Sample notes to financial statements

All companies whether small or big prepare financial statements. These are very important to assess the financial condition of the company. All important stakeholders of the company use these to make decisions. The stakeholders are the company’s management, creditors, shareholders, the government and its competitors. Companies prepare quarterly and annual financial statements. These show the monetary figures for the said period. Financial statements that draw contrasts with the past are called comparative financial statements. There are four main types of financial statements. A balance sheet represents a still snapshot of the company’s financial position at any given point of time. The balance sheet contains monetary information on the company’s equity capital, liabilities and assets. The assets are the belongings of the company. These are classified into long-term and short-term assets. The long-term assets include items like land, buildings, plant, machinery and equipment. Short-term assets are all those assets that the company holds for terms less than a year. These are cash, stock and bills receivable. Liabilities are also classified in a similar manner. Short-term liabilities include bills payable and accrued taxes. Long-term liabilities are loans, debentures and mortgages. Equity is bifurcated into common shares and preferred shares. This statement shows the company’s movements during the period. This shows all the income earned by the company and expenditures. When income exceeds expenditures, the company is said to have made a profit. When expenditures are in excess of income, the company would have incurred a loss. This statement is prepared for all operating and non-operating monetary items. The statement represents figures in both gross terms as well as net terms. The gross sales amount does not show the costs incurred by the company, whereas the net sales amount accounts for all the expenses sustained. The cash statement is prepared to track the inflows and outflows of cash during the statement period. This way, the company is able to assess its cash position at the moment. There are three main heads of the cash flow statement. The first one is the operating cash flows. This shows all the money that the company realized as a result of its operations, and also shows all the costs that the company incurred for its production processes. The investing cash flow segment shows all the purchases the company made and the money it realized on the sale of any assets. The financing cash flow segment shows all the additional debt obtained during the statement period. Outside investments made by the company are also shown. Many times, the shareholders are not paid all the profits made by the company. The management opts to retain some money in the business. The money is utilized for financing its operations, researching developing the product further and for growth and expansion plans. This statement shows the extent of money plowed back into the business. It also shows the dividends paid by the company during the period of the statement. The amount of retained earnings at the beginning of the period and at the end of the period is shown. For investors considering whether to purchase stock in a company, two essential types of financial statements to analyze are the balance sheet and the income statement. While becoming familiar with the statement of cash flow and statement of owner’s equity is also valuable, the balance sheet and income statement supply fundamental information to provide an overview of a business’s current financial position and profitability. Goodshoot/Goodshoot/Getty Images The U.S. Securities and Exchange Commission provides free access to public company financial information in its online database called EDGAR (Electronic Data Gathering, Analysis and Retrieval). Major stock exchanges such as the New York Stock Exchange and NASDAQ also have quarterly and annual reports for listed companies available on their websites. Medioimages/Photodisc/Photodisc/Getty Images The balance sheet, also called a statement of financial position, will contain information about assets and liabilities. A balance sheet typically categorizes assets and liabilities as current or long term. Long-term components are frequently referred to as fixed assets and fixed liabilities. Some examples of current assets are cash, accounts receivable and inventory. Fixed assets can include real estate, vehicles and equipment. Liabilities are considered current if due within one year and fixed if over one year. Following the assets and liabilities on a balance sheet is a section for owner’s equity. Owner’s equity is calculated by subtracting liabilities from assets. Jupiterimages/Comstock/Getty Images The first section of an income statement typically contains revenues, defined as income from normal business operations. Next, costs of earning revenues are tallied. Common examples of these costs include manufacturing costs, freight and sales commissions paid. Basically, revenues minus costs equal profit. Keep in mind that terminology used on financial statements can change over time and also may vary for different business types. Jupiterimages/Photos.com/Getty Images After reading a company's balance sheet and income statement, how does an investor determine if the company is a solid investment? Industry averages are a common guideline used to determine how well a company is doing compared to others in their industry. Industry averages are computed by organizations that collect business information and calculate averages for key data points. Industry averages are available online at major financial news reporting web sites such as Reuters or the Wall Street Journal. Jupiterimages/Photos.com/Getty Images Building on the fundamentals of these two forms of financial statements, here are a few other important factors to consider. Financial statements that have been audited by a reputable accounting firm provide assurance that the information presented is fair and accurate. The auditor’s opinion statement should be prominently displayed. If not, this is an area of concern. Also keep in mind that financial statements show past results, which are not always an accurate predictor of future performance. Reading financial statement footnotes is vital. Footnotes contain a more detailed explanation of financial statement items as well as other key points for understanding business results. Banks run a credit check on loan applicants to help determine whether the borrower has the ability to repay the loan. A real estate investor typically engages the services of a building inspector to determine the structural soundness of a property before she buys it. You should also be concerned about the financial health of a company before you invest in that company's stocks or bonds. You can learn a great deal about a company's financial health by analyzing its financial statements. Contact the investor relations department of the company in which you are interested in investing, and request an annual report. There are a number of different types of financial statements. Annual reports typically include at least the company's balance sheet and income statement. The annual report may also include a cash flow statement and a shareholder's equity statement. Each of these financial statements contains pertinent information. Annual reports include additional information in their footnotes and a section commonly referred to as Management’s Discussion and Analysis. These are not technically financial statements, but the information in these sections can shed additional light on the company's financial condition. Read the annual report and identify each type of financial statement. You also often can find annual reports on company websites in the investor relations section. Determine the company's net worth by analyzing its balance sheet and statement of shareholder equity. A balance sheet may appear complex, but at its heart it has only two sections; one for assets and one for liabilities. A company's assets include