CA BUSINESS SCHOOL
POSTGRADUATE DIPLOMA IN BUSINESS FINANCE AND STRATEGY

SEMESTER 1: Financial Statements Analysis

PREPARATION OF FINANCIAL STATEMENTS

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CONTENT

- Code of Ethics and Corporate Governance
- Business Transactions and Events
- Statement of Financial Position
- Income statement
- Changes in Equity Statement
- Cash Flow Statement

CODE OF ETHICS AND CORPORATE GOVERNANCE

INTRODUCTION

- Code of Ethics & Corporate Governance has become a vital element/concept within the overall business environment and profession of accounting.

- Code of ethics essentially guide professional accountants to work in an ethical manner.

- Corporate Governance basically discusses how to govern/manage the entity's overall activities with best practices and best interest of all stakeholders

- CE & CG leads to the phenomena of Corporate Social Responsibility (CSR) which in turn has become the area that most of the entities are concentrating much and awarded/recognized in recent past.

- Business Sustainability | 3BL | Theories in Business Sustainability

PROFESSIONAL CODE OF ETHICS

Institute of Chartered Accountants of Sri Lanka introduced following fundamental principles to its members.

The Public Interest

- Safeguard the interests of your clients (public practice) and employers
- Accept your responsibility to the public at large

Independence

- Be, and be seen to be, free of any interest that might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity (who are in public practice)

Integrity

- Be straightforward, honest and sincere in your approach to professional work

Objectivity

- Be fair and do not allow prejudice, conflict of interest or bias to override your objectivity
- Maintain an impartial attitude and protect the integrity of your professional services

Confidentiality

- Respect the confidentiality of information acquired in the course of your work and do not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose

Technical and Professional Standards

- Carry out your professional work in accordance with the technical and professional standards relevant to the work

Professional Competence and Due Care

- Perform professional service with due care, competence and diligence
- Maintain professional knowledge and skills at required level
- Refrain from performing any services that you are not competent to carry out unless assistance is obtained

Ethical Behaviour

- Conduct yourself in a manner consistent with the good reputation of the profession and refrain from any conduct that might bring discredit to the entire profession

CORPORATE GOVERNANCE

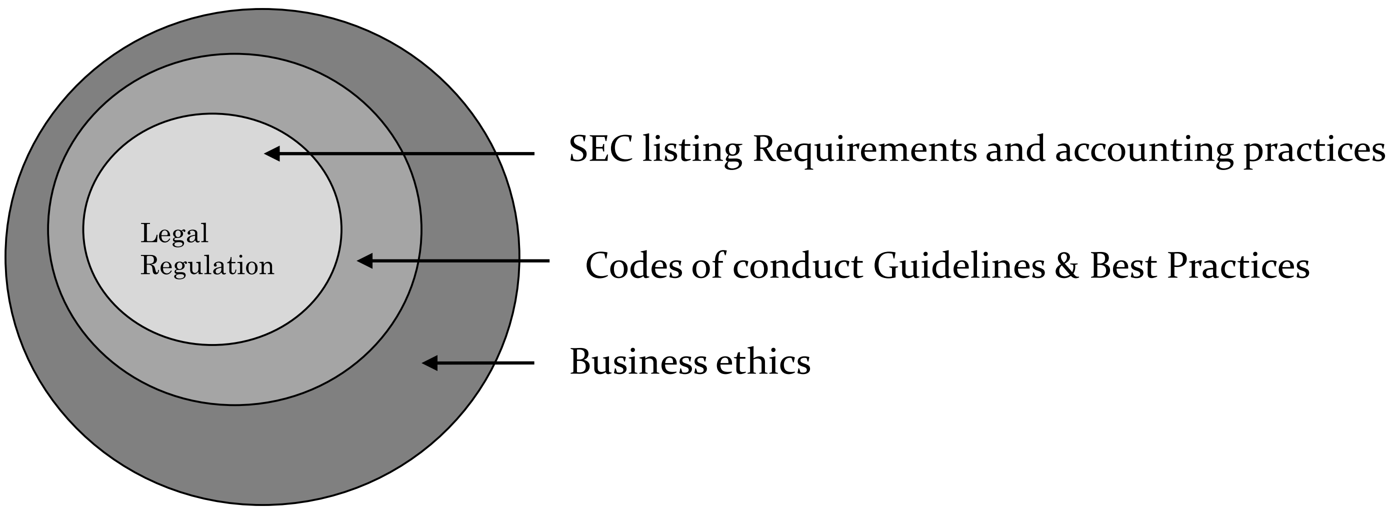
Corporate Governance refers good governance of the organization. This means the members of the Director Board direct/control and manage the entity with good motive.

