TARAS SHEVCHENKO
NATIONAL UNIVERSITY OF KYIV
EDUCATIONAL AND SCIENTIFIC INSTITUTE OF INTERNATIONAL RELATIONS

Department of International Business

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«INTERNATIONAL FINANCIAL MANAGEMENT AND CORPORATE FINANCE »

Study guide for independent work and distance learning. Part 1.

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Author: **Prylyuk Vyacheslav**, Ph.D., Associate Professor

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Drafted by: Prylyuk Vyacheslav, Ph.D., Associate Professor, Department of International Business

APPROVED
Head of the Chair of International Business
____________________ Dmytro Rasshyvalov
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Head of the Commission ____________________ Olena Pryiatelchuk

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Foreword

The purpose and objective of the Guide is to provide the students with basic knowledge about methodologies, methods and practice of internationa1 financial management and corporate finance as a part of training for their professional scientific career. International financial management and corporate finance business are considered within the framework of business in general. The different aspects of theory are discussed in view of business practice. Different fonts are used to mobilize attention of the readers.Detailed table of contents can be used as a Subject Index and self control questions tool.

Topic 1. International financial management: content and system.

Business concern needs finance to meet their requirements in the economic world. Any kind of business activity depends on the finance. Hence, it is called as lifeblood of business organization. Whether the business concerns are big or small, they need finance to fulfil their business activities.

In the modern world, all the activities are concerned with the economic activities and very particular to earning profit through any venture or activities. The entire business activities are directly related with making profit. (According to the economics concept of factors of production, rent given to landlord, wage given to labour, interest given to capital

and profit given to shareholders or proprietors), a business concern needs finance to meet

all the requirements. Hence finance may be called as capital, investment, fund etc., but

each term is having different meanings and unique characters. Increasing the profit is the

main aim of any kind of economic activity.

MEANING OF FINANCE

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns.

The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern.

DEFINITION OF FINANCE

According to **Khan and Jain,** "Finance is the art and science of managing money".

2 Financial Management

According to **Oxford dictionary**, the word 'finance' connotes 'management of money'.

Webster's Ninth New Collegiate Dictionary defines finance as "the Science on study of the management of funds' and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

DEFINITION OF BUSINESS FINANCE

According to the **Wheeler,** "Business finance is that business activity which concerns with the acquisition and conversation of capital funds in meeting financial needs and overall objectives of a business enterprise".

According to the **Guthumann and Dougall**, "Business finance can broadly be defined as the activity concerned with planning, raising, controlling, administering of the funds used in the business".

In the words of **Parhter and Wert**, "Business finance deals primarily with raising, administering and disbursing funds by privately owned business units operating in nonfinancial fields of industry".

Corporate finance is concerned with budgeting, financial forecasting, cash

management, credit administration, investment analysis and fund procurement of the business concern and the business concern needs to adopt modern technology and application suitable to the global environment.

According to the **Encyclopedia of Social Sciences**, "Corporation finance deals with the financial problems of corporate enterprises. These problems include the financial aspects of the promotion of new enterprises and their administration during early development, the accounting problems connected with the distinction between capital and income, the administrative questions created by growth and expansion, and finally, the financial adjustments required for the bolstering up or rehabilitation of a corporation which has come into financial difficulties”.

TYPES OF FINANCE

Finance is one of the important and integral part of business concerns, hence, it plays a major role in every part of the business activities. It is used in all the area of the activities under the different names.

Finance can be classified into two major parts:

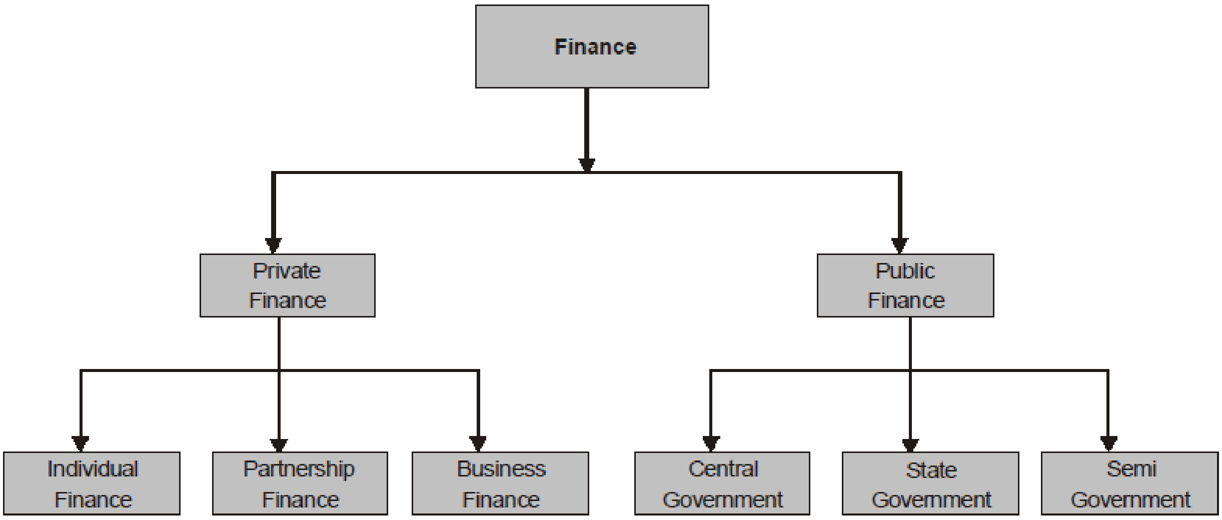

Fig. 1.1 *Types of Finance*

Fig. 1.1 Types of Finance

Private Finance, which includes the Individual, Firms, Business or Corporate Financial activities to meet the requirements.

Public Finance which concerns with revenue and disbursement of Government such as Central Government, State Government and Semi-Government Financial matters.

DEFINITION OF FINANCIAL MANAGEMENT

Financial management is an integral part of overall management. It is concerned with the duties of the financial managers in the business firm.

The term financial management has been defined by **Solomon**, “It is concerned with the efficient use of an important economic resource namely, capital funds”.

The most popular and acceptable definition of financial management as given by **S.C. Kuchal** is that "Financial Management deals with procurement of funds and their effective utilization in the business".

Howard and Upton : Financial management "as an application of general managerial principles to the area of financial decision-making.

Weston and Brigham : Financial management "is an area of financial decision-making, harmonizing individual motives and enterprise goals".

Joshep and Massie : Financial management "is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations.

Thus, Financial Management is mainly concerned with the effective funds management in the business. In simple words, Financial Management as practiced by business firms can be called as Corporation Finance or Business Finance.

SCOPE OF FINANCIAL MANAGEMENT

Financial management is one of the important parts of overall management, which is directly related with various functional departments like personnel, marketing and production.

Financial management covers wide area with multidimensional approaches. The following are the important scope of financial management.

1. Financial Management and Economics

Economic concepts like micro and macroeconomics are directly applied with the financial management approaches. Investment decisions, micro and macro environmental factors are closely associated with the functions of financial manager.

Financial management also uses the economic equations like money value discount factor, economic order quantity etc. Financial economics is one of the emerging area, which provides immense opportunities to finance, and economical areas.

2. Financial Management and Accounting

Accounting records includes the financial information of the business concern. Hence, we can easily understand the relationship between the financial management and accounting. In the olden periods, both financial management and accounting are treated as a same discipline and then it has been merged as

Management Accounting because this part is very much helpful to finance manager to take decisions. But nowaday's financial management and accounting discipline are separate and interrelated.

3. Financial Management or Mathematics

Modern approaches of the financial management applied large number of mathematical and statistical tools and techniques. They are also called as econometrics. Economic order quantity, discount factor, time value of money, present value of money, cost of capital, capital structure theories, dividend theories, ratio analysis and working capital analysis are used as mathematical and statistical tools and techniques in the field of financial management.

4. Financial Management and Production Management

Production management is the operational part of the business concern, which helps to multiple the money into profit. Profit of the concern depends upon the production performance. Production performance needs finance, because production department requires raw material, machinery, wages, operating expenses etc. These expenditures are decided and estimated by the financial department and the finance manager allocates the appropriate finance to production department. The financial manager must be aware of the operational process and finance required for each process of production activities.

5. Financial Management and Marketing

Produced goods are sold in the market with innovative and modern approaches. For this, the marketing department needs finance to meet their requirements. Introduction to Financial Management The financial manager or finance department is responsible to allocate the adequate finance to the marketing department. Hence, marketing and financial management are interrelated and depends on each other.

6. Financial Management and Human Resource Financial management is also related with human resource department, which provides manpower to all the functional areas of the management. Financial manager should carefully evaluate the requirement of manpower to each department and allocate the finance to the human resource department as wages, salary, remuneration, commission, bonus, pension and other monetary benefits to the human resource department. Hence, financial management is directly related with human resource management.

OBJECTIVES OF FINANCIAL MANAGEMENT

Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management. Objectives of Financial Management may be broadly divided into two parts such as:

1. Profit maximization
2. Wealth maximization.

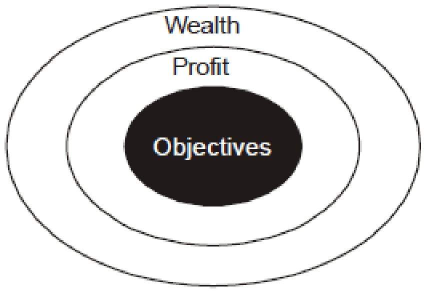

Fig. 1.2 *Objectives of Financial Management*

Profit Maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizes the profit of the concern. Profit maximization consists of the following important features.

1. Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.

2. Ultimate aim of the business concern is earning profit, hence, it considers all the possible ways to increase the profitability of the concern.

3. Profit is the parameter of measuring the efficiency of the business concern. So it shows the entire position of the business concern.

4. Profit maximization objectives help to reduce the risk of the business.

Favourable Arguments for Profit Maximization

The following important points are in support of the profit maximization objectives of the business concern:

(i) Main aim is earning profit.

(ii) Profit is the parameter of the business operation.

(iii) Profit reduces risk of the business concern.

(iv) Profit is the main source of finance.

(v) Profitability meets the social needs also.

Unfavourable Arguments for Profit Maximization

The following important points are against the objectives of profit maximization:

(i) Profit maximization leads to exploiting workers and consumers.

(ii) Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.

(iii) Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.

Drawbacks of Profit Maximization

Profit maximization objective consists of certain drawback also:

(i) **It is vague:** In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.

(ii) **It ignores the time value of money:** Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.

(iii) **It ignores risk:** Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

Wealth Maximization

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern.

Wealth maximization is also known as value maximization or net present worth maximization. This objective is an universally accepted concept in the field of business.

Favourable Arguments for Wealth Maximization

(i) Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.

(iii) Wealth maximization considers both time and risk of the business concern.

(iv) Wealth maximization provides efficient allocation of resources.

(v) It ensures the economic interest of the society.

Unfavourable Arguments for Wealth Maximization

(i) Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.

(ii) Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization.

(iii) Wealth maximization creates ownership-management controversy.

(iv) Management alone enjoy certain benefits.

(v) The ultimate aim of the wealth maximization objectives is to maximize the profit.

(vi) Wealth maximization can be activated only with the help of the profitable position of the business concern.

APPROACHES TO FINANCIAL MANAGEMENT

Financial management approach measures the scope of the financial management in various fields, which include the essential part of the finance. Financial management is not a revolutionary concept but an evolutionary. The definition and scope of financial management has been changed from one period to another period and applied various innovations. Theoretical points of view, financial management approach may be broadly divided into two major parts - Traditional Approach and Modern Approach

Traditional Approach

Traditional approach is the initial stage of financial management, which was followed, in the early part of during the year 1920 to 1950. This approach is based on the past experience and the traditionally accepted methods. Main part of the traditional approach is rising of funds for the business concern. Traditional approach consists of the following important areas.

Arrangement of funds from lending body. Arrangement of funds through various financial instruments. Finding out the various sources of funds.

FUNCTIONS OF FINANCE MANAGER

Finance function is one of the major parts of business organization, which involves the permanent, and continuous process of the business concern. Finance is one of the interrelated functions which deal with personal function, marketing function, production function and research and development activities of the business concern. At present, every business concern concentrates more on the field of finance because, it is a very emerging part which reflects the entire operational and profit ability position of the concern. Deciding the proper financial function is the essential and ultimate goal of the business organization.

Finance manager is one of the important role players in the field of finance function. He must have entire knowledge in the area of accounting, finance, economics and management. His position is highly critical and analytical to solve various problems related to finance. A person who deals finance related activities may be called finance manager.

Finance manager performs the following major functions:

1. Forecasting Financial Requirements

It is the primary function of the Finance Manager. He is responsible to estimate the financial requirement of the business concern. He should estimate, how much finances required to acquire fixed assets and forecast the amount needed to meet the working capital requirements in future.

2. Acquiring Necessary Capital

After deciding the financial requirement, the finance manager should concentrate how the finance is mobilized and where it will be available. It is also highly critical in nature.

3. Investment Decision

The finance manager must carefully select best investment alternatives and consider the reasonable and stable return from the investment. He must be well versed in the field of capital budgeting techniques to determine the effective utilization of investment. The finance manager must concentrate to principles of safety, liquidity and profitability while investing capital.

4. Cash Management

Present days cash management plays a major role in the area of finance because proper cash management is not only essential for effective utilization of cash but it also helps to meet the short-term liquidity position of the concern.

5. Interrelation with Other Departments

Finance manager deals with various functional departments such as marketing, production, personnel, system, research, development, etc. Finance manager should have sound knowledge not only in finance related area but also well versed in other areas. He must maintain a good relationship with all the functional departments of the business organization.

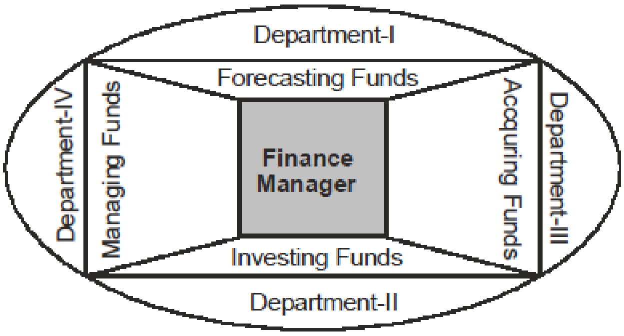

Fig 1.4 Functions of Financial Manager

IMPORTANCE OF FINANCIAL MANAGEMENT

Finance is the lifeblood of business organization. It needs to meet the requirement of the business concern. Each and every business concern must maintain adequate amount of finance for their smooth running of the business concern and also maintain the business carefully to achieve the goal of the business concern. The business goal can be achieved only with the help of effective management of finance. We can’t neglect the importance of finance at any time at and at any situation. Some of the importance of the financial management is as follows:

Financial Planning

Financial management helps to determine the financial requirement of the business concern and leads to take financial planning of the concern. Financial planning is an important part of the business concern, which helps to promotion of an enterprise.

Acquisition of Funds

Financial management involves the acquisition of required finance to the business concern.

Acquiring needed funds play a major part of the financial management, which involve possible source of finance at minimum cost.

Proper Use of Funds

Proper use and allocation of funds leads to improve the operational efficiency of the business concern. When the finance manager uses the funds properly, they can reduce the cost of capital and increase the value of the firm.

Financial Decision

Financial management helps to take sound financial decision in the business concern.

Financial decision will affect the entire business operation of the concern because there is a direct relationship with various department functions such as marketing, production personnel, etc.

company purely depends on the effectiveness and proper utilization of funds by the **company**. Financial management helps to improve the profitability position of the **company** with the help of strong financial control devices such as budgetary control, ratio analysis and cost volume profit analysis.

Increase the Value of the Firm

Financial management is very important in the field of increasing the wealth of the investors and the **company**. Ultimate aim of any **company** will achieve the maximum profit and higher profitability leads to maximize the wealth of the investors as well as the nation.

Promoting Savings

Savings are possible only when the **company** earns higher profitability and maximizing wealth. Effective financial management helps to promoting and mobilizing individual and corporate savings.

Nowadays financial management is also popularly known as business finance or corporate finances. The **company** or corporate sectors cannot function without the importance of the financial management.

International financial management is to provide

financial managers with an understanding of the fundamental concepts and the tools necessary to be effective global managers. Throughout, the text emphasizes how to deal with exchange risk and market imperfections, using the various instruments and tools that are available, while at the same time maximizing the benefits from an expanded global opportunity set.

Effective financial management, however, is more than the application of the newest business techniques or operating more efficiently. There must be an underlying goal. *International Financial Management* is written from the perspective that the fundamental goal of sound financial management is shareholder wealth maximization. **Shareholder wealth maximization** means that the firm makes all business decisions and investments with an eye toward making the owners of the firm—the shareholders—better off financially, or more wealthy, than they were before.

