THE IT ANNUAL REPORTS USED IN THE FINANCIAL ANALYSIS

Batrancea Ioan
Faculty of Economics and Business Administration
Babes-Bolyai University, Cluj-Napoca, Romania

Moscviciov Andrei
Faculty of Economics and Business Administration
Babes-Bolyai University, Cluj-Napoca, Romania

Batrancea Maria
Faculty of Economics
Bogdan Voda University, Cluj-Napoca, Romania

Nechita Anca
Faculty of Economics and Business Administration
Babes-Bolyai University, Cluj-Napoca, Romania

In the paper the authors presented the importance of financial reporting system used in financial analysis of IT firms. Thus were presented balance sheet, income statement and cash flows.

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1. Background Information

Finance is the application of economic principles and concepts to business decision-making and problem solving. The field of finance can be considered to comprise three broad categories: financial management, investments, and financial institutions.

(i) *Financial management*. Sometimes called corporate finance or business finance, this area of finance is concerned primarily with financial decision-making within a business entity. Financial management decisions include maintaining cash balances, extending credit, acquiring other firms, borrowing from banks, and issuing stocks and bonds.

(ii) *Investments*. This area of finance focuses on the behavior of financial markets and the pricing of securities. An investment manager's tasks, for example, may include valuing common stocks, selecting securities for a pension fund, or measuring a portfolio's performance.

(iii) *Financial institutions*. This area of finance deals with banks and other firms that specialize in bringing the suppliers of funds together with the users of funds. For example, a manager of a bank may make decisions regarding granting loans, managing cash balances, setting interest rates on loans, and dealing with government regulations.

No matter the particular category of finance, business situations that call for the application of the theories and tools of finance generally involve either investing (using funds) or financing (raising funds). Managers who work in any of these three areas rely on the same basic knowledge of finance.

Financial analysis is "a tool of financial management. It consists of the evaluation of the financial condition and operating performance of a business firm, an industry, or even the economy, and the forecasting of its future condition and performance. It is, in other words, a means for examining risk and expected return."[298] Data for financial analysis may come from other areas within the firm, such as marketing and production departments, from the firm's own accounting data, or from financial information vendors such as "Moody's Investors Service" and "Standard & Poor's Corporation". Financial publications such as "Business Week", "Forbes", "Fortune", and the "Wall Street Journal" also publish financial data (concerning individual firms) and economic data (concerning industries, markets, and economies), much of which is now also available on the Internet.

The financial/economic analysis sponsored and used by the economic manager can be viewed within a broad hierarchy of decision-making needs. The diagram in Figure 1.1 shows four key areas in the typical business where financial/economic analysis is a necessary ingredient. This conceptual pyramid rests on the broadest area: day-to-day decisions and operational planning. It successively rises via strategy development, investment analysis and capital structure planning, on to performance assessment and incentives, and finally to valuation and investor communication. Each of these areas contains challenges and issues in the practice of analysis and decision-making that the economic manager must address.

Figure 1.1 Area for Financial/Economic Analysis

(Source: Erich A. Helfert, Financial Analysis: Tools and Techniques, McGraw-Hill, 2001, p. 10)

Despite the great variety of issues faced every day by managers of different businesses, management tasks are so similar in principle that we can effectively group all business decisions into three basic areas: the investment of resources; the operation of the business using these resources; the proper mix of financing that fund these resources. Figure 2 reflects the continuous interrelationship of these three areas.

Figure 2 The Three Basic Business Decisions

(Source: Erich A. Helfert, Financial Analysis: Tools and Techniques, McGraw-Hill, 2001, p 24)

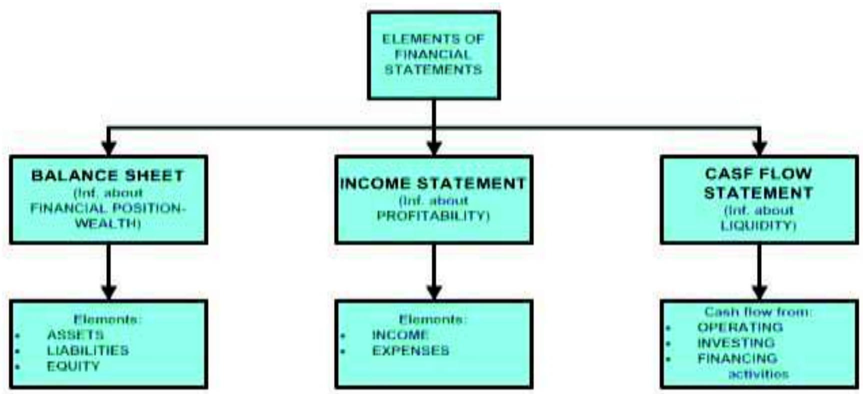
[298] Frank J. Fabozzi, Pamela P. Peterson, **Financial Management and Analysis**, Second Edition, John Wiley & Sons, Inc., Hoboken, New Jersey, 2003, p. 5

2. Financial Statements in IT Enterprises

In the process of financial/economic analysis, a variety of formal or informal data are normally reviewed and tested for their relevance to the specific purpose of the analysis. The most common form in which basic financial information is available publicly, unless a company is privately held, is the set of financial statements issued under guidelines of the Financial Accounting Standards Board (FASB) in the case of USA, or issued under guidelines of the International Accounting Standards Board (IASB) for the countries of the European Union and other countries like for example Hong Kong, Australia, Russia, and Singapore. Such a set of statements usually contains balance sheets as of given dates, income statements for given periods, and cash flow statements for the same periods. A special statement highlighting changes in owners' equity on the balance sheet is commonly provided as well.

