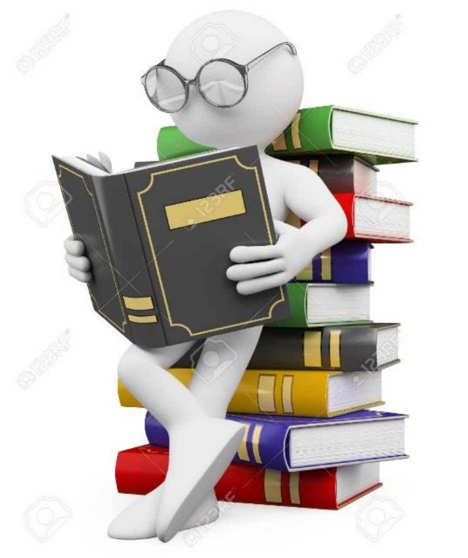
THE BASICS OF ACCOUNTING FOR LAWYERS



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COURSE STRUCTURE

Lecture 1 – Wednesday, 27 April 2022

17:30hrs to 19:30hrs – online

- The accounting framework in Malta
- The elements of financial statements:
- The accruals concept
- The going concern concept
- The duality concept

COURSE STRUCTURE (CONT.)

Lecture 2 – Wednesday, 4 May 2022

17:30hrs to 19:30hrs – online

- Analysing the statement of profit or loss and the statement of financial position
  - The concept of revenue
  - Depreciation, amortisation and impairment
  - Revaluations of assets and their effect on profits and reserves
  - Provisions vs contingent liabilities
  - Events after the reporting period: are they adjusted for in the financial statements?
- Reference will be made to the published financial statements of some local companies

COURSE STRUCTURE (CONT.)

Lecture 3 – Wednesday, 11 May 2022

17:30hrs to 19:30hrs – online

- The statement of cash flows
  - Profit vs cash
  - Analysing the statement of cash flows into operating, financing and investing activities
- Group accounts
  - Subsidiary vs associate: control vs significant influence
  - Salient points to keep in mind when looking at group accounts

COURSE STRUCTURE (CONT.)

Lecture 4 – Wednesday, 18 May 2022

- 17:30hrs to 19:30hrs – online
- Interpretation of financial statements
    - Analysis and appraisal of the performance and position of an entity using ratios
- The growing importance of forensic accounting

COURSE OBJECTIVES

- To explain the main accounting concepts which may emerge in legal work
- To understand financial information and accounting terminology
- To better understand the full picture of legal matters that involve elements of accounting

THE ACCOUNTING PROFESSION IN MALTA

- The Accountancy Board regulates the profession in Malta: -
  - Has formulated a code of ethics for accountants and auditors
  - Set up a system of Quality Assurance
  - Conducts disciplinary proceedings on members of the profession
  - Has the collaboration and technical support of the Malta Institute of Accountants

THE ACCOUNTING FRAMEWORK IN MALTA

Period	Default Framework	Alternative Framework
Up to 31 December 2008	IFRS	-
From 1 January 2009 up to 31 December 2015	IFRSs as adopted by the EU	GAPSE
From 1 January 2016	GAPSME	IFRSs as adopted by the EU

THE ACCOUNTING FRAMEWORK IN MALTA

GAPSME has become the default accounting framework for SMEs for financial reporting periods starting on or after 1 January 2016

The directors of SMEs may still elect to apply IFRSs as adopted by the EU, if the Board of Directors or its governing body, has passed a resolution to this effect

Large and Public Interest Entities fall outside the scope of GAPSME, and are therefore obliged to prepare a full set of financial statements in accordance with IFRS (as adopted by the EU)

IFRS

- International Financial Reporting Standards
- Developed by the standard-setting board, the International Accounting Standards Board (IASB)
  - The IASB sets IFRS Accounting Standards
    - set out how a company prepares its financial statements
  - The ISSB will set the IFRS Sustainability Disclosure Standards
    - set out how a company discloses information about sustainability-related factors that may help or hinder a company in creating value

INTERNATIONAL SUSTAINABILITY STANDARDS BOARD (ISSB)

- Set up on 3 November 2021 during COP26 held in Glasgow
- Objective of the ISSB:
  - to deliver a comprehensive global baseline of sustainability-related disclosure standards that **provide investors and other capital market participants** with information about companies' sustainability-related risks and opportunities to help them make informed decisions
- 2 exposure drafts issued on 31 March 2022:
  - General Requirements for Disclosure of Sustainability-related Financial Information
  - Climate-related Disclosures

