4. ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

4.1 PRIMARY CHARACTERISTICS: A financial statement discloses a company's financial status by showing what a company has and what it owes. An accurate financial statement of the company is required by the SEC (Securities Exchange Commission). There are four types of financial statements: a balance sheet, an income statement, a cash flow statement and a statement of shareholder's

Balance Sheet

- A balance sheet displays the company's assets, liabilities and shareholder's equity. Assets are things owned by the company, such as property, equipment and cash. Liabilities are the company's debts. Shareholder's equity, also known as capital or net worth, is the money that remains if a company sells all of its assets and pays off its debts. This remaining money would belong to the shareholders.

Income Statement

An income statement shows how much money a company has earned or lost during a specific time period, which is usually a year. Income statements also define earnings per share, which is the money the shareholders would receive for that specified time period if it was distributed.

Cash Flow Statement

A cash flow statement shows cash inflows and outflows that reflect a net increase or decrease in cash. It has three categories: operating activities, financing activities and investing activities.

Shareholder's Equity Statement

A shareholder's equity statement outlines money that the shareholder has received or lost, depending on the financial status of the company. It reflects the changes in shareholder's or stockholder's equity during a period of time and gives a breakdown of stock transactions.

4.2 QUALITATIVE CHARACTERISTICS: *Financial statements are governed by GAAP (generally accepted accounting principles). Financial statements include balance sheets, income statements, statements of cash flows and statements of shareholder's, or owner's, equity, according to the U.S. GAAP Codification of Accounting Standards. These statements have certain qualitative characteristics that ensure their usefulness to both the company and an outside observer.*

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The main qualitative characteristics of financial statements are encompassed in five elements of a financial statement.

Reliable

- According to College Accounting Coach, the information on the statement should represent what it claims to represent. For example, a company cannot say that its shareholder's equity is twice what it really is; the statement must provide accurate data. Also, if another party were to look at the statement, it should be able to interpret the information to the extent that it could understand aspects of the company's financial scenario, asserts College Accounting Coach.

Consistent

- College Accounting Coach says financial statements are consistent. GAAP set detailed guidelines for the presentation of financial statements to ensure their consistency, according to the U.S. GAAP Codification of Accounting Standards. This way, information can be accurately compared between competing companies. If financial statements were done differently by each company, the comparisons wouldn't be valid. College Accounting Coach provides an effective example if Company A discounts all of its liabilities, and Company B discounts none of its liabilities; any comparison made between the two companies' financial statements would be misleading.

Unbiased

- Companies cannot work a financial statement differently to make themselves look better or worse off financially. According to College Accounting Coach, unless you understand the bias, biased financial statements aren't useful to an observer. This goes hand in hand with consistency.

Clear and Concise

- Financial statements are clear and concise. They're in an easy-to-read format with rows and columns. They're user-friendly, and the explanations are located in a separate area, away from the data. Financial statements are in a summary format and are never too long or drawn out.

Relevant

IAS Plus says financial statements are relevant in that they can influence the decision-making of their users. They help the user of the statement make an informed decision because they're timely, they help predict other values, and they provide relevant input on past decisions, according to College Accounting Coach.

4.3 PRIMARY FINANCIAL STATEMENTS: *There are three primary financial statements managers use to gauge how a business is operating, growing, succeeding and areas for improvement: the income statement, the balance sheet and the statement of cash flows. While reviewing each independently can give an adequate picture of some key items, examining the three in conjunction gives a good overview of the performance of a business for both management and investors.*

What Are the Primary Financial Statements & How Do the Statements Tie Together?

Income Statement

- The income statement also goes by several other names, such as the profit and loss statement or earnings statement. The statement reports the expenses, revenue, gains and losses for a particular period of time, usually a year, month, or quarter. The main purpose of the income statement is to show managers how profitable the company was over the reporting period and changes from the prior reporting period. Management can then gauge the progress that the company is making or where improvements need to be made.

Balance Sheet

- The balance sheet is a snapshot of an organization's assets, liabilities and stockholders' equity at a particular point in time. The company lists each category separately, which gives management a clear picture of the breakdown and totals on the reporting date. Assets are the possessions of the company, such as cash, property, buildings, accounts receivable, inventory, investments, equipment and prepaid expenses. Liabilities are what the company owes to others and includes accounts payable, unearned revenue, promissory notes, bonds payable and deferred tax liabilities or assets. Stockholders' equity represents the value of the shares of stock that the company issued. It is important to recognize that this financial statement is a representation of the primary accounting equation: Assets = Liabilities + Stockholder's Equity. This is one of the items that management is reviewing to ensure that all items of the organization are accounted for.

Statement of Cash Flows

The statement of cash flows allows management to review the changes in cash and cash equivalents from the previous reporting period to the current one. There are three separate sections pertinent to the statement: operating activities, financing activities and investing activities. The breakdown enables management to clearly understand where and how cash is flowing in and out of the company. Since generally accepted accounting principles require that businesses report using the accrual method of accounting, then the other statements may not report an accurate picture of the actual cash that the organization has on hand. This statement changes the accrual method into a cash basis for that purpose.

