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The Role of Financial Statements in the Financial Communication Process

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Abstract: *Financial statements are the final product of accounting and serve as the primary means of financial communication for entities. Since ancient times, record-keeping has been an essential part of economic activities, evolving into a structured accounting system governed by international standards. The International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) provide a framework for the preparation and presentation of financial statements, ensuring consistency, comparability, and reliability across entities. This paper explores the structure and significance of financial statements, as outlined in IAS 1, including the statement of financial position, statement of comprehensive income, statement of cash flows, statement of changes in equity, and accompanying notes. The study also emphasises the qualitative characteristics of financial information and the impact of financial reporting on stakeholders' decision-making processes.*

Keywords: *financial statements; IFRS; IAS 1; accounting standards; financial reporting; transparency; financial position; qualitative characteristics; corporate governance; audit.*

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1. Introduction

Accounting has long been an essential component of economic activities, dating back to the earliest trade systems. Over time, financial reporting has evolved into a highly regulated and structured discipline, ensuring transparency and accountability. Financial statements are a fundamental output of accounting, summarising an entity's financial position, performance, and cash flows.

Internationally, financial reporting is governed by IFRS, a set of accounting standards that provide guidelines on the preparation and presentation of financial statements. IAS 1, "Presentation of Financial Statements," establishes the framework for financial statements, ensuring uniformity across different jurisdictions and enabling investors, regulators, and stakeholders to make informed decisions.

This paper examines the role and structure of financial statements, detailing their key components and their significance in financial communication. Additionally, it explores the qualitative characteristics that enhance the reliability and relevance of financial information. Understanding financial statements is crucial for various stakeholders, as they provide insights into an entity's financial health and operational efficiency.

2. Financial Statements - The Final Product of Accounting

Since ancient times, with the emergence of bartering—the simplest form of trade—methods for keeping records were introduced, effectively shaping the concept of accounting as a necessity for upholding moral integrity. As society has evolved, accounting has become a vast field of activity that involves more than just recording transactions. It has been concluded that the foundation of accounting lies in records and summary documents, which are now known as financial statements.

International regulations regarding financial reporting of company performance are consolidated in the International Accounting Standards and are legally mandated in numerous jurisdictions to provide financial information to users. Most countries use the International Financial Reporting Standards (IFRS), either partially or fully, often alongside their national accounting regulations. The current financial reporting system is based on a model developed in the 1930s, which presents financial performance based on historical values but does not provide relevant information for economic decision-making (Lapteș & Sofian, 2016).

To generate relevant and concise financial information, the International Accounting Standards Board (IASB) issued a series of accounting norms in 1973 called the International Accounting Standards (IAS), which were renamed in 2001 as International Financial Reporting Standards (IFRS). With the transition from IAS to IFRS, accounting practices underwent international transformations (Trimble, 2017).

The accounting standard that addresses the preparation of financial statements at an international level is IAS 1, "Presentation of Financial Statements." The purpose of IAS 1 is to establish the general structure and content of financial statements, ensuring comparability between an entity's financial statements over time and those of other entities. This accounting standard defines the general characteristics of financial statements and provides guidelines on their structure and minimum content requirements (Romic, 2013).

Financial statements provide a systematic presentation of a company's financial position and performance. Their purpose is to generate information about an entity's financial position, financial performance, and cash flows (Bratu & Gurău, 2019).

According to IAS 1, financial statements include the following summary accounting documents:

- Statement of financial position;
- Statement of comprehensive income;
- Statement of cash flows;
- Statement of changes in equity;
- Notes (Feleagă, Feleagă, & Dumitrașcu, 2017).

Each component of the financial statements set, as outlined in IAS 1, will be presented in detail.

The statement of financial position provides information about an entity's ability to adapt to environmental changes and presents assets (controlled economic resources), liabilities, and equity (financing structures), distinguishing between current and non-current assets as well as current and non-current liabilities (Munteanu, Țînță, & Lungu, 2006).

An asset is classified as current if it meets at least one of the following criteria:

- It is expected to be sold, used in regular operations, or consumed during the normal business cycle;
- Its primary purpose is trading;
- It is expected to be realised within one year after the reporting period;
- It is cash or a cash equivalent unless restrictions prevent its exchange or use for settling liabilities for at least one year after the reporting period (Istrate, 2016).

Specifically, current assets include inventories and trade receivables that are traded, consumed, or realised during normal business operations, even when their realisation is not expected within one year after the reporting period.

If an asset does not meet any of the criteria above, it is classified as a non-current asset, including tangible, intangible, and financial fixed assets (Feleagă, Feleagă, & Dumitrașcu, 2017).

