Segment: Financial Reporting

Topic: Financial Statements

Table of Contents

Introduction

The key component of a financial report is the financial statement section. These statements provide information about a company's financial position, profitability and cash-generating ability. The financial statements comprise the

- balance sheet (or statement of financial position)
- statement of changes in shareholders' equity
- income statement (or the statement of financial performance)
- statement of cash flows

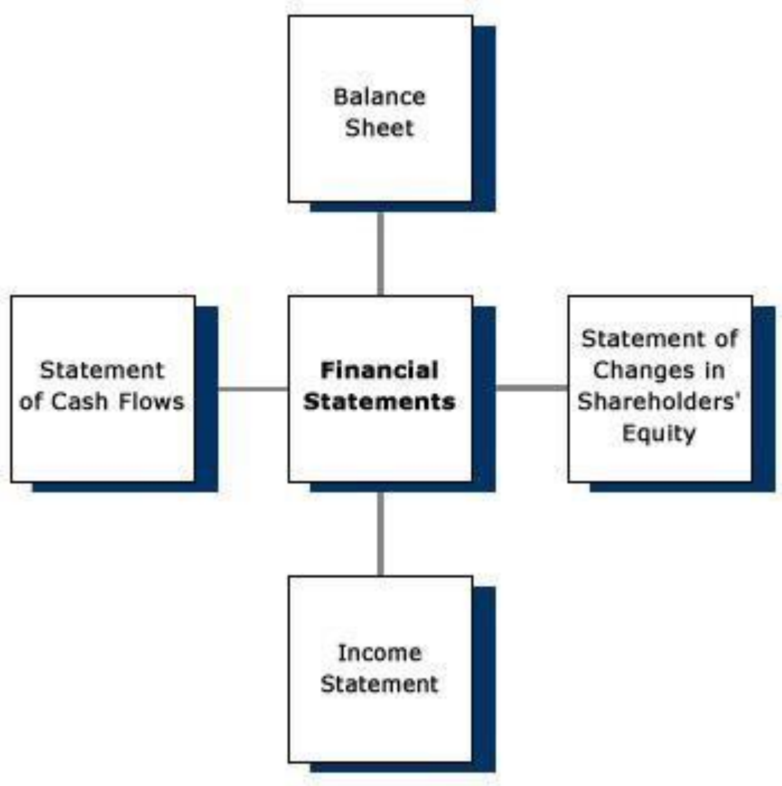

Fig.1: Components of Financial Statement

Learning Objectives

At the end of this topic, you will be able to:

- state the purpose of the financial statement section in a financial report
- describe the four types of information displayed within the financial statement section.

1. The Balance Sheet

The balance sheet, or statement of financial position, presents a snapshot summary of a company's financial position at a particular point of time at the end of the reporting period.

Think about the balance sheet as a statement that records a company's resources and the claims on these resources. The difference between the resources and the claims reflects a company's equity. For example, let us say that you own a small business and that you are seeking a loan from your bank. The loan officer asks you to provide a current summary of your business's financial position. Your business resources might include properties, merchandise, cash in the bank, investments and some equipment to the value of US$100,000. These are resources that you own or control. The common accounting term for these resources is assets. You may also owe money to suppliers and have an outstanding short-term loan to the value of US$60,000. These are claims against the resources that you own or control. The common accounting term for these claims is liabilities. Equity is the difference between assets and liabilities. The difference between your assets and your liabilities, US$40,000, is referred to as your net equity and it reflects your current financial position. The balance sheet for a company provides a similar summary of its assets, liabilities and equity at the period-end. An example of a balance sheet layout is displayed below.

