A Crash Course On Understanding Financial Statements

By I Henman

Financial statements (or financial reports) are a record of a business' financial flows and levels. The big four statements are:

1. Balance sheet which describes a company's assets and liabilities.

2. Income statement which describes a company's income and expenses.

3. Statement of Cash Flows which describes how corporate operating, investment, and financing activities have affected the company's cash position.

4. Statement of Retained Earnings which describes changes to shareholders equity (for example a payment of dividend).

Because these statements are often complex an extensive set of Notes to the Financial Statements and management discussion and analysis is usually included. The notes will typically describe each item on the Balance Sheet and Income statement in further detail. In many cases the notes are much longer than the financial statement they are elucidating.

If a company has extraordinary items that affect the balance sheet or the shareholders equity position it will usually include a Other Comprehensive Income Statement, which describes the adjustments to made. Examples of Other Comprehensive Income include revaluation of corporate assets away from their stated cost, as well as accruals for liabilities.

Income Statement: An income statement, otherwise known as a profit and loss statement, is a summary of a company's profit or loss during any one given period of time, such as a month, three months, or one year. The income statement records all revenues for a business during this given period, as well as the operating expenses for the business. It is very important to format an income statement so that it is appropriate to the business being conducted. Income statements, along with balance sheets, are the most basic elements required by potential lenders, such as banks, investors, and vendors. They will use the financial reporting contained therein to determine credit limits.

Statement of Changes in Financial Position: A statement of changes in financial position (also referred to as the Cash flow Statement) reports the amount of cash coming in (cash receipts) and the amount of cash going out (cash payments or disbursements) during a specified period. Business activities result in either a net cash inflow (receipts greater than payments) or a net cash outflow (payments greater than receipts) during a period. The cash flow statement shows the net increase or decrease in cash during the period and the cash balance at the end of the period. It explains the causes for the changes in the cash balance. The cash flow statement covers a span of time.

Balance Sheet: A balance sheet, in formal bookkeeping and accounting, is a statement of the book value of a business or other organization or person at a particular date, often at the end of its "fiscal year," as distinct from an income statement, also known as a profit and loss account (P&L), which records revenue and expenses over a specified period of time.

Assets: Any item of economic value owned by an individual or corporation, especially that which could be converted to cash. Examples are cash, securities, accounts receivable, inventory, office equipment, real estate, a car, and other property. On a balance sheet, assets are equal to the sum of liabilities, common stock, preferred stock, and retained earnings.

>From an accounting perspective, assets are divided into the following categories: current assets (cash and other liquid items), long-term assets (real estate, plant, equipment), prepaid and deferred assets (expenditures for future costs such as insurance, rent, interest), and intangible assets (trademarks, patents, copyrights, goodwill).

Liabilities: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Owner's Equity: Total assets minus total liabilities of an individual or company. For a company, also called net worth or shareholders' equity or net assets.

Why Financial Statements Are Important: A Beginner's Guide

By Adrian Lawrence

Accounting is considered to be one of those complicated yet necessary chores that keep people's financial affairs relatively clean. For the beginner who is just getting started, the process may not be the first obstacle. Often, it is understanding the special language used by accountants and those that work around them. In other words, one must wade through the jargon in order to understand what's going on. The first step in gaining understanding of accounting is to break concepts down to one fundamental point: financial statements.

Corporations are extremely fond of financial statements – after all, they are required to have them. Financial statements are, in a broader sense, just timely statements of the financial situation of an organization. They hold companies accountable for how money is earned and spent, down to the very last detail. Financial statements are often audited by external auditors to ensure that the company is handling records properly. This also confirms to third parties that the company is displaying a fair and balanced view of the organization's position. These are also called “cash flow statements”. Like most financial concepts, financial statements can be broken down into several smaller concepts. They are: balance sheets, cash flow statements, and profit and loss accounts.

Cash flow statements is another term for financial statements, but a little more specific. This statement shows exactly where the money goes – how it was made, where it was made, and most importantly, how was it spent. A business, after all, has many areas where money flows in and out: operating activities, investing activities, financing activities.

To clarify, operating activities are the daily internal business a company relies on to survive. This may include, but is not limited to: collecting money from customers, paying employees and vendors, interest and taxes, or even revenue from interest payouts. Investing activities are generally investments made by the company to fund purchases of equipment. Finally, financing activities are those that affect the flow of money directly, such as the sale of common stock or adjustments in long or short-term loans.

These calculations are then used to find the total increase (or decrease) in cash and investments. Fluctuations in operations, investing, or financing affect cash flow. This is called the “net change” in cash and marketable securities. From here, these calculations are checked against the balance sheet.

Wait, a balance sheet? Isn't that what we just did, balance?

No. A balance sheet sums up a company's assets, liabilities, and value at a certain point in time. Investors look to the balance sheet to determine a company's value based on what the company owns and what they owe to external sources. The amount of money invested by the shareholders affects company value in this way as well. The balance sheet follows a specific formula, where assets equal liabilities plus shareholder's equity. It is called a balance sheet because the two sides must balance out; after all, a company must pay for assets by either borrowing the money directly, or through shareholders. The balance sheet is clearly a great source of financial information on a company.

The last line of defense, the profit and loss account, shows the activities of a company during a period of time. This differs from the balance sheet in that a profit and loss account serves as a log of a company's activities over a period of time, while the balance sheet is just the financial position at a specific moment in time. Some value the profit and loss account over the balance sheet, as it marks a longer stretch of time than the balance sheet does.

Once broken down into parts, financial statements are not such a hard topic to handle, even for a beginner. Financial statements expose the practices of a company – while one does not get a specific blueprint of how a company makes or loses money, the end results are clearly displayed for people to see.

Adrian Lawrence is the webmaster of Finance Alley the best place to find financial articles http://www.financealley.com covering topics such as accounting, money and loans and all aspects of finance.

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