Whereas shareholder wealth maximization is generally accepted as the ultimate goal of financial management in "Anglo-Saxon" countries, such as Australia, Canada, the United Kingdom, and especially the United States, it is not as widely embraced a goal in other parts of the world. In countries like France and Germany, for example, shareholders are generally viewed as one of the "stakeholders" of the firm, others being employees, customers, suppliers, banks, and so forth. European managers tend to consider the promotion of the firm's stakeholders' overall welfare as the most important corporate goal. In Japan, on the other hand, many companies form a small number of interlocking business groups called *keiretsu,* such as Mitsubishi, Mitsui, and Sumitomo, which arose from consolidation of family-owned business empires. Although *keiretsu* have weakened in recent years, Japanese managers still tend to regard the prosperity and growth of their *keiretsu* as the critical goal; for instance, they tend to strive to maximize market share, rather than shareholder wealth.

It is pointed out, however, that as capital markets are becoming more liberalized and internationally integrated in recent decades, even managers in France, Germany, Japan, and other non-Anglo-Saxon countries are beginning to pay serious attention to shareholder wealth maximization. In Germany, for example, companies are now allowed to repurchase stocks, if necessary, for the benefit of shareholders. In accepting an unprecedented page 8 $203 billion takeover offer by Vodafone AirTouch in 2000, a leading British wireless phone company, Klaus Esser, CEO of Mannesmann of Germany, cited shareholder interests: "The shareholders clearly think that this company, Mannesmann, a great company, would be better together with Vodafone AirTouch. . . . The final decision belongs to shareholders."[4]

Obviously, the firm could pursue other goals. This does not mean, however, that the goal of shareholder wealth maximization is merely an alternative, or that the firm should enter into a debate as to its appropriate fundamental goal. Quite the contrary. If the firm seeks to maximize shareholder wealth, it will most likely simultaneously be accomplishing other legitimate goals that are perceived as worthwhile. Shareholder wealth maximization is a long-run goal. A firm cannot stay in business to maximize shareholder wealth if it treats employees poorly, produces shoddy merchandise, wastes raw materials and natural resources, operates inefficiently, or fails to satisfy customers. Only a well-managed business firm that profitably produces what is demanded in an efficient manner can expect to stay in business in the long run and thereby provide employment opportunities.

While managers are hired to run the company for the interests of shareholders, there is no guarantee that they will actually do so. As shown by a series of corporate scandals at companies like Enron, WorldCom, Parmalat, and Global Crossing, managers may pursue their own private interests at the expense of shareholders when they are not closely monitored. This so-called agency problem is a major weakness of the public corporation. Extensive corporate malfeasance and accounting manipulations at these companies eventually drove them into financial distress and bankruptcy, devastating shareholders and employees alike. Lamentably, some senior managers and corporate insiders enriched themselves enormously in the process. Clearly, the boards of directors, the ultimate guardians of the interests of shareholders, failed to perform their duties at these companies. In the wake of these corporate calamities that have undermined the credibility of the free market system, the society has painfully learned the importance of **corporate governance**, that is, the financial and legal framework for regulating the relationship between a company's management and its shareholders. Needless to say, the corporate governance problem is not confined to the United States. In fact, it can be a much more serious problem in many other parts of the world, especially emerging and transition economies, such as Indonesia, Korea, China, Italy, and Russia, where legal protection of shareholders is weak or virtually

As we will discuss in Chapter 4 in detail, corporate governance structure varies greatly across countries, reflecting different cultural, legal, economic, and political environments in different countries. In many countries where shareholders do not have strong legal rights, corporate ownership tends to be concentrated. The concentrated ownership of the firm, in turn, may give rise to the conflicts of interest between dominant shareholders (often the founding family) and small outside shareholders. The collapse of Parmalat, a family-controlled Italian company, in 2003 after decades of accounting frauds, provides an example of corporate governance risk. The company allegedly hid debts, "invented" assets, and diverted funds to bail out failing ventures of the family members. Because only the Tanzi (founding) family and close associates knew how the company was run, it was possible to hide the questionable practices for decades. Outside shareholders who collectively control a 49 percent stake did not know how Parmalat was operating. Franco Ferrarotti, professor of sociology at the University of Rome, was quoted as saying, "The government is weak, there is no sense of state, public services are bad and social services are weak. The family is so strong because it is the only institution that doesn't let you down."[5]

Shareholders are the owners of the business; it is their capital that is at risk. It is only equitable that they receive a fair return on their investment. Private capital may not have been forthcoming for the business firm if it had intended to accomplish any other objective. As we will discuss shortly, the massive privatization that has been taking place in developing and formerly socialist countries, which will eventually enhance the standard of living of these countries' citizens, depends on private investment. It is thus vitally important to strengthen corporate governance so that shareholders receive fair returns on their investments. In what follows, we are going to discuss in detail: (i) the globalization of the world economy and (ii) the growing role of MNCs in the world economy.

The *theory of comparative advantage* provides a basis for explaining and justifying international trade in a model world assumed to enjoy free trade, perfect competition, no uncertainty, costless information, and no government interference. The theory's origins lie in the work of Adam Smith, and particularly his seminal book, *The Wealth of Nations*, published in 1776. Smith sought to explain why the division of labor in productive activities, and subsequently international trade of goods produced, increased the quality of life for all citizens. Smith based his work on the concept of *absolute advantage*, with every country specializing in the production of those goods for which it was uniquely suited. More would be produced for less. Thus, with each country specializing in products for which it possessed absolute advantage, countries could produce more in total and trade for goods that were cheaper in price than those produced at home.

In his work *On the Principles of Political Economy and Taxation*, published in 1817, David Ricardo sought to take the basic ideas set down by Adam Smith a few logical steps further. Ricardo noted that even if a country possessed absolute advantage in the production of two goods, it might still be relatively more efficient than the other country in one good's production than the production of the other good. Ricardo termed this *comparative advantage*. Each country would then possess comparative advantage in the production of one of the two products, and both countries would benefit by specializing completely in one product and trading for the other.

Although international trade might have approached the comparative advantage model during the nineteenth century, it certainly does not today, for a variety of reasons. Countries do not appear to specialize only in those products that could be most efficiently produced by that country's particular factors of production. Instead, governments interfere with comparative advantage for a variety of economic and political reasons, such as to achieve full employment, economic development, national self-sufficiency in defense-related industries, and protection of an agricultural sector's way of life. Government interference takes the form of *tariffs*, *quotas*, and other non-tariff restrictions.

At least two of the factors of production—capital and technology—now flow directly and easily between countries, rather than only indirectly through traded goods and services. This direct flow occurs between related subsidiaries and affiliates of multinational firms, as well as between unrelated firms via loans and license and management contracts. Even labor can flow between countries to varying degrees, such as immigrants into the European Union from North Africa and the Middle East, and then in turn between states in the EU.

Modern factors of production are more numerous than in this simple model. Factors considered in the location of production facilities worldwide include managerial skills, a dependable legal structure for settling contract disputes, research and development competence, educational levels of available workers, energy resources, consumer demand for brand-name goods, mineral and raw material availability, access to capital, tax differentials, supporting infrastructure (roads, ports, and communication facilities), and possibly others. Although the *terms of trade* are ultimately determined by supply and demand, the process by which the terms are set is different from that visualized in traditional trade theory. They are determined partly by administered pricing in oligopolistic markets.

Comparative advantage shifts over time as less-developed countries become more developed and realize their latent opportunities. For example, over the past 150 years, comparative advantage in producing cotton textiles has shifted from the United Kingdom to the United States, to Japan, to Hong Kong, to Taiwan, and to China. The classical model of comparative advantage also does not address certain other issues such as the effect of uncertainty and information costs, the role of differentiated products in imperfectly competitive markets, and economies of scale.

Nevertheless, although the world is a long way from the pure theory of comparative advantage, the general principle of comparative advantage is still valid. The closer the world gets to true international specialization, the more world production and consumption can be increased, provided that the problem of equitable distribution of the benefits can be solved to the satisfaction of consumers, producers, and political leaders. Complete specialization, however, remains an unrealistic limiting case, just as perfect competition is a limiting case in microeconomic theory.

Comparative advantage is still a relevant theory to explain why particular countries are most suitable for exports of goods and services that support the global supply chain of both MNEs and domestic firms. The comparative advantage of the twenty-first century, however, is one that is based more on services, and their cross-border facilitation by telecommunications and the Internet. The source of a nation's comparative advantage, however, is still the mixture of its own labor skills, access to capital, and technology.

For example, India has developed a highly efficient and low-cost software industry. This industry supplies not only the creation of custom software, but also call centers for customer support, and other information technology services. The Indian software industry is composed of subsidiaries of MNEs and independent companies. If you own a Hewlett-Packard computer and call the customer support center number for help, you are likely to reach a call center in India. Answering your call will be a knowledgeable Indian software engineer or programmer who will "walk you through" your problem. India has a large number of well-educated, English-speaking technical experts who are paid only a fraction of the salary and overhead earned by their U.S. counterparts. The overcapacity and low cost of international telecommunication networks today further enhance the comparative advantage of an Indian location.

The extent of global outsourcing is already reaching every corner of the globe. From financial back offices in Manila, to information technology engineers in Hungary, modern telecommunications now bring business activities to labor rather than moving labor to the places of business.

So, what's about international financial management?

Exhibit 1.3 details some of the main differences between international and domestic financial management. These component differences include institutions, corporate governance, foreign exchange, and political risks, and the modifications required of financial theory and financial instruments. As illustrated in *Global Finance in Practice 1.3*, foreign exchange risks impact all businesses, even the digital specter of the Pokémon.

Multinational financial management requires an understanding of cultural, historical, and institutional differences such as those affecting corporate governance. Although both domestic firms and MNEs are exposed to foreign exchange risks, MNEs alone face certain unique risks, such as political risks, that are not normally a threat to domestic operations. MNEs also face other risks that can be classified as extensions of domestic finance theory.

For example, the normal domestic approach to the cost of capital, sourcing debt and equity, capital budgeting, *working capital management*, taxation, and credit analysis need to be modified to accommodate foreign complexities. Moreover, a number of financial instruments that are used in domestic financial management have been modified for use in international financial management. Examples are foreign currency options and futures, interest rate and currency swaps, and letters of credit.

EXHIBIT 1.3 What Is Different about International Financial Management?

Concept	International	Domestic
Culture, history, and institutions	Each foreign country is unique and not always understood by MNE management	Each country has a known base case
Corporate governance	Foreign countries' regulations and institutional practices are all uniquely different	Regulations and institutions are well known
Foreign exchange risk	MNEs face foreign exchange risks due to their subsidiaries, as well as import/export and foreign competitors	Foreign exchange risks from import/export and foreign competition (no subsidiaries)
Political risk	MNEs face political risk because of their foreign subsidiaries and high profile	Negligible political risks
Modification of domestic finance theories	MNEs must modify finance theories like capital budgeting and the cost of capital because of foreign complexities	Traditional financial theory applies
Modification of domestic financial instruments	MNEs utilize modified financial instruments such as options, forwards, swaps, and letters of credit	Limited use of financial instruments and derivatives because of few foreign exchange and political risks

The main theme of this book is to analyze how an MNE's financial management evolves as it pursues global strategic opportunities and as new constraints emerge. In this chapter, we introduce the challenges and risks associated with Aidan Corporation (Aidan), a company we use as an example throughout this book. Aidan is a company evolving from being domestic in scope to becoming truly multinational. The discussion includes constraints that a company will face in terms of managerial goals and governance as it becomes increasingly involved in multinational operations. But first we need to clarify the unique value proposition and advantages that the MNE was created to exploit.

Market Imperfections: A Rationale for the Existence of the Multinational Firm

MNEs strive to take advantage of imperfections in national markets for products, factors of production, and financial assets. Imperfections in the market for products translate into market opportunities for MNEs. Large international firms are better able to exploit such competitive factors as economies of scale, managerial and technological expertise, product differentiation, and financial strength than are their local competitors. In fact, MNEs thrive best in markets characterized by international oligopolistic competition, where these factors are particularly critical. In addition, once MNEs have established a physical presence abroad, they are in a better position than purely domestic firms to identify and implement market opportunities through their own internal information network.

Why Do Firms Go Global?

Why do firms become multinational

The Reasons a Business Might Become Multinational

A multinational company can produce different parts of their business in other places to maximize profits and efficiency. Outsourcing: Many businesses can cut costs when outsourcing tasks or services internationally.

What Makes a Corporation Multinational?

A multinational corporation is one that has business offices and operations in two or more countries in the world. These companies are often managed from a central office headquartered in the home country. Simply exporting goods for sale abroad does not make a business a multinational company.

6 REASONS WHY A BUSINESS MIGHT WANT TO BECOME MULTINATIONAL

At some point, many businesses face the decision on whether or not to become multinational. A multinational business has certain advantages that others might not, including locating different parts of the supply chain in different countries and specializing parts of the production process in different areas of the world. What are some of the reasons why a business might want to become multinational?

THE REASONS A BUSINESS MIGHT BECOME MULTINATIONAL

1. Specialized Production: Many industries are located in different parts of the world. For example, the components of an iPhone don't just come from one factory in one country. Instead, they use pieces from different branches of the tech industry and

different parts of the world. A multinational company can produce different parts of their business in other places to maximize profits and efficiency.

2. Outsourcing: Many businesses can cut costs when outsourcing tasks or services internationally. A high-labor cost country moving some of the more labor-intensive parts of the process to countries with a lower cost for labor can save a great deal on their typical production costs.

3. Scale for Savings: Depending on what industry you want to become multinational in, you might face high fixed costs when getting started. Businesses that can grow quickly will experience more cost savings thanks to greater efficiency and the lower cost per item or unit that comes with producing at scale.

4. Different Taxes: Another common reason why a business will become multinational is to take advantage of countries that offer lower corporate tax rates. Make sure that you work with an experienced tax planning team to ensure that you understand how your tax obligation will change and any potential ramifications as a result.

5. Skilled Labor: When you become multinational, you can access the broad and deep talent pool that the globe has to offer and reap the rewards.

6. More Consumers: Just like you can access a larger talent pool, you can also access a larger customer base. Selling abroad gives you a new audience excited about your products, and it might even open up new avenues that wouldn't be possible in your own country.

What are 5 reasons to become a multinational company?

Reasons for Being a Multinational Corporation

- Access to lower production costs. Setting up production in other countries, especially in developing economies, usually translates to spending significantly less on production costs. ...
- Proximity to target international markets. ...
- Access to a larger talent pool. ...
- Avoidance of tariffs.
- Why Would a Business Want to Become a Multinational Company?
- Usually, the primary goal of a business is to increase profits and growth. If it can grow a global customer base and increase its market share abroad, it may believe that opening offices in foreign countries is worth the expense and effort.

Multinational Corporation: Definition, How It Works, Four Types

What Is a Multinational Corporation?

A multinational corporation (MNC) is a company that has business operations in at least one country other than its home country. By some definitions, it also generates at least 25% of its revenue outside of its home country.

Generally, a multinational company has offices, factories, or other facilities in different countries around the world as well as a centralized headquarters which coordinates global management.

Multinational companies can also be known as international, stateless, or transnational corporate organizations or enterprises. Some may have budgets that exceed those of small countries.

Strategic motives drive the decision to invest abroad and become an MNE. These motives can be summarized under the following categories:

1. *Market seekers* produce in foreign markets either to satisfy local demand or to export to markets other than their home market. U.S. automobile firms manufacturing in Europe for local consumption are an example of market-seeking motivation.
2. *Raw material seekers* extract raw materials wherever they can be found, either for export or for further processing and sale in the country in which they are found—the host country. Firms in the oil, mining, plantation, and forest industries fall into this category.
3. *Production efficiency seekers* produce in countries where one or more of the factors of production are underpriced relative to their productivity. Labor-intensive production of electronic components in Taiwan, Malaysia, and Mexico is an example of this motivation.
4. *Knowledge seekers* operate in foreign countries to gain access to technology or managerial expertise. For example, German, Dutch, and Japanese firms have purchased U.S. electronics firms for their technology.
5. *Political safety seekers* acquire or establish new operations in countries that are considered unlikely to expropriate or interfere with private enterprise. For example, Hong Kong firms invested heavily in the United States, United Kingdom, Canada, and Australia in anticipation of the consequences of China's 1997 takeover of the British colony.

These five types of strategic considerations are not mutually exclusive. Forest products firms seeking wood fiber in Brazil, for example, may also find a large Brazilian market for a portion of their output.

In industries characterized by worldwide oligopolistic competition, each of the above strategic motives should be subdivided into proactive and defensive investments. Proactive investments are designed to enhance the growth and profitability of the firm itself. Defensive investments are designed to deny growth and profitability to the firm's competitors. Examples of the latter are investments that try to preempt a market before competitors can get established in it, or capture raw material sources and deny them to competitors.

You the Professional and Multinational Financial Management

So where do you fit professionally within the global landscape of multinational finance? Mass media has a tendency to characterize the global marketplace by corporate names—IBM, Lafarge, Rolls-Royce, Tata, Google, Apple, Haier, Cemex—among thousands. But these multinational enterprises are made up of people—hard-working, ambitious, driven, experienced, educated, talented people. As a student of global business, you need to develop the skills, knowledge, and insights to not only be one of those people, but also to excel.