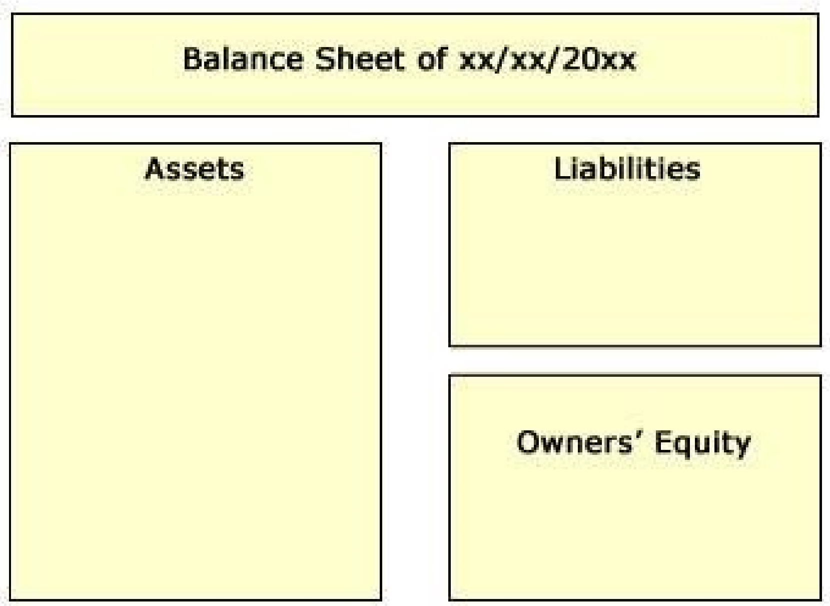

Fig.2: An Example of Balance Sheet Layout

Where,

Assets – Liabilities = Equity

For a publicly- traded company, this equation (sometimes referred to as the accounting equation), can be rewritten as

Assets = Liabilities + Shareholders' Equity

The assets of a company reflect its investment decisions. On the other hand, a company's liabilities as well as its shareholders' equities reflect its financing decisions (e.g., a company may prefer to finance its investments in assets by borrowing money, thus increasing its liabilities, or it may prefer to finance its investments in assets by issuing equity).

2. The Statement of Changes in Shareholders' Equity

The statement of changes in shareholders' equity is, in effect, the shareholders' equity section of the balance sheet. However, this statement also provides information about the sources of the change for each component of the owners' equity in the balance sheet during a reporting period.

The relationship between beginning and ending balances for the main components of the owners' equity section of the balance sheet is illustrated as follows:

Ending contributed capital balance:

Ending contributed capital balance =
Beginning contributed capital balance
(+) New equity issued during the period
(−) Equity retired during the period

Ending retained earnings balance:

Ending retained earnings balance =

Beginning retained earnings balance
(+) Reported profit for the period
(−) Dividends declared during the period