Financial statements are summaries of the operating, financing, and investment activities of a business. Financial statements should provide information useful to both investors and creditors in making credit, investment, and other business decisions. And this usefulness means that investors and creditors can use these statements to predict, compare, and evaluate the amount, timing, and uncertainty of potential cash flows. In other words, financial statements provide the information needed to assess a company's future earnings and therefore the cash flows expected to result from those earnings. In Figure 3 there is a depiction of the financial statements and of its most important elements.

Figure 3 Elements of Financial Statements



2.1. The Balance Sheet Source of Information for Financial Position Analysis

The balance sheet, prepared as of a specific date, records the categories and amounts of assets employed by the business (the resources committed) and the offsetting liabilities incurred to lenders and owners (the funds obtained). Also called the "statement of financial condition" or "statement of financial position", it must always balance. By definition, "the recorded value of the total assets invested in the business at any point in time must be matched precisely by the recorded liabilities and owners' equity supporting these assets."[299] Liabilities are specific obligations that represent claims against the assets of the business, ranking ahead of the owners in repayment priority. In contrast, the recorded shareholders' equity in effect represents a residual claim of the owners on the remaining assets after all liabilities have been subtracted.

The major categories of assets, or resources committed, are[300]:

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[299]Erich A. Helfert, **Financial Analysis: Tools and Techniques**, McGraw-Hill, 2001, p 38

[300] *ACCA-F7 **Financial Reporting (Int)**, Cromwell Press Trowbridge Wiltshire, 2008, p. A 1.4*

(i) ***Current assets*** (items that turn over in the normal course of business within a relatively short period of time, such as cash, marketable securities, accounts receivable, and inventories).
(ii) ***Fixed assets*** (such as land, mineral resources, buildings, equipment, machinery, and vehicles), all of which are used over a longer time frame.
(iii) ***Other assets***, such as deposits, patents, and various intangibles, including goodwill that arose from an acquisition.
Major sources of the funds obtained are:
(i) ***Current liabilities***, which are obligations to vendors, tax authorities, employees, and lenders due within one year or less.
(ii) ***Long-term liabilities***, which are a variety of debt instruments repayable beyond one year, such as bonds, loans, and mortgages.
(iii) ***Owners' (shareholders')*** equity, which represents the recorded net amount of funds contributed by various classes of owners of the business as well as the accumulated earnings retained in the business after payment of dividends.
Balance sheets are static in that, like snapshots, they reflect conditions on the date of their preparation. They're also cumulative because they represent the effects of all decisions and transactions that have taken place since the inception of the business and have been accounted for up to the date of preparation.

2.2. The Income Statement and the Financial Performance Analysis of the IT Enterprises

The income statement[301] reflects the effect of management's operating decisions on business performance and the resulting accounting profit or loss for the owners of the business over a specified period of time. The profit or loss calculated in the statement increases or decreases owners' equity on the balance sheet. Thus, the income statement is a necessary adjunct to the balance sheet in explaining this major component of change in owners' equity, and it provides a variety of performance assessment information. The income statement also referred to as the "operating statement", "earnings statement", or "profit and loss statement", displays the revenues recognized for a specific period, and the costs and expenses charged against these revenues, including write-offs (depreciation and amortization of various assets) and taxes. Revenues and costs involve elements such as: sales for cash or credit; purchases of goods for resale or manufacture, or cost of services provided; general and administrative expenses; sales and marketing expenses; research and development costs.
The income statement represents the best effort of the firm's accountants to match the relevant items of revenue with the relevant items of cost and expense for the period, a process which involves accrual accounting and extensive use of allocation of prior and future revenues and costs. Among the judgmental areas involving costs are: recognizing the incidence of revenues received in advance or delayed in time; depreciation of assets being used over more periods than the current reporting period; cost of goods purchased or manufactured in previous periods; proper allocation of general expenses to a specific period.

2.3. The Cash Flow Statement Used in the Changes in Financial Position Analysis

Because we are interested in the combined effects of investment, operating, and financing decisions, analyzing both the income statement for the period and the balance sheets at the beginning and the end of the period together provides more basic insights than either statement alone. Management decisions not only affect the profit for the period, but cause accompanying changes in most assets and liabilities, particularly in the accounts making up working capital, such as cash, receivables, inventories, and current payables. The statement that captures both the

[301] *: ACCA-F7* ***Financial Reporting (Int),*** *Cromwell Press Trowbridge Wiltshire, 2008,p. A 1.4*

current operating results and the accompanying changes in the balance sheet is the “cash flow statement”, “statement of cash flows”, or “funds flow statement”. It gives us a dynamic picture of the ultimate changes in cash resulting from the combined decisions made during a given period.

The cash flow statement thus offers a ready overview of the combined cash impact of all management decisions during the period. The user can judge both the magnitude and the relationships of these cash movements, such as the company’s ability to fund investment needs from operational results, the magnitude and appropriateness of financing changes, and disproportional movements in working capital needs. Observing the cash flow patterns can stimulate questions about the effectiveness of management strategies as well as the quality of operational decisions. The amount of detail can vary widely, depending on the nature of the business and the different types of movements emphasized.

3. Conclusions

As we saw above financial reporting system IT firms do not differ from annual financial reporting system provided by IFRS. Such system is based on three pillars namely the balance sheet, income statement and cash flows.

Information provided by balance are static information while the information provided by profit and loss and cash flows are dynamic information.

Data from annual financial reports are used in financial analysis of IT companies, using methods and techniques among which the most important is the method rates.

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