In the recent past, much of the business development in these companies was led by cross-functional teams, combining marketing, operations, finance, the supply chain, among others. So the international financial elements of any prospective business deal were handled by a specialist. In that arena, a professional like yourself who understands the implications of cross-border risks arising from currencies, interest rates, commodity prices, capital controls, and political risks could work within your team to elevate the financial concerns relevant to the successful execution of the business. This is the international financial professional.

But the pace of global business, and the organizational structure of global business, are changing. Teams are increasingly virtual and unique, each team custom-tailored for the business proposal or opportunity, and often drawing upon the available talent across geographies, markets, and cultures. Organizational agility, a phrase often used to describe decision-making rather than the decision-makers, requires different skills. This requires business professionals

include more than a passing knowledge of multinational finance and how it impacts investments and operations. And as more organizations empower their people, more of their people on all levels of global enterprises, and hold them accountable for outcomes, knowledge of the financial dimensions of the business in the international business environment is more and more a concern for all; that's you.

10 Basic Principles of Financial Management

To master Financial Management you can start with your own finances.

- 1. Organize Your Finances
- Organizing your finances is the first step to creating wealth. Credit cards, bank accounts, personal loans, brokerage accounts, mortgages, car loans and retirement accounts should to be tracked. Budgeting software can provide complete solutions to track all such accounts, make on-time payments and more. Jeff Morris, a certified public accountant in Bethesda, Maryland, points out: “Once you enter your accounts and balances into budgeting software, you will be able to spend less time getting organized and more time making sense of your situation.”
- 2. Spend Less Than You Earn
- Personal financial software provides powerful tools to help you track and budget your spending and take steps to achieve your long-term goals. If you learn to track your finances and know where you spend the most, you’ll be able to control your money. “The best way to ensure that you either overcome debt or avoid it in the first place is to never spend more than you make,” Morris says.
- 3. Put Your Money to Work

- Take advantage of the time value of money. Morris gives the following example: “A 21-year-old who invests $17.50 a day until retiring at the age of 65 at a 5 percent average annual investment return can be a millionaire. At age 30, the required daily savings amount almost doubles. At age 40 the amount quadruples.” So save early and often, even if the amount is small.
- 4. Limit Debt to Income-Producing Assets
- With credit cards and car loans, every penny you spend to repay that debt is money flushed down the drain. All but a few models of cars depreciate to zero and require more in repairs and finance charges than can be reasonably expected to be returned to the owner upon being sold. Morris explains, “With their ultra-high interest rates, credit cards utilized to buy household goods and clothes that quickly wear out are bad bargains. If you have to be in debt, stick to financing items that retain their value over time, like real estate and education.”
- 5.Continuously Educate Yourself
- Budgeting software often links to hoards of research that puts the collective knowledge of Wall Street at your fingertips. “Read every financial periodical, book and blog you can find from well-regarded financial authors,” Morris recommends. “Understand why you are investing so that you will stick to your plan. Periodically gather research so you do not miss excellent investment opportunities.”
- 6. Understand Risk
- The key to understanding return on investments is that the more you risk, the better the return should be. This is called a risk-return trade-off. Investments like stock and bonds that have a higher rate of return often have a higher risk of losing the principal that you invested. Investments like certificates of deposit and money market accounts with a lower rate of return have a lower risk of losing principal. Since no one knows the future, you cannot be 100 percent sure any investment will do well. Morris explains, “If you diversify your investments, one can go sour without severe impact to your overall portfolio.”
- 7. Diversification Is Not Just for Investments
- Find creative ways to diversify your income. Everyone has a talent or special skill. “Turn your talents into a money-making opportunity. Investigate ways to make money from home and launch a home-based business,” Morris says. The extra income can supplement your full-time income or even result in an exciting career change. Good financial management software can show you how even a slight improvement in income can positively change your financial profile.

- 8. Maximize Your Employment Benefits
- Employment benefits like a 401(k) plan, flexible spending accounts and medical and dental insurance yield some of the highest rates of return that you have access to. "Make sure you are taking advantage of all the ways benefits can save you money by reducing taxes or out-of-pocket expenses," says Morris.
- 9.Pay Attention to Taxes
- Financial planning software helps you manage your tax information. For example, Quicken quickly analyzes taxable investments and provides powerful organizing tools that make year-end tax filings go much smoother. Morris emphasizes, "We all know that any money you make is going to be taxed. That is why it is important to consider the related tax implications for every investment."
- 10.Plan for the Unexpected
- Despite of your best efforts, you'll face unforeseen emergencies. Morris urges, "Save enough money and stock up on insurance to be able to weather extended unemployment, accidents, catastrophic medical care, large car or house repairs and natural disasters." Increasing the amount of money you save when times are good can help you manage the cost impact of hedging against bumps in the road, making sure unexpected financial exposure does not derail your long-term goals and your family's financial security.
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REMEMBER:

- Multinational corporations conduct business in two or more countries.
- Some consider a multinational company to be one that generates 25% or more of its revenue outside the home country.
- An MNC can have a positive economic effect on the countries in which it operates.
- Some believe outsourcing U.S. manufacturing to a foreign country has a negative effect on the U.S. economy.
- Investing in a multinational corporation is a way to add international exposure to a portfolio.
-

Multinational Corporations

How a Multinational Corporation Works

A multinational corporation is an enterprise whose business activities occur in at least two countries. Some may consider any company with a foreign branch to be a multinational corporation. Others may limit the definition to only those companies that derive at least a quarter of their revenue outside of their home country.

Multinational companies can make direct investments in foreign countries. Many are based in developed nations. Advocates say they create high-paying jobs and technologically advanced goods in countries that otherwise would not have access to such opportunities or goods.

However, critics of these enterprises believe multinational corporations exert undue political influence over governments, exploit developing nations, and create job losses in their own home countries.

The history of the multinational company is linked with the history of colonialism. Many of the first multinational companies were commissioned at the behest of European monarchs to conduct international expeditions.

Some of the colonies not held by Spain or Portugal existed under the administration of some of the world's earliest multinational companies. One of the first was The East India Company, established in 1600. This British multinational enterprise took part in international trade and exploration, and operated trading posts in India.1 Other early examples of multinational companies include the Swedish Africa Company, founded in 1649, and the Hudson's Bay Company, founded in 1670.

Characteristics of a Multinational Corporation

Some of the characteristics common to various types of multinational corporations include:

- A worldwide business presence
- Typically, large and powerful organizations
- Business conducted in various languages
- A complicated business model and structure
- Direct investments in foreign countries
- Jobs created in foreign countries, potentially with higher wages than found locally
- Seeks improved efficiencies, lower production costs, larger market share
- Has substantial expenses associated with navigating rules and regulations of foreign countries
- Pays taxes in countries in which it operates
- Reports financial information according to International Financial Reporting Standards (IFRS)

- Sometimes accused of negative economic and/or environmental impacts in foreign markets
- Sometimes accused of negative economic impacts in home country due to outsourcing jobs

U.S. multinational corporations employed 43.9 million workers throughout the world in 2019.

4 Types of Multinational Corporations

Multinational corporations can be viewed as four main organizational types.

A Decentralized Corporation

A decentralized corporation maintains a presence in its home country and has autonomous offices and other facilities in locations around the world. This type of multinational company has the capability to achieve more, faster because it's decentralized. Each office manages the local business itself, making its own decisions.

A Centralized Global Corporation

A centralized global corporation has a central headquarters in the home country. Executive officers and management located there oversee the global offices and operations as well as domestic operations. They, rather than managers at local offices in foreign countries, make the key business decisions. The offices typically must report to and obtain approval from headquarters personnel for major activities.

An International Division Within a Corporation

An international division is that part of the multinational corporation that has been made responsible for all international operations. This structure facilitates business decision-making and general activities in local, foreign markets. However, operating independently can pose problems when overall corporate consensus and action is required. Maintaining and presenting the carefully nurtured, enterprise-wide brand image established by the multinational may also be a challenge.

A Transnational Corporation

A transnational corporation involves a parent-subsidiary structure whereby the parent company oversees the operations of subsidiaries in foreign countries as well as in the home country. Subsidiaries can make use of the parent's assets, such as research and development data. Subsidiaries may be different brands, as well. The parent usually maintains a management role directing the operations of its subsidiaries, domestic and foreign.

Examples of multinational corporations include IBM, Berkshire Hathaway, Apple, Microsoft, Amazon, and Walmart. Nestlé S.A. is an example of a transnational corporation that executes business and operational decisions in and outside of its headquarters. One of its subsidiaries is Nespresso.5

Advantages and Disadvantages of Multinational Corporations

International operations present a variety of advantages and disadvantages to multinational companies, consumers, and a workforce.

Advantages

Developing an international presence can open up new markets and sales opportunities unavailable or not feasible when operating just domestically. For example, a presence in a foreign country such as India can allow a corporation to meet widespread Indian demand for particular products without the transaction costs associated with long-distance shipping.

Corporations can establish operations in markets where their capital can be used most efficiently and wages have less impact on the bottom line than they did in the home country.

By producing the same quality of goods at lower costs, multinational companies can reduce prices and increase the purchasing power of consumers worldwide.

Multinational companies can also take advantage of lower tax rates available in countries eager for their direct investments and the jobs that they'll create. Note, however, that the European Union has a plan to implement a minimum tax of 15% on corporate profits, to become effective in 2023.

Other benefits include a direct financial investment in foreign countries and job growth in their local economies.

Disadvantages

A trade-off of globalization—the price of lower prices—is that domestic jobs move overseas. This can increase unemployment in the home country and make it difficult for longtime employees in outsourced industries to find new jobs.

Those opposed to multinational corporations point to the potential they may have to develop a monopoly (for certain products). This can drive up prices for consumers, stifle competition, and inhibit innovation.

Multinational corporations are also said to have a detrimental effect on the environment because their operations may encourage land development and the depletion of local and natural resources.

Multinational companies may also cause the downfall of small, local businesses. Activists have also claimed that multinational companies breach ethical standards. They accuse them of evading laws to advance their business agendas.

What Makes a Corporation Multinational?

A multinational corporation is one that has business offices and operations in two or more countries in the world. These companies are often managed from a central office headquartered in the home country. Simply exporting goods for sale abroad does not make a business a multinational company.

Why Would a Business Want to Become a Multinational Company?

Usually, the primary goal of a business is to increase profits and growth. If it can grow a global customer base and increase its market share abroad, it may believe that opening offices in foreign countries is worth the expense and effort. Companies may also see a benefit in certain tax structures or regulatory regimes found abroad.

What Are Some Risks That Multinational Corporations Face?

Multinational corporations are exposed to risks related to the different countries and regions in which they operate. These can include regulatory or legal risks, political instability, crime and violence, cultural sensitivities, as well as fluctuations in currency exchange rates. People in the home country may also resent the outsourcing of jobs.

MODEL QUESTIONS

1. What is finance? Define business finance.
2. Explain the types of finance.
3. Discuss the objectives of financial management.
4. Critically evaluate various approaches to the financial management.
5. Explain the scope of financial management.
6. Discuss the role of financial manager.
7. Explain the importance of financial

Topic 2. Financial Statements

- **Financial reporting .**
- The Objective of General Purpose Financial Reporting

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions include buying, selling or holding equity and debt instruments, providing or settling loans and other forms of credit, exercising rights to vote on, or otherwise influence, management. General purpose financial reports provide information about the resources of, and claims against, an entity and the effects of transactions and other events on those resources and claims.

It's useful t remember:

Golden rules of accounting

- Rule 1: Debit all expenses and losses, credit all incomes and gains.
- Rule 2: Debit the receiver, credit the giver.
- Rule 3: Debit what comes in, credit what goes out.

Financial reporting aims to track, analyze and report your business income. This helps you and any investors make informed decisions about how to manage the business. These reports examine resource usage and cash flow to assess the financial health of the business.

What is the concept of financial reporting?

Financial reporting is a standard accounting practice that uses financial statements to disclose a company's financial information and performance over a particular period, usually on an annual or quarterly basis.

What are the two bases of financial reporting?

The two main types of bases are cash basis and accrual basis accounting. Cash basis records finances when money exchanges hands, while accrual basis when the transaction occurs, whether or not any cash has been received or paid.

Why Do Shareholders Need Financial Statements?

Financial statements provide a snapshot of a corporation's financial health at a particular point in time, giving insight into its performance, operations, cash flow, and overall conditions. Shareholders need financial statements to make informed decisions about their equity investments, especially when it comes time to vote on corporate matters.

There are a variety of tools shareholders have at their disposal to make these equity evaluations. In order to make better decisions, it is important for them to analyze their stocks using a variety of measurements, rather than just a few. Some of the metrics available include profitability ratios, liquidity ratios, debt ratios, efficiency ratios, and price ratios.

REMEMBER:

- Financial statements provide a snapshot of a corporation's financial health, giving insight into its performance, operations, and cash flow.
- Financial statements are essential since they provide information about a company's revenue, expenses, profitability, and debt.
- Financial ratio analysis involves the evaluation of line items in financial statements to compare the results to previous periods and competitors.
- Liquidity and solvency ratios provide information about a company's ability to repay its debts and obligations.
- Valuation ratios help determine a fair value or price target for a company's shares.

Financial statements are the financial records that show a company's business activity and financial performance. Companies are required to report their financial statements on a quarterly and annual basis by the U.S. Securities and Exchange Commission (SEC). The SEC monitors the markets and companies to ensure that everyone is playing by the same rules and that markets function efficiently. There are specific guidelines that are required by the SEC when issuing financial reports so that investors can analyze and compare one company with another easily.

Financial statements are important to investors because they can provide enormous information about a company's revenue, expenses, profitability, debt load, and the ability to meet its short-term and long-term financial obligations. There are three major financial statements.

Balance Sheet

The balance sheet shows a company's assets (what they own), liabilities (what they owe), and stockholders' equity (or ownership) at a given moment.3

Income Statement

The income statement reports the revenue generated from sales, the operating expenses involved in creating that revenue as well as other costs, such as taxes and interest expense on any debt on the balance sheet. The net amount or the bottom line of the income statement is the net income or the profit for the period. Net income is revenue minus all of the costs of doing business.3

Cash Flow Statement

The cash flow statement (CFS) measures the cash generated for a period, including all of the transactions added to or subtracted from cash. Cash flow is important because it shows how much cash is available to meet short-term obligations, invest in the company, or pay dividends to shareholders.3

In addition to reviewing a company's financial statements themselves, also pay attention to the information provided in the footnotes to the financial statements.

What are the three objectives of financial reporting?

The objectives of financial reporting cover three areas, dealing with useful information, cash flows, and liabilities.

What are the two 2 main objectives of financial reporting?

Reported information should cover both monetary and non-monetary information. There are two basic objectives of financial reporting: first, to help users make investment decisions; and second, to provide information that enables a judgment about the effectiveness of the enterprise to be made.

What is the best objective of financial reporting?

The most specific objective of external financial reporting is to provide information about the enterprise's resources, claims to those resources, and how both the resources and claims to resources change over time.

What is the most important in financial reporting?

Another way of looking at the question is which two statements provide the most information? In that case, the best selection is the income statement and balance sheet, since the statement of cash flows can be constructed from these two documents

What are the uses of financial reporting?

Financial reporting allows finance teams and the business to track and analyze cash inflows and outflows to help identify current and future cash flow risks. This ensures that the organization has sufficient cash flow to grow the business and take advantage of opportunities when they arise.

Examples of Financial Reporting

External financial statements (income statement, statement of comprehensive income, balance sheet, statement of cash flows, and statement of stockholders' equity)

Characteristics of a Good Report

- Several characteristics of a good report include: Precision. ...
- Accuracy of Facts. Information contained in a report must be based on accurate facts. ...
- Relevancy. The facts presented in a report should be accurate and relevant. ...
- Conciseness. ...
- Grammatical. ...
- Clarity. ...
- Presentation. ...
- Complete Information.
-
- What are the 5 C's of report writing?
- All this can be avoided by following the 5 Cs of report writing. For reports to help your team in any situation, they have to be clear, concise, complete, consistent, and courteous.
- What are the qualities of financial reporting?
- The two fundamental qualitative characteristics of financial reports are relevance and faithful representation. The four enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability

What are the five elements of financial reporting?

The elements of the financial statements will be assets, liabilities, net assets/equity, revenues and expenses.

What are the rules of financial reporting?

Financial statements need to reflect certain basic features: fair presentation, going concern, accrual basis, materiality and aggregation, and no offsetting. Financial statements must be prepared at least annually, must include comparative information from the previous period, and must be consistent.

What are limitations of financial reporting?

Financial Statements Have No Predictive Value

The information in a set of financial statements provides information about either historical results or the financial status of a business as of a specific date. The statements do not necessarily provide any value in predicting what will happen in the future.

What are the two bases of financial reporting?

The two main types of bases are cash basis and accrual basis accounting. Cash basis records finances when money exchanges hands, while accrual basis when the transaction occurs, whether or not any cash has been received or paid.

What are the five elements of financial reporting?

