MALTA INSTITUTE OF TAXATION

MIT COURSE ON TAX COMPLIANCE

ACCOUNTING FOR NON-ACCOUNTANTS

Luca Pace

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Date: 11 October 2022

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AGENDA

- An introduction to key accounting concepts
- Examples of Financial Reporting and their users
- An introduction to Financial Reporting
- Analysing financial data
- A general overview of the functions of the auditor
- Deadlines and compliance reporting

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INTRODUCTION TO KEY ACCOUNTING CONCEPTS

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Introduction

- Accounting is a systematic process of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating economic information through the publication of financial statements.
- The primary objective of financial statements is to provide information about financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users making economic decisions.
- It is the recording of financial transactions, reported in accordance with the applicable financial reporting standards*.

** GAPSME (General Accounting Principles for Small and Medium Enterprises) or IFRS (International Financial Reporting Standards)*

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USERS OF FINANCIAL REPORTING

There are many different stakeholders who may be interested in the financial statements of an entity to enable them to make decisions based on the past performance of a business. Users include:

- Managers – day to day decision makers. They need to know how well things are progressing financially.
- Shareholders – they want to be able to see whether or not the business is profitable and if targets are being reached.
- Prospective buyers – should the shareholders decide to sell an entity, the buyer will want to seek comfort on the performance of the business from the financial statements, and to ascertain the viability of, and return from, their investment
- Banks and creditors – lenders would want to calculate the risk of providing finance, and whether they can expect to be paid back.
- Tax authorities – to determine taxable income and tax charge
- Employees – to ensure stability and performance
- Regulatory Authorities – to ensure compliance with reporting regulations

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
The accounting equation

From the large, multi-national corporation down to the corner beauty salon, every business transaction will have an effect on a company's financial position. The financial position of a company is measured by the following items:

1. Assets - a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the enterprise
2. Liabilities - a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits
3. Owner's Equity - the residual interest in the assets of the entity after deducting all its liabilities

- The accounting equation (or basic accounting equation) offers a simple way of understanding how these three amounts relate to each other. The accounting equation is expressed in the statement of financial position, and can be expressed as:

Total Assets = Total Liabilities + Equity

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Double entry

- Double entry is a simple yet powerful concept: each and every one of a company's transactions will result in an amount recorded into at least two of the accounts in the accounting system.
- For each transaction accounts will be opened and a bookkeeping entry will have to be made in the account for each different type of transactions that the business undertakes to show an increase or decrease of one item, and a subsequent entry to show the increase or decrease of the other item.
- This means that there will be separate accounts for each type of asset, each type of expense and each type of income. In addition there will be separate accounts opened for every individual credit supplier and credit customer of the business. All the transactions between the business and the owner will also be recorded in either a capital account or a drawings account, depending on whether the owner is adding resources to or withdrawing resources from the business
- Each account will have a name (eg. Cash), and a debit and a credit, along with a cross reference to the account containing the other entry for the double entry transaction.

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Double entry concept

- A newly incorporated company makes the initial deposit representing the issued share capital.

Non current assets	+	Current Assets	=	Current liabilities	+	Equity
€0	+	€1,200	=	€0	+	€1,200

Debit (Dr)	Bank	€1,200	Increase in current assets
Credit (Cr)	Share Capital	€1,200	Increase in Equity

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Double entry concept

- The next day, the company buys furniture for € 5,000. It pays € 1,000 in cash upon purchase and will pay the remaining € 4,000 within 30 days.

