FINANCIAL STATEMENTS AS DESCRIPTION OF BUSINESS ACTIVITY

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1. Introduction

Each enterprise executes a number of activities aimed at providing saleable products and achieving profitability of invested funds at the same time. Financial (accounting) statements and associated reporting duties serve to give information about four main activities of any enterprise. These are:

- planning;
- financing;
- investment activity;
- operating activity

It is important to understand each of these activities prior to detailed analysis of financial statements.

2. Business activities in a free market economy

2.1. Planning

Each enterprise has its own intentions and objectives [1; 2; 3]. These intentions and objectives are included in a business plan which describes the reason for the existence of the enterprise and its strategies and tactics for the performed activities. The business plan serves managers to target their activity in accordance with this plan and to identify emerging possibilities or obstacles. A detailed knowledge of such a business plan significantly helps to analyze the current and future situation of the enterprise. Following are the fundamental facts for the analysis: information about business objectives and strategies how to achieve these, about market needs, competition analysis, sales strategy (price, distribution and marketing policy), about management efficiency and financial projections. Information of this kind, sometimes in various forms, is often included in financial statements. This information can be frequently obtained also in a more informal way, via news in business and academic press, specialized publications, views of analysts etc. Letters to shareholders and other information in the annual report of an enterprise are also important sources of information about a business plan.

At the same time, it is certainly important to realize that business planning is not unchanging and collides with the dynamic situation which brings the issue of risk into the analysis. Some business activities are riskier than others. Analysis of financial statements helps to estimate the size of earnings or uncertainty and enables better decision making with a higher level of information. Although the information taken from financial statements does not offer infallible answers it quite positively helps to judge the whole situation of the enterprise, and to better understand its financial, investment and operating needs.

2.2. Financing

Each enterprise has to provide financing for its business plan. With regard to the extent of financing and its determining influence on a successful or unsuccessful activity of an enterprise, financing must be an object of exceptional attention. In principle, two main sources of financing are available: owners and creditors. Decisions affecting structure of financing are connected to the conditions existing on financial markets. Financial markets are a potential source of financing. When

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examining how to use these financial markets, the enterprise has to take into account several circumstances, mainly the amount of necessary financial means, financial sources (owners or creditors), the time horizon of repayment and the structure of financial agreements. The decisions about these circumstances then determine also the organizational structure of the enterprise, affect growth of the enterprise and also its risk rate, and they likewise determine authority of external subjects.

1. Equity financing
   Owners (investors) are the main source of financing on developed capital markets. The objective of their interest is, therefore, the return on their investments. This return on investment can have two forms:

- distribution of earnings;
- reinvestment of earnings.

An enterprise executes the distribution of earnings by paying cash (or other assets) to its investors. The dividend paid represents the part of distributed earnings and is very often expressed as a percentage of earnings. The reinvestment of earnings means an increase of the enterprise's value. The growth of shareholders' equity represents the sum of reinvested earnings and similarly is often described as a percentage of shareholders' equity.

Financing via investors can have the form of cash or noncash investment in exchange for shares. Private share issue usually means the sale of shares to predetermined individuals or institutions. Public issue represents the sale of shares to public investors. The public issue is often accompanied by considerable expenses related to requirements of stock exchanges, regulatory bodies, underwriters etc. A number of large companies list their shares on stock exchanges.

2. Debt financing

The second way of financing is to receive funds from creditors. Typical instruments of this type of financing are loans. Banks, savings banks and other financial or non-financial institutions represent wide spectrum of creditors. These creditors are also e.g. the employees of the enterprise that receive their wages weekly or monthly. There are many more implicit creditors such as suppliers and tax authorities.

Debt financing differs from equity financing in the way that there usually is a contract or an agreement which specifies the repayment of the borrowed sum together with the interest during the given time schedule. This time interval can vary a lot and ranges from one or a few days up to e.g. fifty years.

Like investors, creditors also take return and risk into account. In contrast to investors, the return of a creditor is usually specified in the applicable contract. E.g. a contract on a long-term loan will very clearly specify the interest rate either on a fixed or a floating basis. The creditors' risk is the probability that the enterprise will be unsuccessful and will not repay the principal and/or the interest of the loan. In such cases, creditors may not get their investment fully back and it usually results in a declaration of insolvency or other legal proceedings. Such scenarios may bring various outcomes.

2.3. Investment activity

Investment activity is generally understood as the activity connected to obtaining a particular asset that is expected to bring future economic profit for the enterprise.

Information about financial and investment activities helps to answer the question of the enterprise's efficiency. Various enterprises differ to the extent and structure of their investment. Many enterprises demand extensive investment in order to ensure their activity, whereas others carry forward with low investment. The size of investment does not necessarily determine the success of the enterprise. This is determined by the efficiency of the enterprise's activity.

Investment decisions include a number of factors such as: the type of necessary investment (together with its capital and labour intensity), the demanded level of investment time schedule, place and relevant contract insurance (purchase or leasing). Similarly to financing, investment activities affect the organizational structure of the enterprise (centralization or decentralization) and affect the growth and risk rate of business activity.

The total level and structure of investment provides important information about profitability of the enterprise for both internal and external users.

2.4. Operating activity

The analysis of the operating activity of an enterprise is one of the important parts of the total observation. Operating activity of the enterprise in fact means the execution of the business plan based on the current financing and investment policy. For example, the operating activity of a manufacturing enterprise has at least four basic parts:

- research activity;
- purchasing activity;
- manufacturing activity;
- marketing activity.

The final mix of these fundamental components depends on the type of business activity, plans of the enterprise and on the input markets. Input markets are in principle markets which provide production inputs (labour market, market for machinery and equipment). Management of the enterprise has to determine the best possible structure of the components of the operating activity in order to ensure competitiveness of its enterprise.