The elements of the financial statements will be assets, liabilities, net assets/equity, revenues and expenses.

What are the 10 main components of a report?

The components of a formal report are a cover page, a letter of transmittal, a table of contents, a list of figures and tables, an executive summary, an introduction, methods, a results section, a discussion section, conclusion, recommendations, and an appendix.

- How many types of financial reports are there?
- The three main types financial statements are the balance sheet, the income statement, and the cash flow statement. These three statements together show the assets and liabilities of a business, its revenues and costs, as well as its cash flows from operating, investing, and financing activities.
- What are the 4 four key of financial statement?
- But if you're looking for investors for your business, or want to apply for credit, you'll find that four types of financial statements—the balance sheet, the income statement, the cash flow statement, and the statement of owner's equity—can be crucial in helping you meet your financing goals.

What is the meaning of International financial reporting Standard?

International Financial Reporting Standards (IFRS) are a set of accounting rules for the financial statements of public companies that are intended to make them consistent, transparent, and easily comparable around the world. The IFRS is issued by the International Accounting Standards Board (IASB) and used in 161 countries.

What are the 4 principles of IFRS?

IFRS requires that financial statements be prepared using four basic principles: clarity, relevance, reliability, and comparability

What are the new IFRS Standards?

IFRS 17 establishes the principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the standard. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts.

What is IFRS checklist?

The checklist summarizes the recognition, measurement, presentation and disclosure requirements set out in IFRS® Standards in issue as of December 31, 2021.

The Objective of General Purpose Financial Reporting (see above)

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions include buying, selling or holding equity and debt instruments, providing or settling loans and other forms of credit, exercising rights to vote on, or otherwise influence, management. General purpose financial reports provide information about the resources of, and claims against, an entity and the effects of transactions and other events on those resources and claims.

Qualitative Characteristics of Useful Financial Information

For financial information to be useful, it needs to meet the qualitative characteristics set out in the Framework. The fundamental qualitative characteristics are relevance and faithful representation. Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. In the sections that follow, we have summarised the requirements of the Standards and Interpretations on issue at 1 April 2021.

Faithful representation means the information must be complete, neutral and free from error. Neutrality is supported by exercising caution when making judgements under conditions of uncertainty, which is referred to in the Framework as prudence. Such prudence does not imply a need for asymmetry, for example, a systematic need for more persuasive evidence to support the recognition of assets or income than the recognition of liabilities or expenses. Such asymmetry is not a qualitative characteristic of useful financial information. Financial information is also more useful if it is comparable, verifiable, timely and understandable. Financial Statements and the Reporting Entity

Financial statements are prepared from the perspective of an entity as a whole, rather than from the perspective of any particular group of investors, lenders or other creditors (the entity perspective). Financial statements are prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future.

A reporting entity is an entity that chooses, or is required, to prepare financial statements. Obvious examples include a single legal structure, such as an incorporated entity, and a group comprising a parent and its subsidiaries. A reporting entity need not be a legal entity, although this makes it more difficult to establish clear boundaries when it is not a legal entity, or a parent-subsidiary group. When a reporting entity is not a legal entity, the boundary should be set by focusing on the information needs of the primary users.

A reporting entity could also be a portion of a legal entity, such as a branch or the activities within a defined region. The Framework acknowledges combined financial statements. These are financial statements prepared by a reporting entity comprising two or more entities that are not linked by a parent subsidiary relationship. However, the Framework does not discuss when or how to prepare them.

The Elements of Financial Statements

An asset is a present economic resource controlled by the entity as a result of past events.

An economic resource is a set of rights—the right to use, sell, or pledge the object, as well as other undefined rights. In principle, each right could be a separate asset. However, related rights will most commonly be viewed collectively as a single asset that forms a single unit of account.

Control links a right to an entity and is the present ability to direct how a resource is used so as to obtain the economic benefits from that resource (power and benefits).

can be controlled by only one party at any point in time.

is a present obligation of the entity to transfer an economic resource as a result of past events.

An obligation is a duty or responsibility that an entity has no practical ability to avoid.

An entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself.

The going-concern basis implies that an entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade. If new legislation is enacted, a present obligation arises only when an entity obtains economic benefits, or takes an action, within the scope of that legislation.

The unit of account is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied. Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

What are the 3 key financial documents?

The income statement, balance sheet, and statement of cash flows are required financial statements. These three statements are informative tools that traders can use to analyze a company's financial strength and provide a quick picture of a company's financial health and underlying value.

What 7 items must financial statements consist of?

Revenues and expenses are included in the income statement. Changes in these elements are noted in the statement of cash flows....

The main elements of financial statements are as follows:

- Assets. ...
- Liabilities. ...
- Equity. ...
- Revenue. ...
- Expenses.

What are 2 most important financial statements sheets?

The balance sheet provides an overview of assets, liabilities, and shareholders' equity as a snapshot in time. The income statement primarily focuses on a company's revenues and expenses during a particular period

Which financial statement is prepared first?

The income statement

The income statement, which is sometimes called the statement of earnings or statement of operations, is prepared first. It lists revenues and expenses and calculates the company's net income or net loss for a period of time.

What is the most important financial report?

The most important financial statement for the majority of users is likely to be the income statement, since it reveals the ability of a business to generate a profit. Also, the information listed on the income statement is mostly in relatively current dollars, and so represents a reasonable degree of accuracy.

It starts with current assets, then non-current assets, and total assets. Below that are liabilities and stockholders' equity, which includes current liabilities, non-current liabilities, and finally shareholders' equity

What are the 2 basic forms of the balance sheet - Balance Sheet Formats?

Standard accounting conventions present the balance sheet in one of two formats: the account form (horizontal presentation) and the report form (vertical presentation).

What are the 10 elements of financial statement?

The 10 elements are: (1) assets, (2) liabilities, (3) equity, (4) investments by owners, (5) distributions to owners, (6) revenues, (7) expenses, (8) gains, (9) losses, and (10) comprehensive income.

What Are Financial Statements?

Financial statements are written records that convey the business activities and the financial performance of a company. Financial statements are often audited by government agencies, accountants, firms, etc. to ensure accuracy and for tax, financing, or investing purposes. For-profit primary financial statements include the balance sheet, income statement, statement of cash flow, and statement of changes in equity. Nonprofit entities use a similar but different set of financial statements.

REMEMBER:

- Financial statements are written records that convey the business activities and the financial performance of an entity.
- The balance sheet provides an overview of assets, liabilities, and shareholders' equity as a snapshot in time.
- The income statement primarily focuses on a company’s revenues and expenses during a particular period. Once expenses are subtracted from revenues, the statement produces a company's profit figure called net income.
- The cash flow statement (CFS) measures how well a company generates cash to pay its debt obligations, fund its operating expenses, and fund investments.

- The statement of changes in equity records how profits are retained within a company for future growth or distributed to external parties.

Understanding Financial Statements

Investors and financial analysts rely on financial data to analyze the performance of a company and make predictions about the future direction of the company's stock price. One of the most important resources of reliable and audited financial data is the annual report, which contains the firm's financial statements.

The financial statements are used by investors, market analysts, and creditors to evaluate a company's financial health and earnings potential. The three major financial statement reports are the balance sheet, income statement, and statement of cash flows.

Not all financial statements are created equally. The rules used by U.S. companies is called Generally Accepted Accounting Principles, while the rules often used by international companies is International Financial Reporting Standards (IFRS). In addition, U.S. government agencies use a different set of financial reporting rules.

Balance Sheet

The balance sheet provides an overview of a company's assets, liabilities, and shareholders' equity as a snapshot in time. The date at the top of the balance sheet tells you when the snapshot was taken, which is generally the end of the reporting period. Below is a breakdown of the items in a balance sheet.

Assets

- Cash and cash equivalents are liquid assets, which may include Treasury bills and certificates of deposit.
- Accounts receivables are the amount of money owed to the company by its customers for the sale of its product and service.
- Inventory is the goods a company on hand it intends to sell as a course of business. Inventory may include finished goods, work in progress that are not yet finished, or raw materials on hand that have yet to be worked.
- Prepaid expenses are costs that have been paid in advance of when they are due. These expenses are recorded as an asset because the value of them has not yet been recognized; should the benefit not be recognized, the company would theoretically be due a refund.
- Property, plant, and equipment are capital assets owned by a company for its long-term benefit. This includes buildings used for manufacturing for heavy machinery used for processing raw materials.

- Investments are assets held for speculative future growth. These aren't used in operations; they are simply held for capital appreciation.
- Trademarks, patents, goodwill, and other intangible assets can't be physically be touched but have future economic (and often long-term benefits) for the company.

Liabilities

- Accounts payable are the bills due as part of the normal course of operations of a business. This includes the utility bills, rent invoices, and obligations to buy raw materials.
- Wages payable are payments due to staff for time worked.
- Notes payable are recorded debt instruments that record official debt agreements including the payment schedule and amount.
- Dividends payable are dividends that have been declared to be awarded to shareholders but have not yet been paid.
- Long-term debt can include a variety of obligations including sinking bond funds, mortgages, or other loans that are due in their entirety in longer than one year. Note that the short-term portion of this debt is recorded as a current liability.

Shareholders' Equity

- Shareholders' equity is a company's total assets minus its total liabilities. Shareholders' equity (also known as stockholders' equity) represents the amount of money that would be returned to shareholders if all of the assets were liquidated and all of the company's debt was paid off.
- Retained earnings are part of shareholders' equity and are the amount of net earnings that were not paid to shareholders as dividends.

Example of a Balance Sheet

Below is a portion of ExxonMobil Corporation's (XOM) balance sheet for fiscal-year 2021, reported as of Dec. 31, 2021.

- Total assets were $338.9 billion.
- Total liabilities were $163.2 billion.
- Total equity was $175.7 billion.
- Total liabilities and equity were $338.9 billion, which equals the total assets for the period.1

CONSOLIDATED BALANCE SHEET

	Note Reference Number	December 31, 2021	December 31, 2020
		(millions of dollars)	
Assets			
Current assets			
Cash and cash equivalents		6,802	4,364
Notes and accounts receivable - net	6	32,383	20,581
Inventories			
Crude oil, products and merchandise	3	14,519	14,169
Materials and supplies		4,261	4,681
Other current assets		1,189	1,098
Total current assets		59,154	44,893
Investments, advances and long-term receivables	8	45,195	43,515
Property, plant and equipment, at cost, less accumulated depreciation and depletion	9	216,552	227,553
Other assets, including intangibles - net		18,022	16,789
Liabilities			
Current liabilities			
Notes and loans payable	6	4,276	20,458
Accounts payable and accrued liabilities	6	50,766	35,221
Income taxes payable		1,601	684
Total current liabilities		56,643	56,363
Long-term debt	14	43,428	47,182
Postretirement benefits reserves	17	18,430	22,415
Deferred income tax liabilities	19	20,165	18,165
Long-term obligations to equity companies		2,857	3,253
Other long-term obligations		21,717	21,242
Total liabilities		163,240	168,620
Commitments and contingencies	16		
Equity			
Common stock without par value (9,000 million shares authorized, 8,019 million shares issued)		15,746	15,688
Earnings reinvested		392,059	383,943
Accumulated other comprehensive income		(13,764)	(16,705)
Common stock held in treasury (3,780 million shares in 2021 and 3,786 million shares in 2020)		(225,464)	(225,776)
ExxonMobil share of equity		168,577	157,150
Noncontrolling interests		7,106	6,980
Total equity		175,683	164,130
Total liabilities and equity		338,923	332,750

The Difference Between Horizontal and Vertical Balance sheets is of presentation. In the horizontal balance sheet, the assets and liabilities are shown side by side but in the vertical balance sheet, the assets and liabilities are shown from top to bottom

What is the Horizontal form of the Balance sheet?

In this form of presentation of the balance sheet, we have to present all account information across the page from left to right. All assets are shown on the corresponding side of all liabilities. All liabilities are shown on the left side of the balance sheet and all assets are shown on the right side of the balance sheet.

There is also two way to sort the accounts of assets and liabilities, these are shown as following:

1. Based on Liquidity
2. Based on Permanence

What is the Verticals form of the Balance sheet?

In the vertical form of the presentation of the balance sheet, we have to present all account information across the page from top to bottom. First, we show all liabilities and capital and then after all assets. All assets are shown after all liabilities.

1. There is also two way to sort the accounts of assets and liabilities, these are shown as following: Based on Liquidity
2. Based on Permanence

Chart of Difference between Horizontal and Vertical Balance sheet: –

Basis of Difference	Horizontal	Vertical
Meaning	We have to present all account information across the page from left to right.	we have to present all account information across the page from top to bottom.
Base of Presentation	It is present **side by side**.	It is present from **top to bottom.**
Number of Sides	It has **two sides**	It has only a **single side.**
Sides shows	The left side shows Liabilities and the right side shows assets.	It has only a single side so firstly shown all liabilities(including capital) and then shown all assets.
Period Includes	It has included a single year data only i.e. Current year.	It has included two years of data i.e., the current year as well as the previous year.
Comparability	It is difficult to compare with the previous year because it includes only current year data.	It is easy to compare with the previous year because includes the data of the previous year as well.

Thus, both terms have the only main difference of presentation of the accounts of assets, liabilities, and capital. One is prepared side by side and another is prepared from top to bottom.

What Is an Asset?

An asset is a resource with economic value that an individual, corporation, or country owns or controls with the expectation that it will provide a future benefit.

Assets are reported on a company's balance sheet. They're classified as current, fixed, financial, and intangible. They are bought or created to increase a firm's value or benefit the firm's operations.

An asset can be thought of as something that, in the future, can generate cash flow, reduce expenses, or improve sales, regardless of whether it's manufacturing equipment or a patent.

REMEMBER:

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- An asset is something that may generate cash flow, reduce expenses or improve sales, regardless of whether it's manufacturing equipment or a patent.
- Assets can be classified as current, fixed, financial, or intangible.

Understanding Assets

An asset represents an economic resource owned or controlled by, for example, a company. An economic resource is something that may be scarce and has the ability to produce economic benefit by generating cash inflows or decreasing cash outflows.

An asset can also represent access that other individuals or firms do not have. Furthermore, a right or other type of access can be legally enforceable, which means economic resources can be used at a company's discretion. Their use can be precluded or limited by an owner.

For something to be considered an asset, a company must possess a right to it as of the date of the company's financial statements.

Assets can be broadly categorized into current (or short-term) assets, fixed assets, financial investments, and intangible assets.

Types of Assets

Current Assets

In accounting, some assets are referred to as current. Current assets are short-term economic resources that are expected to be converted into cash or consumed within one year. Current assets include cash and cash equivalents, accounts receivable, inventory, and various prepaid expenses.

While cash is easy to value, accountants periodically reassess the recoverability of inventory and accounts receivable. If there is evidence that a receivable might be uncollectible, it'll be classified as impaired. Or if inventory becomes obsolete, companies may write off these assets.

Some assets are recorded on companies' balance sheets using the concept of historical cost. Historical cost represents the original cost of the asset when purchased by a company. Historical cost can also include costs (such as delivery and set up) incurred to incorporate an asset into the company's operations.

Fixed Assets

Fixed assets are resources with an expected life of greater than a year, such as plants, equipment, and buildings. An accounting adjustment called depreciation is made for fixed assets as they age. It allocates the cost of the asset over time. Depreciation may or may not reflect the fixed asset's loss of earning power.

Generally accepted accounting principles (GAAP) allow depreciation under several methods. The straight-line method assumes that a fixed asset loses its value in proportion to its useful life, while the accelerated method assumes that the asset loses its value faster in its first years of use.

Financial Assets

Financial assets represent investments in the assets and securities of other institutions. Financial assets include stocks, sovereign and corporate bonds, preferred equity, and other, hybrid securities. Financial assets are valued according to the underlying security and market supply and demand.

Intangible Assets

Intangible assets are economic resources that have no physical presence. They include patents, trademarks, copyrights, and goodwill. Accounting for intangible assets differs depending on the type of asset. They can be either amortized or tested for impairment each year.

While an asset is something with economic value that's owned or controlled by a person or company, a liability is something that is owed by a person or company. A liability could be a loan, taxes payable, or accounts payable.

What Is Considered an Asset?

When looking at an asset definition, you'll typically find that it is something that provides a current, future, or potential economic benefit for an individual or company. An asset is, therefore, something that is owned by you or something that is owed to you. A $10 bill, a desktop computer, a chair, and a car are all assets. If you loaned money to someone, that loan is also an asset because you are owed that amount. For the person who owes it, the loan is a liability.

What Are Examples of Assets?

Personal assets can include a home, land, financial securities, jewelry, artwork, gold and silver, or your checking account. Business assets can include such things as motor vehicles, buildings, machinery, equipment, cash, and accounts receivable.

What Are Non-Physical Assets?

Non-physical or intangible assets provide an economic benefit even though you cannot physically touch them. They are an important class of assets that include things like intellectual property (e.g., patents or trademarks), contractual obligations, royalties, and goodwill. Brand equity and reputation are also examples of non-physical or intangible assets that can be quite valuable.