Statement of Stockholders' Equity

While the statement of stockholders' equity is not one of the three primary financial statements, it is also useful to management. This financial statement helps paint a picture of the changes occurring between the reporting date and the prior financial statement date. Some of the changes that management can see upon reviewing this statement include the exercise of stock options by employees, dividend increase or decrease, subsequent issuance of common stock to the public or a change in net income

4.4 BASIC FINANCIAL STATEMENTS: *Financial statements provide insight into companies; if you can understand a firm's financial statements, you can understand how it works and how successful it is. Although many people train for years in accounting or corporate finance to gain an understanding of firms' finances, much can be understood simply by understanding the four basic financial statements commonly used in business.*

Statement of Financial Position

Firms use a statement of financial position, also known as a balance sheet, to demonstrate the firm’s assets, liabilities and owners' equity. A statement of financial position consists of two columns. The left-hand column lists all of the firms assets. Assets include cash, property, accounts receivable and others. The right-hand column includes both the firm's liabilities, such as accounts payable, and the owners' equity. The total amount in both columns must be equal.

Income Statement

- An income statement lists a firm's total revenues and expenses for a specific period of time. It consists of a list of both revenues and expenses, with a debit and credit column. Revenues are placed in the credit column, while expenses are placed in the debit column. The total debits are subtracted from the total credits to give the firm's net income.

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Statement of Retained Earnings

○ A statement of retained earnings, also known as an equity statement, is used to show the owners' equity in the firm. It is a simple statement that shows the retained earnings at the beginning of the period and the net income over the same period. The net income is added to the initial retained earnings to give the retained earnings for the end of the period.

Statement of Cash Flows

○ A statement of cash flows is used to demonstrate the money being paid into and out of a business. It consists of a list of cash flows with the amount of each cash flow stated. Positive cash flows---those paid to the company---are listed without any notation, while negative cash flows, payments outside the company, are listed in parentheses. The total of all the negative cash flows is subtracted from the total positive cash flows to give the firm's net cash flow.

4.5 BALANCE SHEET – FEATURES: In financial accounting, a **balance sheet** or **statement of financial position** is a summary of the financial balances of a sole proprietorship, a business partnership, a corporation or other business organization, such as an LLC or an LLP. Assets, liabilities and ownership equity are listed as of a specific date, such as the end of its financial year. A balance sheet is often described as a "snapshot of a company's financial condition". Of the three basic financial statements, the balance sheet is the only statement which applies to a single point in time of a business' calendar year.

A standard company balance sheet has three parts: assets, liabilities and ownership equity. The main categories of assets are usually listed first, and typically in order of liquidity. Assets are followed by the liabilities. The difference between the assets and the liabilities is known as equity or the net assets or the net worth or capital of the company and according to the accounting equation, net worth must equal assets minus liabilities.

Another way to look at the balance sheet equation is that total assets equals liabilities plus owner's equity. Looking at the equation in this way shows how assets were financed: either by borrowing money (liability) or by using the owner's money (owner's or shareholders' equity). Balance sheets are usually presented with assets in one section and liabilities and net worth in the other section with the two sections "balancing".

A business operating entirely in cash can measure its profits by withdrawing the entire bank balance at the end of the period, plus any cash in hand. However, many businesses are not paid immediately; they build up inventories of goods and they acquire buildings and equipment. In other words: businesses have assets and so they cannot, even if they want to, immediately turn these into cash at the end of each period. Often, these businesses owe money to suppliers and to tax authorities, and the proprietors do not withdraw all their original capital and profits at the end of each period. In other words businesses also have liabilities.

Types

A balance sheet summarizes an organization or individual's assets, equity and liabilities at a specific point in time. Two forms of balance sheet exist. They are the report form and the account form. Individuals and small businesses tend to have simple balance sheets. Larger businesses tend to have more complex balance sheets, and these are presented in the organization's annual report. Large businesses also may prepare balance sheets for segments of their businesses. A balance sheet is often presented alongside one for a different point in time (typically the previous year) for comparison.

Personal balance sheet

A personal balance sheet lists current assets such as cash in checking accounts and savings accounts, long-term assets such as common stock and real estate, current liabilities such as loan debt and mortgage debt due, or overdue, long-term liabilities such as mortgage and other loan debt. Securities and real estate values are listed at market value rather than at historical cost or cost basis. Personal net worth is the difference between an individual's total assets and total liabilities.

US small business balance sheet

A small business balance sheet lists current assets such as cash, accounts receivable, and inventory, fixed assets such as land, buildings, and equipment, intangible assets such as patents, and liabilities such as accounts payable, accrued expenses, and long-term debt. Contingent liabilities such as warranties are noted in the footnotes to the balance sheet. The small business's equity is the difference between total assets and total liabilities.