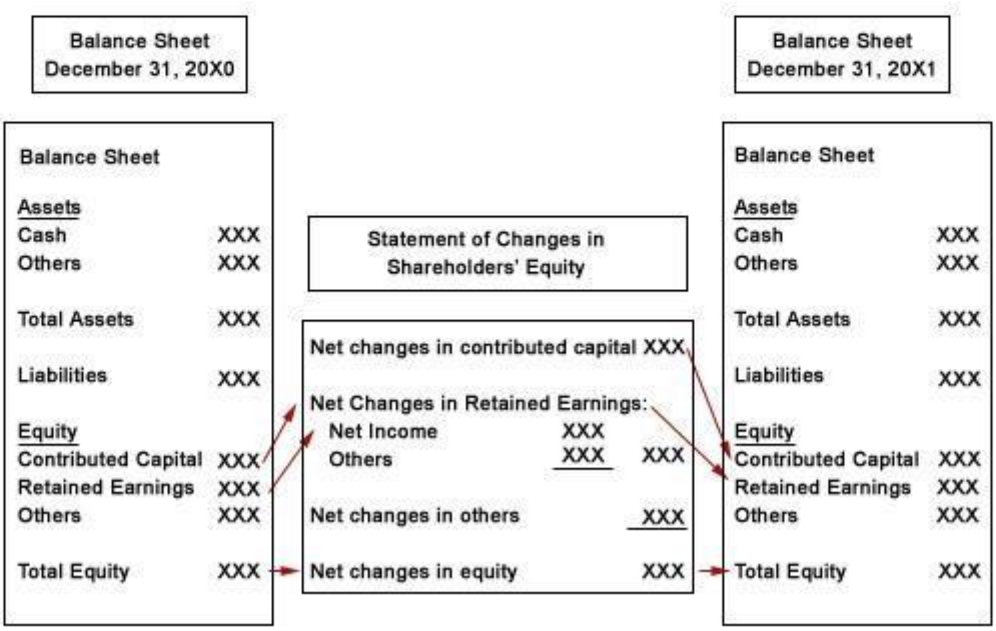

Fig.3: Balance Sheet

Some companies provide this statement as a stand-alone statement, while others provide the details about the shareholders' equity section of the balance sheet in the footnotes to the financial statements. Samsung did not provide a separate statement of shareholders' equity, but it provided the details in the footnotes to the financial statements.

3. The Income Statement

The income statement, or the statement of financial performance, summarises a company's financial performance during a reporting period. It comprises revenues earned during a particular period, and the expenses incurred to generate the reported revenues, regardless of the timing of the underlying cash inflows and outflows. In other words, it reports revenues in the period in which they are earned rather than in the period in which they are collected, and reports expenses in the period in which they are incurred rather than in the period in which they are paid. In addition to revenues and expenses, the income statement comprises gains and losses caused by transactions that are not part of a company's day-to-day operations. The excess of all revenues and gains over all expenses and losses during a period is referred to as net income (or net earnings).

Revenues are earned from operating activities (such as sales revenue) and from non-operating activities (such as interest and dividend income). Similarly, expenses are incurred in operating activities (such as the cost of goods sold and selling and administrative expenses), and in non-operating activities (such as interest expenses). Gains and losses tend to arise out of non-operating non-routine transactions such as the sale of property and equipment and the disposal of investment in securities.

The relationships among the various components of a typical income statement may be illustrated as follows:

Net Sales Revenue
– Cost of Goods Sold
= Gross Profit
– Operating Expenses
= Operating Income before Tax
+ Net Non-Operating Income
= Income before Taxes and Extraordinary Items
– Income Taxes
= Income before Extraordinary Items
+ Net Extraordinary Items
= Net Income
– Preferred Stocks Dividends
= Net Income Available to Common Shareholders

4. The Statement of Cash Flows

The statement of cash flows provides information about a company's cash generating ability. It reports a summary:

- of a company's cash transactions

- tracks its cash sources and uses during a period.

In effect, the statement of cash flows reports the sources of the changes in the balance sheet's cash balance during a period. For example, Company ABC’s ending cash balance as reported in its 2018 balance sheet is US$30,340,505 million and its ending cash balance as reported in its 2019 balance sheet is US$26,885,999 million. ABC’s cash account has decreased by US$3,454,506 during 20019.

The statement of cash flows provides a breakdown of the sources of this change by tracking three types of cash flows:

- operating
- investing
- financing

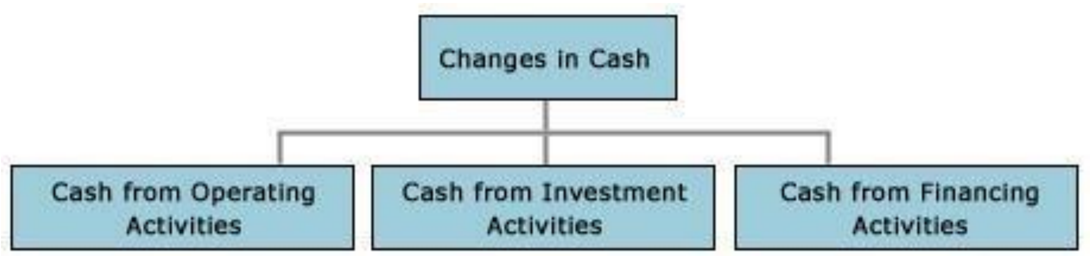

Fig.4: Types of Cash Flows

Operating Cash Flows

One of the main benefits of the statement of cash flows is that it provides information about whether a company has generated sufficient cash flows from its operating activities during a period to finance its investment growth and to service its debt. The other financial statements do not provide such information. In fact, as we will see in later segments, a company can be profitable when it is unable to generate sufficient operating cash flows, or it might even have net cash outflows from its operating activities. In the extreme scenario, a profitable company can face a cash crisis, which may affect its survival.

