

FINANCIAL REPORTING

- I. **Financial statements** (or **financial reports**) are formal records of a business' financial activities.

In British English, including United Kingdom company law, financial statements are often referred to as **accounts**, although the term financial statements is also used, particularly by accountants.

Financial statements provide an overview of a business' financial condition in both short and long term. All the relevant financial information of a business enterprise, presented in a structured manner and in a form easy to understand, are called the financial statements. There are four basic financial statements:

1. **Balance sheet**: also referred to as statement of financial position or condition, reports on a company's [assets](#), [liabilities](#), and net equity as of a given point in time.
2. **Income statement**: also referred to as Profit and Loss statement (or a "P&L"), reports on a company's income, expenses, and profits over a period of time. Profit & Loss account provide information on the operation of the enterprise. These include sale and the various expenses incurred during the processing state.
3. **Statement of retained earnings**: explains the changes in a company's retained earnings over the reporting period.
4. **Statement of cash flows**: reports on a company's cash flow activities, particularly its operating, investing and financing activities.

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities and equity are directly related to an organization's financial position. Reported income and expenses are directly related to an organization's financial performance.

Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently.

- Owners and managers require financial statements to make important business decisions that affect its continued operations. [Financial analysis](#) are then performed on these statements to provide management with a more detailed understanding of the figures. These statements are also used as part of management's annual report to the stockholders.
- Employees also need these reports in making [collective bargaining](#) agreements (CBA) with the management, in the case of [labor unions](#) or for individuals in discussing their compensation, promotion and rankings.
- **External Users**: are potential investors, banks, government agencies and other parties who are outside the business but need financial information about the business for a diverse number of reasons.

- II. **Accounting standards and regulations**: Different countries have developed their own accounting principles over time, making international comparisons of companies difficult. To ensure uniformity and comparability between financial statements prepared by different companies, a set of guidelines and rules are used. Commonly referred to as Generally Accepted Accounting Principles (GAAP), these set of guidelines provide the basis in the preparation of financial statements.

Recently there has been a push towards standardizing accounting rules made by the International Accounting Standards Board ("IASB"). IASB develops International Financial Reporting Standards that have been adopted by Australia, Canada and the European Union (for publicly quoted companies only), are under consideration in South Africa and other countries. The United States Financial Accounting Standards Board has made a commitment to converge the U.S. GAAP and IFRS over time.

III. Basic statements

1. The **balance sheet** is a snapshot of the firm. It is a convenient means of organizing and summarizing what a firm owns (its assets), what a firm owes (its liabilities), and the difference between the two (the firm's equity) at a given point in time.

ASSETS: THE LEFT SIDE

Assets are classified as either *current* or *fixed*. A fixed asset is one that has a relatively long life. Fixed assets can be either *tangible*, such as a truck or a computer, or *intangible*, such as a trademark or patent. A current asset has a life of less than one year. This means that the asset will convert to cash within 12 months. For example, inventory would normally be purchased and sold within a year and is thus classified as a current asset. Obviously, cash itself is a current asset. Accounts receivable (money owed to the firm by its customers) are also current assets.

LIABILITIES AND OWNERS' EQUITY: THE RIGHT SIDE

The firm's liabilities are the first thing listed on the right side of the balance sheet. These are classified as either *current* or *long-term*. Current liabilities, like current assets, have a life of less than one year (meaning they must be paid within the year) and are listed before long-term liabilities. Accounts payable (money the firm owes to its suppliers) are one example of a current liability.

A debt that is not due in the coming year is classified as a long-term liability. A loan that the firm will pay off in five years is one such long-term debt.

Finally, by definition, the difference between the total value of the assets (current and fixed) and the total value of the liabilities (current and long-term) is the *shareholders' equity*, also called *common equity* or *owners' equity*. This feature of the balance sheet is intended to reflect the fact that, if the firm were to sell all its assets and use the money to pay off its debts, then whatever residual value remained would belong to the shareholders. So, the balance sheet "balances" because the value of the left side always equals the value of the right side. That is, the value of the firm's assets is equal to the sum of its liabilities and shareholders' equity:

This is the *balance sheet identity*, or equation, and it always holds because shareholders' equity is defined as the difference between assets and liabilities.

2. The **income statement** measures performance over some period of time, usually a quarter or a year. The income statement equation is:

Revenues - Expenses = Income

If you think of the balance sheet as a snapshot, then you can think of the income statement as a video recording covering the period between before and after pictures. The first thing reported on an income statement would usually be revenue and expenses from the firm's principal operations. Subsequent parts include, among other things, financing expenses such as interest paid. Taxes paid are reported separately. The last item is *net income* (the so-called bottom line). Net income is often expressed on a per-share basis and called *earnings per share (EPS)*.

3. In financial accounting, a **cash flow statement** or **statement of cash flows** is a financial statement that shows a company's flow of cash. The money coming into the business is called cash inflow, and money going out from the business is called cash outflow. The statement shows how changes in balance sheet and income accounts affect cash and cash equivalents, and breaks the analysis down to **operating**, **investing**, and **financing** activities. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.

The cash flow statement is partitioned into three segments, namely: cash flow resulting from operating activities, cash flow resulting from investing activities, and cash flow resulting from financing activities. **Operating activities** include the production, sales and delivery of the company's product as well as collecting payment from its customers. This could include purchasing raw materials, building inventory, advertising, and shipping the product.

Examples of Investing activities are: 1) Purchase of an asset (assets can be land, building, equipment marketable securities), 2) Loans made to suppliers or customers

Financing activities include the inflow of cash from investors such as banks and shareholders, as well as the outflow of cash to shareholders as dividends as the company generates income. Other activities which impact the long-term liabilities and equity of the company are also listed in the financing activities section of the cash flow statement.

4. The **Statement of Retained Earnings** (also known as **Equity Statement**,) explains the changes in a company's retained earnings over the reporting period. It breaks down changes affecting the account, such as profits or losses from operations, dividends paid, and any other items charged or credited to retained earnings. A retained earnings statement is required by Generally Accepted Accounting Principles (GAAP) whenever comparative balance sheets and income statements are presented. It may appear in the balance sheet, in a combined income statement and changes in retained earnings statement, or as a separate schedule. Therefore, the statement of retained earnings uses information from the income statement and provides information to the balance sheet. Retained earnings are part of the balance sheet (another basic financial statement) under "stockholders equity," and is mostly affected by net income earned during a period of time by the company less any dividends paid to the company's owners / stockholders. The retained earnings account on the balance sheet is said to represent an "accumulation of earnings" since net profits and losses are added/subtracted from the account from period to period.