

## Copyright Notice

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# SECTION A

## EXTERNAL FINANCIAL REPORTING DECISIONS

(15% of the CMA exam)





# Financial Statements

## ✓ Learning Objectives

### Financial Statements

For the balance sheet, income statement, statement of changes in equity, and the statement of cash flows, the candidate should be able to:

- a) Identify the users of these financial statements and their needs.
- b) Demonstrate an understanding of the purposes and uses of each statement.
- c) Identify the major components and classifications of each statement.
- d) Identify the limitations of each financial statement.
- e) Identify how various financial transactions affect the elements of each of the financial statements and determine the proper classification of the transaction.
- f) Demonstrate an understanding of the relationship among the financial statements.
- g) Demonstrate an understanding of how a balance sheet, an income statement, a statement of changes in equity, and a statement of cash flows (indirect method) are prepared.

### Integrated Reporting

With respect to integrated reporting, the candidate should be able to:

- h) Define integrated reporting (IR), integrated thinking, and the integrated report and demonstrate an understanding of the relationship between them.
  - i) Identify the primary purpose of IR.
  - j) Explain the fundamental concepts of value creation, the six capitals, and the value creation process.
  - k) Identify elements of an integrated report (i.e., organizational overview and external environment, governance, business model, risks and opportunities, and presentation).
  - l) Identify and explain the benefits and challenges of adopting IR.

## A.1.1. Financial Statements

### A.1.1.1. Identify the users of these financial statements and their needs

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.<sup>1</sup>

Financial accounting develops financial information for decision-makers such as share-holders to make investment decisions and evaluate management's actions and the results thereof, for suppliers to assess short-term liquidity, financial institutions to decide whether a loan should be granted to a company or not and government regulatory agencies to evaluate compliance with SEC or inspect if the company is filing the correct income tax.

Users of financial statements can be classified into primary and secondary users:

Existing and potential investors, lenders, and other creditors have the most critical and immediate need for the information in financial reports, and many cannot require the entity to provide the information to them directly.<sup>2</sup> They are the primary users to which financial statements are primarily directed.

1. Existing and potential investors – For existing investors, financial statements may provide an indication of how well management is effective and efficient in managing its resources and may be used in deciding whether to hold or sell its outstanding shares. For potential investors, financial statement information is important in choosing the best investment opportunity that will yield the highest favorable return.
2. Existing and potential lenders and other creditors – Information about a reporting entity's financial performance may reflect the ability to generate future net operating cash inflows and consequently, may suggest liquidity and solvency. Thus, existing and potential lenders and other creditors are generally concerned about the entity's ability to pay its liabilities.

Secondary users are parties to which financial statements are not primarily directed. Users other than primary users are considered as secondary users such as customers, employees, the government, and its regulatory agencies and the general public.

1. Customers – Customers may need to know if a company will be able to cater to their increasing supply needs in the future.
2. Employees – Employees may be interested in financial statements to determine the stability of the company's performance so as to secure employment and ask for salary increases if favorable results can be attributed to employee's performance.
3. Government and its regulatory agencies – They are more concerned about the compliance of business and non-business organizations to tax statutes and SEC reporting requirements. The government also uses the information to monitor economic development by analyzing financial statements from different industries.

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<sup>1</sup>FASB Statement of Concepts No. 8 issued September 2010, Chapter 1, paragraph OB2.

<sup>2</sup>FASB Statement of Concepts No. 8 issued September 2010, Chapter 1, paragraph BC 1.16.

4. The General Public – Information may be useful in different ways to several users other than mentioned above. For example, the general public may be concerned if the organization will be able to sustain financing for social responsibility programs appropriated for social welfare, poverty alleviation, and environmental preservation.

However, a complete set of financial statements may not necessarily provide all the information needed by each user. They need to look for other information which may affect their decision such as economic forecasts, political climate, legal environment, and technological evolution.

