Introducing Financial Statements

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the format and purpose of different financial statements. Specifically, this lesson will cover:

1. Defining the Financial Statement

A financial statement is a formal report of the financial activities of a business, person, or other entity. Financial statements are a key component of accounting; they represent the process of communicating information about a financial entity. Financial statements are presented in a structured manner with conventions accepted by accounting and regulatory personnel. An entity's financial statement typically includes four basic components: a balance sheet, income statement, cash flow statement, and statement of changes in equity:

Financial Statements	Description
Balance Sheet	Reports on a company's **assets**, **liabilities** and ownership **equity**. A balance sheet is often described as a "snapshot of a company's financial condition" at a single point in time. Balance sheets are usually presented with assets in one section and liabilities and net worth in the other.
Income Statement	Reports on a company's expenses and profits to show whether the company made or lost money. It also displays the revenues of a specific period, and the cost and expenses charged against these revenues. In contrast with the balance sheet, which represents a single moment in time, the income statement represents a period of time
Cash Flow Statement	Shows how changes in income affect cash and cash equivalents, breaking the analysis down to operating, investing and financing. Essentially, the cash flow statement is concerned with the flow of cash in and out of the business. As an analytical tool, a cash flow statement is useful in determining the short-term viability of a company.
Statement of Changes in Equity	Explains the company's equity throughout the reporting period. The statement breaks down changes in the owners' interest in the organization and in the application of retained profit or surplus from one accounting period to the next. Line items typically include profits or losses, dividends paid, redemption of stock, and any other items credited to retained earnings.

For complex entities, financial statements often include an extensive set of notes as an explanation of financial policies. The notes typically describe each item in detail. For example, the notes may explain financial figures or the accounting methods used to prepare the statement.

TERMS TO KNOW

Assets
Something or someone of any value; economic resources that represent value of ownership that can be converted into cash.

Liability
An obligation, debt or responsibility owed to someone.

Equity
The residual claim or interest to investors in assets after all liabilities are paid.

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2. Uses of the Financial Statement

Readers of a financial statement are seeking to understand key facts about the performance and disposition of a business. They make decisions about the business based on their reading of the statements. Because financial statements are widely relied upon, they must be straightforward to read and understand.

For large corporations, these statements are often complex and may include an extensive set of notes to the financial statements and explanation of financial policies and management discussion and analysis. The notes typically describe each item on the balance sheet, income statement, and cash flow statement in further detail. Notes to financial statements are considered an integral part of the financial statements.

Owners and managers frequently use financial statements to make important business decisions, for example:

- Whether or not to continue or discontinue part of the business.
- Whether to make or to purchase certain materials.
- Whether to acquire or to rent/lease certain equipment in the production of goods.

The documents are also helpful in making long-term decisions and as a source of historical records.
Other individuals and entities use financial statements, for instance:

- Prospective investors use financial statements to perform **financial analysis**, which is a key component in making investment decisions.
- A lending institution will examine the financial health of a person or organization and use the financial statement to decide whether or not to lend funds.
- Philanthropies may use financial statements of a non-profit as a component in determining where to donate funds.
- Government entities (tax authorities) need financial statements to ascertain the propriety and accuracy of taxes and other duties declared and paid by a company.
- Vendors who extend credit may use financial statements to assess the creditworthiness of the business.
- Employees also may use reports in making collective bargaining agreements.

TERM TO KNOW

Financial Analysis

Also referred to as financial statement analysis; an assessment of the viability, stability, and profitability of an organization or project.

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3. Limitations of Financial Statements

The limitations of financial statements include inaccuracies due to intentional manipulation of figures; cross-time or cross-company comparison difficulties if statements are prepared with different accounting methods; and an incomplete record of a firm's economic prospects, some argue, due to a sole focus on financial measures.

One limitation of financial statements is that they are open to human interpretation and error, in some cases even intentional manipulation of figures. Due to the events that transpired in the Enron scandal, there has been some mistrust regarding the validity of the content of financial statements. High-profile cases in which management manipulated figures in financial statements to indicate inflated economic performance highlighted the need to review the effectiveness of accounting standards, auditing regulations, and corporate governance principles.

As a result, there has been renewed focus on the objectivity and independence of auditing firms. An**audit** of the financial statements of a public company is usually required for investment, financing, and tax purposes, and these are usually performed by independent accountants or auditing firms and included in the annual report. Additionally, in terms of **corporate governance**, managing officials like the CEO and CFO are personally liable for attesting that financial statements are not untrue or misleading, and making or certifying misleading financial statements exposes the people involved to substantial civil and criminal liability.

Another set of limitations of financial statements arises from different ways of accounting for activities across time periods and across companies. This can make it difficult to compare a company's finances across time or to compare finances across companies. Different countries have developed their own accounting principles, making international comparisons of companies difficult. However, the **Generally Accepted Accounting Principles (GAAP)**, a set of guidelines and rules, are one means by which uniformity and comparability between financial statements is improved. Recently there has been a push toward standardizing accounting rules made by the International Accounting Standards Board (IASB).

Another limit to financial statements as a window into the creditworthiness or investment attractiveness of an entity is that financial statements focus solely on financial measures of health. Even traditional investment analysis incorporates information outside of the financial statements to make organizational assessments. However, other methods such as full cost accounting (FCA) or true cost accounting (TCA) argue that an organization's health cannot just be determined by its economic characteristics. Therefore, one needs to collect and present information about environmental, social, and economic costs and benefits (collectively known as the "triple bottom line") to make an accurate evaluation.

TERMS TO KNOW

Audit

The verification of the financial statements of a legal entity intended to enhance the degree of confidence of intended users in the financial statements by providing reasonable assurance that the financial statements are presented fairly.

Corporate Governance

The roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed. Much of the contemporary interest in corporate governance is concerned with mitigation of the conflicts of interests and the nature and extent of accountability of people in the business.

GAAP

Generally Accepted Accounting Principles; refers to the standard framework of guidelines, conventions, and rules accountants are expected to follow in recording, summarizing, and preparing financial statements in any given jurisdiction.

SUMMARY

In this lesson, you learned that there are four types of **financial statements** that communicate information about a company's finances: balance sheet, income statement, cash flow statement, and statement of changes in equity. **Financial statements are useful** to many stakeholders who may want to perform financial analysis, including owners and managers, investors, lenders and creditors, employees, the government and philanthropists, among others. Financial statements also have **limitations** and do not always fully communicate a company's health.

Best of luck in your learning!

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