GAPSME

- General Accounting Principles for Small and Medium-Sized Entities
- The EU Single Accounting Directive 2013/34/EU, which repealed the 4th and 7th Accounting Directives on Individual and Consolidated Accounts, introduced a simplified procedure for financial statement reporting
- This Directive was transposed into Maltese law via LN 289 of 2015
- The objective of GAPSME
  - to ensure that the reporting entities or groups falling within its scope provide in their financial statements **information about the financial position and performance of the entity or group** that would be useful to users in assessing the **stewardship of management and for making economic decisions**

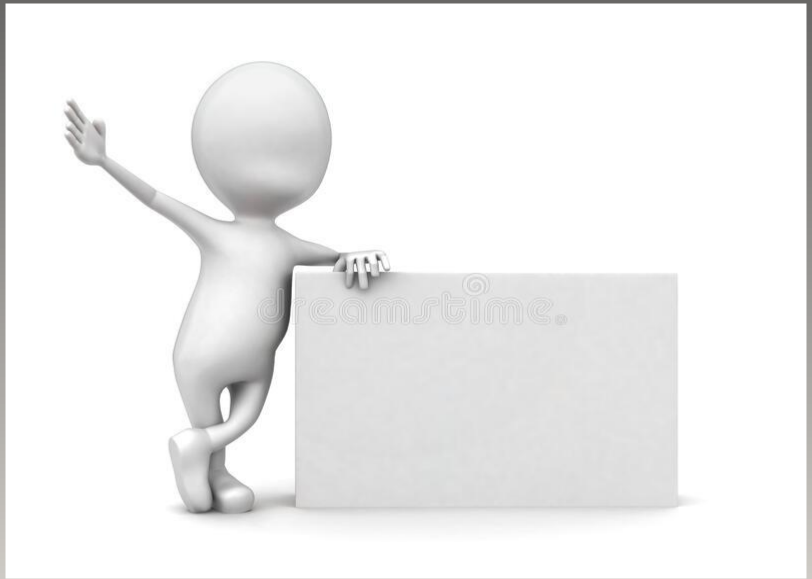
SIZE THRESHOLDS

- The thresholds affect the designation of a company as small, medium, or large by reference to two consecutive accounting periods. **Two** out of the above three criteria must be satisfied.

- A newly incorporated company will determine whether it qualifies as small, medium-sized, or large by reference to the size thresholds in that year.

	Small Companies	**Medium-sized Companies**
Balance sheet total	< €4,000,000	< €20,000,000
Turnover	< €8,000,000	< €40,000,000
Average number of employees	< 50	< 250

A Set of Financial Statements



A COMPLETE SET OF FINANCIAL STATEMENTS INCLUDES:

- a statement of financial position (balance sheet) at the end of the period
- a statement of profit or loss and other comprehensive income (income statement) for the period
- a statement of changes in equity for the period
- a statement of cash flows for the period
- notes, comprising a summary of significant accounting policies and other explanatory notes
- comparative information

IAS 1

FINANCIAL STATEMENTS: SOME SALIENT POINTS

- The objective of financial statements: - to provide information about an **entity's assets, liabilities, equity, income and expenses** that is useful to financial statements’ users;
- Financial statements are prepared for a **specified period of time** and provide comparative information;
- Financial statements provide information about **transactions and other events** viewed from the perspective of the reporting entity as a whole;
- A reporting entity is an entity that is **required, or chooses, to prepare financial statements**. It can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.

GAPSME REQUIREMENTS

	Required for Small Entities	Required for Medium-Sized Entities
Directors’ report		✓
Balance Sheet	✓	✓
Income Statement	✓	✓
Statement of changes in equity		✓
Statement of cash flows		✓
Notes to the financial statements	✓	✓

Elements of Financial Statements

THE MAIN ELEMENTS OF FINANCIAL STATEMENTS

The elements directly related to **financial position** (balance sheet) are:

- **Assets**
- **Liabilities**
- **Equity**

The elements directly related to **performance** (statement of profit or loss) are:

- **Income**
- **Expenses**

The statement of cash flows reflects both performance elements and some changes in balance sheet elements.

ASSET

- A present economic resource CONTROLLED by the entity as a result of past events
- An economic resource is a right that has the potential to produce economic benefits
- Owning an asset is not a prerequisite to including an asset in the balance sheet

TIME TO THINK!

XYZ Co employs a skilled and efficient workforce which has been very expensive to train. Some of these staff are still in the employment of the company.