	Non current assets	+	Current Assets	=	Current liabilities	+	Equity
Before transaction	€0	+	€1,200	=	€0	+	€1,200
After transaction	€5,000	+	€200	=	€4,000	+	€1,200

Debit (Dr)	Furniture and Fittings	€5,000	Increase in non current assets
Credit (Cr)	Cash	€1,000	Decrease in current assets
Credit (Cr)	Trade payables	€4,000	Increase in current liabilities

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Prudence concept

- Professional judgement needs to be exercised when adopting accounting policies and estimates, to avoid having an entity's assets and income overstated, or its liabilities and expenses understated.
- The rationale behind prudence is that an organisation should not recognize an asset at a value that is higher than the amount which is expected to be recovered from its sale or use. Conversely, liabilities of an entity should not be presented below the amount that is likely to be paid in its respect in the future.

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Going concern concept

- This concept stipulates the basis on which the financial statements are prepared, whereby it is assumed that an organisation will continue its business in the foreseeable future.
- In the event that an organisation ceases to be a going concern, the financial statements are no longer prepared on a going concern basis, but rather on break up basis.

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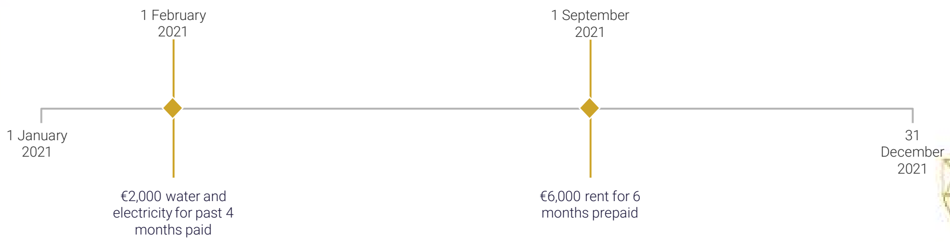
AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS

Accruals concept

- The effects of transactions and other events are recognised when they occur and reported in the financial statements of the period to which they relate, not when they are settled or received.
- Eg. Accruals
  Prepayments



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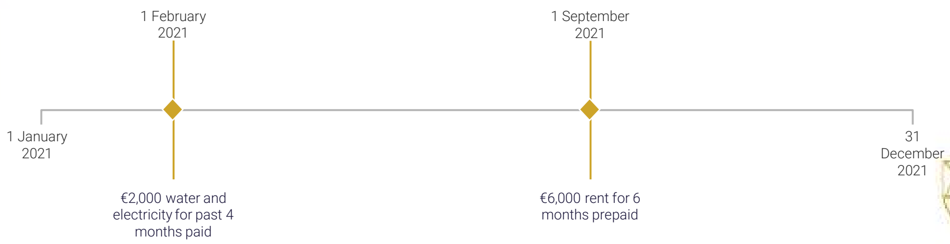
AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS

Accruals concept

Debit (Dr)	Rent	€4,000	Increase in expenses (rent)
Debit (Dr)	Prepaid expenses	€2,000	Increase in current assets (prepaid rent)
Credit (Cr)	Cash	€6,000	Decrease in current assets (cash)



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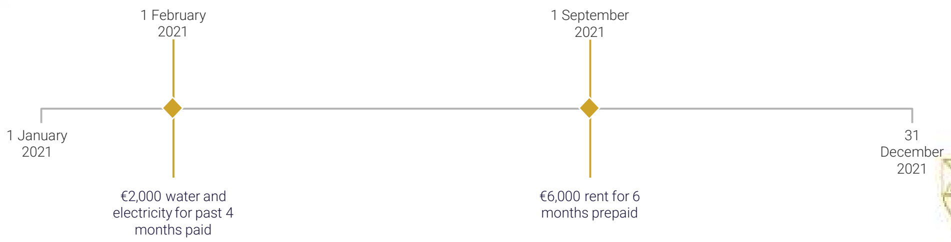
AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Accruals concept

Debit (Dr)	Water & electricity	€500	Increase in expenses for the year (W&E)
Debit (Dr)	Accrued expenses	€1,500	Decrease in current liability (accrued W&E)
Credit (Cr)	Cash	€2,000	Decrease in current assets (cash)



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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Consistency concept

- Once accounting methods and policies are adopted, accountants are required to continue applying them consistently in the future. If there is a valid reason for a change in accounting policy, such change must be documented and disclosed.
- This is to ensure that financial statements are comparable, meaning that stakeholders have the ability to compare the present and past financial statements of an organisation.

