

Introducing to financial accounting, **balance sheet**:

- Describe the key elements of financial statements
- Identify business transactions
- Explain the nature and purpose of the balance sheet
- Apply the definition and recognition criteria for assets and liabilities
- Discuss the definition and nature of equity
- Describe the format and presentation of the balance sheet
- Describe the main classes of assets, liabilities and equity
- Discuss the measurement of assets and liabilities on the balance sheet
- Discuss the limitations of the balance sheet

FINANCIAL ACCOUNTING is the preparation and presentation of financial statements to allow users to make economic decisions about the entity.

FINANCIAL STATEMENT are a set of reports (tables) directed towards the common information needs of a wide range of (internal and external) users, with the aim of providing information about the financial position (assets and resources and the way those have been produced), financial (the ability of an entity to make profit, to create value for the owners), cash flow (the ability of an entity to meet the shorter limitation, lower money, and manage the company in a good way).

The **balance sheet** (statement of financial position) shows the financial position on an entity (what an entity owns) and the claims against these assets at a particular point in time. In this document there is a description of the aims of the company during the passed year, the income flows, etc.

Income statement shows an entity's profit for a specific time period.

Statement of cash flows shows the ability of an entity for earn money in flows.

Statement of changes in equity show changes in the entity's ownership structure.

Key elements of financial statements:

- **Assets**: 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
- **Liabilities**: A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources
- **Equity**: The residual interest in the assets of the entity after all its liabilities have been deducted
- **Income**: Inflows or other enhancements of assets, or decreases in liabilities that result in an increase in equity other than those relating to contributions by equity participants
- **Expenses**: Decreases in economic benefits in the form of outflows or depletions of assets or incurrence of liabilities that result in a decrease in equity other than those relating to distributions from equity participants

There are different types of business entities that have different requirements in terms of financial reporting. The accounting principles are called international financial reporting standards which are mandatory for companies whose shares trade in a public market (listed public companies), also bank and insurance companies, because they raise a lot of capital for investments.

There are different methods concerning how to provide data for the sheet. IFRS provides preparers with choice. Apart from the mentioned documents another important part of the financial report of a company are the notes to the financial statements, which show the rules, the criteria, and the types of assumptions used to create the tables.

The reporting period is the time period to which the financial statements are related, usually it is of one year, but in some cases it can be required that companies make it more frequently, where information is reported and forecasts are made.

Apart from the quantitative information of the statements there are some qualitative characteristics:

- **Relevance**

- Information should help users in making a decision

- **Faithful Representation**

- Implies that financial information faithfully represents the phenomena it purports to represent
- Information must be complete, neutral and free from error

- **Comparability**

- Users must be able to compare:
 - Aspects of the entity across time
 - Different entities

- **Verifiability**

- A company's accounting results must be reproducible (given the same data and assumptions, an independent accountant can produce the same result)

- **Timeliness**

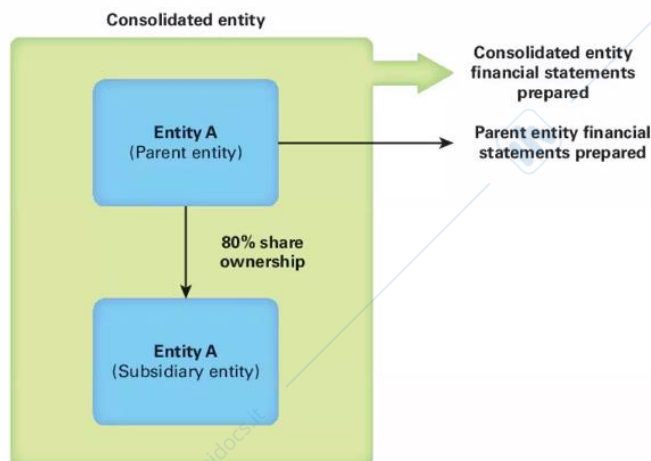
- Information is available to all stakeholders in time for decision making purposes

- **Understandability**

- The preparers should present information in the most understandable manner for users

Business groups typically report: (a business group is created by a parent company which owns other companies, subsidiaries, in a direct or indirect way). When the parent company has to do the report can choose to report only itself or the performance of all other companies as well.

- Parent entity financial statements (for controller)
- Consolidated financial statements (for business group)



Business transactions

In these statements what we are really able to get is a kind of summary of what we call 'business transaction', which are the starting point of the financial statement.

A business transaction is an event that involves an exchange of something of value (money, physical goods, assets, labor, ..) between a business entity and a third party (another business entity or an individual person).