Generally, Directors owe the following duties/tasks (legal) to the company they work.

- To act in good faith, in the best interest of the company.
- To act with care and diligence.
- To avoid improper use of information or position.
- To avoid complex between their role as a director and any of their personal interests. (agency theory)

The chief executive officer and the chief financial officer should state in writing to the board that the company's financial reports present a true and fair view in all material respects of the company's financial condition/position and operational results and are in accordance with relevant accounting standards.

- Though the corporate governance basically deals with the rights and obligations of companies' key management (Directors), It also considers the duties & rights of shareholders and other various stakeholders.
- The practice of corporate governance is vary from one country to another. Commonly, following structure could be seen in corporate governance.



Every entity must establish suitable policies/procedures and applications of corporate social responsibility along with the corporate governance.
Corporate Social Responsibility (CSR) refers the responsibility of an entity towards all stakeholders, including society in general and the physical environment within which it operates.

ROLE OF AN ACCOUNTANT

Accountants – with their information systems, performance appraisal expertise, and qualities such as integrity, objectivity and independence can help entities discharge their social and environmental obligations through the following types of activities:

- Modifying the existing systems to incorporate environmental and social revenues and expenditures.
- Rethinking the use of some accounting techniques (such as investment and performance appraisal) because they ignore the environmental and social elements.
- Having a greater awareness of the future by bringing to account potential contingent liabilities, changing payback periods, and determining the cost of environmental and social initiatives as well as the cost of not undertaking such initiatives.

- Expanding and developing new information systems to incorporate environmental and social information (for example, by including information on incorporation on the whole lifecycle of a product and not just the production cost).
- Including environmental and social information in external reporting. The accountant’s role goes beyond providing financial information to satisfy statutory requirements. It includes the provision of information – relevant, reliable, accurate and timely – on a number of issues for various stakeholders.
- Developing systems that not only capture the environmental and social activities but also evaluate the extent to which the activities meet the objectives.
- Attempting to measure both the cost of environmental and social activities as well as the benefits.

IDENTIFYING AND RECORDING ;

BUSINESS TRANSACTIONS & EVENTS

BUSINESS TRANSACTION

- Business Transaction is the main source through which an entity compile its financial statements for the given period.
- Every entity should identify & record business transactions as and when they occurred.
- Business Transactions are occurrence of incidents which results external exchanges of resources between the entity and another entity or individual through which entity’s assets, liabilities and/or equity get affected.
- Business Events are occurrences/incidents that have a potential to be a business transactions but could not be yet recorded in the books of accounts.
- Every business transaction must measure in monetary term & treated to be occur at arm’s length.
- Also, BT should be recorded subject to the entity concept.

ACCOUNTING EQUATION

- Accounting equation is one of the basic/fundamental phenomena in financial accounting
- Depicts the relationship between total assets, total liabilities and total equity of the particular entity at a given particular time.
- At a given particular time, total assets of an entity must equal to the aggregation of total equity and total liabilities.

Assets = Equity + Liabilities (Basic)

- Equity - own capital/finance.
- Liabilities - Other than own capital, all the other third party capital.

CONCEPT OF DUALITY

Duality means every business transaction will have dual effect.

- Introduction of capital

RULES OF DEBIT AND CREDIT

It is crucial / important to understand and remember the rules of debit and credit since it provides the basis for the recording of transactions and preparation of financial statements thereafter.

Step 1

Understand the Five (05) categories of Ledger Accounts available in any types of entity to which all transactions could be categorized.