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AN INTRODUCTION TO KEY ACCOUNTING CONCEPTS
Historical cost concept

- This concept requires an asset to be recorded at its historical cost at the time of acquisition. The historic cost of assets represents the price that the business paid to acquire the assets and any additional costs (such as installation costs) in getting the asset in working condition. Such cost is then to be spread over the useful life of the asset.
- Eg. Company buys equipment for € 7,000. Useful life is estimated to be 4 years. Estimated residual value at the end of its useful life is € 1,200.

€ 7,000 - € 1,200 = € 5,800 ÷ 4 years = € 1,450

- The € 1,450 represents what is called depreciation, being the portion of the asset to be taken to the P/L in a particular year.

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EXAMPLES OF FINANCIAL REPORTING

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EXAMPLES OF FINANCIAL REPORTING

- Financial Reporting can serve different purposes, which determines the way they are prepared for the targeted users.

- The most common types are:
  i. Audited financial statements
  ii. Interim financial statements
  iii. Projections and Forecasts
  iv. Management accounts

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AN INTRODUCTION TO FINANCIAL STATEMENTS

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AN INTRODUCTION TO FINANCIAL REPORTING

An audited Report and Financial Statements contains the following:

- Directors' Report
- Independent Auditors' Report
- Statement of Profit or Loss
- Statement of Financial Position
- Statement of Changes in Equity
- Statement of Cash Flows
- Notes to the Financial Statements

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AN INTRODUCTION TO FINANCIAL REPORTING

- Audited financial statements are prepared in accordance with either of 2 financial reporting standards, GAPSME or IFRS.

(Up to financial periods ending on or before 31 December 2015, companies could opt to prepare financial statements in line with the older version of simplified reporting standards GAPSE. GAPSE used to limit its applicability to entities at lower thresholds and included other limitations on its applicability, such as to entities carrying out a licensable activity or subject to other authorisations issued by the MFSA).

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AN INTRODUCTION TO FINANCIAL REPORTING

IFRS (International Financial Reporting Standards) as adopted by the EU

- IFRS is a set of accounting standards, developed by the International Accounting Standards Board (IASB), that is becoming the global standard for the preparation of public company financial statements.
- Gives the benefit of international comparability (circa 120 nations / jurisdictions allow or require IFRS).
- Detailed and relatively complex standards, which are fully fledged and constantly being updated and refined to cater for complex financial reporting.

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AN INTRODUCTION TO FINANCIAL REPORTING

GAPSME (General Accounting Principles for Small and Medium Enterprises)

- Simplified preparation of statutory financial statements, brought about by the EU Single Accounting Directive 2013/34/EU and transposed into Maltese law through the GAPSME and other amendments in the Companies Act (Cap. 386)
- Aimed at micro / small / medium entities (excluding Public Interest Entities*) which satisfy set criteria, and applies to reporting periods starting on or after 1 January 2016

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AN INTRODUCTION TO FINANCIAL REPORTING
GAPSME (General Accounting Principles for Small and Medium Enterprises)

- GAPSME is the default accounting framework in Malta for small and medium enterprises (SME), although companies may still opt to prepare financial reports in accordance with IFRS, subject to a resolution passed by the Board of Directors
- Companies are no longer eligible to file abridged financial statements with MBR for financial periods starting on or after 1 January 2016
- In order for an entity to qualify as an SME (either Small or Medium), 2 out of 3 criteria must be satisfied:

	Small	Medium
SOFP Total	≤ €4,000,000	≤ €20,000,000
Total Revenue	≤ €8,000,000	≤ €40,000,000
Average number of employees	≤ 50	≤ 250

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AN INTRODUCTION TO FINANCIAL REPORTING
GAPSME (General Accounting Principles for Small and Medium Enterprises)

	Small	Medium
Director's report		x
Statement of financial position	x	x
Statement of profit and loss	x	x
Statement of changes in equity		x
Statement of ash flows		x
Notes to the financial statements	x	x

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STATEMENT OF PROFIT OR LOSS
Refer to model financial statements

For most businesses, the income would be the revenue earned from sales made during that period. This may be supplemented by other forms of income, such as rent received, commission earned or income from investments made by the firm.