everything of value that the company owns. This includes cash on hand, securities and investments, tangible property such as real estate, vehicles, equipment and buildings, and intangible property such as patents and trademarks and goodwill. A company's liabilities include all amounts the company owes. Liabilities may include borrowed funds, outstanding corporate bonds, taxes due and other legal obligations. You can determine the company's net worth by subtracting its total liabilities from its current assets. If the result is a positive number, the company has a positive net worth. If the result is a negative number, the company has a negative net worth. A company's net worth is sometimes referred to as shareholder equity. This amount is also detailed on the company's statement of shareholder's equity. Determine a company's operating results by analyzing its income statements and cash flow statements. The company's income statement reveals the profits and losses resulting from operations and special circumstances during a specified period of time, typically quarterly and annually. The income statement lists all income received and expenses paid by the company during the specified time frame. The income statement usually includes the earnings per share, which is derived by subtracting expenses from income and dividing the remainder by the total number of outstanding shares of stock. The company cash flow statement provides a fluid accounting of how much cash the company has available at any given time to meet its obligations. Don't neglect the footnotes and management’s discussion and analysis. The footnotes can provide important information regarding company income taxes, pensions and profit sharing plan obligations, stock option policies and accounting methods. The Securities and Exchange Commission requires company management to inform company shareholders about events, trends and other situations that may impact the financial information supplied in the annual report. This information is designed to provide context to the company's financial reports, and can help you to understand certain decisions and policies implemented by management. Warnings All investments involve a level of risk and past performance never guarantees future results. A company's financial statements contain important financial information about it. The preparation and reporting of financial statements are governed by generally accepted accounting principles. Financial statements play an important role within business, providing key information to managers, investors and creditors. Primary functions of financial statements include financial reporting, financial analysis and cash flow management. Managers, investors and creditors must understand the functions of financial statements to use them in the most effective manner. The three key financial statements produced by most companies include the income statement, balance sheet and the cash flow statement. The income statement shows how much a company earns in revenue over a certain time period and the expenses related to the revenue earned. A balance sheet displays a company’s assets, liabilities and owner equity at a specific point in time. The cash flow statement shows how much cash is coming into a company and how much cash is flowing out of a company during a specific time period. Financial statements are connected to each other. For example, the changes in assets and liabilities shown on the balance sheet are connected to the change in revenue presented in the income statement. One function of financial statements is financial reporting. Investors and creditors depend on the financial reporting of a company to make investment decisions. Financial reporting involves the preparation and distribution of formal financial records that show a company's financial activities. Financial statements help creditors and investors determine whether a company is effectively using the money invested in the firm. Publicly traded companies are required by the SEC to make their financial statements available to the public. Many private companies choose to make their financial statements available to their investors and creditors. Another function of financial statements is financial ratio analysis. Financial statements contain important financial data that business owners and investors use to calculate key financial ratios. Financial ratio analysis allows investors to compare the current financial position of a company to its historical financial data and to the financial data of its competitors. A manager uses financial ratio analysis to make key decisions regarding its company. Financial ratio analysis indicates a company’s efficiency, liquidity, profitability, leverage and creditworthiness. Maintaining an adequate amount of cash is an important aspect within business. The possibility exists for a company to experience a positive or negative cash flow. A primary function of financial statements is to show how effectively a company manages its cash inflows and outflows. A company that earns a profit but maintains an inadequate amount of cash may experience a difficult time attracting investors and lenders. The cash flow statement focuses primarily on a company's net cash flow. Managers must adapt effective cash management policies to maintain a positive cash flow. As a fundamental financial statement that contains detailed information about a company’s assets, liabilities and shareholders’ equity, a balance sheet is an essential part of your company’s financial records and should be one of the first documents you create. The information on a balance sheet is separated into sections, with all your company’s assets listed and totaled at the top and all its liabilities and shareholders’ equity listed and totaled at the bottom. Assets are anything of value that your company owns as well as any cash in bank accounts. The term generally applies to anything that could be sold or used by the company itself to create value. Examples of assets include physical property, such as furniture, vehicles, equipment and inventory. Intangible items that have value and could be sold, such as patents and trademarks, are also included in a company’s assets. This also applies to any stocks, bonds or other financial investments a company makes. Accounts receivable amounts also count as assets, even if the funds haven’t been collected yet. Your company’s liabilities consist of any debts owed to lenders, other businesses and individuals. This could include a variety of obligations, such as loans to purchase business property or launch a new product, outstanding balances owed to suppliers for materials, unpaid payroll expenses, and taxes owed to the government, just to name a few. Liabilities may also include obligations to provide goods or services to clients in the future. Shareholders’ equity is the official term used in the liability section on a spreadsheet, but it may help to think of it as owner’s equity for your small business if you don’t have outside shareholders. This equity is the amount of profit that remains after all the company’s liabilities are paid — often referred to as net worth or net assets. Although shareholders’ equity is a positive amount that indicates profit, it appears in the liabilities portion of the spreadsheet because it doesn’t belong to the company — a non-living entity. It belongs to the investors in the company, either the owners or its shareholders (or both), and it remains on the spreadsheet as a liability until it is paid out to the investors or invested back into the company. The main rule of a balance sheet is that the two sections — assets and liabilities/shareholders’ equity — must always "balance" by totaling the same amount. It works in much the same way as a mathematical equation. Any amount added to the company’s assets at the top must also be added to the company’s liabilities at the bottom. A balance sheet doesn't show how cash flows in and out of the company during any particular period, but it does provide an overall snapshot of a company’s general financial strength.