DOI 10.5281/zenodo.6758786
CZU 657.37:005.332.5(478)

RELEVANCE OF INFORMATION PRESENTED IN FINANCIAL STATEMENTS FOR EXTERNAL USERS

RELEVANȚA INFORMAȚIEI PREZENTATE ÎN SITUAȚIILE FINANCIARE PENTRU UTILIZATORII EXTERNI

Lica ERHAN, ORCID ID: 0000-0001-5204-6367
lica.erhan@ase.md
Luminița GRECU
grecu.luminita@ase.md
Academy of Economic Studies of Moldova, Republic of Moldova

Abstract. *Financial statements are an important source of information for different external users in determining and analyzing the financial health, profitability of the company, as well as various financial problems that it might face. However, not all the time the financial statements present enough information or the included one is irrelevant.*
The purpose of this research is to understand the ways in which financial statements are useful for different external users such as investors, creditors, business partners, and governmental units.
Moreover, through the analysis of the full, simplified and abridged financial statements, we aim to determine which of these 3 types are the most suitable for external users, as all of them include different information.
Out of the 3 types of financial statements we currently use in the Republic of Moldova, the most exhaustive and useful is the complete one, as it provides information about the financial health of the entities from different point of view.
Nevertheless, there are some aspects, from the international practice, that national authorities should consider, such as: including information about interest rates on loans, the amount of depreciation of fixed assets, as well as information related to the compromised receivables and liabilities.

Keyword: financial statement, external user, accounting, report, entity
JEL: M41, F65

Introduction

Financial statements are an important source of information for different external users in determining and analyzing the financial health, profitability of the company, as well as various financial problems that it might face. However, not all the time the financial statements present enough information or the included one is irrelevant.

In the Republic of Moldova, according to Article 4 from LAW No. 287 of December 15, 2017 on Accounting and Financial Reporting, the entities are classified according to several criteria:

- Micro entity (total assets ≤ 5 600 000 MDL, sales revenue ≤ 11 200 000, average number of employees ≤ 10);
- Small entity (total assets ≤ 63 600 000 MDL, sales revenue ≤ 127 200 000, average number of employees ≤ 50);
- Medium-sized entity (total assets ≤ 318 000 000 MDL, sales revenue ≤ 636 000 000, average number of employees ≤ 250);
- Large entity (total assets > 318 000 000 MDL, sales revenue > 636 000 000, average number of employees > 250).

In turn to this classification, the manner of keeping the accounting differs. Therefore, according to Article 5 from LAW No. 287 of December 15, 2017 on Accounting and Financial

Reporting, different categories of entities must keep the accounting according to either IFRS standards or NAS standards:

- Public interest entities apply IFRS and elaborate their financial standards according to it;
- Medium-sized and large entities apply NAS and present full financial statements;
- Small entities apply NAS and present simplified financial statements;
- Micro-entities and individuals that conduct entrepreneurial activity apply NAS and present abridged financial statements.[100]

The purpose of this research is to understand the ways in which financial statements are useful for different external users such as investors, creditors, business partners, and governmental units.

These four categories are the main external users who require an excellent and precise analysis of the financial statements, as investors need to understand if they should invest or not in the respective company, creditors if they should grant a loan to that company, business partners should determine if the company is worth collaborating with, and the government should determine whether the company is obeying the law and is establishing fair prices or not.

Moreover, through the analysis of the full, simplified and abridged financial statements, we aim to determine which of these three types is the most suitable for external users, as all of them include different information:

- Full financial statement includes the Balance Sheet, the Statement of Profit or Loss, the Statement of Cash Flows, and the Statement of Changes in Owner's Equity;
- Simplified financial statement includes just the Balance Sheet and the Statement of Profit or Loss;
- Abridged financial statement includes abridged Balance Sheet and abridged Statement of Profit or Loss.

All of the above mentioned emphasize the relevance of the given topic as the information provided by entities differ and the analysis external users perform can neglect important details.