Should XYZ Co include the workforce as an asset in its balance sheet?

ANSWER

A skilled and efficient workforce may be the most valuable asset of any successful company.

But does an entity have control over its workers?

No because an employee may quit an organisation any day and seek employment in a rival firm much to the detriment of the company.

Therefore, this **cannot** be included as an asset in the financial statements of XYZ Co.

TIME TO THINK!

ABC Co, a manufacturing company, leased a machine for 5 years from PQR Ltd.

Should ABC Co include the machine as an asset in its financial statements?

ANSWER

- Yes, a lessee must recognise assets and liabilities for all leases (right-of-use assets) with a term of more than 12 months, unless the underlying asset is of low value.
- In accounting, we apply the '**Substance over Form**' concept:

the economic **substance** of transactions and events must be recorded in the financial statements rather than just their **legal form** in order to present a true and fair view of the affairs of the entity.

STATEMENTS OF FINANCIAL POSITION

ASSETS

		As at 31 January			
		Group		Company	
		2021	2020	**2021**	2020
	Notes	**€'000**	€'000	**€'000**	€'000
Non-current assets					
Property, plant and equipment	5	**121,944**	119,626	**113,863**	111,559
Right-of-use assets	6	**5,526**	6,159	**187**	188
Intangible assets	7	**604**	612	**-**	-
Investments in subsidiaries	8	**-**	-	**9,202**	9,202
Deferred tax assets	20	**7,565**	8,195	**8,455**	9,442
Trade and other receivables	10	**865**	1,695	**865**	1,695
Total non-current assets		**136,504**	136,287	**132,572**	132,086
Current assets					
Inventories	9	**13,752**	16,772	**8,263**	9,425
Trade and other receivables	10	**19,630**	26,469	**24,827**	20,714
Current tax assets		**5**	5	**-**	-
Cash and cash equivalents	11	**17,148**	8,409	**2,664**	1,002
Total current assets		**50,535**	51,655	**35,754**	31,141
Total assets		**187,039**	187,942	**168,326**	163,227

Simonds Farsons Cisk plc,
Annual Report, 2020/2021, pg. 66

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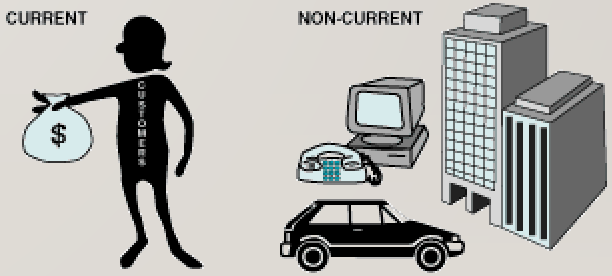
NON-CURRENT VS CURRENT ASSETS

Current Assets

- Assets that are: -
  - expected to be realised in the entity's normal operating cycle
  - held primarily for the purpose of trading
  - expected to be realised within 12 months after the reporting period
- E.g., inventories, trade receivables, bank and cash



NON-CURRENT ASSETS

- Distinguished from current assets by the following characteristics:
- **long-term** in nature
- not normally acquired for resale
- could be **tangible or intangible**
- used to generate income directly or indirectly for a business
- not normally liquid assets (i.e. not easily and quickly converted into cash without a significant loss in value)

TANGIBLE VS INTANGIBLE ASSETS

Tangible assets

- Property, plant and equipment that
  - are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
  - are expected to be used during more than one period

Intangible assets

- Identifiable non-monetary assets without physical substance
- Identifiable when they are separable or when they arise from contractual or other legal rights
- E.g., computer software, licences, trademarks, patents, brands, films, copyrights, import quotas, goodwill acquired in a business combination

TIME TO THINK!

In 2021, MVP Gaming Ltd entered into negotiations to acquire the Dawra brand from Widget Ltd for €1 million. This would give MVP Gaming Ltd the ability to sell products under the Dawra brand and give access to the Dawra web domain name.

However, MVP Gaming Ltd did not wish to acquire any other assets of Widget Ltd and had no interest in acquiring the Widget business as a whole.

Would MVP Gaming Ltd include this brand as an asset in its financial statements?