#### **A.1.1.2. Demonstrate an understanding of the purposes and uses of each statement**

Financial statements are the medium to which financial information is communicated to its users. A complete set of financial statements include the following:

1. Statement of Financial Position (Balance Sheet) at the end of the period
2. Statement of Earnings (Income Statement) for the period
3. Statement of Comprehensive Income for the period
4. Statement of Cash Flows during the period
5. Statement of Changes in Stockholder's Equity during the period

#### **Statement of Financial Position (Balance Sheet)**

A statement of financial position informs the reader what the company owns (assets), how much the company owes to its creditors (liabilities) and the residual interest of the company (equity). The balance sheet's fundamental accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

The balance sheet reflects the financial position of an entity at a particular point in time. Balance sheet statement accounts are real or permanent accounts which are carried forward into the next accounting period. Therefore, the balances reflected in a statement of financial position are the accumulation of transactions from the inception of the entity to the current reporting period.

A typical balance sheet would have a period heading that starts with "As of". For example, "As of December 31, 2015" if the company opts a calendar year or any date if on a fiscal basis.

A statement of financial position does not purport to show the value of a business enterprise but, altogether with other financial statements and other information, should provide information that is useful to those who desire to make their own estimates of the enterprise's value.<sup>3</sup>

Important uses of information about an entity's financial position include helping users to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk.<sup>4</sup>

<sup>3</sup>FASB Statement of Concepts No. 5 issued December 1984, paragraph 27.

<sup>4</sup>FASB Statement of Concepts No. 5 issued December 1984, paragraph 29.

## Income Statement (also known as Statement of Earnings, Profit and Loss Statement or Statement of Operations)

The Income statement reflects what the company earned (revenues) and how the resources of the company were spent (expenses) in order to produce those revenues over a period of time. The income statement equation is:

$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$

Income statement accounts are nominal or temporary accounts that are closed at the end of the reporting period to the Retained Earnings equity section of the balance sheet. Therefore, at the beginning of each calendar or fiscal year, all income statement accounts are zero.

Unlike the balance sheet, the income statement presents the financial performance of an entity during a specified period of time. (e.g., "For the Year Ended December 31, 2015" for the calendar year or any date if on a fiscal basis).

Net income or net profit or earnings is partial as compared to comprehensive income. However, it may be useful in predicting future cash flows and forecasting financial performance of an entity by excluding items that may distort financial analysis such as the unrealized holding gains or losses from available-for-sale securities which go directly to shareholders' equity.

The income statement is also useful in evaluating the financial performance of an entity within a reporting period in comparison to competitors and industry standards.

## Statement of Cash Flow

The Statement of Cash Flows (SCF) is the report that contains the inflows and outflows of cash during a specified period of time. The sources and uses of cash can be classified as:

- a) Operating Cash Flows – includes cash flows from transactions that affect the firm's normal operations such as cash received from customers and cash paid for suppliers.
- b) Investing Cash Flows – contains cash flows that relate to the acquisition and disposal of non-current assets such as cash paid for the acquisition of fixed assets.
- c) Financing Cash Flows – consists of cash flows from transactions affecting long-term debt and equity or the capital structure of an entity such as the issuance of bonds and common stock.

Similar to the income statement, it presents the sources and uses of cash in a particular reporting period. (e.g., "For the Year Ended December 31, 2015" for the calendar year or any date if on a fiscal basis).

It provides useful information about an entity's activities in generating cash through operations to repay debt, distribute dividends, or reinvest to maintain or expand operating capacity; about its investing and spending of cash. Important uses of information about an entity's current cash receipts and payments include helping to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk.<sup>5</sup>

<sup>5</sup>FASB Statement of Concepts No. 5 issued December 1984, paragraph 52.

## Statement of Comprehensive Income

Comprehensive income includes all changes in equity except those transactions executed by the owners of the company, such as the owner's contribution and distribution. Comprehensive income is broader in scope as compared to the income statement by including all changes in equity except for shareholder transactions.

The statement of comprehensive income encompasses all items that are included in the income statement, but the income statement may not comprise all items that are reflected in the statement of comprehensive income. Thus, comprehensive income consists of net income and *other comprehensive income*.