	Generally
- Assets	Dr
- Liabilities	Cr
- Equity	Cr
- Expenses	Dr
- Income	Cr

Step 2

Apply the rule (increase will take the same position and vice versa)

When,

Assets & Expenses Increase → Debit

Assets & Expenses Decrease → Credit

When,

Equity, Liabilities & Income Increase → Credit

Equity, Liabilities & Income Decrease → Debit

TRIAL BALANCE (TB)

Trial Balance is the summary of entire ledger accounts balances for the particular date is concern. Trial Balance is treated as source (ultimate) to prepare financial statements. Trial Balance provides assurance that concept of duality applied properly, but not give comprehensive assurance on accuracy of recording transactions. (what does mean and how to prepare TB?)

STATEMENT OF FINANCIAL POSITION

INTRODUCTION

- Balance Sheet is the most powerful/influential element represents overall sets of financial statements.
- Balance sheet essentially assess the financial position of an entity for a given particular date/time.
- Balance sheets shows how Assets, Liabilities & Equity are being balanced for a particular date/time.

  Assets - The Resources owned by the entity.
  Liabilities - External Claims / Borrowings.
  Equity - Internal Claims / Capital.

- Balance Sheet represents investment & financing decisions of a particular entity for a given time.

  Investment Decision - The Acquisition (or sale) of assets.
  Financing Decision - The decision of how to finance the cost of the assets. (How to acquire the resources) (D & E)

USE OF BALANCE SHEET

Balance Sheet provides an assurance of accurate use/practice of duality concept and accounting equation by the particular entity.

Analyzing the balance sheet, users will make preliminary assessment of the entity's economic condition. They would evaluate;

- The types of assets in which the entity **invest**. (NCA Vs. CA)
- How the entity **finance** its assets? (own Vs. 3rd party)
- **Gearing position** of the company. (TE Vs. TL)
- **Liquidity position** of the company. (CA Vs. CL)

Assets	Liabilities	Equity
Assets are the resources controlled by an entity and as a result, future economic benefits will flow in to the entity. Three (03) key criteria to be satisfied; ❑ Future economic benefits must flow in to the entity. ❑ Controlled by the entity. ❑ As a result of the past events. How to recognize/record the asset? ❑ Future economic benefits must be probable/certain. ❑ Cost & Value (fair) should able to be measure reliably. *Recent changes to the rules/conditions* *Why an employee(s) not being treated as an asset of the organization?*	A present obligation of an entity arising from past events and settlement will essentially result outflow of resources embodying economic benefits. Three (03) key criteria to be satisfied; ❑ A present obligation. ❑ As a result of the past events. ❑ Outflow of resources embodying economic benefits. How to recognize/record the Liability? ❑ Outflow of resources embodying economic benefits must be probable/certain ❑ Value should able to be measure reliably *Recent changes to the rules/conditions*	Equity represents the owners' claims on the assets/owners' interest of the entity. Equity = Total Assets - Total Liabilities Equity comprised capital introduced by the owners and retained earnings. Retained Earnings is treated as most powerful source of finance for most of the organization where struggling to seek finance from any other internal or external sources. *Recent changes to the rules/conditions*

FORMAT AND PRESENTATION OF THE BALANCE SHEET

Format → " T " Format. (Horizontal) (Traditional)

Format → Narrative/Vertical Format.

- It's compulsory to indicate previous year similar line items (Comparatives) when presenting current year balance sheets' line items.
- When presenting the consolidated/group balance sheet, figures/amounts of both parent company and consolidation (Group) should indicate with previous year figures/amounts separately.

BROADER CATEGORIES OF ASSETS AND LIABILITIES

Assets → Non-Current Assets (NCA)
→ Current Assets (CA)

Liabilities → Non-Current Liabilities (NCL)
→ Current Liabilities (CL)

- Regardless the type of Entity, Current & Non-Current Assets/Liabilities should shown separately on the statement of financial position.

TYPES OF COMMONLY APPLICABLE ASSETS

- Property, Plant & Equipment
- Agricultural assets/biological assets
- Intangibles

NCA

- Inventories
- Trade Debtors
- Cash & cash equivalents

CA

Goodwill (Intangibles) → Internal (not recorded)

Goodwill (Intangibles) → External (recorded in group)

- Determination: how to identify and measure?