Basic content

Analyzing the legal framework regarding financial reporting in the Republic of Moldova the national authorities may justify that the information required from entities is diversified and is according to the amount of activity they perform on the market. However, analyzing Figure 1 it is visible that more than 98% of the total entities from Moldova are SMEs, these entities being required to present only their Balance Sheet and Statement of Profit or Loss, which are lacking details, data and indicators for a comprehensive understanding of the financial health of the entity.

[100] Legea contabilității și raportării financiare Nr. 287 din 15-12-2017. Publicat : 05-01-2018 în Monitorul Oficial Nr. 1-6 art. 22. [online]. [accessed 20.03.2022]. Available on: < https://www.legis.md/cautare/getResults?doc_id=120938&lang=ro >.

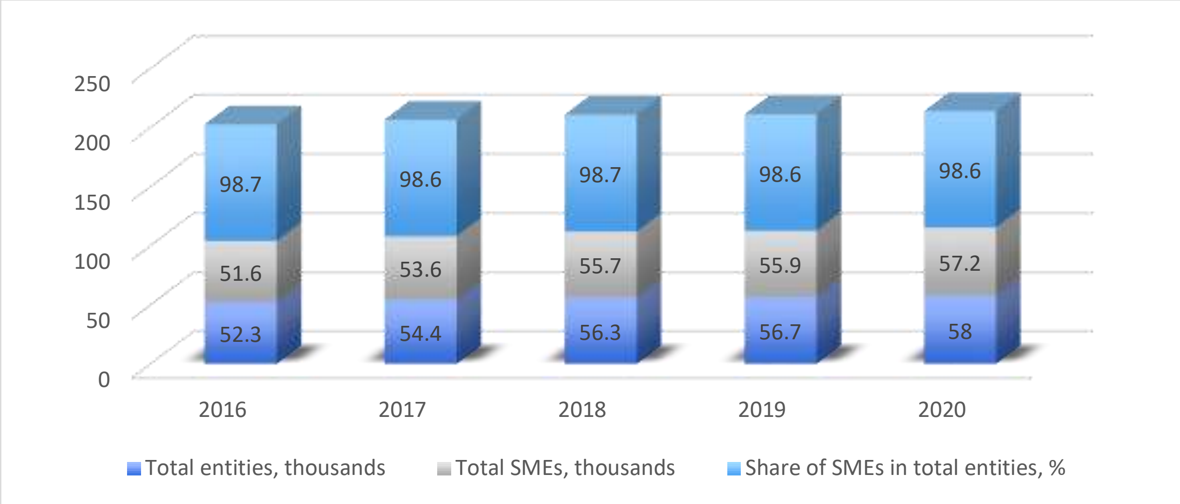

Figure 1. Dynamics of the SME sector in the Republic of Moldova

Source: elaborated by the authors based on the information from the National Bureau of Statistics from the Republic of Moldova.

Referring to the information external users usually analyze, investors are the most common external users of financial statements. Equity investors make and assess their investment decisions by using relevant financial information in a company's financial statements, including the Balance Sheet and the Statement of Profit or Loss. These are the two basic sets of financial statements to give an account of a business' positions of assets, liabilities, and equity at the end of an accounting period, as well as revenues, expenses, and profit (loss) for the accounting period.[101] Financial information is important for an investor for making sure that the investment is secure. Usually, investors analyze net profit, sales, margins, cash flow, debt, accounts receivable turnover, breakeven point.

Financial statements will reveal a company's net profit. The net profit is the money that a business has left over after paying all expenses. "Is the company making money?" is often the first question asked, but it is only a starting point. Unsustainable profits are bad, and losses can be good if the entity is on track to profitability as it scales up. However, as many business owners do not often have a clear understanding of their net profit, this is a good place to start.

Sales are meaningless if the entity is not making money. Investors also want to see profit margins both overall and at the individual product level.

Investors view of cash in the bank as a sign that the entity can deal with unexpected problems and capitalize on new opportunities. Free cash flow, the amount of cash that is left after it meets expenses each period, is a sign of sustainable operations. If a company has both, investors will not have to worry that it could go under at any time.[102]

They will also compare the company's margins against industry standards and their other available investment opportunities. Higher margins generally lead to a better return for investors.