A liability is classified as current if:

- It is expected to be settled during the company's normal operating cycle;
- It is held for trading;
- It is due within one year from the date of the financial statements;

The company does not have an unconditional right to defer settlement for more than one year after the reporting period. If a liability does not meet any of these criteria, it is classified as a non-current liability.

The statement of comprehensive income summarises an entity's financial performance over a specific period (Tiffin, n.y.). IAS 1 lists essential elements to be included in financial reports, such as revenue, financial costs, tax expenses, profit or loss from discontinued operations, and profit or loss from affiliated companies and joint ventures using the equity method.

Revenue represents increases in economic benefits during an accounting period, manifested through asset inflows or liability reductions that lead to equity growth, excluding owner contributions.

Revenue is recognised in the profit and loss account when the increase in future economic benefits associated with an increase in the value of an asset or a decrease in the value of a liability can be reliably measured.

According to OMFP no. 1802/2014, expenses represent decreases in economic benefits recorded during the accounting period in the form of outflows or reductions in asset values or increases in liabilities, which translate into reductions in equity, other than capital distributions to owners.

An expense is recognised in the profit and loss account when the decrease in future economic benefits associated with the depreciation of an asset or the increase in the value of a liability can be reliably measured.

The statement of changes in equity plays a crucial role in understanding a company's financial evolution. It provides a detailed view of how an entity's capital has evolved over a certain period, highlighting structural changes and assisting in assessing net assets (Istrate, 2016).

The statement of cash flows, regulated under IAS 7, provides a clear perspective on an entity's ability to generate cash and cash equivalents and illustrates how these are utilised.

Cash comprises demand deposits and liquid funds readily accessible to the entity. Cash flows represent cash inflows and outflows during financial activities (Istrate, 2016).

At the time of presentation, the statement of changes in equity must include the following information:

- The total comprehensive income for the period;
- The effect of applying or retrospectively restating changes recognised in accordance with IAS 8, "Accounting Policies, Changes in Accounting Estimates and Errors," for each component of equity;
- A reconciliation for each component of equity between the carrying amount at the beginning and the end of the period.

This document highlights structural and quantitative changes recorded in an entity’s equity during the financial year.

Another key financial statement in the full set of financial reports is the cash flow statement, regulated under IAS 7, "Statement of Cash Flows."

The cash flow statement provides a clear perspective on an entity’s ability to generate cash and cash equivalents and illustrates how these are used.

Cash includes demand deposits and liquid funds, specifically money that the entity has immediate access to. Cash flows represent cash inflows and outflows, or corresponding transactions carried out by the company (Istrate, 2016).

Cash equivalents comprise short-term financial investments that are easily convertible into cash and are not subject to significant value fluctuation risks. Investments qualify as cash equivalents when they have a short maturity period, typically three months or less.

The cash flow statement includes all cash movements of an entity during the financial year, categorised into three main activities: operating activities, investing activities, and financing activities.

The notes provide explanations and detailed analyses of the elements included in the statement of financial position, the statement of comprehensive income, the statement of cash flows, and the statement of changes in equity. They also contain all relevant information to ensure an accurate and complete representation of the entity's economic reality.

They serve to supplement the accounting information prescribed by IFRS in the other financial statement documents, as well as to provide comments and explanations on specific results or transactions. These documents provide not only accounting information but also non-accounting information, such as the entity's name, address, headquarters, a description of its business activity, and the number of employees, among others.

In Romania, entities that follow IAS 1 are generally those listed on the Bucharest Stock Exchange, as well as multinational companies and corporate groups that are part of international groups and choose to prepare their consolidated financial statements in accordance with international standards for group-level reporting.

For other entities in Romania, national regulations aligned with the International Financial Reporting Standards (IFRS) apply, particularly O.M.F.P. no. 1802/2014 - “Accounting Regulations on Individual Annual Financial Statements and Consolidated Annual Financial Statements”.

O.M.F.P. no. 2844/2016 establishes the rules and procedures for the preparation and presentation of annual financial statements and accounting reports for entities, including commercial companies, sole proprietorships, and other legally regulated entities. It details the essential content of annual financial statements, such as the balance sheet, income statement, cash flow statement, statement of changes in equity, and accompanying explanatory notes. Additionally, it regulates aspects related to the audit of financial statements, including requirements for financial auditors and the methods for communicating audit results.