The other comprehensive income items which are not included in the net income are the following:

- a) Foreign currency translation gains and losses.
- b) Gains or losses and prior service costs or credits related to a defined benefit pension plan that have not been recognized as components of net periodic benefit cost.
- c) Unrealized holding gains or losses on available-for-sale securities, and;
- d) The effective portion of the gain or loss on a derivative designated as a cash flow hedge.

## Statement of Changes in Stockholders' Equity

The statement of changes in stockholders' equity is simply the reconciliation of the transactions affecting the balances of each of the stockholders' equity accounts, including the capital stock, additional paid-in-capital, retained earnings and accumulated other comprehensive income, during a specified period of time. Stockholders' equity accounts as a component of the balance sheet are permanent accounts in which transactions were accumulated to date, and transactions in between the beginning and ending balances make the financial statement useful.

Investments by owners establish or increase ownership interests in the entity and may be received in the form of cash, goods or services, or satisfaction or conversion of the entity's liabilities. Distribution decrease ownership interests and include, not only cash dividends when declared (or other cash withdrawals by owners of non-corporate entities) but also transactions such as re-acquisitions of the entity's equity securities and distributions "In-kind" of non-cash assets. Information about those events is useful, in conjunction with other financial statement information, to investors, creditors, and other users as an aid in assessing factors such as the entity's financial flexibility, profitability, and risk.<sup>6</sup>

### A.1.1.3. Identify the major components (elements) and classifications of each statement

Elements of financial statements are the building blocks to which financial statements are constructed – the classes of items that financial statements comprise.<sup>7</sup>

<sup>6</sup>FASB Statement of Concepts No. 5 issued December 1984, paragraph 56.

<sup>7</sup>FASB Statement of Concepts No. 6 issued December 1985, paragraph 5.

Elements refer to main categories such as assets, liabilities, equity, revenues, gains, expenses, and losses. Other specific financial representations and transactions such as cash, accounts receivables, and inventories may meet the definition of elements but are not considered elements.

Although notes to financial statements are described in some authoritative pronouncements as an integral part of financial statements, they are not elements. They serve different functions, including amplifying or complementing information about items in financial statements.<sup>8</sup>

## Statement of Financial Position (Balance Sheet)

### ELEMENTS (MAJOR COMPONENTS) OF THE BALANCE SHEET

The balance sheet's fundamental accounting equation is also the representation of its elements. The elements (major components) of the balance sheet are the assets, liabilities, and the equity of an entity.

- a) Assets are the resources owned or controlled by an entity as a result of past transactions or events in which future economic benefits are expected to be realized.
- b) Liabilities are the present obligations of an entity as a result of past transactions or events in which future outflow of economic resources are expected to be settled.
- c) Equity is the owner's residual interest in the assets of an entity after deducting the liabilities.

### CLASSIFICATION OF THE ELEMENTS OF THE BALANCE SHEET

Let us classify each of the elements of the balance sheet:

A classified balance sheet will distinguish assets and liabilities into current assets and non-current assets and current liabilities and non-current liabilities based on how long they are likely to persist.

#### CURRENT ASSETS

Current assets are the assets of an entity that are expected to be converted into cash or consumed within one year or the *operating cycle*, whichever is *longer*.

Operating cycle is the average time between the acquisition of assets (usually inventories) and the conversion of those assets into cash.

Current assets include:

#### 1. Cash and cash equivalents

Cash includes currency on hand (coins and paper bills), demand deposits, money order, bank draft, and unreleased checks.

Cash equivalents refer to short-term, highly liquid investments that are readily convertible into a known amount of cash with an insignificant change of value due to changes in interest rates and will be maturing *within three months or less from the date of acquisition*. Examples include treasury bills, commercial paper, and money market funds.

#### 2. Trade or accounts receivable are financial assets, which represent the amount owed by a customer for the sale of goods or rendering of services *on account or on credit*.

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<sup>8</sup>See 7.