TYPES OF COMMONLY APPLICABLE LIABILITIES

- Debentures
- Bank Loan
- Leasing

NCL

- Provisions
- Trade Creditors
- Bank Overdraft

CL

TYPES OF COMMONLY APPLICABLE EQUITY

- Share Capital (UITF announcement on redeemable P/Sc.)
- Reserves
- Retained Earnings

TYPICAL ASSETS & LIABILITIES : MEASUREMENT TECHNIQUES

- Historical Cost. (Original purchase cost)
- Current Cost. (Cost of replacement)
- Market Value. (Expected in the market)
- Present Value. (Discounted Value of future cash flows)
- Fair Value. (Determined in an arms length transactions)

VALUATION OF STOCKS/INVENTORIES

Stock

Cost — NRV

Whichever is lower [why?]

- Scope IN and elimination

Inventory Valuation Techniques.

- FIFO
- LIFO (no more applicable)
- HIFO
- WAC

VALUATION OF TRADE DEBTORS

- Value appear in the balance sheet should be a Net Debtor
- Concepts of Bad Debtors and Doubtful Debtors

VALUATION OF PROPERTY, PLANT & EQUIPMENT

- Value appear in the balance sheet should be a Written Down Value (WDV)
- Concepts of depreciation & method of depreciation including UITF announcement.)
- Amortization. (Intangibles)
- Impairment.
- Revaluation.

POTENTIAL LIMITATIONS OF THE BALANCE SHEET

- Some items might be missing.
- Different techniques used to value the assets.
- Using historical cost.
- Using some assumptions & estimates.

INCOME STATEMENT |

CHANGES IN EQUITY STATEMENT

OVERVIEW

- Income statement is one of the key element represents overall sets of financial statements

- Usually prepares at the end of the particular financial period (year)

- Income statement reflects the overall financial performance of the particular entity for the given period of time and depicts profit/loss earned/incurred for such period

- The end result (bottom line) of an income statement called either “profit or loss” which basically derived through the adjustment of income and expenses for the given period

- Income comprised from revenue earned from major operational activities and other sources such as dividends/interests/profit from sale of NCA. All expenses & revenue are recurring nature including some provisions for the depreciation and bad/doubtful debtors

KEYS IN INCOME STATEMENT

- The reporting period
- Concept of accrual accounting
  - accrual income (Income & asset)
  - income received in advance (Liability)
  - accrued expenses (Expense & Liability)
  - expenses paid in advance (Asset)
- Accounting policies
- Depreciations/ Amortization (2 types)/ Impairment

MEASURING FINANCIAL PERFORMANCE THROUGH INCOME STATEMENT

- Recognition of income. How? When?
- Types of income recognized. Revenue & Gain.
- Classifications.

- Recognition of expenses. How? When?
- Types of expenses recognized. Cost & Loss.
- Classifications.

INCOME

Defined as increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increase in equity, other than those relating to contributions from equity participants. (applies new IFRS – 15 with effect from 01/01/2018 which described five-step model)

Should identify revenue when satisfy the following;

- Does an agreement for the provision of goods and services exist between the entity and a party external to the entity? ***Identify the contract(s) with a customer***
- Has cash been received; or does the entity have a claim against an external party that is for a specified consideration and is unavoidable without penalty? ***Determine the transaction price / Allocate the transaction price to the performance obligations in the contract***
- Have all acts of performance necessary to establish a valid claim against the external party been completed? ***Identify the performance obligations in the contract***
- Is it possible to reliably estimate the collectability of debts? ***Recognize revenue when (or as) the entity satisfies a performance obligation***