O.M.F.P. no. 1802/2014 plays a key role in establishing principles and procedures for properly accounting for and presenting elements in individual annual financial statements, including rules for recognising revenues and expenses, asset and liability valuation, and presenting relevant information. It also details the steps and requirements necessary for preparing, approving, auditing/reviewing, and publishing annual financial statements in accordance with legal provisions and applicable accounting standards, as well as the structure and operation of the general chart of accounts, an instrument used for properly recording transactions and financial events in an entity's accounting system.

With the adoption of international accounting standards, annual financial statements have become more complex and comprehensive. Under fully harmonised accounting regulations with international standards (IAS), entities must prepare the following accounting documents: balance sheet, income statement, statement of changes in equity, cash flow statement, and a detailed description of accounting policies in the explanatory notes.

According to O.M.F.P. no. 1802/2014, Romania has several categories of reporting entities: micro-entities, small entities, and medium and large entities (Guide for the application of O.M.F.P. 1802/2014).

Micro-entities are those that, at the balance sheet date, do not exceed at least two of the following size criteria:

- Total assets: 1,500,000 lei;
- Net turnover: 3,000,000 lei;
- Average number of employees during the financial year: 10.

According to O.M.F.P. no. 82/2022, these entities are required to prepare annual financial statements, including the abbreviated balance sheet and the abbreviated income statement. Micro-entities are not required to prepare explanatory notes; however, they must attach the "Informative Data" form and the "Statement of Fixed Assets" form.

Small entities are those that, at the balance sheet date, do not fall under the category of micro-entities and do not exceed at least two of the following size criteria:

- Total assets: 17,500,000 lei;
- Net turnover: 35,000,000 lei;
- Average number of employees during the financial year: 50.

Small entities must prepare annual financial statements in accordance with O.M.F.P. no. 85/2022, which include the abbreviated balance sheet, the income statement, and also the explanatory notes to the annual financial statements. Additionally, these entities have the option to prepare, on a voluntary basis, the statement of changes in equity and/or the cash flow statement (Istrate, 2016).

Medium and large entities are those that, at the balance sheet date, exceed at least two of the size criteria mentioned above.

These entities prepare the full set of annual financial statements, which includes the following accounting documents:

- Balance sheet;
- Income statement;
- Statement of changes in equity;
- Cash flow statement;
- Explanatory notes.

Next, each accounting document in the set of annual financial statements under O.M.F.P. no. 1802/2014 will be briefly presented.

The balance sheet is a summary accounting document that presents the entity's assets, liabilities, and equity both at the financial year-end and at other legally required moments, such as mergers, cessation of activity, etc.

The balance sheet follows the fundamental accounting equation:

ASSETS – LIABILITIES = EQUITY

In Romania, the balance sheet is prepared in a list format, which has been the official format established by the Ministry of Finance for the first time through Order no. 94/2001. According to the provisions of O.M.F.P. no. 1802/2014, the balance sheet starts with the presentation of fixed assets, followed by current assets and prepaid expenses, detailing each category, and concludes with the presentation of equity elements.

Next, the following accounting document in the set of financial statements, namely the income statement, will be presented.

The income statement presents the total amount of revenues generated and the expenses associated with these revenues, providing an analytical explanation of the entity's financial performance and its ability to generate profit.

The income statement, prepared in accordance with national accounting regulations, includes revenue and expense elements for the financial year, organised by nature into two categories:

- Operating revenues and expenses;
- Financial revenues and expenses.

Operating revenues represent earnings obtained from the entity's core activity. These include sales of goods and services, rental income, license fees, etc. Operating expenses are the costs incurred in carrying out the entity's core activities, including the cost of goods sold, personnel expenses, administrative expenses, etc.

Financial revenues represent earnings obtained by an entity from financial activities. These may include interest income, dividend income, foreign exchange differences, etc. Financial expenses are costs incurred by an entity as a result of financial activities, such as interest paid, bank fees and other charges, and foreign exchange differences.

Within this document, the first section presents details about the entity's net turnover, followed by the determination of various types of results: operating result, financial result, gross result for the period, and net result for the period.

Another summary accounting document that must be prepared by medium and large entities in Romania is the statement of changes in equity.

This summary accounting document analyses changes in each component of equity from the beginning to the end of the financial year to provide users with information on the company's ability to maintain its stability.

Another document in the complete set of financial statements is the cash flow statement.

The cash flow statement is a summary accounting document that provides a detailed reflection of an entity's total cash receipts and payments throughout the financial year, structured into three activities: cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities (Bratu & Gurău, 2019).

In this document, the key indicator "Net cash flow = total inflows - total outflows" is calculated for each of the three activities.