For investors the abridged financial statement has a low level of information: no clear debt structure, no information about cash flows, poor information about the revenues and expenses. A better situation is in the case of simplified ones: sufficient about the debt structure, as well as the revenues and expenses, no information about the cash flows and the equity structure. However, the

[101] Common External Users of Financial Statements. [online]. [accessed 20.03.2021]. Available on: < https://quickbooks.intuit.com/ca/resources/marketing/common-external-users-financial-statements/ >.

[102] Najjar, D., *What Investors Want to See in Financial Statements*. [online]. 2021. [accessed 20.03.2022]. Available on: < https://www.thebalancesmb.com/what-investors-want-to-see-in-financial-statements-4067557 >.

complete financial statement has the highest level of information: there is information for the majority of the indicators required by investors: cash flow, sales, profit, equity structure, etc.

Creditors or lenders use the accounting information to find out the ability of the borrower to repay the loan, the number of assets and liabilities of the borrower, evidence of income, economic position, before he or she lend the money to the economic entity. Lenders are likely to look into a company's total existing debt level as stated in the balance sheet to determine if the business is overleveraged and how safe its credit claims may be. They study also the statement of profit or loss in particular, the earnings before interest, tax, depreciation and impairment to be sure that the business earns enough profit to cover its interest payments.

Usually, they analyze current ratio, quick ratio, debt-to-equity ratio, EBITDA, sources of loan repayment. Current is defined as the coming 12 months. Assets include cash, receivables, inventory and prepaid expenses, while liabilities include accounts payable, credit cards and accrued expenses. A current ratio of more than 1.2 is generally accepted as a good ratio. Creditors use this ratio to determine the ability of a business to repay its debt over the next year.

Creditors use the debt-to-equity ratio to determine the relative proportion of shareholders' equity and debt used to finance a company's assets. This ratio gives creditors an understanding of how the business uses debt and its ability to repay additional debt. The formula for determining debt-to-equity is total business liabilities divided by shareholder's equity. How creditors evaluate the debt-to-equity ratio varies depending on the type of business or industry.

Creditors analyze business financial statements to determine how a business will repay a loan or additional debt, with cash flow considered the primary source of debt repayment. Since existing cash flow may not be enough to cover additional debt, creditors look for growth trends, one-time expenses that affected cash flow, debt elimination, discretionary spending and expiring obligations to estimate future cash flow.

While cash flow is typically considered a primary source of loan repayment, it may not be sufficient to cover operating expenses and additional debt repayment. Estimating cash flow can also be difficult for start-up businesses or business expansion. Creditors utilize financial statements to determine secondary sources of loan repayment, also referred to as collateral, such as business-owned real estate, equipment, receivables or inventory. In the event a business is unable to repay its debt, the creditor may be able to liquidate these items to satisfy the debt.[103]

For creditors the abridged financial statement does not offer enough information: no details about current assets and current liabilities, not enough information to calculate depreciation and quick assets, as well as too little information about taxes. The simplified one contains detailed current assets and current liabilities information, enough information to calculate quick assets, but low information about taxes and the evolution of cash flows. The best situation is in the case of the complete financial statement: there is information for the majority of the indicators required by creditors: cash flow, sales, profit, equity structure, as well as other indicators required for the calculation of different ratios.

Business partners, such as suppliers and service providers, use financial information for various reasons. They delve into accounting statements to evaluate the state of the economy and appraise how companies are faring in the competitive landscape.

Suppliers rely on financial statements to appraise the economic soundness of customers, especially those they intend to deal with on a long-term basis.

A supplier uses financial information as part of the due-diligence process, an important step in identifying the risks associated with doing business with a client. The vendor may do so before – or

[103] O'Kelley, J., *What Do Creditors Look for on Financial Statements?* [online]. 2019. [accessed 20.03.2022]. Available on: < https://bizfluent.com/info-8179840-do-creditors-look-financial-statements.html >.

after – establishing a business relationship with the customer, depending on the sector and transaction. Suppliers rely on specific bits of data when gauging customers' financial profiles. These relate to solvency indicators in balance sheets as well as liquidity information in statements of cash flows. Vendors also comb through customers' Statement of Profit or Loss to set clients that are making money apart from those scraping by in near-insolvency. Suppliers also use financial information with an internal focus, meaning they use to understand their operations and determine whether they are making money.