ANSWER

- The brand would be recognised as an intangible asset in the financial statements of MVP Gaming Ltd at the cost of €1 million. The brand name has been purchased.
- However, if the brand is internally generated, it cannot be capitalised because it is difficult to establish the true benefit from the asset or even to establish specific costs that can be attributable to it

LIABILITY

A present obligation of the entity to transfer an economic resource as a result of past events

An obligation is a duty or responsibility that the entity has no practical ability to avoid

NON-CURRENT VS CURRENT LIABILITIES

Non-current liabilities					
Trade and other payables	22	**2,802**	456	**2,802**	456
Lease liabilities	19	**4,394**	4,965	**349**	500
Derivative financial instruments	17	**156**	273	**156**	273
Borrowings	18	**33,328**	32,994	**33,328**	32,994
Provisions for other liabilities and charges	21	**25**	36	**25**	36
Total non-current liabilities		**40,705**	38,724	**36,660**	34,259
Current liabilities					
Provisions for other liabilities and charges	21	**11**	50	**11**	50
Trade and other payables	22	**21,940**	20,760	**14,517**	12,896
Lease liabilities	19	**1,253**	1,426	**142**	134
Current tax liabilities		**904**	1,003	**-**	-
Derivative financial instruments	17	**161**	195	**161**	195
Borrowings	18	**2,411**	9,561	**2,411**	4,247
Total current liabilities		**26,680**	32,995	**17,242**	17,522
Total liabilities		**67,385**	71,719	**53,902**	51,781
Total equity and liabilities		**187,039**	187,942	**168,326**	163,227

Simonds Farsons Cisk plc, Annual Report, 2020/2021 pg 67

NON-CURRENT VS CURRENT LIABILITIES

Current Liabilities

- Liabilities that are: -
  - expected to be settled within the entity's normal operating cycle
  - held for purpose of trading
  - due to be settled within 12 months
- E.g., bank overdraft, trade payables, accruals
- Some current liabilities such as **trade payables and employee costs** are part of the normal working capital of the entity and the entity classifies the amounts as current even if they are to be settled outside of the 12-month period

All other liabilities are non-current, e.g. loan notes, redeemable preference shares

EQUITY

- Equity is the **residual interest** in the assets of the entity after deducting all its liabilities

Assets – Liabilities = Equity

Assets – Liabilities = Share capital + Reserves

- E.g. equity instruments – issued ordinary shares, irredeemable preference shares
- E.g. reserves - retained earnings, asset revaluation reserves, foreign currency translation reserves

		As at 31 January			
		Group		Company	
		2021	2020	**2021**	2020
	Notes	**€'000**	€'000	**€'000**	€'000
Capital and reserves attributable to owners of the company					
Share capital	12	**9,000**	9,000	**9,000**	9,000
Revaluation and other reserves	14, 15	**49,409**	49,409	**46,137**	46,137
Hedging reserve	16	**(206)**	(304)	**(206)**	(304)
Retained earnings		**61,451**	58,118	**59,493**	56,613
Total equity		**119,654**	116,223	**114,424**	111,446

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STATEMENTS OF CHANGES IN EQUITY

GROUP

	Notes	Share capital €'000	Hedging reserve €'000	Revaluation and other reserves €'000	Retained earnings €'000	Total equity €'000
Balance at 1 February 2019		9,000	(385)	49,409	50,249	108,273
Comprehensive income						
Profit for the year		-	-	-	11,869	11,869
Other comprehensive income:						
Cash flow hedges net of deferred tax	16	-	81	-	-	81
Total comprehensive income		-	81	-	11,869	11,950
Transactions with owners						
Dividends relating to 2019 and 2020						
– paid in cash	13	-	-	-	(4,000)	(4,000)
Total transactions with owners		-	-	-	(4,000)	(4,000)
Balance at 31 January 2020		**9,000**	**(304)**	**49,409**	**58,118**	**116,223**
Balance at 1 February 2020		9,000	(304)	49,409	58,118	116,223
Comprehensive income						
Profit for the year		-	-	-	3,333	3,333
Other comprehensive income:						
Cash flow hedges net of deferred tax	16	-	98	-	-	98
Total comprehensive income		-	98	-	3,333	3,431
Balance at 31 January 2021		**9,000**	**(206)**	**49,409**	**61,451**	**119,654**

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INCOME

- Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims

- The definition of income encompasses both **revenue and gains**.
    - **Revenue** arises in the course of the **ordinary activities** of an entity; e.g. sale of goods or provision of a service
    - **Gains** represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity; e.g. gain on disposal of a building

