

# Equity Capital Maintenance as the Cash Flow Net Assets of an Organisation for a More Accurate Assessment of Its Financial Sustainability

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**Abstract.** The article considers the problem of the creation of an equity capital in an organisation as a net asset, and the influence of financial tools and unfunded items on it. A number of items are identified that are included in stock capital and connected with financial instruments and re-evaluation of capital assets without monetary substance. Part of financial accounting indicators are represented by comprehensive items and items shown as accrued total. The article shows adjustment indicators that specify the sum of equity capital and are used for the calculation of financial sustainability of an organisation. A comparative analysis aimed at finding methods that could improve financial sustainability assessment was conducted on their basis and showed that after adjustments, coefficients began to more accurately show the financial state of a company. The article presents the conclusion that the contents and structure of existing financial accounting affects negatively the creation of an accurate database for the purposes of financial assessment of the company in terms of capital equity maintenance in the form of net assets.

## 1. Introduction

Modern economic situation is characterised by intense competition in the market and runs the risk of various crises, this is why companies have to monitor even smallest changes and deviations from their normal and common activities, to assess the financial situation in order to prevent bankruptcy and losses. For example, the number of legal entities in Russia that went bankrupt from 2007 to 2018 doubled and amounted to 12,274 bankrupt legal entities as of the end of 2018 [1].

## 2. Pertinence

This is why we introduce the definition of financial sustainability of an organisation that shows that the situation stable, income is higher than expenditures, and the profit and capital of a company grow [2]. The key elements of financial sustainability calculation is the equity capital of an organisation, that according to accounting balance is not only capital and reserves, but also the re-evaluation of capital assets and undistributed profits, which show the results of the financial instrument revaluation that is summed up with every new period and increases the capital. Provision of accurate data on changing equity capital is one of the main accounting objectives [3]. This is associated with financial capital maintenance concept that says that a company received profit, if after all the liabilities and

debts are paid in the end of the period, the total net assets as of the end of the period are higher than the total net assets in its beginning [4].

**3. Description of the goal**

The authors want to address the task of enhancing the accuracy of financial sustainability assessment through adjustments of the equity capital by unfunded items. We will also consider the necessity of a detailed explanation of comprehensive items in the accounting balance and report on financial outcomes that influence the creation of the equity capital of a company.

**4. Theory**

In order to solve this problem, it is necessary to identify the part of equity capital that plays the major role in its maintenance, and assess it as funded net assets. To identify the first part, let us group its major elements by incoming sources and possibility of fluctuations in the accounting period of a company. The equity capital of an organisation comes either from outside the company, or is created by accumulating profit [5]. The part that comes from outside the company is mainly provided by founders as chartered capital and does not change until the general meeting of shareholders takes the relevant decision. This is why it is feasible to call this part of the capital conditionally constant.

The variable part of the equity capital is classified by its connection to the core business. It is directly associated with undistributed profit, which shows that the more the variable part of the capital, the more losses can be covered [6]. The main elements of equity capital that are connected to its maintenance are shown in Table 1.

**Table 1.** Structure of equity capital in the form of net assets in terms of its maintenance.

The conditionally constant part of equity capital produced by the shareholders' operations	Variable part of equity capital produced by operations and performance of a joint stock company	
	Not connected to the core business	Connected to the core business
Charter capital and amendments: ✓ subsequent offering ✓ equity shares issue ✓ changes in par value	Incremental capital: ✓ reevaluation (final appraisal) of the equity capital and non-material assets ✓ re-evaluation of FI according FVOCI ✓ currency differences, if the equity capital is in a foreign currency ✓ share premium	Undistributed profit and surplus reserve

The Table shows that the variable part of Equity capital is produced by the business results and is the part that is most prone to change, in other words influences is growth or reduction. The more the variable part of the capital, the greater the possibility that after all losses and expenditures are covered, the organisation will have money to develop its activities and create a reserve to cover future costs [7]. Lesser costs of net assets make it difficult to cover them, and if the cost is lower than the registered capital, it means that it is being wasted due to non-profitable operations, which can lead to bankruptcy [8, 9]. If we consider profits or losses in terms of capital equity, they must come from the real cash flows and represent the real outcome and not the conditional one [10].