Operating cash flows can be tracked directly or indirectly.

Under the *direct* method, the main source of operating cash inflows is cash collected from the sale of goods and services. The main source of operating cash outflows is cash paid to suppliers of inventory, to employees for services, and to others for advertising and the like.

Under the *indirect* method, operating cash flow is tracked by reconciling it with net income (as reported in the income statement).

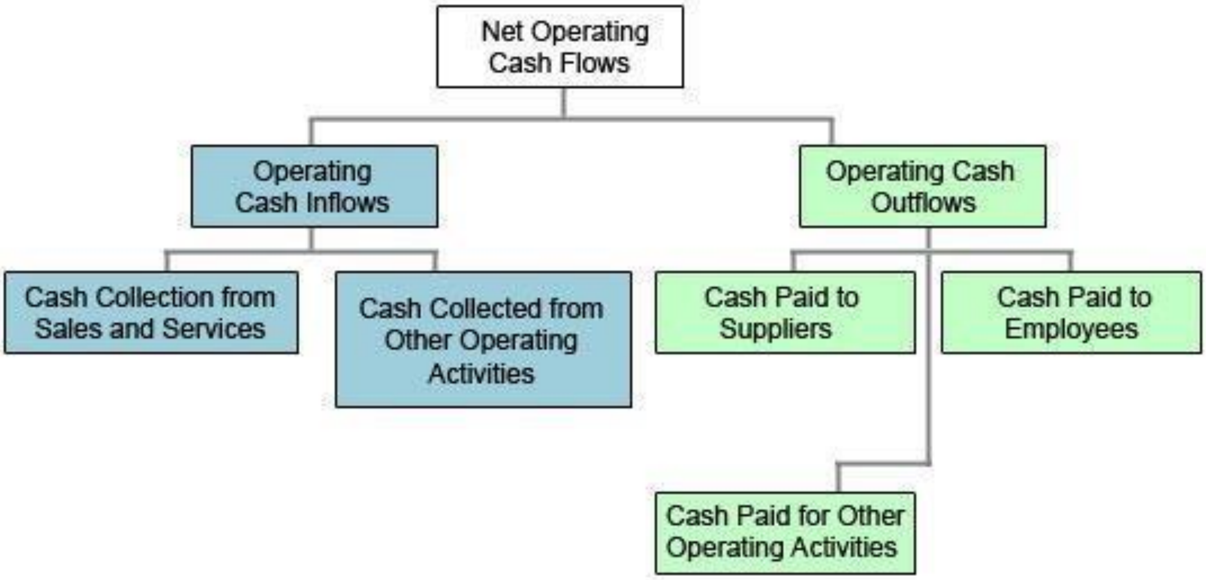

Fig.5: Operating Cash Flows

While tracking operating cash flows using the direct method is more useful to financial statement users, many companies prefer to use the indirect method. Some countries require companies to report operating cash flows using both methods. We will discuss both methods in more detail in a later topic, "Cash Flow Statement". A company in a steady state is expected to consistently generate net cash inflows from its operating activities. Typically, a newly established company tends to report a net cash outflow from its operating activities during the first few years of its operation.

Investing Cash Flows

The main source of investing cash inflows is cash collected from the sale and disposal of investments, properties and other non-current assets. The main source of investing cash outflows is cash paid for acquiring new properties, new investments and acquisitions of other non-current assets. A growing company tends to report a net cash outflow from its investment activities.