A business transaction has an effect on any of the accounting elements: assets, liabilities, equity, income, and expenses. A business transaction can be recorder in the financial statements if it occurs at arm length (if we have the business and the third party, we should have the exchange and the two parties are unrelated and act for their own interest) - monetary concept; it can be reliably measured in monetary terms; it is kept separate from any personal transaction of the owners – entity concept.

Based on these characteristics we can clarify what is not a business transaction:

- Personal transactions of the owners, partners or shareholders that are unrelated to the operations of the business
- Business events, which are occurrences that will probably affect the entity in some way, but are not recorded as business transactions.

Business transactions, **personal transactions**, or **business events**?

- Purchase of raw materials from a supplier
- Payment of wages to employees
- Signing a contract with a new employee that will start working on January, 2022
- Owner's purchase of a family car
- Sale of goods on credit (cash will be received later) to a customer
- Negotiating the loan agreement with a bank

N. B. About the payment of wages to employees: they are considered a third party to which the company owns money in exchange to their labor.

N. B. sales of goods on credit: the product has been delivered to the customer in exchange of the legal obligation that the customer will have to pay. If the payment will not occur the business entity will be able to press legal charges and receive the money in some way.

Examples of business transactions

- Contribution of capital by owners
- Payment of wages
- Receipt of bank interest
- Purchase of something for business purpose
- Payment of trade payables (when an entity sells on credit and the customer has the legal obligation to pay the company in the future)
- Sales of goods to customers
- Purchase of accounting software
- Withdrawal of capital
- Repayment of short-term loan to financial institution
- Cash purchases of office supplies
- Payment of advertising

The balance sheet

- To achieve profits, business entities need to invest in **productive assets (investment decisions)**
 - Properties, land, equipment, machinery....
- The acquisition of assets requires **financing**, which are provided by **(financing decisions)**:
 - External parties (e.g. lenders such as banks and financial institutions)
 - Internal parties (owners)

The balance sheet is a financial statement that allows external users to understand the details of assets of the entity, the internal (equity) and external (liabilities) claims (how these resources have been financed).

THE ACCOUNTING EQUATION must always hold

$$\begin{array}{rcccl} \text{ASSETS} & = & \text{LIABILITIES} & + & \text{EQUITY} \\ \text{A} & = & \text{L} & + & \text{E} \\ \text{(Own)} & = & \text{(Owe)} & + & \text{(Owner)} \end{array}$$

- Assets need to be funded by owners and lenders
- Liabilities and equity represent the *claims against* the entities assets
- The accounting equation **must** be kept in balance after a transaction is entered (**Duality concept**)

Example: M. and F. wish to start an internet business, marketing cosmetics. As they concerned about legal issues, they decide to incorporate a private company. Each of them contributes 5000\$.

Balance sheet of the company after this first transaction:

Assets	Liabilities	Equity
10k	0	10k

However in a few days they realize they need 15000\$ to do business (9000 to purchase office equipment and 6000 for cosmetics). They decide to borrow additional funds (5000) to purchase the items needed.

Balance sheet after second transaction:

Assets	Liabilities	Equity
9k+6k <u>15k</u>	5k	10k

Definition criteria of assets: an asset is formally defined as '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'. In order to record an item as an asset we have three definition criteria: control, past event, and future economic benefits.

- Control refers to the capacity of an entity to use an asset, and to the capacity to regulate or deny it to others. Ex. Purchase of an investment property (when a business entity uses a fund to purchase buildings, etc.); car leasing (contract from which this entity doesn't purchase the car but can use it for its own purposes).
- The resource must be generated by a transaction that has happened: the company cannot include an asset it will be getting in the future.
- Future economic benefits are expected to generate future benefits, to flow to the entity from the resource: items must provide benefits to the entity that uses them in order to be regarded as assets. Those benefits can be either cash or the control of resources. When a customer has the obligation to pay the entity, this will generate in the future a benefit for the company having sold that product, being the transaction a past event.

Additionally the monetary value associated to the asset must be reliable: the value of the asset can be measured reliably, however sometimes estimates are needed and those are not always reliable (ex. Patent: the exclusive right of an inventor to use their invention exclusively).

Future economic benefits must be probable: it is more than likely that the future economic benefits will flow from the asset to the business controlling it.

Liability is the opposite of an asset, it is an obligation that will generate a decrease of assets in the future. It is a commitment to another entity to provide resources to that entity, this can be formal (legal) or informal, while the amount of money may not be known. An outflow of resources embodying economic benefits is expected to flow from the entity as a result of settling the present obligation. As in the case of the asset it is important that we are able to manage the values of those liabilities.