Is Labor an Asset?

No. Labor is the work carried out by human beings, for which they are paid in wages or a salary. Labor is distinct from assets, which are considered to be capital.

How Are Current Assets Different From Fixed (Noncurrent) Assets?

In accounting, assets are categorized by their time horizon of use. Current assets are expected to be sold or used within one year. Fixed assets, also known as noncurrent assets, are expected to be in use for longer than one year. Fixed assets are not easily liquidated. As a result, unlike current assets, fixed assets undergo depreciation.

Current Assets vs. Noncurrent Assets: An Overview

In financial accounting, assets are the resources that a company requires in order to run and grow its business. Assets are divided into two categories: current and noncurrent assets, which appear on a company's balance sheet and combine to form a company's total assets. You may think of current assets as short-term *assets*, which are necessary for a company's immediate needs; whereas noncurrent assets are long-term, as they have a useful life of more than a year.

REMEMBER:

- Current assets are a company's short-term assets; those that can be liquidated quickly and used for a company's immediate needs. Noncurrent assets are long-term and have a useful life of more than a year.
- Examples of current assets include cash, marketable securities, inventory, and accounts receivable. Examples of noncurrent assets include long-term investments, land, property, plant, and equipment (PP&E), and trademarks.

- Current assets are most often valued at market prices whereas noncurrent assets are valued at cost less depreciation.
- Capital gains tax applies to profits on the sale of assets held for more than a year (noncurrent assets).

Current Assets

Current assets are considered short-term assets because they generally are convertible to cash within a firm's fiscal year, and are the resources that a company needs to run its day-to-day operations and pay its current expenses. Current assets are generally reported on the balance sheet at their current or market price.

Current assets may include items such as:

- Cash and cash equivalents
- Accounts receivable
- Prepaid expenses
- Inventory
- Marketable securities

Cash and equivalents (that may be converted) may be used to pay a company's short-term debt. Accounts receivable consist of the expected payments from customers to be collected within one year. Inventory is also a current asset because it includes raw materials and finished goods that can be sold relatively quickly.

Marketable securities include assets such as stocks, Treasuries, commercial paper, exchange traded funds (ETFs), and other money market instruments.

Another important current asset for any business is inventories. It is important for a company to maintain a certain level of inventory to run its business, but neither high nor low levels of inventory are desirable. Other current assets can include deferred income taxes and prepaid revenue.

Noncurrent Assets

Noncurrent assets are a company's long-term investments that have a useful life of more than one year. Noncurrent assets cannot be converted to cash easily. They are required for the long-term needs of a business and include things like land and heavy equipment.

Noncurrent assets are reported on the balance sheet at the price a company paid for them, which is adjusted for depreciation and amortization and is subject to being re-evaluated whenever the market price decreases compared to the book price.

Noncurrent assets may include items such as:

- Land

- Property, plant, and equipment (PP&E)
- Trademarks
- Long-term investments and goodwill—when a company acquires another company

Noncurrent assets may be subdivided into tangible and intangible assets—such as fixed and intangible assets.

Fixed assets include property, plant, and equipment because they are tangible, meaning that they are physical in nature; we may touch them. A company cannot liquidate its PP&E easily. For example, an auto manufacturer's production facility would be labeled a noncurrent asset.

Intangible assets are nonphysical assets, such as patents and copyrights. They are considered noncurrent assets because they provide value to a company but cannot be readily converted to cash within a year. Long-term investments, such as bonds and notes, are also considered noncurrent assets because a company usually holds these assets on its balance sheet for more than a year.

Key Differences

Current Assets

- Equal to cash or will be converted into cash within a year
- Used to fund immediate or current needs
- Items like cash and cash equivalents, short term investments, accounts receivables, and inventories
- Valued at market prices
- Tax implications: Selling current assets results in the profit from trading activities
- Current assets are generally not subject to revaluation—though in certain cases, inventories are subject to revaluation

Noncurrent Assets

- Will not be converted into cash within one year
- Used to fund long-term or future needs
- Items like long term investments, PP&E, goodwill, depreciation, amortization, and long-term deferred tax assets
- Valued at cost less depreciation

- Tax implications: Selling assets results in capital gains and capital gains tax is applied
- Common revaluation of PP&E—for instance, when the market value of a tangible asset decreases compared to the book value, a firm needs to revalue that asset

Current Assets vs. Noncurrent Assets Example

The portion of ExxonMobil's balance sheet pictured below from its 10-K 2021 annual filing displays where you will find current and noncurrent assets.

Current assets generally sit at the top of the balance sheet. Here, they include receivables due to Exxon, along with cash and cash equivalents, accounts receivable, and inventories. Total current assets for fiscal-year end 2021 were $59.2 billion.

Noncurrent assets are listed below current assets. These represent Exxon's long-term investments like oil rigs and production facilities that come under property, plant, and equipment (PP&E). Total noncurrent assets for fiscal-year end 2021 were $279.7 billion.

The combined total assets are located at the very bottom and for fiscal-year end 2021 were $338.9 billion.

CONSOLIDATED BALANCE SHEET

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Assets			
Current assets			
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Crude oil, products and merchandise	3	14,519	14,169
Materials and supplies		4,261	4,681
Other current assets		1,189	1,098
Total current assets		59,154	44,893
Investments, advances and long-term receivables	8	45,195	43,515
Property, plant and equipment, at cost, less accumulated depreciation and depletion	9	216,552	227,553
Other assets, including intangibles - net		18,022	16,789
Total assets		338,923	332,750

What Are Examples of Current Assets and Noncurrent Assets?

Examples of current assets include cash, marketable securities, cash equivalents, accounts receivable, and inventory. Examples of noncurrent assets include long-term investments, land, intellectual property and other intangibles, and property, plant, and equipment (PP&E).

What Is the Difference Between a Fixed Asset and a Noncurrent Asset?

A fixed asset is a type of noncurrent asset. Noncurrent assets include a variety of assets, such as fixed assets and intellectual property, and other intangibles. In general, a fixed asset is a physical asset that cannot be converted to cash readily. To convert a fixed asset into cash may take months or over a year. Fixed assets include property, plant, and equipment, such as a factory.

Why Are Noncurrent Assets Depreciated?

Noncurrent assets are depreciated in order to spread the cost of the asset over the time that it is used; its useful life. Noncurrent assets are not depreciated in order to represent a new value or a replacement value but simply to allocate the cost of the asset over a period of time.

What Is a Liability?

A liability is something a person or company owes, usually a sum of money. Liabilities are settled over time through the transfer of economic benefits including money, goods, or services.

Recorded on the right side of the balance sheet, liabilities include loans, accounts payable, mortgages, deferred revenues, bonds, warranties, and accrued expenses.

Liabilities can be contrasted with assets. Liabilities refer to things that you owe or have borrowed; assets are things that you own or are owed.

REMEMBER:

- A liability (generally speaking) is something that is owed to somebody else.
- Liability can also mean a legal or regulatory risk or obligation.
- In accounting, companies book liabilities in opposition to assets.
- Current liabilities are a company's short-term financial obligations that are due within one year or a normal operating cycle (e.g. accounts payable).
- Long-term (non-current) liabilities are obligations listed on the balance sheet not due for more than a year.
-

How Liabilities Work

In general, a liability is an obligation between one party and another not yet completed or paid for. In the world of accounting, a financial liability is also an obligation but is more defined by previous business transactions, events, sales, exchange of assets or services, or anything that would provide economic benefit at a later date. Current liabilities are usually considered short-term (expected to be concluded in 12 months or less) and non-current liabilities are long-term (12 months or greater).

Liabilities are categorized as current or non-current depending on their temporality. They can include a future service owed to others (short- or long-term borrowing from banks, individuals, or other entities) or a previous transaction that has created an unsettled obligation. The most common liabilities are usually the largest like accounts payable and bonds payable. Most companies will have these two line items on their balance sheet, as they are part of ongoing current and long-term operations.

Liabilities are a vital aspect of a company because they are used to finance operations and pay for large expansions. They can also make transactions between businesses more efficient. For example, in most cases, if a wine supplier sells a case of wine to a restaurant, it does not demand payment when it delivers the goods. Rather, it invoices the restaurant for the purchase to streamline the drop-off and make paying easier for the restaurant.

The outstanding money that the restaurant owes to its wine supplier is considered a liability. In contrast, the wine supplier considers the money it is owed to be an asset.

Liability may also refer to the legal liability of a business or individual. For example, many businesses take out liability insurance in case a customer or employee sues them for negligence.

Other Definitions of Liability

Generally, liability refers to the state of being responsible for something, and this term can refer to any money or service owed to another party. Tax liability, for example, can refer to the property taxes that a homeowner owes to the municipal government or the income tax he owes to the federal government. When a retailer collects sales tax from a customer, they have a sales tax liability on their books until they remit those funds to the county/city/state.

Liability can also refer to one's potential damages in a civil lawsuit.

Types of Liabilities

Businesses sort their liabilities into two categories: current and long-term. Current liabilities are debts payable within one year, while long-term liabilities are debts payable over a longer period. For example, if a business takes out a mortgage payable over a 15-year period, that is a long-term liability. However, the mortgage payments that are due during the current year are considered the current portion of long-term debt and are recorded in the short-term liabilities section of the balance sheet.

Current (Near-Term) Liabilities

Ideally, analysts want to see that a company can pay current liabilities, which are due within a year, with cash. Some examples of short-term liabilities include payroll expenses and accounts payable, which include money owed to vendors, monthly utilities, and similar expenses. Other examples include:

- Wages Payable: The total amount of accrued income employees have earned but not yet received. Since most companies pay their employees every two weeks, this liability changes often.
- Interest Payable: Companies, just like individuals, often use credit to purchase goods and services to finance over short time periods. This represents the interest on those short-term credit purchases to be paid.
- Dividends Payable: For companies that have issued stock to investors and pay a dividend, this represents the amount owed to shareholders after the dividend was declared. This period is around two weeks, so this liability usually pops up four times per year, until the dividend is paid.
- Unearned Revenues: This is a company's liability to deliver goods and/or services at a future date after being paid in advance. This amount will be reduced in the future with an offsetting entry once the product or service is delivered.
- Liabilities of Discontinued Operations: This is a unique liability that most people glance over but should scrutinize more closely. Companies are required to account for the financial impact of an operation, division, or entity that is currently being held for sale or has been recently sold. This also includes the financial impact of a product line that is or has recently been shut down.

Non-Current (Long-Term) Liabilities

Considering the name, it’s quite obvious that any liability that is not near-term falls under non-current liabilities, expected to be paid in 12 months or more. Referring again to the AT&T example, there are more items than your garden variety company that may list one or two items. Long-term debt, also known as bonds payable, is usually the largest liability and at the top of the list.

Companies of all sizes finance part of their ongoing long-term operations by issuing bonds that are essentially loans from each party that purchases the bonds. This line item is in constant flux as bonds are issued, mature, or called back by the issuer.

Analysts want to see that long-term liabilities can be paid with assets derived from future earnings or financing transactions. Bonds and loans are not the only long-term liabilities companies incur. Items like rent, deferred taxes, payroll, and pension obligations can also be listed under long-term liabilities. Other examples include:

- Warranty Liability: Some liabilities are not as exact as AP and have to be estimated. It's the estimated amount of time and money that may be spent repairing products upon the agreement of a warranty. This is a common liability in the automotive industry, as most cars have long-term warranties that can be costly.
- Contingent Liability Evaluation: A contingent liability is a liability that may occur depending on the outcome of an uncertain future event.
- Deferred Credits: This is a broad category that may be recorded as current or non-current depending on the specifics of the transactions. These credits are basically revenue collected before it is recorded as earned on the income statement. It may include customer advances, deferred revenue, or a transaction where credits are owed but not yet considered revenue. Once the revenue is no longer deferred, this item is reduced by the amount earned and becomes part of the company's revenue stream.
- Post-Employment Benefits: These are benefits an employee or family members may receive upon his/her retirement, which are carried as a long-term liability as it accrues. In the AT&T example, this constitutes one-half of the total non-current total second only to long-term debt. With rapidly rising health care and deferred compensation, this liability is not to be overlooked.
- Unamortized Investment Tax Credits (UITC): This represents the net between an asset's historical cost and the amount that has already been depreciated. The unamortized portion is a liability, but it is only a rough estimate of the asset's fair market value. For an analyst, this provides some details of how aggressive or conservative a company is with its depreciation methods.

Liabilities vs. Assets

Assets are the things a company owns—or things owed to the company—and they include tangible items such as buildings, machinery, and equipment as well as intangible items such as accounts receivable, interest owed, patents, or intellectual property.

If a business subtracts its liabilities from its assets, the difference is its owner's or stockholders' equity. This relationship can be expressed as follows:

Assets−Liabilities=Owner's Equity

However, in most cases, this accounting equation is commonly presented as such:

Assets=Liabilities+Equity

Revenue

Revenue is the money generated from normal business operations, calculated as the average sales price times the number of units sold. It is the top line (or gross income) figure from which costs are subtracted to determine net income. Revenue is also known as sales on the income statement.

REMEMBER:

- Revenue, often referred to as sales or the top line, is the money received from normal business operations.
- Operating income is revenue (from the sale of goods or services) less operating expenses.
- Non-operating income is infrequent or nonrecurring income derived from secondary sources (e.g., lawsuit proceeds).
- Non-business entities such as governments, nonprofits, or individuals also report revenue, though calculations and sources for each differ.
- Revenue is only sale proceeds, while income or profit incorporate the expenses to generate revenue and report the net (not gross) earnings.

What is Revenue?

Understanding Revenue

Revenue is money brought into a company by its business activities. There are different ways to calculate revenue, depending on the accounting method employed. Accrual accounting will include sales made on credit as revenue for goods or services delivered to the customer. Under certain rules, revenue is recognized even if payment has not yet been received.

It is necessary to check the cash flow statement to assess how efficiently a company collects money owed. Cash accounting, on the other hand, will only count sales as revenue when payment is received. Cash paid to a company is known as a "receipt." It is possible to have receipts without revenue. For example, if the customer paid in advance for a service not yet rendered or undelivered goods, this activity leads to a receipt but not revenue.

Revenue is known as the top line because it appears first on a company's income statement. Net income, also known as the bottom line, is revenues minus expenses. There is a profit when revenues exceed expenses.

To increase profit, and hence earnings per share (EPS) for its shareholders, a company increases revenues and/or reduces expenses. Investors often consider a company's revenue and net income separately to determine the health of a business. Net income can grow while revenues remain stagnant because of cost-cutting.

Such a situation does not bode well for a company's long-term growth. When public companies report their quarterly earnings, two figures that receive a lot of attention are revenues and EPS. A company beating or missing analysts' revenue and earnings per share expectations can often move a stock's price.

Revenue may also be referred to as sales and is used in the price-to-sales (P/S) ratio—an alternative to the price-to-earnings (P/E) ratio that uses revenue in the denominator.

Types of Revenue

A company's revenue may be subdivided according to the divisions that generate it. For example, Toyota Motor Corporation may classify revenue across each type of vehicle. Alternatively, it can choose to group revenue by car type (i.e. compact vs. truck).

A company may also distinguish revenue between tangible and intangible product lines. For example, Apple products include iPad, Apple Watch, and Apple TV. Alternatively, Apple may be interested in separately analyzing its Apple Music, Apple TV+, or iCloud services.

Revenue can be divided into operating revenue—sales from a company's core business—and non-operating revenue which is derived from secondary sources. As these non-operating revenue sources are often unpredictable or nonrecurring, they can be referred to as one-time events or gains. For example, proceeds from the sale of an asset, a windfall from investments, or money awarded through litigation are non-operating revenue.

Formula and Calculation of Revenue

The formula and calculation of revenue will vary across companies, industries, and sectors. A service company will have a different formula than a retailer, while a company that does not accept returns may have different calculations than companies with return periods. Broadly speaking, the formula to calculate net revenue is:

Net Revenue = (Quantity Sold * Unit Price) - Discounts - Allowances - Returns

The main component of revenue is the quantity sold multiplied by the price. For a service company, this is the number of service hours multiplied by the billable service rate. For a retailer, this is the number of goods sold multiplied by the sales price.

The obvious constraint with this formula is a company that has a diversified product line. For example, Apple can sell a MacBook, iPhone, and iPad, each for a different price. Therefore, the net revenue formula should be calculated for each product or service, then added together to get a company's total revenue.

There are several components that reduce revenue reported on a company's financial statements in accordance to accounting guidelines. Discounts on the price offered, allowances awarded to customers, or product returns are subtracted from the total amount collected. Note that some components (i.e. discounts) should only be subtracted if the unit price used in the earlier part of the formula is at market (not discount) price.

One entity's revenue is often another entity's expense. For example, your personal household expense of $1,000 to buy the latest smartphone is $1,000 revenue for the phone company.

Revenue vs. Income/Profit

Many entities may report both revenue and income/profit. These two terms are used to report different accumulations of numbers.

Revenue is often the gross proceeds collected by an entity. It is the measurement of only income component of an entity's operations. For a business, revenue is all of the money it has earned.