3. Short-term notes receivable
4. Receivables or loans due from officers, employees, and other parties, which is due within one year from the balance sheet date.
5. Inventories such as raw materials, work-in-process inventories, and finished goods.
6. Marketable securities intended as an investment for current operations which will be realized into cash within one year or the operating cycle, whichever is longer. Marketable securities classified as trading securities are mostly current assets unless they otherwise qualify as non-current assets.
7. Prepaid expenses are future expenses that are paid in advance, which will be recognized as an expense upon satisfaction of its economic benefit, which may vary depending on its purpose. Examples are payment of office rent in advance in which the expenses will be recorded, usually at the end of each month, as the entity uses the office space. Other examples include prepaid advertising and prepaid insurance.

#### NON-CURRENT ASSETS

Non-current assets are the assets of an entity that are *not* expected to be converted into cash or consumed within one year or the operating cycle, whichever is longer.

Generally, all assets that do not fall under the definition of current assets are considered non-current assets.

Non-current assets include:

1. Cash items that are restricted as to withdrawal or use for purposes other than current operations are appropriated for the purchase or construction of non-current assets or are reserved for the settlement of non-current liabilities.
2. Long-term receivables and investments such long-term loans and receivables, trading securities in which management intends to hold for a period of more than one year or more than the operating cycle, whichever is longer, available-for-sale securities which are not available for current operations, and held-to-maturity securities maturing for more than one year or more than the operating cycle, whichever is longer, cash surrender value of a life insurance policy and fixed assets which are idle or held for future use.
3. Property, plant and equipment are tangible assets that are utilized for operations and which are expected to be utilized for more than one year or the operating cycle, whichever is longer. Examples include land, land improvements, buildings, machinery and equipment, furniture, leased or borrowed right-to-use assets.
4. Intangible Assets are assets without physical substance, but from which probable economic benefit to the entity is expected to be realized. Examples of intangible assets are patents, copyrights, trademarks, and goodwill. Intangible assets may be purchased or internally developed. However, for purposes of financial reporting, internally created are not recorded on the balance sheet.

#### CURRENT LIABILITIES

Current liabilities are the liabilities of an entity that are expected to be settled within one year or the *operating cycle*, whichever is *longer*.

Current liabilities include:

1. Trade and accounts payable resulting from the ordinary course of business of an entity.
2. Unearned revenues are advance payment or deposit for future delivery of goods or services.
3. Accrued expense which arises from current operations or within the operating cycle such as accrual for salaries, commissions, and rent.
4. Short-term notes payable.
5. Notes which are payable immediately upon demand
6. Current portion of long-term debt due within one year from the balance sheet date.
7. Agency obligations where an entity acts as an agent to collect or hold money for purposes of remitting it in the future. For example, holding client funds in escrow or as part of a service to pay bills to a third party.
8. Dividends Payable arises from the distribution of retained earnings to stockholders.
9. Long-term debt which has been rendered as callable at the balance sheet date due to a violation of a loan agreement.

#### NON-CURRENT LIABILITIES

Non-current liabilities are the liabilities of an entity that are *not* expected to be settled within one year or the *operating cycle*, whichever is *longer*.

Generally, all liabilities that do not fall under the definition of current liabilities are considered non-current liabilities.

Non-current liabilities include:

1. Long-term notes payable or bank loans
2. Long-term bonds payable
3. Non-current liabilities under capital or finance leases.
4. Post-retirement benefit obligations
5. Long-term deferred tax liabilities-are future income tax liabilities arising from taxable temporary differences. Note that if the net of all long and short-term deferred tax assets and liabilities is a liability, that number is presented here.
6. Obligations under product or service warranty agreements
7. Advances and deposits in which the entity committed for long-term delivery of goods or services.
8. Deferred revenues.

#### CLASSIFICATION OF EQUITY ACCOUNTS

As defined, equity is the residual interest in assets after deducting all of the entity's liabilities.

Equity includes:

1. Capital stock or the par value or stated value of the issued capital.