The last document in the financial statements is the explanatory notes.

The explanatory notes illustrate how the information is presented in the other components of the financial statements. As a result, entities must establish the format of the explanatory notes, provided that they include at least the required information related to the elements included in the annual financial statements. Entities are required to prepare at least ten explanatory notes. These notes must cover all necessary information, including a description of the entity's activities and its achieved results.

According to O.M.F.P. no. 58/2021, financial statements must be submitted within 150 days after the financial year-end for companies, national enterprises, autonomous administrations, national research and development institutes, branches opened in Romania by companies resident in countries within the European Economic Area, as well as for Romanian branches that are part of foreign legal entities and for permanent establishments. For micro-entities and small entities, the deadline is 140 days.

3. Qualitative Characteristics of Financial Information

The final product of accounting is financial information. Financial and accounting information constitutes one of the primary sources of information for any decision-making system. From reporting production or inventory to preparing annual reports, the objective remains the same: facilitating the selection of optimal solutions for different categories of users. Due to the vast diversity of information required by users or provided by entities, the qualitative characteristics of financial reports take shape, as the credibility of information largely depends on adherence to these characteristics.

For financial information published in financial statements to be useful, it must be relevant and accurately represent what it intends to convey. Thus, the fundamental qualitative characteristics of financial information are relevance and faithful representation.

Relevance refers to the capacity of financial information to influence users' economic decisions. It helps users evaluate past, present, or future events and confirm or adjust previous evaluations. For example, the balance sheet and income statement provide users with information about the company's financial position and performance in the previous financial period. Additionally, they support estimating future financial positions and performances, as well as other major areas of interest, such as dividend payments, salaries, and the company's ability to meet due obligations.

Faithful representation – Annual financial statements provide a detailed presentation of economic phenomena through words and figures. To be precise, a description must be complete, neutral, and free from errors. A complete description includes all essential information necessary for a user to understand the phenomenon described, including necessary explanations.

According to the IASB's Conceptual Framework, the usefulness of financial information is enhanced if it is understandable, comparable, timely, and verifiable.

- Understandability is considered the primary characteristic of financial information. Understandability means that financial information is comprehensible as long as it is clearly presented. To meet this objective, there must be a balance between accounting knowledge and understanding of business and economic activities sufficient for users, on the one hand, and their willingness to analyse the information reflected in financial statements, with appropriate effort, on the other.
- Comparability allows users to compare an entity's financial reports across different periods to identify trends in its financial position and performance. Additionally, users should be able to compare financial reports of different entities to evaluate financial position, performance, and changes therein, which may influence their decisions. Information should be presented in a manner that enables decision-makers to identify similarities, differences, and characteristic developments across different periods or enterprises.
- Timeliness ensures that financial information is available to decision-makers in time to facilitate economic decision-making. Any significant delay in providing financial information diminishes its relevance. Untimely information reduces credibility, as it fails to fulfil its role in the economic decision-making process.
- Verifiability in financial information is an essential assurance for users that it accurately reflects relevant economic phenomena. This concept implies that multiple independent and well-informed observers should reach a consensus on the correctness of the presented description. Verification can be carried out either directly by confirming values or representations through direct observation, such as cash counting, or indirectly by examining inputs for a model or formula and recalculating results using the same methodology. Ensuring verifiability in financial information is crucial for strengthening user confidence and making informed decisions in the economic environment.

The preparation of financial statements is equally important for those who prepare them and those who use them. Accounting generates financial documents that significantly impact society and can influence individual behaviour, bringing substantial changes to the social and economic environment. Over time, the number of potential users of financial statements has increased considerably, intensifying the pressure to publish financial information. This growth in users has also led to a greater risk of conflicts between managers and external users, necessitating accounting regulations and rigorous auditing of financial statements.

4. Conclusion

Financial statements are a critical component of financial reporting, providing structured and standardised information about an entity's financial health and performance. Governed by international accounting standards such as IFRS and IAS 1, financial statements facilitate comparability and transparency, allowing stakeholders to make informed economic decisions.

The statement of financial position, statement of comprehensive income, statement of cash flows, and statement of changes in equity serve as the primary financial documents that communicate an entity's economic reality. Additionally, qualitative characteristics such as relevance, faithful representation, comparability, timeliness, and verifiability enhance the reliability of financial reporting.

As financial reporting continues to evolve, the role of financial statements remains paramount in corporate governance, investment decisions, and economic policy-making. Future research should focus on the impact of digital transformation and emerging technologies on financial reporting, as well as the effectiveness of IFRS in different regulatory environments.

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