Overall profit may be the objective, however it is important to measure the size of the profit made on the actual sales before deducting expenses incurred.

- Gross profit – Profit earned from trading
- Profit before interest and tax – profit remaining after all expenses, except interest, have been deducted.

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STATEMENT OF FINANCIAL POSITION
Refer to model financial statements

Assets

The resources that are used within the business. Can be owned outright or have been purchased and financed through borrowing. Divided into two categories: Non-current assets and current assets

- Non current assets are long term assets that are likely to be held by the business for at least one year. Likely to have been acquired to add value to the business, and may be further divided into tangible and intangible assets.
  1. Tangible assets have a physical substance, and tend to be used by the business to facilitate the production of goods or the provision of a service. Examples include land and buildings, machinery, equipment and vehicles.
  2. Intangible assets are assets without a physical form, owned by the business and which normally lead to the generation of revenue and profit for the business. Often, these intangibles arise out of a business that is long established and has built a successful brand name or customer loyalty.
- Investments may also be included within the non-current assets. Financial assets acquired by the entity for the purpose of providing future economic return are typically listed under investments.

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STATEMENT OF FINANCIAL POSITION

Refer to model financial statements

- Current assets form part of the trading cycle of the business. They are used in the ongoing trading cycle of a business and will be in a state of constant change, with values fluctuating on a daily basis. Current assets are considered to be highly liquid assets, and include items such as:
  1. Inventory – this represents the firm's holdings of products which are either ready to be sold or are to be used in the production process and will be turned into finished goods.
  2. Trade receivables – these are amounts owing to the business for any sales made on credit, and are likely to be collected in the near future.
  3. Cash and cash equivalents – cash is the ultimate liquid asset, and this amount will comprise cash at hand and bank deposits available on demand, as well as any short term investments, such as treasury bills which are very liquid and can be converted into cash with ease, such as treasury bills.

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STATEMENT OF FINANCIAL POSITION

Refer to model financial statements

Liabilities

These represent amounts due by the firm, and are split into two categories: current liabilities and non-current liabilities.

- Current liabilities are essentially short-term debts, ad likely to be settled within the next 12 months, and is likely to include the following items:
  1. Trade payables – amounts owing in relation to purchases made on credit from suppliers.
  2. Accruals – such balances represent expenses incurred but not yet paid by the entity.
  3. Taxation owing – since the balance sheet is drawn up at the same date which profit, and the basis of income tax, is calculated, the taxation owing will appear as a current liability, after taking into account any amounts of provisional tax already paid during the year.
- Non-current liabilities are long term debts which are expected to fall due after at least one year, and are likely to take the form of bank loans and debentures.

Equity

Also known as capital, resources from the selling of shares to shareholders and profits earned through the operations of the entity will be shown as reserves and will represent an increase of the firm's equity.

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ANALYSING FINANCIAL DATA

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ANALYSING FINANCIAL DATA
Types of ratios

- Liquidity Ratios
- Debt / Leverage Ratios
- Efficiency / Activity Ratios
- Profitability / Performance Ratios

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ANALYSING FINANCIAL DATA
Statement of financial position ratios

- Return on Capital Employed
- Current Ratio
- Quick Ratio (Acid Test Ratio)
- Receivable days
- Payable days
- Gearing Ratio

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ANALYSING FINANCIAL DATA
ROCE (Profitability)