The operating activity of the enterprise is the primary source of its income. The way which an enterprise chooses to execute its business plan and strategies, and furthermore how it combines single components of operating activity, determines success or failure of the enterprise.

3. Financial statements as a description of business activity

Execution of business activity (planning, financing, investment and operating) enables the activity of the enterprise under free market conditions [4; 5]. In practice, this process is of course constantly in progress. At the beginning, the enterprise has to have its business plan and strategy defined. Then, the enterprise must secure its finances, either via investors or creditors. Financing serves to fund the provision of land, buildings, machinery and equipment, material, labour and other sources necessary for production of goods or provision of services. The amount of money needed for investment activity is specified in the business plan. Investment activity and financing are closely inter dependant since investment cannot exceed financial sources. Having secured the financing and implemented investment activity, the enterprise starts its manufacturing activity aimed at fulfilling its business plan. The operating activity results from the combination of planning, financing and investment activity.

At the end of a given term (e.g. quarterly, monthly), financial statements are compiled. These statements bring updated information about financing, investment and operating activity. The financial statement describing financing and investment activity characterizes the situation at a given point in time. On the other hand, the financial statement describing the operating activity represents a particular period of time. The basic financial statements (balance sheet, profit and loss account, cash flow statement) are going to be briefly described. Three other financial statements (statement of changes in equity, retained earnings statement, statement of comprehensive income) are not covered by this article.

3.1. Balance Sheet

The basic function of a balance sheet is to provide an overview of a financial situation of the enterprise at a particular point in time. The importance of the balance sheet is determined by the fact that its analysis shows how successfully the enterprise fulfilled its basic tasks (economic stability and progress development). The task of maintaining economic stability lies in the optimization of assets, optimization of sources (single components of used capital) and furthermore in the finding of an optimal interrelation between the enterprise's assets (its components) and the types of used capital.

Enterprises compile their balance sheets at least once a year at the end of the accounting period. However, many enterprises compile their quarterly and monthly balance sheets in addition. Compilation of balance sheets for such shorter intervals is indispensable for the routine management.

The balance sheet summarizes the financial situation of the enterprise at a particular moment in time.

The basic balance equation can be then expressed as follows:

investment activity = financing

In more detail:

investment activity = equity financing (financing by investors) +debt financing (financing by creditors)

3.2. Income statement (profit and loss account)

The basic function of an income statement is to give information about expenses, revenues and operating profit (or loss) of an enterprise during a particular exactly specified period. Like the balance sheet, the income statement is usually compiled for a yearly period. Numerous enterprises also compile quarterly and monthly income statements that are indispensable for routine management.

The information about operating profit of the enterprise has a very extensive use:

- for executives of the enterprise, it serves as a criterion of successful or unsuccessful management during a given period and, also as the initial information and guidance for the adjustment of the enterprise's business in the future;
- operating profit is a starting basis for the calculation of corporate tax which is the basic form of taxation of enterprises;
- operating profit gives meaningful information for the decision making about possible future growth as well as about the determination of e.g. dividends;
- for shareholders (owners), creditors, banks and other external bodies, it is the main criterion of good or bad performance of the enterprise in a particular period, the criterion of earning ability of the enterprise.

When calculating the operating profit, various principles are generally applied, e.g. accrual principle (revenues are accredited to the period of their origin irrespective of the cash inflow, and similarly, expenses are recorded irrespective of the cash outflow), realization principle etc.

In terms of operating profit, the important decision is which components of profit (and loss) should be included in the operating profit. In this regard, two basic concepts of operating profit are distinguished:

- operating profit includes all profits (losses) in the given period, i.e. regular profits (losses) and also profits (losses) of extraordinary nature;
- operating profit should be the criterion of earning ability of the enterprise and as such it should not include extraordinary profits (losses) arisen during the particular period.

Both mentioned concepts of operating profit have their advantages and disadvantages. In present practice, the usual procedure is to include both regular profit (loss) and extraordinary profit (loss) while the extraordinary items are recorded separately.

3.3. Cash flow statement

The term cash flow is a flow quantity which reflects increases (decreases) of cash and cash equivalents in the course of economic activity of an enterprise in a given period of time. Cash flow statement compares single sources of generation of cash and cash equivalents against their use. Its function is to provide information about cash flows connected to the operating activity of the enterprise in the given period of time and also information about investment and financing activity of the enterprise. This constitutes the structure of the statement that respects the division of business activity into three basic fields:

- operating activity;
- investment activity;
- financing activity

The cash flow statement has an unsubstitutable relevance for managing the enterprise. It is used for the analysis of causes of changes in the total of cash and cash equivalents, for observation and assessment of liquidity etc.

3.4. The interconnections among financial statements

Time connections exist among financial statements. E.g.the balance sheet illustrates operating activity, investment activity and financing at a given point in time. In contrast, the cash flow statement and income statement characterize changes during a particular time period. Each operation recorded in these two statements has its reflection on the balance sheet. For example, expenses and revenues determine net profit and are subsequently projected into retained earnings from past periods. Cash operations recorded on the cash flow statement aggregately occur as cash on the balance sheet etc.

4. Conclusions

The results of financial accounts do not appear only on the above described formal financial statements. These statements can be supplemented by a number of other facts from various sources. Therefore, a thorough analysis of financial statements must be accompanied by an analysis of supplementary information from the notes to financial statements.

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Summary

Thus, a summary can be made that financial statements are mutually interconnected. The data on the balance sheet which represent the state at a given moment are explained in other two statements. However the characteristic feature is that they always describe operations for a particular period of time.

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