Income/profit usually incorporates other facets of a business. For example, net income or incorporate expenses such as cost of goods sold, operating expenses, taxes, and interest expenses. While revenue is a gross amount focused just on the collection of proceeds, income or profit incorporate other aspects of a business that reports the net proceeds.

Special Considerations

Recognizing Revenue: ASC 606

In 2016, the Financial Accounting Standards Board released Revenue from Contracts with Customers (Topic 606). The accounting standards update outlined new guidance on how companies must report revenue. The guidance requires an entity recognize revenue in accordance with five steps:

1. Identify the contract with the customer.
2. Identify the performance obligation in the contract.
3. Determine the contract price.
4. Allocate the transaction price to the performance obligation(s) in the contract.

5. Recognize revenue when the entity satisfies a performance obligation.2

Government Revenue

In the case of government, revenue is the money received from taxation, fees, fines, inter-governmental grants or transfers, securities sales, mineral or resource rights, as well as any sales made. Governments collect revenue from citizens within its district and collections from other government entities.

Nonprofit Revenue

For nonprofits, revenues are its gross receipts. Its components include donations from individuals, foundations, and companies, grants from government entities, investments, and/or membership fees. Nonprofit revenue may be earned via fundraising events or unsolicited donations.

Real Estate Revenue

In terms of real estate investments, revenue refers to the income generated by a property, such as rent or parking fees or rent. When the operating expenses incurred in running the property are subtracted from property income, the resulting value is net operating income (NOI). Vacant real estate technically does not earn any operating revenue, though the owner of the property may be required to report fair market value adjustments that result in gains when externally reporting their finances.

What Does Revenue in Business Mean?

Revenue is the money earned by a company obtained primarily from the sale of its products or services to customers. There are specific accounting rules that dictate when, how, and why a company recognizes revenue. For instance, a company may receive cash from a client. However, a company may not be able to recognize revenue until they've performed their part of the contractual obligation.

Are Revenue and Cash Flow the Same Thing?

No. Revenue is the money a company earns from the sale of its products and services. Cash flow is the net amount of cash being transferred into and out of a company. Revenue provides a measure of the effectiveness of a company's sales and marketing, whereas cash flow is more of a liquidity indicator. Both revenue and cash flow should be analyzed together for a comprehensive review of a company's financial health.

What Is the Difference Between Revenue and Income?

Revenue and income are sometimes used interchangeably. However, these two terms do usually mean different things. Revenue is often used to measure the total amount of sales a company from its goods and services. Income is often used to incorporate expenses and report the net proceeds a company has earned.

How Does One Generate and Calculate Revenue?

For many companies, revenues are generated from the sales of products or services. For this reason, revenue is sometimes known as gross sales. Revenue can also be earned via other sources. Inventors or entertainers may receive revenue from licensing, patents, or royalties. Real estate investors might earn revenue from rental income.

Revenue for federal and local governments would likely be in the form of tax receipts from property or income taxes. Governments might also earn revenue from the sale of an asset or interest income from a bond. Charities and non-profit organizations usually receive income from donations and grants. Universities could earn revenue from charging tuition but also from investment gains on their endowment fund.

What Is Accrued and Deferred Revenue?

Accrued revenue is the revenue earned by a company for the delivery of goods or services that have yet to be paid by the customer. In accrual accounting, revenue is reported at the time a sales transaction takes place and may not necessarily represent cash in hand.

Deferred, or unearned revenue can be thought of as the opposite of accrued revenue, in that unearned revenue accounts for money prepaid by a customer for goods or services that have yet to be delivered. If a company has received prepayment for its goods, it would recognize the revenue as unearned, but would not recognize the revenue on its income statement until the period for which the goods or services were delivered.

What Is an Expense?

An expense is the cost of operations that a company incurs to generate revenue. It is simply defined as the cost one is required to spend on obtaining something. As the popular saying goes, “it costs money to make money.”

Common expenses include payments to suppliers, employee wages, factory leases, and equipment depreciation. Businesses are allowed to write off tax-deductible expenses on their income tax returns to lower their taxable income and thus their tax liability; however, the Internal Revenue Service (IRS) has strict rules on which expenses businesses are allowed to claim as a deduction.

REMEMBER:

- An expense is the cost of operations that a company incurs to generate revenue.
- Businesses can write off tax-deductible expenses on their income tax returns, provided that they meet the IRS' guidelines.
- Accountants record expenses through one of two accounting methods: cash basis or accrual basis.
- There are two main categories of business expenses in accounting: operating expenses and non-operating expenses.
- The IRS treats capital expenses differently than most other business expenses.

Understanding Expenses

One of the main goals of company management teams is to maximize profits. This is achieved by boosting revenues while keeping expenses in check. Slashing costs can help companies to make even more money from sales.

However, if expenses are cut too much it could also have a detrimental effect. For example, paying less on advertising reduces costs but also lowers the company's visibility and ability to reach out to potential customers.

How Expenses Are Recorded

Companies break down their revenues and expenses in their income statements. Accountants record expenses through one of two accounting methods: cash basis or accrual basis. Under cash basis accounting, expenses are recorded when they are paid. In contrast, under the accrual method, expenses are recorded when they are incurred.

For example, if a business owner schedules a carpet cleaner to clean the carpets in the office, a company using the cash basis records the expense when it pays the invoice. Under the accrual method, the business accountant would record the carpet cleaning expense when the company receives the service. Expenses are generally recorded on an accrual basis, ensuring that they match up with the revenues reported in accounting periods.

Expenses are used to calculate net income. The equation to calculate net income is revenues minus expenses.

Types of Business Expenses

There are two main categories of business expenses in accounting:

Operating Expenses

Operating expenses are the expenses related to the company’s main activities, such as the cost of goods sold, administrative fees, office supplies, direct labor, and rent. These are the expenses that are incurred from normal, day-to-day activities.

Operating expense is deducted from revenue to arrive at operating income; the amount of profit a company earns from its direct business activities. Companies need to manage their operating expenses to ensure that they are maximizing profits; this is usually done by keeping expenses at a minimum; however, reducing expenses too much can reduce the company's productivity.

Non-operating Expenses

Non-operating expenses are not directly related to the business's core operations. Common examples include interest charges and other costs associated with borrowing money. These are expenses that occur outside of a company's day-to-day activities. These costs may occur from restructuring, reorganizing, interest charges on debt, or on obsolete inventory.

Non-operating expenses are separate from operating expenses from an accounting perspective so as to be able to determine how much a company earns from its core activities.

Special Considerations

Capital Expenses

Capital expenditures, commonly known as CapEx, are funds used by a company to acquire, upgrade, and maintain physical assets such as property, buildings, an industrial plant, technology, or equipment.

The IRS treats capital expenses differently than most other business expenses. While most costs of doing business can be expensed or written off against business income the year they are incurred, capital expenses must be capitalized or written off slowly over time.1

The IRS has a schedule that dictates the portion of a capital asset a business may write off each year until the entire expense is claimed. The number of years over which a business writes off a capital expense varies based on the type of asset.

Not All Expenses Can Be Deducted

According to the IRS, to be deductible, a business expense "must be both ordinary and necessary." Ordinary means the expense is common or accepted in that industry, while necessary means the expense is helpful in the pursuit of earning income. Business owners are not allowed to claim their personal, non-business expenses as business deductions. They also cannot claim lobbying expenses, penalties, and fines.2

Investors can refer to Publication 535, Business Expenses on the IRS website for more information.2

What Are Examples of Expenses?

Examples of expenses include rent, utilities, wages, salaries, maintenance, depreciation, insurance, and the cost of goods sold. Expenses are usually recurring payments needed to operate a business.

What Are the Types of Expenses?

Expenses can be categorized in a variety of ways. Expenses can be defined as fixed expenses, such as rent or mortgage; those that do not change with the change in production. Expenses can also be defined as variable expenses; those that change with the change in production. These include utilities and the cost of goods sold. Expenses can also be categorized as operating and non-operating expenses. The former are the expenses directly related to operating the company, and the latter is indirectly related.

Is Salary Considered an Expense?

Yes, salary is considered an expense and is reported as such on a company's income statement.

The Bottom Line

An expense is a cost that businesses incur in running their operations. Expenses include wages, salaries, maintenance, rent, and depreciation. Expenses are deducted from revenue to arrive at profits. Businesses are allowed to deduct certain expenses from taxes to help alleviate the tax burden and bulk up profits.

Liabilities vs. Expenses

An expense is the cost of operations that a company incurs to generate revenue. Unlike assets and liabilities, expenses are related to revenue, and both are listed on a company's income statement. In short, expenses are used to calculate net income. The equation to calculate net income is revenues minus expenses.

For example, if a company has more expenses than revenues for the past three years, it may signal weak financial stability because it has been losing money for those years.

Expenses and liabilities should not be confused with each other. One is listed on a company's balance sheet, and the other is listed on the company's income statement. Expenses are the costs of a company's operation, while liabilities are the obligations and debts a company owes. Expenses can be paid immediately with cash, or the payment could be delayed which would create a liability.

Example of Liabilities

As a practical example of understanding a firm's liabilities, let's look at a historical example using AT&T's (T) 2020 balance sheet.1 The current/short-term liabilities are separated from long-term/non-current liabilities on the balance sheet.

Consolidated Balance Sheets
Dollars in millions except per share amounts

	December 31,	
	2020	2019
Assets		
Current Assets		
Cash and cash equivalents	**$ 9,740**	$ 12,130
Accounts receivable – net of related allowance for credit loss of $1,221 and $1,235	**20,215**	22,636
Prepaid expenses	**1,822**	1,631
Other current assets	**20,231**	18,364
Total current assets	**52,008**	54,761
Noncurrent Inventories and Theatrical Film and Television Production Costs	**14,752**	12,434
Property, Plant and Equipment – Net	**127,315**	130,128
Goodwill	**135,259**	146,241
Licenses – Net	**93,840**	97,907
Trademarks and Trade Names – Net	**23,297**	23,567
Distribution Networks – Net	**13,793**	15,345
Other Intangible Assets – Net	**15,386**	20,798
Investments in and Advances to Equity Affiliates	**1,780**	3,695
Operating Lease Right-Of-Use Assets	**24,714**	24,039
Other Assets	**23,617**	22,754
Total Assets	**$525,761**	$551,669
Liabilities and Stockholders' Equity		
Current Liabilities		
Debt maturing within one year	**$ 3,470**	$ 11,838
Accounts payable and accrued liabilities	**49,032**	45,956
Advanced billings and customer deposits	**6,176**	6,124
Accrued taxes	**1,019**	1,212
Dividends payable	**3,741**	3,781
Total current liabilities	**63,438**	68,911
Long-Term Debt	**153,775**	151,309
Deferred Credits and Other Noncurrent Liabilities		
Deferred income taxes	**60,472**	59,502
Postemployment benefit obligation	**18,276**	18,788
Operating lease liabilities	**22,202**	21,804
Other noncurrent liabilities	**28,358**	29,421
Total deferred credits and other noncurrent liabilities	**129,308**	129,515

AT&T clearly defines its bank debt that is maturing in less than one year under current liabilities. For a company this size, this is often used as operating capital for day-to-day operations rather than funding larger items, which would be better suited using long-term debt.

Like most assets, liabilities are carried at cost, not market value, and under generally accepted accounting principle (GAAP) rules can be listed in order of preference as long as they are categorized. The AT&T example has a relatively high debt level under current liabilities. With smaller companies, other line items like accounts payable (AP) and various future liabilities like payroll, taxes will be higher current debt obligations.

AP typically carries the largest balances, as they encompass the day-to-day operations. AP can include services, raw materials, office supplies, or any other categories of products and services where no promissory note is issued. Since most companies do not pay for goods and services as they are acquired, AP is equivalent to a stack of bills waiting to be paid.

How Do I Know If Something Is a Liability?

A liability is something that is borrowed from, owed to, or obligated to someone else. It can be real (e.g. a bill that needs to be paid) or potential (e.g. a possible lawsuit).

A liability is not necessarily a bad thing. For instance, a company may take out debt (a liability) in order to expand and grow its business. Or, an individual may take out a mortgage to purchase a home.

How Are Current Liabilities Different From Long-Term (Noncurrent) Ones?

Companies will segregate their liabilities by their time horizon for when they are due. Current liabilities are due within a year and are often paid for using current assets. Non-current liabilities are due in more than one year and most often include debt repayments and deferred payments.

How Do Liabilities Relate to Assets and Equity?

The accounting equation states that—assets = liabilities + equity. As a result, we can re-arrange the formula to read liabilities = assets - equity. Thus, the value of a firm's total liabilities will equal the difference between the values of total assets and shareholders' equity. If a firm takes on more liabilities without accumulating additional assets, it must result in a reduction in the value of the firm's equity position.

What Is a Contingent Liability?

A contingent liability is an obligation that might have to be paid in the future, but there are still unresolved matters that make it only a possibility and not a certainty. Lawsuits and the threat of lawsuits are the most common contingent liabilities, but unused gift cards, product warranties, and recalls also fit into this category.

What Are Examples of Liabilities That Individuals or Households Have?

Like businesses, an individual's or household's net worth is taken by balancing assets against liabilities. For most households, liabilities will include taxes due, bills that must be paid, rent or mortgage payments, loan interest and principal due, and so on. If you are pre-paid for performing work or a service, the work owed may also be construed as a liability.

What Is Equity?

Equity, typically referred to as shareholders' equity (or owners' equity for privately held companies), represents the amount of money that would be returned to a company's shareholders if all of the assets were liquidated and all of the company's debt was paid off in the case of liquidation. In the case of acquisition, it is the value of company sales minus any liabilities owed by the company not transferred with the sale.

In addition, shareholder equity can represent the book value of a company. Equity can sometimes be offered as payment-in-kind. It also represents the pro-rata ownership of a company's shares.

Equity can be found on a company's balance sheet and is one of the most common pieces of data employed by analysts to assess a company's financial health.

REMEMBER:

- Equity represents the value that would be returned to a company's shareholders if all of the assets were liquidated and all of the company's debts were paid off.
- We can also think of equity as a degree of residual ownership in a firm or asset after subtracting all debts associated with that asset.
- Equity represents the shareholders' stake in the company, identified on a company's balance sheet.
- The calculation of equity is a company's total assets minus its total liabilities, and it's used in several key financial ratios such as ROE.
- Home equity is the value of a homeowner's property (net of debt) and is another way the term equity is used.

By comparing concrete numbers reflecting everything the company owns and everything it owes, the "assets-minus-liabilities" shareholder equity equation paints a clear picture of a company's finances, easily interpreted by investors and analysts. Equity is used as capital raised by a company, which is then used to purchase assets, invest in projects, and fund operations. A firm typically can raise capital by issuing debt (in the form of a loan or via bonds) or equity (by selling stock). Investors usually seek out equity investments as it provides a greater opportunity to share in the profits and growth of a firm.

Equity is important because it represents the value of an investor's stake in a company, represented by the proportion of its shares. Owning stock in a company gives shareholders the potential for capital gains and dividends. Owning equity will also give shareholders the right to vote on corporate actions and elections for the board of directors. These equity ownership benefits promote shareholders' ongoing interest in the company.

Shareholder equity can be either negative or positive. If positive, the company has enough assets to cover its liabilities. If negative, the company's liabilities exceed its assets; if prolonged, this is considered balance sheet insolvency. Typically, investors view companies with negative shareholder equity as risky or unsafe investments. Shareholder equity alone is not a definitive indicator of a company's financial health; used in conjunction with other tools and metrics, the investor can accurately analyze the health of an organization.

Formula and How to Calculate Shareholders' Equity

The following formula and calculation can be used to determine the equity of a firm, which is derived from the accounting equation:

$$\text{Equity} = \text{Total Assets} - \text{Total Liabilities}$$

This information can be found on the balance sheet, where these four steps should be followed:

1. Locate the company's total assets on the balance sheet for the period.
2. Locate total liabilities, which should be listed separately on the balance sheet.
3. Subtract total liabilities from total assets to arrive at shareholder equity.
4. Note that total assets will equal the sum of liabilities and total equity.

Shareholder equity can also be expressed as a company's share capital and retained earnings less the value of treasury shares. This method, however, is less common. Though both methods yield the exact figure, the use of total assets and total liabilities is more illustrative of a company's financial health.

What the Components of Shareholder Equity Are

Retained earnings are part of shareholder equity and are the percentage of net earnings that were not paid to shareholders as dividends. Think of retained earnings as savings since it represents a cumulative total of profits that have been saved and put aside or retained for future use. Retained earnings grow larger over time as the company continues to reinvest a portion of its income.

At some point, the amount of accumulated retained earnings can exceed the amount of equity capital contributed by stockholders. Retained earnings are usually the largest component of stockholders' equity for companies operating for many years.

Treasury shares or stock (not to be confused with U.S. Treasury bills) represent stock that the company has bought back from existing shareholders. Companies may do a repurchase when management cannot deploy all of the available equity capital in ways that might deliver the best returns. Shares bought back by companies become treasury shares, and the dollar value is noted in an account called treasury stock, a contra account to the accounts of investor capital and retained earnings. Companies can reissue treasury shares back to stockholders when companies need to raise money.