INCOME STATEMENTS

		Year ended 31 January			
		Group		Company	
		2021	2020	2021	2020
	Notes	€'000	€'000	€'000	€'000
Revenue	4	**73,016**	103,491	**41,391**	55,310
Cost of sales	23	**(47,004)**	(62,950)	**(23,028)**	(27,204)
Gross profit		**26,012**	40,541	**18,363**	28,106
Selling and distribution costs	23	**(8,912)**	(12,602)	**(6,689)**	(9,492)
Administrative expenses	23	**(11,427)**	(14,249)	**(6,910)**	(8,330)
Operating profit		**5,673**	13,690	**4,764**	10,284
Finance income	26	**-**	-	**25**	7
Finance costs	27	**(1,246)**	(1,370)	**(975)**	(1,096)
Profit before tax		**4,427**	12,320	**3,814**	9,195
Tax (expense)/income	28	**(1,094)**	(451)	**(934)**	706
Profit for the year		**3,333**	11,869	**2,880**	9,901
Basic and diluted earnings per share for the year attributable to shareholders	30	**€0.111**	€0.396		

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EXPENSES

- Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims
- The definition of expenses encompasses **losses** as well as those **expenses** that arise in the course of the ordinary activities of the entity
  - Expenses that arise in the course of the ordinary activities of the entity include, e.g., cost of sales, wages and administration costs
  - Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity, e.g. a revaluation loss on property

23. Expenses by nature

	Group		Company	
	2021	2020	**2021**	2020
	€'000	€'000	**€'000**	€'000
Depreciation of property, plant and equipment (Note 5)	**7,814**	7,796	**6,701**	6,734
Depreciation of right-of-use assets (Note 6)	**1,405**	1,327	**1**	2
Profit on disposal of property, plant and equipment (Note 5)	**(149)**	(200)	**(120)**	(142)
Employee benefit expense (Note 24)	**15,323**	20,900	**8,984**	11,499
Termination benefits (Note 24)	**13**	92	**13**	92
Raw materials, imported goods and consumables	**33,361**	45,419	**10,067**	12,175
Movement in inventory levels of finished goods and work in progress (Note 9)	**(2,166)**	381	**(419)**	(309)
Movement in loss allowance (net of receivable write offs) (Note 10)	**1,787**	668	**1,682**	417
Amortisation of intangible assets (Note 7)	**41**	44	**-**	-
Other expenses	**9,914**	13,374	**9,718**	14,558
Total cost of sales, selling and distribution costs and administrative expenses	**67,343**	89,801	**36,627**	45,026

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RECOGNITION OF ELEMENTS IN FINANCIAL STATEMENTS

- **What do we mean by ‘recognition’?**
- The process of capturing for inclusion, in the financial statements, an item that meets the definition of an asset, a liability, equity, income or expenses

- Recognition is appropriate if it results in both **relevant information** about assets, liabilities, equity, income and expenses and a **faithful representation** of those items, because the aim is to *provide information that is useful to investors, lenders and other creditors*

DERECOGNITION OF ELEMENTS IN FINANCIAL STATEMENTS

What do we mean by 'derecognition'?

- The removal of all or part of a recognised asset or liability from an entity's statement of financial position

Derecognition normally occurs	
For an asset: When the entity loses control of all or part of the recognized asset	For a liability: When the entity no longer has a present obligation for all or part of the recognised liability

THE UNDERLYING ASSUMPTION

Going Concern

- An entity prepares financial statements on a going concern basis when it is viewed as continuing in business for the foreseeable future
  - a period of at least 12 months from the end of the reporting period
- Probably the most challenging area for both management and auditors because of the uncertainty caused by Covid-19

GOING CONCERN

- It is assumed that the entity has **neither the intention, nor the need, to liquidate or curtail materially the scale of its operations**
- If management conclude that the entity has no alternative but to liquidate or curtail materially the scale of its operations, the going concern basis **cannot** be used and the financial statements must be prepared on a different basis (such as the 'break-up' basis)

SOME FACTORS THAT MAY HAVE AN IMPACT ON AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN

- ✓ significant decline in the demand for an entity's products or services
- ✓ major losses or cash flow difficulties that have arisen since the reporting date
- ✓ adverse key financial ratios
- ✓ indications of withdrawal of financial support from the bank or other financial institutions
- ✓ delayed payments to suppliers with some suppliers withdrawing credit and insisting on cash on delivery
- ✓ negative operating cash flows
- ✓ major debt repayments falling due which the entity will not be able to meet
- ✓ pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied

BREAK-UP BASIS

Where the accounts should be drawn up on a break up basis: -

- All non-current assets are shown as **current assets** and are valued **at the lower of cost and net realisable value;**
- Non-current liabilities are taken to **current liabilities** and any costs of early settlement are recognised; and
- Any **other costs associated with winding up** the business are recognised.