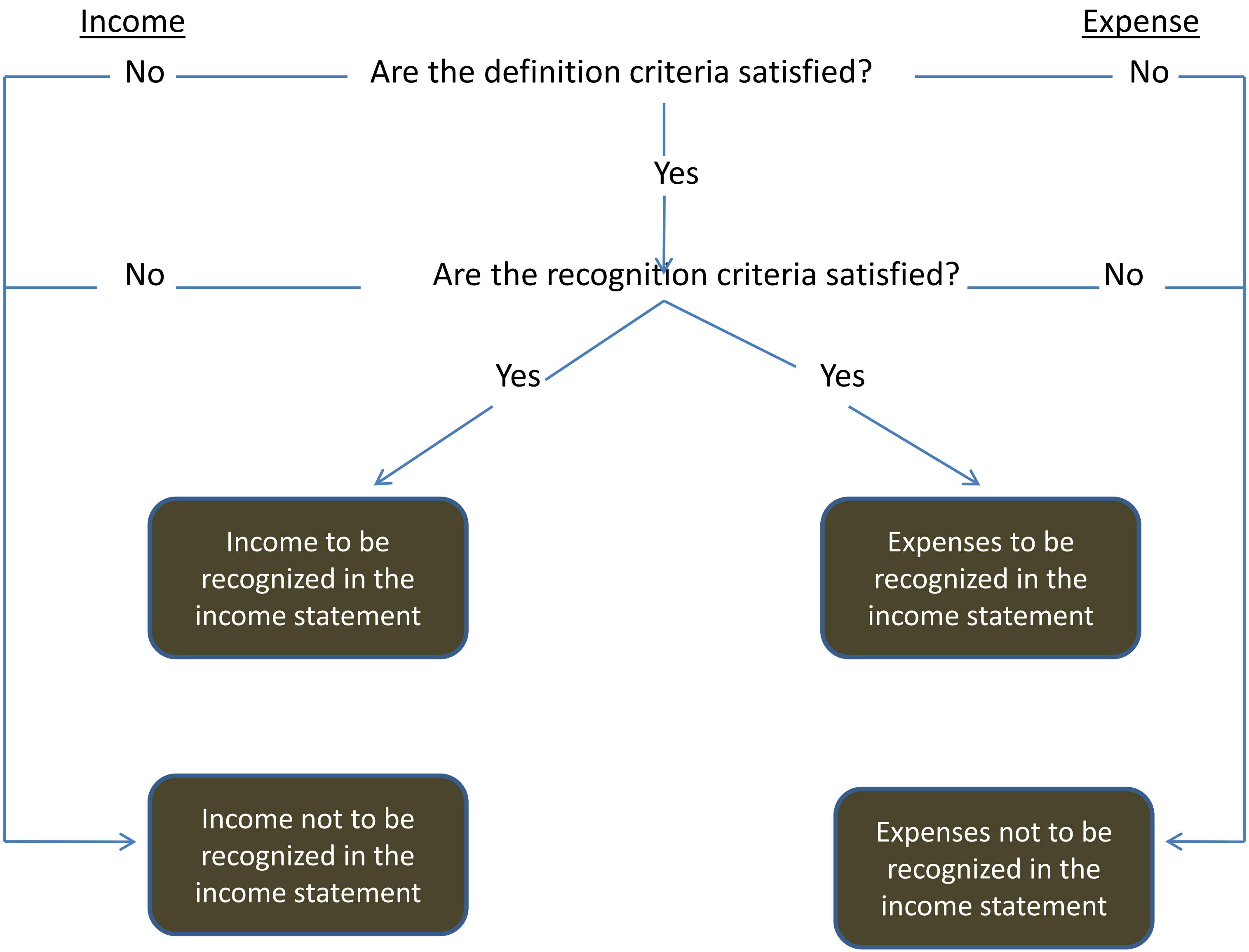
EXPENSES

Defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. (dividends & buy back)

Should identify when satisfy the following;

- Decrease in economic benefit is certain.
- Such outflow could measure reliably.

SUMMARY TO REMEMBER



PREPARATION & PRESENTATION

Appearance/format → External perspective
Appearance/format → Internal perspective

Entities which are govern by companies act, must comply with the SLFRSs and LKASs when preparing and presenting their financial statements.

Further, on the face of the income statement, following elements should disclose separately.

- Revenue
- Finance cost
- Share of profit/loss from associates/joint ventures
- Tax expenses
- Profit or Loss

It is a mandatory requirement to segregate/separate profit/loss from continuing & discontinuing operation.

Treatment in relation to the following elements is also require in income statement;

- Material income & expenses
- Extraordinary items

Entities which are not govern by the companies act (non-reporting entities), may prepare & present income statement as their own wish. No predetermined format or presentation requirement for such category of entities.

MEASURING FINANCIAL PERFORMANCE

- **Gross profit – GP**

  GP purely measures operational & production efficiency of the entity.

