.
12. Tax on profit or loss.
13. Profit or loss after taxation.
14. Other taxes not shown under items 1 to 13.
15. Profit or loss for the financial year

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KEY POINTS

- **Balance sheet** - A summary of a firm's financial position on a given date that shows total assets = total liabilities + owners' equity.
- **Profit and loss account** - A summary of a firm's revenues and expenses over a specified period, ending with net income or loss for the period.
- **Notes to the financial statements** - provide information necessary for a fair presentation of the financial position and business results that are not directly noticeable from the financial statements themselves or are not included in them.

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CONCLUSION

- Financial statements provide information about the financial state of a company, they give an overall picture of the health of a business.
- They provide information concerning company's asset structure, source of funds, debt level, income, expenses, performance, and other sorts of information such as applied accounting policies, expectations of the management, and plans for the future.
- Analysing the financial statements, we can find out the financial position and profitability of a company. Financial analysis will be the topic of our following lecture.

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