



Financial Statements

Topic List

- The Balance Sheet Equation
- Income Statement
- Cash Flow Statement
- GAAP vs IFRS

Learning Objectives

- To understand the different types of financial statements.
- To understand the Balance Sheet Equation and the components of Balance Sheet.
- To understand the various components of Income Statement.
- To understand the different elements of Cash Flow Statement.
- To understand the difference between GAAP and IFRS.

The Users of Accounts

The different users of accounts, often called 'stakeholders' will require financial information for varied purposes. Each will be able to calculate performance indicators specific to their needs in order to make informed decisions about the performance of the company at any given point in time.

The list below shows the different users:

1. Owners: How is their investment performing?
2. Management: Is the business running profitably and efficiently?
3. Employees: Are they going to be remunerated on time / are their jobs secure?
4. Creditors: Can the business pay the amounts owed and on time?
5. Tax Authorities: How much tax should be paid?
6. Banks / Lenders: Is it safe to lend the business money?
7. Potential Investors: What is their potential return should they choose to invest?

Assessing Organisational Performance

Financial Statements provide basic information to assess the current financial standing of an organisation. However, financial statements contain large amounts of data. To analyse and interpret these data in to a meaningful form, financial managers generally focus on a few key financial ratios for forecasting and strategic decision making.

1. How much has the company borrowed? Is the amount of debt likely to result in financial distress?
2. How liquid is the company? Can it easily lay its hands on cash if needed?
3. How productively is the company using its assets? Are there any indicators that the assets are not being used efficiently?
4. How profitable is the company?
5. How highly is the firm valued by investors? Are investors expectations reasonable?

Balance Sheet


Definition

The balance sheet communicates your organization's worth, or "book value," by tallying its assets, liabilities, and shareholders' equity for a given reporting period.

Purpose

For internal stakeholders, the balance sheet provides insight into whether your company is succeeding or failing and aids in strategic decision-making. For external stakeholders, it communicates what resources are available to your business and how you financed them, which can inform investment decisions.

The Balance Sheet Equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$


The balance sheet should always balance, meaning your assets' total value should always equal the combined total of liabilities and owners' equity (also known as shareholders' equity).

Balance Sheet (GAAP vs IFRS)

GAAP

ASSETS			
CURRENT ASSETS			
Cash and cash equivalents	\$	\$	1,000
Accounts receivable		\$	500
Inventory			
Other current assets			
Total current assets		\$	1,500
NON-CURRENT ASSETS			
Property, plant and equipment			
Long-term intangible assets			
Other long-term intangible assets			
Total assets		\$	1,500
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT LIABILITIES			
Current portion of long-term debt	\$		300
Accounts payable			
Accrued expenses			
Other current liabilities			
Total current liabilities		\$	300
NON-CURRENT LIABILITIES			
Long-term debt, less current portion	\$		750
Other long-term liabilities			
Total liabilities		\$	1,050
SHAREHOLDERS' EQUITY			
Common stock			
Retained earnings			
Total shareholders' equity		\$	-
Total liabilities and shareholders' equity		\$	1,050

IFRS

ASSETS	
NON-CURRENT ASSETS	
Brands	\$
Customer relations	
Leasehold rights	
Capitalized expenditures	
Goodwill	
Buildings and land	
Equipment, tools, fixtures, and fittings	
Long-term receivables	
Deferred tax receivables	
Total non-current assets	\$ -
CURRENT ASSETS	
Inventory	
Accounts receivable	
Tax receivable	
Other receivables	
Prepaid expenses	
Short-term equivalents	
Cash and cash equivalents	
Total assets	\$ -
LIABILITIES AND SHAREHOLDERS' EQUITY	
NON-CURRENT LIABILITIES	
Provisions for pensions	
Deferred tax liabilities	
Total non-current liabilities	\$ -
CURRENT LIABILITIES	
Accounts payable	
Tax liabilities	
Other liabilities	
Accrued expenses and other deferred revenue	
Total liabilities	\$ -
SHAREHOLDERS' EQUITY	
Share capital	
Reserves	
Retained earnings	
Total shareholders' equity	\$ -
Total liabilities and shareholders' equity	\$ -

Income Statement

Definition

The income statement summarizes your business's income and expenses during a given period.