  GP = (Total sales – Cost of sales)

- **Net profit – NP**

  NP reflects end result of the operational activities for the given period of time.

  NP = [GP – (all administration & other operational expenditures)]

- **Pre – tax and Post – tax profit**

  Conceptually, users may not change their decisions considerably based on the effect of corporate income tax of the entity.

  PBT = (GP – operational expenditures)

  PAT = (PBT – income tax)

- **Pre – interest and Post – interest profit**

  Users may change their decision by analyzing the fact that how entity manage their finance and costs of funding.

  PBI = (GP – operational expenditures)

  PAI = (PBI – interest/finance cost)

- **Pre and Post depreciation & amortization profit**

  Both depreciation and amortization are not actual expenditures. SLFRSs/LKASs require identifying these as an expenditures and adjusting accordingly.

- **EBITDA**

  Real Profit

- **Pre and Post material items profit**

  Usually entities tend to prepare & present with this format/classification where no mandatory requirement.

- **Pro forma earnings**

  This depicts only actual income & expenditures for the given period of time and end result accordingly.

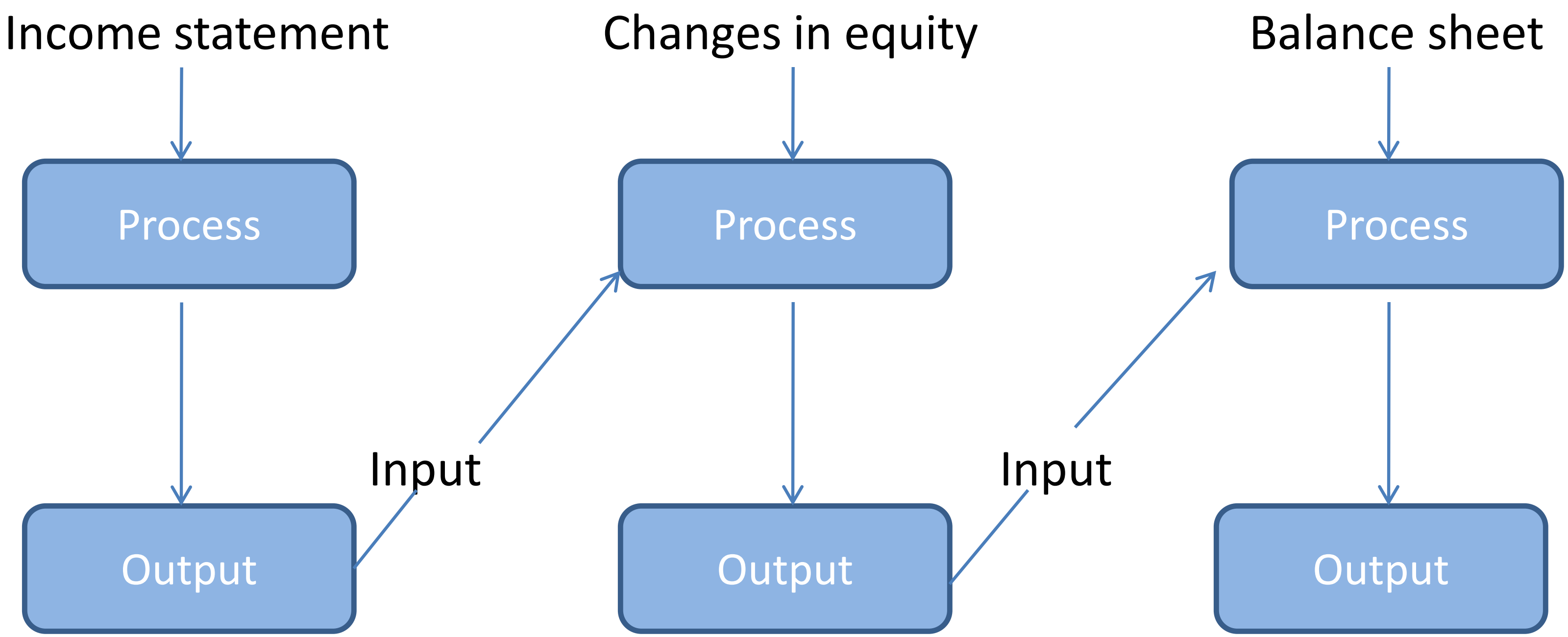
STATEMENT OF CHANGES IN EQUITY

The SLFRSs /LKASs require entities to prepare & present statement of changes in equity as one of the key element of sets of financial statements. This statement denotes the changes in equity from the beginning to the end of the reporting period.