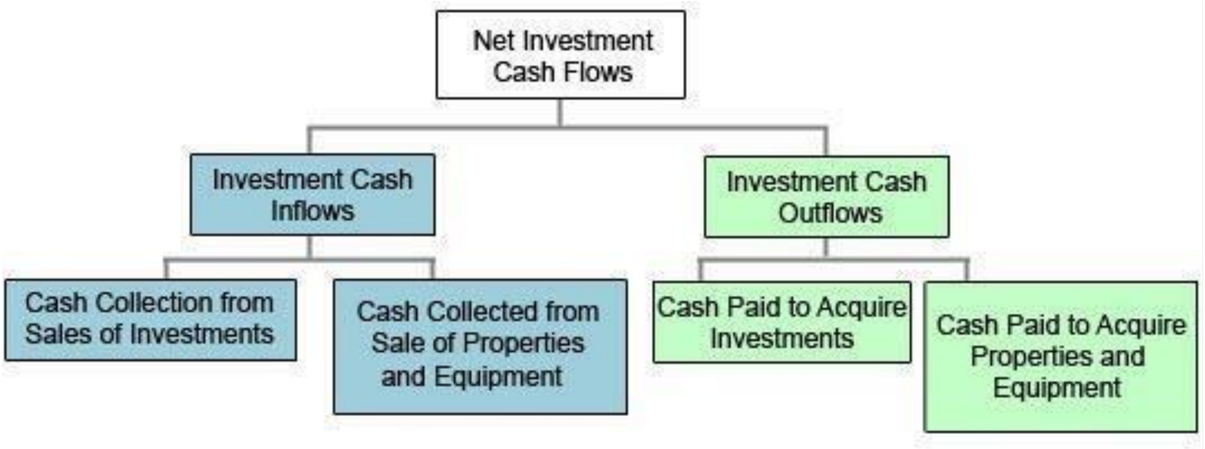

Fig.6: Investing Cash Flows

Financing Cash Flows

The main source of financing cash inflows is cash collected from the issuance of new debt and new equity. The main source of financing cash outflows is cash paid for retiring debt and equity. A company may report a net cash outflow or a net cash inflow from its financing activities, depending on its growth, capital structure and its ability to generate sufficient operating cash inflows.

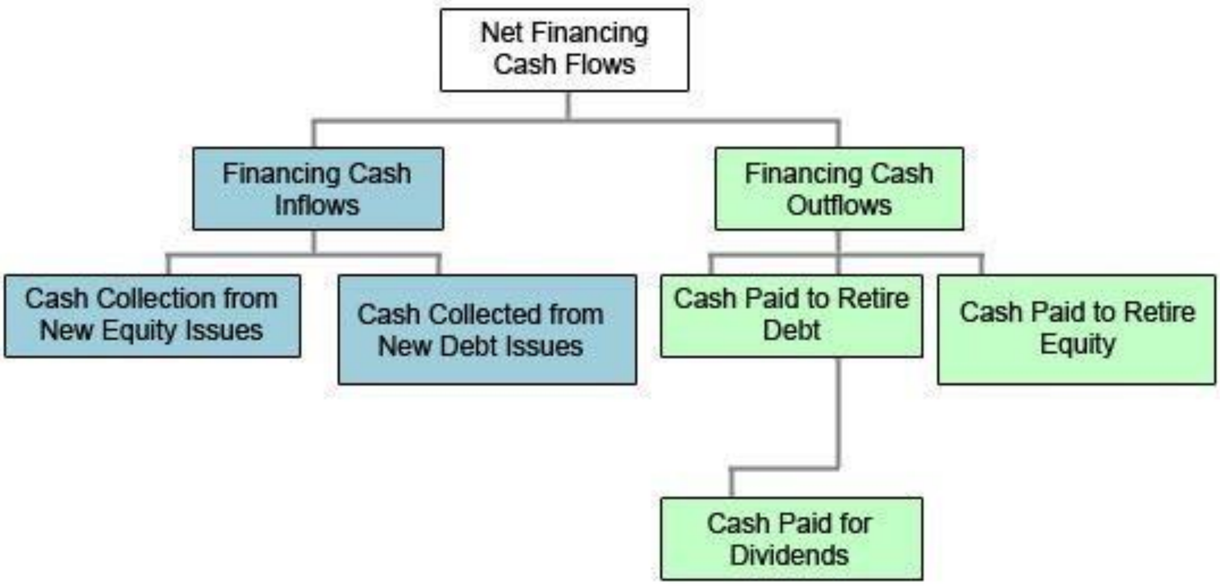

Fig.7: Financing Cash Flows

5. Financial Statement Articulation

Articulation of the financial statements is the way in which these statements fit together and relate to each other. The following diagram illustrates how financial statements relate to each other.