Purpose

The income statement's purpose is to show your company's earnings and operating activities for a given period.



Income Statement

INCOME STATEMENT	
Net sales	\$
Cost of sales	
Gross profit	\$ -
Selling and operating expenses	
General and administrative expenses	
Total operating expenses	\$ -
Operating income	\$ -
Other income	
Gain (loss) on financial instruments	
(Loss) Gain on foreign currency	
Interest expense	
Income before taxes	\$ -
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	
Income tax expense	
Net income	\$ -

Cash Flow Statement

Definition

The **cash flow statement** provides a detailed analysis of what happened to your company's cash during a given period. It shows how your business generated and spent it by including an overview of cash flows from three sources:



Operating activities detail the cash flow your company generated once it delivered regular goods or services. It includes both income and expenses.



Investing activities include cash flow from purchasing or selling assets— think physical property (such as real estate or vehicles) and non-physical property (like patents)—using free cash, not debt.



Financing activities detail cash flow from both debt and equity financing.

Purpose

The cash flow statement provides insight into different areas your business used or received cash. Its information is vital to valuing your company and understanding how it operates.

Cash Flow Statement

Cash and cash equivalents, beginning of year

OPERATING ACTIVITIES:

Net income

Adjustments to reconcile net income to cash generated by operating activities:

Depreciation and amortization

Deferred income tax expense

Other

Changes in operating assets and liabilities:

Accounts receivable, net

Inventories

Vendor non-trade receivables

Other current and non-current assets

Accounts payable

Deferred revenue

Other current and non-current liabilities

Cash generated by operating activities

\$ -

INVESTING ACTIVITIES:

Purchasing of marketable securities

Proceeds from maturities of marketable securities

Proceeds from sales of marketable securities

Payments made in connection with business acquisitions, net of cash acquired

Payments for acquisition of property, plant, and equipment

Payments for acquisition of intangible assets

Other

Cash used in investing activities

\$ -

FINANCING ACTIVITIES:

Dividends and dividend equivalent rights paid

Repurchase of common stock

Proceeds from issuance of long-term debt, net

Other

Cash used in financing activities

\$ -

Increase/(decrease) in cash and cash equivalents

\$ -

Cash and cash equivalents, end of year

\$ -

Accounting Standards: GAAP vs IFRS

How you format your organization's balance sheet and cash flow statement depends on where it's based. The two main sets of accounting standards are GAAP and IFRS.



GAAP

GAAP also referred to as U.S. GAAP is an acronym for Generally Accepted Accounting Principles. The Financial Accounting Standards Board (FASB) sets these guidelines, which most U.S. companies adhere to.

IFRS

IFRS stands for International Financial Reporting Standards. The International Accounting Standards Board (IASB) dictates these principles, which many companies outside the United States follow.

Conclusion:

Regardless of whether you're a finance professional, knowing how to read and analyse financial statements is critical.

Learning the language of business can not only provide a deeper understanding of your organization's financial metrics but help you make data-driven decisions.

References:

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S. Penman, *Financial Statement Analysis and Security Valuation*

G. Donaldson, *Financial Goals and Strategic Consequences*, "Harvard Business Review 63 (May – June 1985)

S.C. Myers, *Finance Theory and Financial Strategy*

G. Donaldson, *Strategy for Financial Mobility* (Boston: Harvard Business School Press, 1986)

R.A. Brealey, S.C Myers, F Allen, *Principles of Corporate Finance*

Useful Links:

Financial ratios for different industries can be found on the Market Insight database at:

www.mhhe.com/edumarketinsight

www.census.gov/csd/qfr

Financial Statements of UK Companies may be accessed at:

www.companieshouse.gov.uk



Thank You

Presented by: Mainak Roy
Financial Controller
London Borough of Brent
London, United Kingdom

Contact Details:
Mob / WA: +44 7502 153 667
Email: mroychowdhury06@gmail.com