Items that reflect additional capital are elements that are directly connected to the core business operation: re-evaluation of capital assets, currency differences that arise if the capital equity is in foreign currency, and share premium. These elements of equity capital are estimated values developed for insuring against future risks, this is why they are not funded, which reduces the accuracy of financial accounting as a source of information. This is why, they must be considered as adjustment items for efficient management of net assets. Additional capital is an exclusion in terms of share

premium paid by cash, but the premium paid by assets should be excluded. This also applies to property capital, it must be adjusted to the amount paid by non-monetary resources (assets).

In order to solve the problems associated with the equity capital assessment in terms of net assets funded by cash flow, it is essential to adjust the amount of distributed profit on the balance. This item is comprehensive and shows both the net profits, or losses, in the current period and in previous periods, and they must be divided to find the actual indicator [11], as it will enhance the accuracy of the accounting information base [12]. The undistributed profits are directly associated with the core business of an organisation, which allows to view it as the main factor that influences the capital maintenance. However, some items are not funded, as they are created to insure against possible losses. Their identification for the adjustment items is necessary to see the real balance profit or losses to assess the financial sustainability of an organisation.

In order to find the adjustment items during the calculation of real net profit or losses, it is necessary to use the methodological approach to its calculation based on foreign best practices that provide for its adjustment to the amount of items not funded by cash flows. This also applies to the depreciation of capital assets and reserves that are included into the prime cost of a product and excluded from the calculation of cash flow from the core activity of the company, when the indicator EBITDA is calculated [13]. The need for such adjustments is explained by the fact that depreciation is not represented by cash, and if it is shown as expenditures, it does not correspond to the cash flow [14].

This directly concerns financial instruments as accounting risk objects that need regular adjustment to the balance cost. The results of reevaluation of financial instruments are expressed in cash [15], this is why they must be shown as adjustment items in the financial reports (impact on profits or losses) and in the accounting balance (impact on the equity capital). International practice shows that the results of financial instruments re-evaluation depend on evaluation categories used in IFRS [16]. At the same time financial reports show the results of financial instrument re-evaluation assessed at their fair value through profits and losses, and financial instruments evaluated by their amortised cost (AC) that is calculated using the effective interest rate. They are shown under such comprehensive items of financial reports as "Other income" and "Other losses", and, in our opinion, they must be identified as adjustment items under financial reports to find the real net profit or losses of an organisation. In international practice the re-evaluation of financial instruments assessed at their fair value through other comprehensive income (FVOCI) are not shown in financial reports, and are not shown under profits or losses items, but is shown in the report on other comprehensive income [17]. Russian accounting practice does not provide for such a report, this is why results of the revaluation can be shown in the third section of the accounting balance "Capital and reserves", similar to the results of the re-evaluation of equity capital. They are not expressed by money, this is why they impact negatively the accuracy of analysis of capital as of total net assets [18]. This is why, they can be viewed as adjustment items in the accounting balance.

We should see that Russian legislation requires to show in the balance the reevaluation of equity assets [19], and the depreciation of equity assets must be presented in the financial report. This is why under the existing requirements for accounting balance in Russia, the final appraisal of capital assets and financial instruments assessed at their fair value through other comprehensive income should be considered to be adjustment indicators, and their depreciation should be seen as an adjustment indicator under the financial report. In order to maintain the capital in an organisation, it is important to develop and show the equity capital funded by cash flow in the financial accounting. This is why we need to identify adjustment indicators to the balance indicator "Equity capital" and the financial report indicator "Net profit" that can be defined as adjustment indicators. The proposed adjustments for equity capital and net profit are shown in Table 2.

**Table 2.** Adjustment indicators that specify the total equity capital funded by cash flow to calculate the financial sustainability of an organisation.