- Return on Capital Employed (also called Accounting Rate of Return)

$$\frac{\text{Operating Profit}}{\text{Capital Employed}}$$

… where Capital Employed = Total Assets – Current liabilities
(or Equity + Non current liabilities)

- Indicates the profitability of the organisation and measures the overall efficiency in using its assets

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ANALYSING FINANCIAL DATA
Current Ratio (Liquidity)

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- If the company had to sell all its readily available assets, would it be able to pay off its immediate debt?
- Ideally between 1.5 to 2 in order for an organisation to have its current liabilities comfortably covered should they fall due, but this ratio will heavily depend on the industry and how liquid the Current Assets are.

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ANALYSING FINANCIAL DATA
Quick Ratio (Liquidity)

$$\frac{\text{Current Assets – Inventory}}{\text{Current Liabilities}}$$

- Ideally at least 1 : 1
- Not every company can quickly convert its Inventory into cash to be able repay its Current Liabilities. Therefore, this ratio is a tougher test on the company's ability to meet its current debt load.

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ANALYSING FINANCIAL DATA
Receivable days (Efficiency)

$$\frac{\text{Receivables}}{\text{Credit Sales}} \times 365$$

- The average number of days it takes for an organisation to collect payments owed
- Reflects how easily the company can collect amounts owed
- Can be used to gauge how strictly the company enforces its credit policies

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ANALYSING FINANCIAL DATA
Payable days (Efficiency)

$$\frac{\text{Payables}}{\text{Purchases}} \times 365$$

… in the absence of the Purchases figure, use Cost of Sales

- The average number of days it takes for an organisation to settle payments which it owes.
- A longer average payable period allows you to maximise your trade credit, therefore delaying spending your cash.

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ANALYSING FINANCIAL DATA
Gearing ratio (Debt)

$$\frac{\text{Debt (long term + short term)}}{\text{Equity}}$$

- Indicates how risky a business is, based on its level of borrowing
- The higher the gearing, the higher the risk
- Lowering gearing ratio:
  - Capitalise loans payable (convert to shares)
  - Reduce working capital (Current assets Current liabilities)
  - Increase profits
  - Share issue (increase share capital)

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ANALYSING FINANCIAL DATA
Statement of profit or loss ratios

- Gross Profit Margin
- Net Profit Margin
- Inventory days
- Interest cover

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ANALYSING FINANCIAL DATA
Profit margins (Profitability)

$$\text{Gross Profit margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

$$\text{Net Profit margin} = \frac{\text{Net Profit}}{\text{Sales}}$$

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ANALYSING FINANCIAL DATA
Inventory days (efficiency)

$$\frac{\text{Average Inventory}}{\text{Cost of Sales}} \text{ X 365}$$

- The lower, the better.
- The longer inventory is held, the greater the risk that it could be subject to theft, damage or obsolescence

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ANALYSING FINANCIAL DATA
Interest cover (Debt & Profitability)

$$\frac{\text{Profit Before Interest and Tax (PBIT)}}{\text{Interest Payable}}$$

- Ideally 3 or higher.
- It is a measurement of the number of times a company could make its interest payments with its earning.
- If low, it could be an indication of high gearing, as well as making profits vulnerable to relatively small changes in operating activity.

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THE FUNCTIONS OF THE AUDITOR

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THE FUNCTIONS OF THE AUDITOR
What is an audit?

- An audit is the examination of an organisation's Report and Financial Statements.
- It is required for limited liability companies and NGOs (which exceed certain thresholds)
- It is not required for partnerships and sole practitioners.
- It is performed by a Certified Public Accountant with a Practicing Certificate in auditing. The auditor must always be independent from the company being audited.