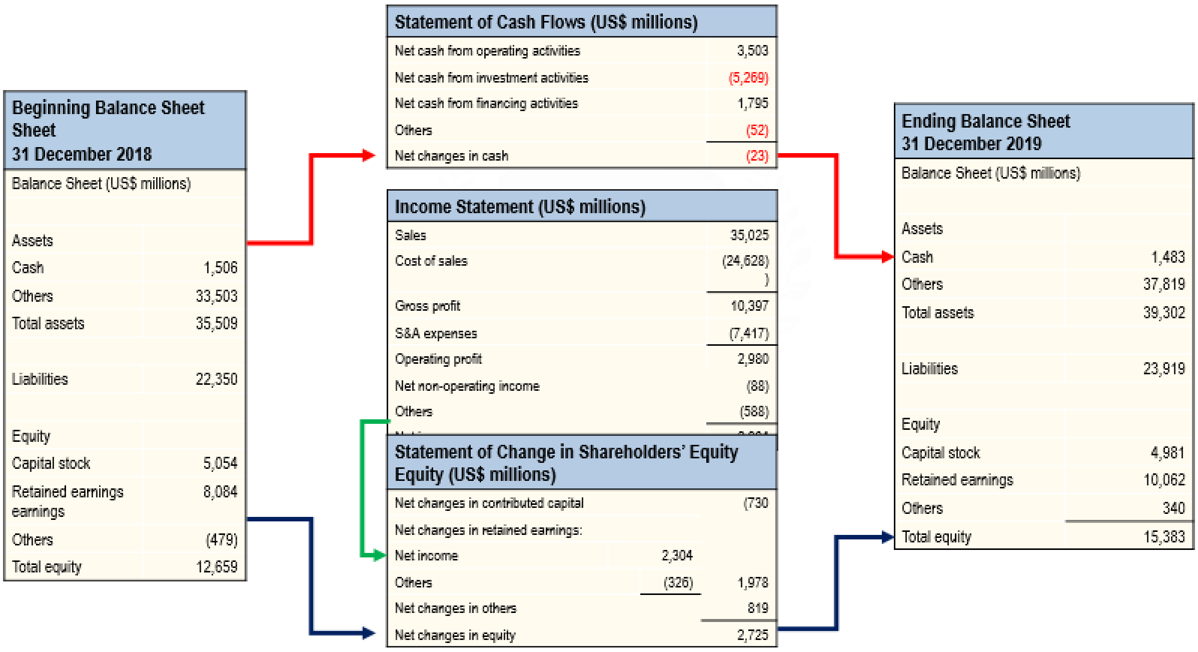

Fig.8: Diagram Illustrating how Financial Statements Relate to Each Other

The articulation of the income statement and the balance sheet is through the statement of shareholders' equity.

- The balance sheet provides the shareholders' equity balance at a particular point of time. It also provides the cash balance at a particular point of time. The statement of cash flows explains the changes in cash between two balance sheet dates
- The statement of shareholders' equity explains the changes in shareholders' equity between two balance sheet dates.
- The income statement explains the change in shareholders' equity resulting from profit generated during a particular period.

6. Summary

Here is a quick recap of what we have learnt so far:

- provide a company's stakeholders with summary information about its financial performance during a period, its financial position at the end of that period, and its cash-generation ability

- articulate with each other to help users understand the historical performance of the company and to also assess and predict the future cash flow and earnings potential of a company
- rely on accounting processes and procedures which, as will be shown in later segments, require the use of judgments.