Summary of the asset and liability definition and recognition criteria

	Definition			Recognition		
Asset	Future economic benefit	+ Control	+ Past event	& Probable	+ Reliable measurement	= Recognise on balance sheet
						≠ Disclosure in notes to accounts is possible
Liability	Outflow of resources embodying future economic benefits	+ Present obligation	+ Past event	& Probable	+ Reliable measurement	= Recognise on balance sheet
						≠ Disclosure in notes to accounts is possible

The definition of equity

Equity is defined as 'the residual interest in the assets of the entity after deducting all its liabilities: Equity= assets – liabilities.'

Residual means that the owners will be able to get profit only if they use resources in a profitable way and if the assets we are able to manage all liabilities, what remains is the right of getting back their initial investments(?)

Example: after 2 months from the incorporation date, M. and F. realize that they are too busy to run the business. Thus, they decide to close the business and to liquidate the company. Remember that: - M. and F. both provided 5000\$

- They borrowed 5000\$ from a bank
- They used 9000\$ to purchase office equipment and 6000\$ for cosmetics
- Before closing the business, the founders decide to sell the office equipment and inventories. They were able to obtain 12000\$.

How does the balance sheet look like now??

Assets	Liabilities	Equity
12	5	7

This means that there has been a loss. There hasn't been a positive profit. If on the other hand they would have been able to obtain 20000\$ the balance sheet would be

Assets	Liabilities	Equity
20	5	15

Making the profit positive and gaining money.

FORMAT AND PRESENTATION OF THE BALANCE SHEET

- T-format (assets on LHS and liabilities on RHS, often used for smaller entities)
- Narrative format (assets, liabilities and equity)

If we analyze a balance sheet according to the IFRS, assets and liabilities are distinguished in current ones and not current ones. Current = associated with (assets) economic benefits, (liabilities) outflow of

resources that are expected to be realized in the next reporting period; non-current ones are the ones expected beyond the next reporting period. Comparing current assets/liabilities allows to assess an entity's liquidity, whether the entity will experience problems related to the fact that the entity will have to pay past liabilities in the future.

Main types of asset classes typically included in the sheet:

- | | |
|---|---|
| <ul style="list-style-type: none"> • Current <ul style="list-style-type: none"> - Cash and cash equivalents - Trade receivables - Inventories - Other current financial assets | <ul style="list-style-type: none"> • Non-current <ul style="list-style-type: none"> - Investments in associates and joint ventures - Non-current financial assets - Property, plant and equipment - Investment property - Deferred tax assets - Agricultural assets - Intangible assets |
|---|---|

CURRENT:

- Cash and cash: cash resources that an entity holds at a particular point of time, representing the liquid resources that can be immediately spent to acquire new assets or can be given back to the owners.
- Trade and other receivables: cash that the entity expects to receive from customers for the sales of goods or services. When you sell a property but the owner hasn't received the cash yet, the entity expects to receive money in the future: the cash will materialize in a short time period from the acquaintance, within the next reporting period.
- Inventories: this is typical of manufacturing companies, that process the physical transformation of raw materials to generate profit. Inventories = of raw materials that start their conversion process into the finished products. Those inventories have a value that can be estimated, and they are expected to be converted into cash in a short period of time, because their maintenance can be expensive.
- Other current financial assets: bonds, investments in shares of other companies (of no significant influence) and derivative assets. These are typically financial securities acquired by the business entity with the idea to sell them in a short period of time (typical of trading). Those are usually expected to be sold within 12 months.

NON-CURRENT

- Investments in associates and joint ventures: value of the shares owned by the entity in another entity, this class of assets appears only if the entity owns enough shares in another entity to enable it to exert a significant influence over the other entity's decision making. Basically the parent entity exerts an active role on the subsidiaries by being the majority owner of the subsidiary company.
- Non-current financial assets: bonds and shares of other companies which are expected to be sold beyond 12 months.

- Property, plant, and equipment: long term assets that have physical substance (tangible assets) which are expected to be used in the operations of the entity for many years. In the case of a building this building is just used as part of the production process.
- Investment property: land or a building, typical of a construction company or real estate. They are expected to earn rentals or for capital appreciation, or both. It includes properties in the course of construction or development. In this case the building and its value are interesting themselves, because we are planning on renting or selling it.
- Deferred tax assets: those are the expected taxation benefits, related to long term taxation benefits. The gov decides to provide tax discounts because the company is deciding to purchase an equipment that will improve its sustainability, thus the gov provides incentives distributed in multiple time periods.
- Agricultural assets: living plants or animals. These are the case of agricultural companies or companies operating in the pharmaceutical sector.
- Intangible assets: assets with non-physical substance (trademarks; brand names; patents; licenses; goodwill = intangible asset that arises as a result of the acquisition of one entity by another for a premium value. It is the difference between the amount paid and the value of net assets acquired.;...).