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THE FUNCTIONS OF THE AUDITOR
Levels of assurance

- Reasonable Assurance (high level of assurance) – sufficient evidence that the subject matter agrees to certain criteria. Hence a positive assurance. "In our opinion the FS give a true and fair view…"
- Eg. An audit engagement for annual statutory audits
- Limited Assurance (moderate level of assurance) sufficient evidence that the subject matter is plausible. Hence a negative assurance. "In our opinion there is nothing to suggest that the…"
- Eg. A review engagement
- Audit opinions are based on the concept of materiality, whereby only misstatements and omissions which in aggregate could influence stakeholders' decisions taken on the audited financial statements will modify the audit report

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THE FUNCTIONS OF THE AUDITOR
Levels of assurance

- The audit opinion, an objective opinion on the financial statements produced by an organisation, is the purpose of the audit engagement. This is arrived to by carrying out audit procedures to examine and assess whether the financial statements:
  i. show a true and fair view of the organisation's performance and position
  ii. were prepared in accordance with applicable reporting standards
- An audit report can therefore be either modified or unmodified (clean), which will greatly influence a stakeholder's perception of the organisation

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THE FUNCTIONS OF THE AUDITOR
Types of modified audit reports

	Auditor's judgement regarding the pervasiveness of the matter	
Nature of the matter	Material but not Pervasive	Material and Pervasive
Financial Statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate evidence	Qualified opinion	Disclaimer of opinion

Pervasive defined as being (ISA 705):
- Not confined to specific accounts in the financial statements
- If so confined, represents a substantial portion of the financial statements
- Disclosure is fundamental to the users' understanding of the financial statements

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DEADLINES AND COMPLIANCE REPORTING

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DEADLINES AND COMPLIANCE REPORTING
Private limited companies

- Private limited companies established in Malta are required to file a set of audited financial statements with MBR on an annual basis.
- The deadline for the approval and signing of the annual accounts is 10 months from the year end, and the deadline for filing the accounts with MBR is an additional 42 days
- In the event that a company's first financial year is of less than 6 months, the company may opt to extend the first financial period to up to a maximum of 18 months. In this case, deadlines shall differ as follows:
- Approval and signing of annual accounts 1 year 10 months from date of incorporation
- Filing with MBR 1 year 10 months + 42 days from date of incorporation

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DEADLINES AND COMPLIANCE REPORTING

Public limited companies

Public limited companies established in Malta are required to file with MBR:

- A set of audited financial statements on an annual basis. The deadline for the approval and signing of the annual accounts is 7 months from the year end, and the deadline for filing the accounts with MBR is an additional 42 days
- A half yearly financial report containing:
- The condensed set of financial statements;
- An interim directors' report;
- When the half yearly financial report has been audited or reviewed, the Auditors' report shall be reproduced in full, together with any reasoned qualifications which may have been made;
- If the half yearly financial report has not been audited or reviewed, the Issuer shall make a statement to that effect in its report;
- Statements made by the persons responsible within the Issuer, whose names and functions shall be clearly indicated, to the effect that, to the best of their knowledge, the condensed set of financial statements which has been prepared in accordance with the applicable set of accounting standards gives a true and fair view; and
- Statement that the interim directors report includes a fair review of the information required in terms of Listing Rules 5.81 to 5.84.

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DEADLINES AND COMPLIANCE REPORTING

Industry specific deadlines - Gaming

- MBR normal deadlines apply
- MGA (Malta Gaming Authority)
  - The licensee shall, within one hundred and eighty days (6 months) from the end of its financial year, file with the Authority (MGA) an audited set of financial statements prepared in accordance with international financial reporting standards (IFRS).
  - The licensee shall, within thirty days (1 month) from the end of the half yearly period, lodge with the Authority (MGA) interim financial statements prepared in accordance with international financial reporting standards (IFRS), showing the licence holder's results and signed by the key official.

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DEADLINES AND COMPLIANCE REPORTING
Industry specific deadlines – Financial services

- The following companies are required to submit annual financial statements, amongst other documents, by not later than 4 months from the year end:
- Investment Services Licence Holder
- Credit institutions (banks)
- Insurance

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