Basics of Financial Statements

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Financial statements are key components in revealing and understanding the financial position of any organization[1] . Thereby, no matter the financial position of the companies is hard to understand, all the dealers and business should at least have a minor basic information about the main elements of the most important financial statements. Understanding the elements of these statements and the difference between them can

[1] Throughout the brochure, we will use the term “company”, as an indication for the main types of organizations that produce balance sheets and different financial statements.

help in evaluating the performance of the companies, and consequently helps in making good financial decisions.

As a point of start, financial statements represent formal records of the all the financial activities of a business. A complete set of financial statements comprises; a statement of financial position; a statement of comprehensive income statement; a statement of cash flows; a statement of changes in equity, all of these statements' figures are for a specific period. In addition to supplementary notes; comprising a summary of significant accounting policies and other explanatory information. To sum it up, almost all businesses produce four major financial statements: (1) balance sheets; (2) income statements; (3) cash flow statements; and (4) statements of shareholders' equity.

In brief, balance sheets show both; what a company owns and owes at a fixed point in time. Income statements show how much money a company made and spent over a certain period. Cash flow statements show the exchange of money between a company and the outside world, also over a specific period of time. The fourth financial statement, called a "statement of shareholders' equity," shows changes in the interests of the company's shareholders over time.

The main elements of each of the financial statements;

1. Balance Sheets;

- A balance sheet is often described as a "snapshot of a company's financial condition on a specific date or at a given time". Thus, it shows the financial position of a business on a specified date (usually the end of the financial year, month or quarter). The information is aggregated into the general classifications of **assets, liabilities, and equities.** Assets are what the company owns and have value whether; current or fixed assets. In which;

- **Current assets** are the most liquid, meaning they are easily convertible to cash; examples are receivables, inventory, work in process, or even cash . In accounting, any asset expected to last or be in use for less than one year is considered a current asset. Assets are generally listed based on how quickly they will be converted into cash.

- **Fixed assets** are long-term assets that is not consumed or sold during the normal course of business, such as land, buildings, equipment, machinery, vehicles, leasehold improvements, and other such items. In accounting, any asset expected to last, or be in use for more than one year is considered a fixed asset.

On the other side, **liabilities** refer to the amounts of money that a company owes to others. This can include all kinds of obligations; like money borrowed from a bank for any business related reason, rental of a building, money owed to suppliers for materials, payroll a company owes to its employees, environmental cleanup costs, or taxes owed to the government. Liabilities are generally listed based on their due dates.

As for the shareholders’ equity, also called capital or net worth, it is defined as the money that would be left if a company sold all of its assets and paid off all of its liabilities. This leftover money belongs to the shareholders, or the owners, of the company.

Therefore, the balance sheet shows a clear snapshot at the end of the reporting period on; what assets the company owns, how it paid for them, what it owes (its liabilities), and what is the amount left after satisfying the liabilities. The following **formula** summarizes what a balance sheet shows:

ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY

A company's assets have to equal, or "balance," the sum of its liabilities and shareholders' equity.

It is worth mentioning that a company's balance sheet is set up like the basic accounting equation shown above. On the left side of the balance sheet, companies list their assets. On the right side, they list their liabilities and shareholders' equity. Sometimes balance sheets show assets at the top, followed by liabilities, with shareholders' equity at the bottom.

2. Income Statements

Income statements report the performance of the financial business or company over a certain accounting period, which may be a month, a quarter or a year. The performance is evaluated through summarizing the revenues, gains, expenses and losses over the course of the period. The aim of the income statement is to calculate the net profit or loss for the company, after subtracting the expenses, incurred in earning the revenue, from the total amount of revenue achieved by the business. In more details, calculations of income statements begin with the companies' total amounts of sales made during the accounting period (revenue), and then subtracts out all expenses and operating costs, including the; depreciation costs, marketing costs,

income taxes and others incurred during the period to arrive finally at the net profit or loss.

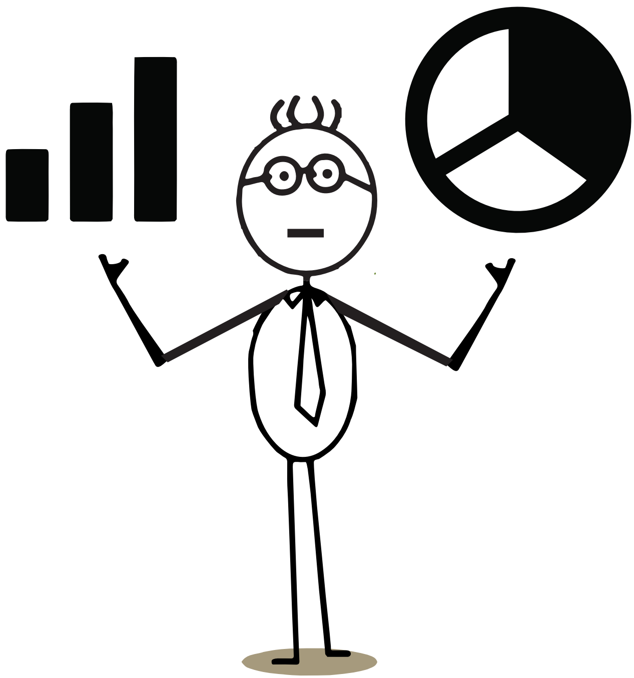
In this regards, the following **formula** summarizes what an Income Statement's data is based on;

INCOME= REVENUES- EXPENSES

Furthermore, income statements also show the rate at which the owners' equity is changing for better or worse, as it report the earnings per share (EPS); which indicates the amount of money that the shareholders might receive for each share they own at the company, if the net earnings are to be distributed. However, mostly they are reinvested in the business cycle of the company.

It is also worth mentioning that income statements are known in accounting for other names as well. For example, income statement may also be referred to as the 'Profit & Loss Statement', 'P&L' , 'Statement of Financial Performance' , 'Revenue Statement' , 'Earnings Statement', 'Operating Statement' or 'Statement of Operations'.

3. Cash Flow Statements



Cash Flow statements report the cash inflows and outflows of the company, in other words, cash flow statement reports the amount of cash within the company, and whether it generated a net increase or decrease **over time**, rather than **at a point of time.**

In this context, cash flow statements are divided into three main parts. Each part reflects the cash flow of a certain type of the business activity, as follows; (A)

A. First section of a cash flow statement : **Operating activities**; shows the cash flowing in and out of the company in relation to its business operation; it analyzes cash flow from net income or losses.

B. Second section of the cash flow statement: **Investing activities**; shows the cash flowing, whether received or spent on the company's capital investments, including purchases or sales of long-term assets, such as property, plant and equipment, as well as investment securities.

C. Third section of a cash flow statement: Financing activities; shows the cash flowing from all the financing activities, as that of the finance raised by selling stocks, bonds or borrowing from banks.

4. Statements of Shareholders' Equity (Statement of Retained Earnings)

This statement shows the changes in the shareholders' equity account. It highlights the business activities that contribute to whether the value of stockholders or shareholders' equity goes up or down, from the beginning of a given accounting period to the end of that period.

Additionally, the statement of shareholders' equity enables companies to make decisions about their future issuance of stock shares, besides being an indicator for the shareholders for tracking the net worth of their investments.

To conclude, it is very essential to highlight the fact that accurate and timely prepared financial statements are crucial for business owners to efficiently run their daily business and make important decisions. It is also important for the public dealing with these companies, as it enables them to evaluate their performance for different reasons. Some of these reasons may include; investing in stocks of the company, offering any kind of facilities or deferred payment or even dealing within the normal course of business.

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