Many view stockholders' equity as representing a company's net assets—its net value, so to speak, would be the amount shareholders would receive if the company liquidated all of its assets and repaid all of its debts.

Example of Shareholder Equity

Using a historical example below is a portion of Exxon Mobil Corporation's (XOM) balance sheet as of September 30, 2018:

- Total assets were $354,628.
- Total liabilities were $157,797.
- Total equity was $196,831.1

The accounting equation whereby Assets = Liabilities + Shareholder Equity is calculated as follows:

Shareholder Equity = $354,628, (Total Assets) - $157,797 (Total Liabilities) = $196,8311

Exxon Mobil Corporation
Condensed Consolidated Balance Sheet
(million of dollars)

	Sept. 30, 2018
Assets	
Current assets	
Cash and cash equivalents	5,669
Notes and accounts receivable — net	27,880
Inventories	
Crude oil, products and merchandise	14,617
Materials and supplies	4,144
Other current assets	1,665

Total current assets	53,975
Investments, advances and long-term receivables	40,427
Property, plant and equipment — net	249,153
Other assets, including intangibles — net	11,073
Total assets	354,628
Liabilities	
Current liabilities	
Notes and loans payable	19,413
Accounts payable and accrued liabilities	41,714
Income taxes payable	4,161
Total current liabilities	65,288
Long-term debt	20,624
Postretirement benefits reserves	21,448
Deferred income tax liabilities	27,084
Long-term obligations to equity companies	4,625
Other long-term obligations	18,728
Total liabilities	157,797
Commitments and contingencies (Note 3)	
Equity	
Common stock without par value (9,000 million shares authorized, 8,019 million shares issued)	15,254
Earnings reinvested	419,155
Common stock held in treasury (3,785 million shares at September 30, 2018 and 3,780 million shares at December 31, 2017)	(225,674)
ExxonMobil share of equity	(190,365)
Noncontrolling interests	6,466
Total equity	196,831
Total liabilities and equity	354,628

Other Forms of Equity

The concept of equity has applications beyond just evaluating companies. We can more generally think of equity as a degree of ownership in any asset after subtracting all debts associated with that asset.

Below are several common variations on equity:

- A stock or any other security representing an ownership interest in a company.
- On a company's balance sheet, the amount of funds contributed by the owners or shareholders plus the retained earnings (or losses). One may also call this stockholders' equity or shareholders' equity.
- The value of securities in a margin account minus what the account holder borrowed from the brokerage in margin trading.
- In real estate, the difference between the property's current fair market value and the amount the owner still owes on the mortgage. It is the amount that the

owner would receive after selling a property and paying any liens. Also referred to as "real property value."

- When a business goes bankrupt and has to liquidate, equity is the amount of money remaining after the business repays its creditors. This is often called "ownership equity," also known as risk capital or "liable capital."

Private Equity

When an investment is publicly traded, the market value of equity is readily available by looking at the company's share price and its market capitalization. For private entities, the market mechanism does not exist, so other valuation forms must be done to estimate value.

Private equity generally refers to such an evaluation of companies that are not publicly traded. The accounting equation still applies where stated equity on the balance sheet is what is left over when subtracting liabilities from assets, arriving at an estimate of book value. Privately held companies can then seek investors by selling off shares directly in private placements. These private equity investors can include institutions like pension funds, university endowments, insurance companies, or accredited individuals.

Private equity is often sold to funds and investors that specialize in direct investments in private companies or that engage in leveraged buyouts (LBOs) of public companies. In an LBO transaction, a company receives a loan from a private equity firm to fund the acquisition of a division of another company. Cash flows or the assets of the company being acquired usually secure the loan. Mezzanine debt is a private loan, usually provided by a commercial bank or a mezzanine venture capital firm. Mezzanine transactions often involve a mix of debt and equity in a subordinated loan or warrants, common stock, or preferred stock.

Private equity comes into play at different points along a company's life cycle. Typically, a young company with no revenue or earnings can't afford to borrow, so it must get capital from friends and family or individual "angel investors." Venture capitalists enter the picture when the company has finally created its product or service and is ready to bring it to market. Some of the largest, most successful corporations in the tech sector, like Google, Apple, Amazon, and Meta—or what is referred to as GAFAM—began with venture capital funding.

Types of Private Equity Financing

Venture capitalists (VCs) provide most private equity financing in return for an early minority stake. Sometimes, a venture capitalist will take a seat on the board of directors for its portfolio companies, ensuring an active role in guiding the company. Venture capitalists look to hit big early on and exit investments within five to seven years. An LBO is one of the most common types of private equity financing and might occur as a company matures.

A final type of private equity is a Private Investment in a Public Company (PIPE). A PIPE is a private investment firm's, a mutual fund's, or another qualified investors' purchase of stock in a company at a discount to the current market value (CMV) per share to raise capital.

Unlike shareholder equity, private equity is not accessible to the average individual. Only "accredited" investors, those with a net worth of at least $1 million, can take part in private equity or venture capital partnerships. Such endeavors might require form 4, depending on their scale.2 For investors who don't meet this marker, there is the option of private equity exchange-traded funds (ETFs).

Home Equity

Home equity is roughly comparable to the value contained in homeownership. The amount of equity one has in their residence represents how much of the home they own outright by subtracting from the mortgage debt owed. Equity on a property or home stems from payments made against a mortgage, including a down payment and increases in property value.

Home equity is often an individual’s greatest source of collateral, and the owner can use it to get a home equity loan, which some call a second mortgage or a home equity line of credit (HELOC). An equity takeout is taking money out of a property or borrowing money against it.

For example, let’s say Sam owns a home with a mortgage on it. The house has a current market value of $175,000, and the mortgage owed totals $100,000. Sam has $75,000 worth of equity in the home or $175,000 (asset total) - $100,000 (liability total).

Brand Equity

When determining an asset's equity, particularly for larger corporations, it is important to note these assets may include both tangible assets, like property, and intangible assets, like the company's reputation and brand identity. Through years of advertising and the development of a customer base, a company's brand can come to have an inherent value. Some call this value "brand equity," which measures the value of a brand relative to a generic or store-brand version of a product.

For example, many soft-drink lovers will reach for a Coke before buying a store-brand cola because they prefer the taste or are more familiar with the flavor. If a 2-liter bottle of store-brand cola costs $1 and a 2-liter bottle of Coke costs $2, then Coca-Cola has brand equity of $1.

There is also such a thing as negative brand equity, which is when people will pay more for a generic or store-brand product than they will for a particular brand name. Negative brand equity is rare and can occur because of bad publicity, such as a product recall or a disaster.

Equity vs. Return on Equity

Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholder equity. Because shareholder equity is equal to a company's assets minus its debt, ROE could be considered the return on net assets. ROE is considered a measure of how effectively management uses a company's assets to create profits.

Equity, as we have seen, has various meanings but usually represents ownership in an asset or a company, such as stockholders owning equity in a company. ROE is a financial metric that measures how much profit is generated from a company's shareholder equity.

What Is Equity in Finance?

Equity is an important concept in finance that has different specific meanings depending on the context. Perhaps the most common type of equity is "shareholders' equity," which is calculated by taking a company's total assets and subtracting its total liabilities.

Shareholders' equity is, therefore, essentially the net worth of a corporation. If the company were to liquidate, shareholders' equity is the amount of money that would theoretically be received by its shareholders.

What Are Some Other Terms Used to Describe Equity?

Other terms that are sometimes used to describe this concept include shareholders' equity, book value, and net asset value. Depending on the context, the precise meanings of these terms may differ, but generally speaking, they refer to the value of an investment that would be left over after paying off all of the liabilities associated with that investment. This term is also used in real estate investing to refer to the difference between a property's fair market value and the outstanding value of its mortgage loan.

How Is Equity Used by Investors?

Equity is a very important concept for investors. For instance, in looking at a company, an investor might use shareholders' equity as a benchmark for determining whether a particular purchase price is expensive. If that company has historically traded at a price to book value of 1.5, for instance, then an investor might think twice before paying more than that valuation unless they feel the company's prospects have fundamentally improved. On the other hand, an investor might feel comfortable buying shares in a relatively weak business as long as the price they pay is sufficiently low relative to its equity.

How Is Equity Calculated?

Equity is equal to total assets minus its total liabilities. These figures can all be found on a company's balance sheet for a company. For a homeowner, equity would be the value of the home less any outstanding mortgage debt or liens.

Income Statement

Unlike the balance sheet, the income statement covers a range of time, which is a year for annual financial statements and a quarter for quarterly financial statements. The income statement provides an overview of revenues, expenses, net income, and earnings per share.

Revenue

Operating revenue is the revenue earned by selling a company's products or services. The operating revenue for an auto manufacturer would be realized through the production and sale of autos. Operating revenue is generated from the core business activities of a company.

Non-operating revenue is the income earned from non-core business activities. These revenues fall outside the primary function of the business. Some non-operating revenue examples include:

- Interest earned on cash in the bank
- Rental income from a property
- Income from strategic partnerships like royalty payment receipts
- Income from an advertisement display located on the company's property

Other income is the revenue earned from other activities. Other income could include gains from the sale of long-term assets such as land, vehicles, or a subsidiary.

Expenses

Primary expenses are incurred during the process of earning revenue from the primary activity of the business. Expenses include the cost of goods sold (COGS), selling, general and administrative expenses (SG&A), depreciation or amortization, and research and development (R&D).

Typical expenses include employee wages, sales commissions, and utilities such as electricity and transportation.

Expenses that are linked to secondary activities include interest paid on loans or debt. Losses from the sale of an asset are also recorded as expenses.

The main purpose of the income statement is to convey details of profitability and the financial results of business activities; however, it can be very effective in showing whether sales or revenue is increasing when compared over multiple periods.

Investors can also see how well a company's management is controlling expenses to determine whether a company's efforts in reducing the cost of sales might boost profits over time.

Example of an Income Statement

Below is a portion of ExxonMobil Corporation's income statement for fiscal-year 2021, reported as of Dec. 31, 2021.

- Total revenue was $276.7 billion.
- Total costs were $254.4 billion.
- Net income or profit was $23 billion.2

CONSOLIDATED STATEMENT OF INCOME

	Note Reference Number	2021	2020	2019
			(millions of dollars)	
Revenues and other income				
Sales and other operating revenue		276,692	178,574	255,583
Income from equity affiliates	7	6,657	1,732	5,441
Other income		2,291	1,196	3,914
Total revenues and other income		285,640	181,502	264,938
Costs and other deductions				
Crude oil and product purchases		155,164	94,007	143,801
Production and manufacturing expenses		36,035	30,431	36,826
Selling, general and administrative expenses		9,574	10,168	11,398
Depreciation and depletion (includes impairments)	3, 9	20,607	46,009	18,998
Exploration expenses, including dry holes		1,054	1,285	1,269
Non-service pension and postretirement benefit expense	17	786	1,205	1,235
Interest expense		947	1,158	830
Other taxes and duties	19	30,239	26,122	30,525
Total costs and other deductions		254,406	210,385	244,882
Income (loss) before income taxes		31,234	(28,883)	20,056
Income tax expense (benefit)	19	7,636	(5,632)	5,282
Net income (loss) including noncontrolling interests		23,598	(23,251)	14,774
Net income (loss) attributable to noncontrolling interests		558	(811)	434
Net income (loss) attributable to ExxonMobil		23,040	(22,440)	14,340
Earnings (loss) per common share *(dollars)*	12	5.39	(5.25)	3.36
Earnings (loss) per common share - assuming dilution *(dollars)*	12	5.39	(5.25)	3.36

Income Statement: How to Read and Use It

An income statement is one of the three important financial statements used for reporting a company's financial performance over a specific accounting period. The other two key statements are the balance sheet and the cash flow statement.

The income statement focuses on the revenue, expenses, gains, and losses of a company during a particular period. Also known as the profit and loss (P&L) statement or the statement of revenue and expense, an income statement provides valuable insights into a company's operations, the efficiency of its management, underperforming sectors, and its performance relative to industry peers.

REMEMBER:

- An income statement is one of the three major financial statements, along with the balance sheet and the cash flow statement, that report a company's financial performance over a specific accounting period.
- The income statement focuses on the revenue, expenses, gains, and losses of a company during a particular period.
- An income statement provides valuable insights into a company's operations, the efficiency of its management, underperforming sectors, and its performance relative to industry peers.

Understanding the Income Statement

The income statement is an integral part of the company performance reports that must be submitted to the U.S. Securities and Exchange Commission (SEC). While a balance sheet provides the snapshot of a company's financials as of a particular date, the income statement reports income through a specific period, usually a quarter or a year, and its heading indicates the duration, which may read as *"For the (fiscal) year/quarter ended June 30, 2021."*

The income statement focuses on four key items: revenue, expenses, gains, and losses. It does not differentiate between cash and non-cash receipts (sales in cash vs. sales on credit) or cash vs. non-cash payments/disbursements (purchases in cash vs. purchases on credit). It starts with the details of sales and then works down to compute net income and eventually earnings per share (EPS). Essentially, it gives an account of how the net revenue realized by the company gets transformed into net earnings (profit or loss).1

Revenue and Gains

The following are covered in the income statement, though its format may vary, depending upon the local regulatory requirements, the diversified scope of the business, and the associated operating activities:

Operating Revenue

Revenue realized through primary activities is often referred to as operating revenue. For a company manufacturing a product, or for a wholesaler, distributor, or retailer involved in the business of selling that product, the revenue from primary activities refers to revenue achieved from the sale of the product. Similarly, for a company (or its franchisees) in the business of offering services, revenue from primary activities refers to the revenue or fees earned in exchange for offering those services.

Non-Operating Revenue

Revenue realized through secondary, noncore business activities is often referred to as nonoperating, recurring revenue. This revenue is sourced from the earnings that are outside the purchase and sale of goods and services and may include income from interest earned on business capital parked in the bank, rental income from business property, income from strategic partnerships like royalty payment receipts, or income from an advertisement display placed on business property.

Gains

Also called other income, gains indicate the net money made from other activities, like the sale of long-term assets. These include the net income realized from one-time nonbusiness activities, such as a company selling its old transportation van, unused land, or a subsidiary company.

Revenue should not be confused with receipts. Payment is usually accounted for in the period when sales are made or services are delivered. Receipts are the cash received and are accounted for when the money is received.

A customer may take goods/services from a company on Sept. 28, which will lead to the revenue accounted for in September. The customer may be given a 30-day payment window due to his excellent credit and reputation, allowing until Oct. 28 to make the payment, which is when the receipts are accounted for.

Expenses and Losses

A business's cost to continue operating and turning a profit is known as an expense. Some of these expenses may be written off on a tax return if they meet Internal Revenue Service (IRS) guidelines.

Primary-Activity Expenses

These are all expenses incurred for earning the average operating revenue linked to the primary activity of the business. They include the cost of goods sold (COGS); selling, general, and administrative (SG&A) expenses; depreciation or amortization; and research and development (R&D) expenses. Typical items that make up the list are employee wages, sales commissions, and expenses for utilities such as electricity and transportation.

Secondary-Activity Expenses

These are all expenses linked to noncore business activities, like interest paid on loan money.

Losses as Expenses

These are all expenses that go toward a loss-making sale of long-term assets, one-time or any other unusual costs, or expenses toward lawsuits.

While primary revenue and expenses offer insights into how well the company's core business is performing, the secondary revenue and fees account for the company's involvement and expertise in managing ad hoc, non-core activities. Compared with the income from the sale of manufactured goods, a substantially high-interest income from money lying in the bank indicates that the business may not be using the available cash to its full potential by expanding the production capacity, or that it is facing challenges in increasing its market share amid competition.

Recurring rental income gained by hosting billboards at the company factory along a highway indicates that management is capitalizing upon the available resources and assets for additional profitability.

Income Statement Structure

Mathematically, net income is calculated based on the following:

Net Income = (Revenue + Gains) - (Expenses + Losses)

To understand the above formula with some real numbers, let's assume that a fictitious sports merchandise business, which additionally provides training, is reporting its income statement for a recent hypothetical quarter.

Excel Sports Income Statement
For the quarter ended 30 September 2018

Revenue	Merchandise Sale	25,800
	Revenue from Training	5,000
	Total Revenue	30,800
Expenses	Procurement Costs	8,000
	Wages	700
	Rent	1,000
	Interest Paid	500
	Transportation	300
	Utilities	150
	Total Expenses	10,650
Gains	Income from sale of van	2,000
Losses	Settlement cost of consumer lawsuit	800
Net Income	(Revenue + Gains) - (Expenses + Losses)	21,350

It received $25,800 from the sale of sports goods and $5,000 from training services. It spent various amounts listed for the given activities that total of $10,650. It realized net gains of $2,000 from the sale of an old van, and it incurred losses worth $800 for settling a dispute raised by a consumer. The net income comes to $21,350 for the given quarter. The above example is the simplest form of income statement that any standard business can generate. It is called the single-step income statement as it is based on a simple calculation that sums up revenue and gains and subtracts expenses and losses.