Hence, the statement of changes in equity shows;

- Income & expenses recognized in the income statement and its results.
- Income & expenses directly recognized to the equity.
- Transactions are carried out with equity holders and end result of them.

RELATIONSHIP BETWEEN THREE ELEMENTS



STATEMENT OF CASH FLOWS

INTRODUCTION

Statement of cash flows clearly denotes **cash inflows** and **outflows** of the entity and end result of **net cash position** for the given particular period of time.

Cash is the **most liquid current asset** of the entity which carries significant level of importance as well as risk in operational activities. (Cash refers cash in hand & cash equivalents)

An entity could take following actions to enhance/improve cash position.

- Enhance cash revenue (expansion/diversifications)
- Expedite/enhance collection from trade debtors
- Reduce unnecessary cash investment in stocks and other STCA
- Sale of (**idle**) assets
- Seek low cost sources of finance (both ST & LT)
- Control Operational & maintenance expenditures (not cut or minimize)
- Defer capital expenditures (has to manage due to tradeoff)
- Maximum utilization of creditors’ support (ethically)

Careful analysis into cash flow statements provide the users below information.

- Ability to generate cash. (now and future)
- Ability to meet financial commitments/obligations including settlement of borrowings & dividends.
- Sources of cash generation and their nature.
- Ability to obtain external finance.

STATEMENT OF CASH FLOWS : FORMAT

Cash flow statement is a key element represents overall sets of financial statement. Hence, format of the cash flow statement is also governed by the accounting standards.

Cash flow statement can prepare & present either in Direct or Indirect method.

Generally, cash flows will be presented by categorizing in to following 03 areas.

1. **Operating Activities**

Cash inflows/outflows from major/key operational activities.

Receipts from customers (trade debtors)	xxxx
Payments to suppliers (trade creditors)	(xx)
Payments of other expenditures (utility)	(xx)
Inflows/(Outflows)	xx/(xx)

2. Investing Activities

Presenting cash inflows & outflows from investing activities which mainly comprised with movement (addition/disposal) of NCA.

Cash inflows from NCA	xxxx
Cash outflows from NCA	(xx)
Net cash inflow/(outflow)	xx/(xx)

3. Financing Activities

Depicts cash inflows & outflows with the effect of changing the composition of NCL. (including equity)

Cash inflows from NCL	xxxx
Cash outflows from NCL	(xx)
Net cash inflow/(outflow)	xx/(xx)

SUMMARY

Area	Cash inflows	Cash outflows	Link to other statements
Operating activities	• Receipts from customers • Interest received • Dividends received	• Payments to suppliers and employees • Interest paid • Taxes paid	Revenue and expenses items in the income statement
Investing activities	• Sale of property, plant and equipment • Receipt of loan payments • Sale of equity in other entities	• Purchase of property, plant and equipment • Purchase of equity in other entities	Assets in the balance sheet
Financing activities	• Borrowing cash • Proceeds from issuing shares	• Repaying borrowed cash • Payments to acquire or redeem the entity's shares • Payment of dividends	Liabilities in the balance sheet

PROFITABILITY VS CASH FLOWS

Reconciliation of cash flows from operational activities with the operating profit of an entity for a particular period shall basically be conducted by an entity.

Operating profit differs from operational cash flows due to following reasons.

- Accrual Vs Cash concept.
- Non - cash items available.
- Working capital increase/decrease.

Hence, under indirect method, this need to be adjusted at the beginning of cash flow statement within the operational activities category.

POINTS TO NOTE

Generally, perusal of cash flow statement communicates following alarming / warning signals to users/management/decision makers.

- Cash received < Cash paid.
- Operating cash outflow.
- Cash receipts from customers < Cash payments to Suppliers.
- Cash from operating activities < Operating Profit. (not same as others)
- Inflows from investing activities are inconsistent.
- Proceeds from borrowings > Repayment of borrowings.