The debate over financial transactions often ripples from vendor and customer quarters to the investment landscape. Business partners, including investors, pay attention to the way vendors use financial data to advance their interests. Specifically, financiers analyze how suppliers shape customers' assessments of product quality and challenge companies to be more forthcoming with performance data. By requiring that economic allies present accurate accounting data, a supplier helps the public see the efforts that top leadership makes to improve profits, product quality and customer service.[104]

As in the previous two cases, the abridged financial statement has lowest level of information out of the three types, providing few details about the Balance Sheet, as well as the structure of revenues and expenses, as well as no information about the cash flows of the company. A medium level of information is found in the simplified financial statement: detailed Balance Sheet and Statement of Profit or Loss, which allows analyzing the overall performance of the company, but no information of the cash flows that the entity generates and from which activity. The highest level is, as well, in the complete one: the Balance Sheet and the Statement of Profit or Loss offer enough information for the business partners, including a detailed cash flow situation and equity structure.

Regarding the importance of financial statements for government, they are highly useful to assess the tax liability of the business concern. The economic condition of a nation is identified by collecting such financial statements from various industrial sector. Both state and central government can find out whether the business concern is following rules and regulations or not. These statements provide a basis for framing new laws and amending the existing laws for regulating the business.

Government agencies, including regulatory bodies and taxing authority, also use financial statements to monitor the financial conditions of the companies they have jurisdictions over. For example, the government may require companies in certain industries to meet mandatory capital injections as measured against total risky business investments a company may undertake. In this case, financial statements are very useful in revealing such capital-to-assets risk ratios based on information from the asset and equity sections of the Balance Sheet. For tax purposes, companies should report accurately in their income statement about tax-deductible expenses and any losses they can use against future earnings to receive tax write-offs from taxing authority.

As it might be obvious, the level of information provided by financial statements is the same and for the governmental bodies. The abridged financial statements have a low level of information: the government gets too little information about the financial situation of the entity, even no clear information about the money resources of the entity. The simplified one present a better understanding: the detailed balance sheet and income statement offer a solid base for the government to understand its financial position, however the lack of cash flows statement will influence negatively on the government assessment. However, the complete one through its four types of statements allow

[104] Codjia, M., *What Is an Unaudited Financial Statement?* [online]. 2017. [accessed 20.03.2022]. Available on: < https://bizfluent.com/info-7993482-unaudited-financial-statement.html >.

government to understand the overall evolution of the entity and to determine approximately the problems, which the entity faces.

As a student research, we cannot neglect the relevance of financial statements for students. While writing the annual paper or the license thesis, most of the times, students are struggling in analyzing the financial statements of entities as the current included indicators do not allow a complete and comprehensive understanding of the financial position of the company.

Even though the complete financial statement contains a wide range of details, students might need a deeper understanding upon the debt structure of the entity, or upon the assets diversification, as well as main sources of the cash flows. Furthermore, as in the beginning of the research, most of the entities in the Republic of Moldova are SMEs, which present simplified financial statements, therefore students do not have enough information to elaborate and perform full and comprehensive researches in order to gain analytical and professional practical skills in the analysis of financial statements.

Conclusion

Out of the three types of financial statements we currently use in the Republic of Moldova, the most exhaustive and useful is the complete one, as it provides information about the financial health of the entities from different point of view.

The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Financial accounting information is mostly historical in nature, although companies and other entities also incorporate estimates into their accounting processes. Financial information has limitations, however, as a predictive tool. Business involves a large amount of uncertainty, and accountants cannot predict how the organization will perform in the future. However, by observing historical financial information, users of the information can detect patterns or trends that may be useful for estimating the company's future financial performance. Collecting and analyzing a series of historical financial data is useful to both internal and external users.

Nevertheless, there are some aspects, from the international practice, that national authorities should consider in including, such as:

1. Information on the interest rate on loans should be added to find out what the credit costs are;
2. The amount of depreciation or impairment of fixed assets should be included, as we only have their book value in the financial statements, but not the accumulated value of depreciation;
3. The information related to the compromised receivables and liabilities should be detailed.

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