Adjustments Equity capital	Adjustments Net profit
- Share premium paid by assets	+ Depreciation and reserves accumulated at the expense of prime cost
- statutory capital paid by assets	+ Capital assets depreciation
- Re-evaluation or final appraisal of capital assets	+ Depreciation of financial instruments assessed at their fair value through other comprehensive income (FVOCI)
- Final appraisal of financial instruments assessed at their fair value through other comprehensive income (FVOCI)	+ depreciation of financial instruments assessed at their fair value through profits and losses (FVTPL)
	- depreciation of financial instruments assessed at their amortised value
- Undistributed profit in terms of non-cash items (see the adjustments of net profits)	- final appraisal of financial instruments assessed at their fair value through profits and losses (FVTPL)
	- final appraisal of financial instruments assessed at their amortised value
	+ Reserves is created at the expense of financial outcomes (other expenditures)

The adjustments shown in the table should be, in our opinion, divided in the following way in the explanation to the financial accounting reports: positive deviations by item, negative deviations by item and a deviation balance that affects the equity capital.

#### 4. Practical relevance

The proposed adjustments to accounting financial reports as an information basis for financial sustainability assessment and calculation of such coefficients, as the financial autonomy coefficient and equity capital, will be demonstrated using the example of 3 organisations with different core activities: health care, retail and fishery. These coefficients are the most common in the assessment of financial sustainability despite the fact that a number of authors [20] believe that it is feasible to adjust them in accordance with today's economic reality. The assessment of financial sustainability calculated with traditional coefficients and adjusted coefficients is shown in table 3.

**Table 3.** Financial sustainability coefficients calculated with traditional coefficients and adjusted coefficients, based on the financial accounting data for 2018.

	Health care	Fishery	Retail
Capital equity depreciation	1 582	27 916	1 037
Final appraisal (depreciation) of capital assets and financial instruments	15	(5 427)	(361)
Net profit	28 884	564,684	8 365
Adjusted net profit	30 451	596,835	10 378
Re-evaluation of capital assets	-	141,975	-
Undistributed profit in terms of non-cash items	54 343	445,745	16 602
Equity capital	65 227	1 139 489	31 375
Adjusted equity capital	30 476	156,215	16 786
Financial autonomy coefficient	0.94	0.632	0.11
Adjusted financial autonomy coefficient	0.437	0.087	0.059
Equity capital level	14.56	1.721	0.124
Adjusted level of equity capital	6.803	0.236	0.066

Based in Table 3, we can come to a conclusion that the proposed adjustments allow to more accurately analyse and show in the accounting reports the condition of the equity capital in an organisation at the end of the current period, except for the undistributed profit under units not funded by cash flows. For example, the estimated cost of the equity capital in Fishery Company in the accounting period amounted to 156 215 thousand rubles in comparison to the reported 1 139 489 thousand rubles, and that shows that the negative deviation was 983 274 thousand rubles. Similar deviations can be common for other companies as well. What is more, we can see from the table that the estimated cost of Net Profit calculated with the adjustments grew in all companies in comparison to the amount in the report. For example, the positive deviation was 1567 thousand rubles in Healthcare, 32 151 thousand rubles in Fishery, and 2 013 in Retail. It is important to say that adjustments affected the assessed indicators in all organisations in the same way (positive deviation in Net Profit and negative deviation in Equity Capital) without any correlation to their core activities.

## 5 Conclusions

When equity capital is assessed, the coefficients calculated with the proposed adjustments show the real financial situation in an organisation at the end of the period without distorting it with unreliable items. Such accounting adjustments are necessary for accurate and transparent evaluation of the equity capital in an organisation as one of the main elements of a balance sheet. According to IFRS, such accounting reports are reliable and necessary for both internal and external users. The owners of an organisation need a reliable information base and high-quality financial sustainability assessment to increase the efficiency of management decision-making, as they must control and maintain the financial capital. It is important for potential investors who are interested in sustainable companies, and also for audit and other social agencies that ensure control. This is why the proposed adjustments are relevant and positively affect the maintenance of financial capital as net assets cost, which increases the accuracy of financial sustainability assessment.

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