ACCRUAL BASIS OF ACCOUNTING

- An entity must prepare its financial statements, except for cash flow information, using the **accrual basis of accounting**

- The **effects of transactions and other events** are recognised when they **occur**, and not as cash is received or paid. Under the accruals basis, events are recorded in the accounting records and reported in the financial statements of the **periods to which they relate**.

ACCRUED VS PREPAID EXPENSES

Accrued expense

e.g., water and electricity consumption bill

- Expense that has been incurred, but not yet paid for
- No expenditure documentation yet

Prepaid expense

e.g., insurance expense

- Expense paid for in one accounting period, but for which the underlying asset will not be consumed until a future period

ACCRUED VS DEFERRED INCOME

Accrued income

- Income which has been earned but not yet received
- e.g., rental income for the period just ended has not yet been received

Deferred income

- Income received in advance
- e.g., a customer pays in advance for some goods or services which still have to be delivered (deferred revenue)

TIME TO THINK!

A company, STP Co, borrowed €500,000 from the bank on 1 September 2021. It agreed with the bank that interest payments will be done semi-annually, with the first payment done on 31 March 2022.

Would the company need to include any interest expense when it is preparing its financial statements at 31 December 2021?

ANSWER

- The interest expense, for the months 1 September to 31 December, has to be calculated and included as an expense in the statement of profit and loss under the heading '**Finance costs**'.

- Since this interest amount has not been paid yet, it is referred to as an '**accrued expense**' – it is included also in the SFP under the heading 'current liabilities'.

ACCRUALS AND PREPAYMENTS – THEIR EFFECT ON THE FINANCIAL STATEMENTS

Accrued expenses: -

- Increase expenses, lower the profit
- Show a current liability in the balance sheet

Prepaid expenses: -

- Reduce expenses, increase the profit
- Show a current asset in the balance sheet

DOUBLE-ENTRY BOOKKEEPING

- Every business transaction is recorded in at least two ledger accounts, also known as T-accounts
- The two sides of the T account reflect the dual nature of transactions, with one side (the left) representing a debit entry and the other side (the right) representing a credit entry
- For each transaction, the debit and credit entries must be of the same amount

Account Name

Date	Narrative	€	Date	Narrative	€

Debit

Credit

DEBITS AND CREDITS

- Debits typically reflect an increase in business assets or the incurring of expenses.
- Credits typically reflect an increase in business liabilities or the earning of income.

Debit if	**Credit if**
Expenses Assets Drawings **Increase**	Liabilities Income Capital **Increase**

Mnemonic: DEADCLIC

TIME TO THINK!

A company, STP Co, borrowed €500,000 from the bank on 1 September 2021.

What is the double-entry for this transaction?

ANSWER (1)

- The company received €500,000. Its bank balance increased – its assets increased. Hence, we need to debit the bank account with €500,000.

- The company has an obligation to repay its bank loan. That's a liability. Its liabilities are increasing, hence, credit the bank loan account with €500,000.

ANSWER (2)

Bank A/c

Date	Narrative	€	Date	Narrative	€
		‘000			
1.9.21	Bank loan	500			

Bank Loan A/c

Date	Narrative	€	Date	Narrative	€
					‘000
			1.9.21	Bank	500

One account is debited, the other account is credited, with the same amount of €500,000

TIME TO THINK!

Let's look at these transactions and consider their double-entry

1. PQ Co bought goods on credit for €200,000 from TS Co
2. PQ Co sold goods on credit for €18,000 to XY Co
3. PQ Co paid wages and salaries of €20,000

ANSWERS (1)

- PQ Co bought goods on credit for €200,000
- Bought goods – purchases – purchases are always debited
- On credit – did not pay immediately – hence the suppliers, TS Co, have still to be paid – trade payables

- Dr Purchases (part of the cost of sales to find the gross profit made) €200,000
- Cr Trade payables (a current liability) €200,000

ANSWERS (2)

- PQ Co sold goods on credit for €18,000
- Sold goods – sales – income is always credited
- On credit – PQ has still not received the amount of €18,000 from XY Co – trade receivables

- Dr Trade receivables €18,000
- Cr Sales revenue €18,000

ANSWERS (3)

- PQ Co paid wages of €20,000 in cash
- Wages are an expense – expenses are debited
- Cash is paid out – cash is going out – credit cash

- Dr wages €20,000
- Cr cash €20,000