However, real-world companies often operate on a global scale, have diversified business segments offering a mix of products and services, and frequently get involved in mergers, acquisitions, and strategic partnerships. Such a wide array of operations, diversified set of expenses, various business activities, and the need for reporting in a standard format per regulatory compliance leads to multiple and complex accounting entries in the income statement.

Listed companies follow the multiple-step income statement, which segregates the operating revenue, operating expenses, and gains from the nonoperating revenue, nonoperating expenses, and losses, and offers many more details through the income statement produced this way.

Essentially, the different measures of profitability in a multiple-step income statement are reported at four different levels in a business's operations: gross, operating, pretax, and after-tax. As we'll see shortly in the following example, this segregation helps in identifying how the income and profitability are moving/changing from one level to the other. For instance, high gross profit but lower operating income indicates higher expenses, while higher pretax profit and lower post-tax profit indicate loss of earnings to taxes and other one-time, unusual expenses.

Let's look at an example based on the 2021 annual income statements of two large, publicly listed, multinational companies from different sectors: technology (Microsoft) and retail (Walmart).

Reading Income Statements

The focus in this standard format is to calculate the profit/income at each subhead of revenue and operating expenses and then account for mandatory taxes, interest, and other nonrecurring, one-time events to arrive at the net income that applies to common stock. Though calculations involve simple additions and subtractions, the order in which the various entries appear in the statement and their relationships often get repetitive and complicated. Let's take a deep dive into these numbers for a better understanding.

Revenue Section

The first section, titled Revenue, indicates that Microsoft's gross (annual) profit, or gross margin, for the fiscal year ending June 30, 2021, was $115.86 billion. It was arrived at by deducting the cost of revenue ($52.23 billion) from the total revenue

($168.09 billion) realized by the technology giant during this fiscal year. Just over 30% of Microsoft's total sales went toward costs for revenue generation, while a similar figure for Walmart in its fiscal year 2021 was about 75% ($429 billion/$572.75 billion).23 It indicates that Walmart incurred much higher cost than Microsoft to generate equivalent sales.

Operating Expenses

The next section, called Operating Expenses, again takes into account Microsoft's cost of revenue ($52.23 billion) and total revenue ($168.09 billion) for the fiscal year to arrive at the reported figures. As Microsoft spent $20.72 billion on R&D and $25.23 billion on SG&A expenses, total operating expenses are computed by summing all these figures ($52.23 billion + $20.72 billion + $25.23 billion = $98.18 billion).

Reducing total operating expenses from total revenue leads to operating income (or loss) of $69.92 billion ($168.09 billion - $98.18 billion).2 This figure represents the earnings before interest and taxes (EBIT) for its core business activities and is again used later to derive the net income.

A comparison of the line items indicates that Walmart did not spend anything on R&D and had higher SG&A and total operating expenses than Microsoft.

Income From Continuing Operations

The next section, titled Income from Continuing Operations, adds net other income or expenses (like one-time earnings), interest-linked expenses, and applicable taxes to arrive at the net income from continuing operations ($61.27 billion) for Microsoft, which is nearly 60% higher than that of Walmart ($13.67 billion).23

After discounting for any nonrecurring events, it's possible to arrive at the value of net income applicable to common shares. Microsoft had a much higher net income of $61.27 billion compared with Walmart's $13.67 billion.23

Earnings per share are computed by dividing the net income figure by the number of weighted average shares outstanding. With 7.55 billion outstanding shares for Microsoft, its 2021 EPS came to $8.12 per share ($61.27 billion ÷ 7.55 billion).2 With Walmart having 2.79 billion outstanding shares that fiscal year, its EPS came to $4.90 per share ($13.67 billion ÷ 2.79 billion).3

Microsoft had a lower cost for generating equivalent revenue, higher net income from continuing operations, and higher net income applicable to common shares compared with Walmart.

Uses of Income Statements

Though the primary purpose of an income statement is to convey details of profitability and business activities of the company to the stakeholders, it also provides detailed insights into the company's internal activities for comparison across different businesses and sectors. By understanding the income and expense components of the statement, an investor can appreciate what makes a company profitable.4

Based on income statements, management can make decisions like expanding to new geographies, pushing sales, expanding production capacity, increasing the use of or the outright sale of assets, or shutting down a department or product line. Competitors also may use them to gain insights about the success parameters of a company and focus areas such as lifting R&D spending.

Creditors may find income statements of limited use, as they are more concerned about a company's future cash flows than its past profitability. Research analysts use the income statement to compare year-on-year and quarter-on-quarter performance. One can infer, for example, whether a company's efforts at reducing the cost of sales helped it improve profits over time, or whether management kept tabs on operating expenses without compromising on profitability.

What Are the Four Key Elements of an Income Statement?

(1) Revenue, (2) expenses, (3) gains, and (4) losses. An income statement is not a balance sheet or a cash flow statement.

What Is the Difference Between Operating Revenue and Non-Operating Revenue?

Operating revenue is realized through a business' primary activity, such as selling its products. Non-operating revenue comes from ancillary sources such as interest income from capital held in a bank or income from rental of business property.

What Insights Should You Look for in an Income Statement?

The income and expense components can help an investor learn what makes a company profitable (or not). Competitors can use them to measure how their company compares on various measures. Research analysts use them to compare performance year-on-year and quarter-on-quarter.

The Bottom Line

An income statement provides valuable insights into various aspects of a business. It includes readings on a company's operations, the efficiency of its management, the possible leaky areas that may be eroding profits, and whether the company is performing in line with industry peers.

Cash Flow Statement

The cash flow statement (CFS) measures how well a company generates cash to pay its debt obligations, fund its operating expenses, and fund investments. The cash flow statement complements the balance sheet and income statement.

The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how money is being spent. The CFS also provides insight as to whether a company is on a solid financial footing.

There is no formula, per se, for calculating a cash flow statement. Instead, it contains three sections that report cash flow for the various activities for which a company uses its cash. Those three components of the CFS are listed below.

Operating Activities

The operating activities on the CFS include any sources and uses of cash from running the business and selling its products or services. Cash from operations includes any changes made in cash accounts receivable, depreciation, inventory, and accounts payable. These transactions also include wages, income tax payments, interest payments, rent, and cash receipts from the sale of a product or service.

Investing Activities

Investing activities include any sources and uses of cash from a company's investments in the long-term future of the company. A purchase or sale of an asset, loans made to vendors or received from customers, or any payments related to a merger or acquisition is included in this category.

Also, purchases of fixed assets such as property, plant, and equipment (PPE) are included in this section. In short, changes in equipment, assets, or investments relate to cash from investing.

Financing Activities

Cash from financing activities includes the sources of cash from investors or banks, as well as the uses of cash paid to shareholders. Financing activities include debt issuance, equity issuance, stock repurchases, loans, dividends paid, and repayments of debt.

The cash flow statement reconciles the income statement with the balance sheet in three major business activities.

Example of a Cash Flow Statement

Below is a portion of ExxonMobil Corporation's cash flow statement for fiscal-year 2021, reported as of Dec. 31, 2021. We can see the three areas of the cash flow statement and their results.

- Operating activities generated a positive cash flow of $48 billion.
- Investing activities generated negative cash flow or cash outflows of -$10.2 billion for the period. Additions to property, plant, and equipment made up the majority of cash outflows, which means the company invested in new fixed assets.
- Financing activities generated negative cash flow or cash outflows of -$35.4 billion for the period. Reductions in short-term debt and dividends paid out made up the majority of the cash outflows.3

CONSOLIDATED STATEMENT OF CASH FLOWS

	Note Reference Number	2021	2020	2019
			(millions of dollars)	
Cash flows from operating activities				
Net income (loss) including noncontrolling interests		23,598	(23,251)	14,774
Adjustments for noncash transactions				
Depreciation and depletion (includes impairments)	3, 9	20,607	46,009	18,998
Deferred income tax charges/(credits)	19	303	(8,856)	(944)
Postretirement benefits expense in excess of/(less than) net payments		754	498	109
Other long-term obligation provisions in excess of/(less than) payments		50	(1,269)	(3,038)
Dividends received greater than/(less than) equity in current earnings of equity companies		(668)	979	(936)
Changes in operational working capital, excluding cash and debt				
Reduction/(increase) - Notes and accounts receivable		(12,098)	5,384	(2,640)
- Inventories		(489)	(315)	72
- Other current assets		(71)	420	(234)
Increase/(reduction) - Accounts and other payables		16,820	(7,142)	3,725
Net (gain)/loss on asset sales	5	(1,207)	4	(1,710)
All other items - net		530	2,207	1,540
Net cash provided by operating activities		48,129	14,668	29,716
Cash flows from investing activities				
Additions to property, plant and equipment		(12,076)	(17,282)	(24,361)
Proceeds from asset sales and returns of investments		3,176	999	3,692
Additional investments and advances		(2,817)	(4,857)	(3,905)
Other investing activities including collection of advances		1,482	2,681	1,490
Net cash used in investing activities		(10,235)	(18,459)	(23,084)
Cash flows from financing activities				
Additions to long-term debt		46	23,186	7,052
Reductions in long-term debt		(8)	(8)	(1)
Additions to short-term debt *(1)*		12,687	35,396	18,967
Reductions in short-term debt *(1)*		(29,396)	(28,742)	(18,367)
Additions/(reductions) in commercial paper, and debt with three months or less maturity		(2,983)	(9,691)	1,011
Contingent consideration payments		(30)	(21)	—
Cash dividends to ExxonMobil shareholders		(14,924)	(14,865)	(14,652)
Cash dividends to noncontrolling interests		(224)	(188)	(192)
Changes in noncontrolling interests		(436)	623	158
Common stock acquired		(155)	(405)	(594)
Net cash provided by (used in) financing activities		(35,423)	5,285	(6,618)
Effects of exchange rate changes on cash		(33)	(219)	33
Increase/(decrease) in cash and cash equivalents		2,438	1,275	47
Cash and cash equivalents at beginning of year		4,364	3,089	3,042
Cash and cash equivalents at end of year		6,802	4,364	3,089

Understanding the Cash Flow Statement

The cash flow statement (CFS), is a financial statement that summarizes the movement of cash and cash equivalents (CCE) that come in and go out of a company. The CFS measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses. As one of the three main financial statements, the CFS complements the balance sheet and the income statement. In this article, we'll show you how the CFS is structured and how you can use it when analyzing a company.

REMEMBER:

- A cash flow statement summarizes the amount of cash and cash equivalents entering and leaving a company.
- The CFS highlights a company's cash management, including how well it generates cash.
- This financial statement complements the balance sheet and the income statement.
- The main components of the CFS are cash from three areas: Operating activities, investing activities, and financing activities.

How the Cash Flow Statement Is Used

The cash flow statement paints a picture as to how a company's operations are running, where its money comes from, and how money is being spent. Also known as the statement of cash flows, the CFS helps its creditors determine how much cash is available (referred to as liquidity) for the company to fund its operating expenses and pay down its debts. The CFS is equally important to investors because it tells them whether a company is on solid financial ground. As such, they can use the statement to make better, more informed decisions about their investments.

Structure of the Cash Flow Statement

The main components of the cash flow statement are:

1. Cash flow from operating activities
2. Cash flow from investing activities
3. Cash flow from financing activities
4. Disclosure of non-cash activities, which is sometimes included when prepared under generally accepted accounting principles (GAAP).1

Cash from Operating Activities

The operating activities on the CFS include any sources and uses of cash from business activities. In other words, it reflects how much cash is generated from a company's products or services.

These operating activities might include:

- Receipts from sales of goods and services
- Interest payments
- Income tax payments
- Payments made to suppliers of goods and services used in production
- Salary and wage payments to employees
- Rent payments
- Any other type of operating expenses

In the case of a trading portfolio or an investment company, receipts from the sale of loans, debt, or equity instruments are also included because it is a business activity.

Changes made in cash, accounts receivable, depreciation, inventory, and accounts payable are generally reflected in cash from operations.

Cash from Investing Activities

Investing activities include any sources and uses of cash from a company's investments. Purchases or sales of assets, loans made to vendors or received from customers, or any payments related to mergers and acquisitions (M&A) are included in this category. In short, changes in equipment, assets, or investments relate to cash from investing.

Changes in cash from investing are usually considered cash-out items because cash is used to buy new equipment, buildings, or short-term assets such as marketable securities. But when a company divests an asset, the transaction is considered cash-in for calculating cash from investing.

Cash from Financing Activities

Cash from financing activities includes the sources of cash from investors and banks, as well as the way cash is paid to shareholders. This includes any dividends, payments for stock repurchases, and repayment of debt principal (loans) that are made by the company.

Changes in cash from financing are cash-in when capital is raised and cash-out when dividends are paid. Thus, if a company issues a bond to the public, the company receives cash financing. However, when interest is paid to bondholders, the company is reducing its cash. And remember, although interest is a cash-out expense, it is reported as an operating activity—not a financing activity.

How Cash Flow Is Calculated

There are two methods of calculating cash flow: the direct method and the indirect method.

Direct Cash Flow Method

The direct method adds up all of the cash payments and receipts, including cash paid to suppliers, cash receipts from customers, and cash paid out in salaries. This method of CFS is easier for very small businesses that use the cash basis accounting method.

These figures can also be calculated by using the beginning and ending balances of a variety of asset and liability accounts and examining the net decrease or increase in the accounts. It is presented in a straightforward manner.

Most companies use the accrual basis accounting method. In these cases, revenue is recognized when it is earned rather than when it is received. This causes a disconnect between net income and actual cash flow because not all transactions in net income on the income statement involve actual cash items. Therefore, certain items must be reevaluated when calculating cash flow from operations.

Indirect Cash Flow Method

With the indirect method, cash flow is calculated by adjusting net income by adding or subtracting differences resulting from non-cash transactions. Non-cash items show up in the changes to a company’s assets and liabilities on the balance sheet from one period to the next. Therefore, the accountant will identify any increases and decreases to asset and liability accounts that need to be added back to or removed from the net income figure, in order to identify an accurate cash inflow or outflow.

Changes in accounts receivable (AR) on the balance sheet from one accounting period to the next must be reflected in cash flow:

- If AR decreases, more cash may have entered the company from customers paying off their credit accounts—the amount by which AR has decreased is then added to net earnings.
- An increase in AR must be deducted from net earnings because, although the amounts represented in AR are in revenue, they are not cash.

What about changes in a company's inventory? Here's how they are accounted for on the CFS:

- An increase in inventory signals that a company spent more money on raw materials. Using cash means the increase in the inventory's value is deducted from net earnings.
- A decrease in inventory would be added to net earnings. Credit purchases are reflected by an increase in accounts payable on the balance sheet, and the amount of the increase from one year to the next is added to net earnings.

The same logic holds true for taxes payable, salaries, and prepaid insurance. If something has been paid off, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings.

Limitations of the Cash Flow Statement

Negative cash flow should not automatically raise a red flag without further analysis. Poor cash flow is sometimes the result of a company's decision to expand its business at a certain point in time, which would be a good thing for the future.

Analyzing changes in cash flow from one period to the next gives the investor a better idea of how the company is performing, and whether a company may be on the brink of bankruptcy or success. The CFS should also be considered in unison with the other two financial statements (see below).

The indirect cash flow method allows for a reconciliation between two other financial statements: the income statement and balance sheet.

Cash Flow Statement vs. Income Statement vs. Balance Sheet

The cash flow statement measures the performance of a company over a period of time. But it is not as easily manipulated by the timing of non-cash transactions. As noted above, the CFS can be derived from the income statement and the balance sheet. Net earnings from the income statement are the figure from which the information on the CFS is deduced. But they only factor into determining the operating activities section of the CFS. As such, net earnings have nothing to do with the investing or financial activities sections of the CFS.

The income statement includes depreciation expense, which doesn't actually have an associated cash outflow. It is simply an allocation of the cost of an asset over its useful life. A company has some leeway to choose its depreciation method, which modifies the depreciation expense reported on the income statement. The CFS, on the other hand, is a measure of true inflows and outflows that cannot be as easily manipulated.

As for the balance sheet, the net cash flow reported on the CFS should equal the net change in the various line items reported on the balance sheet. This excludes cash and cash equivalents and non-cash accounts, such as accumulated depreciation and accumulated amortization. For example, if you calculate cash flow for 2019, make sure you use 2018 and 2019 balance sheets.

The CFS is distinct from the income statement and the balance sheet because it does not include the amount of future incoming and outgoing cash that has been recorded as revenues and expenses. Therefore, cash is not the same as net income, which includes cash sales as well as sales made on credit on the income statements.

Example of a Cash Flow Statement

Below is an example of a cash flow statement:

Cash Flow Statement Company XYZ FY Ended 31 Dec 2017 All Figures in USD		
Cash Flow From Operations		
Net Earnings		2,000,000
Additions to Cash		
Depreciations		10,000
Decrease in Accounts Receivable		15,000
Increase in Accounts Payable		15,000
Increase in Taxes Payable		2,000
Subtractions From Cash		
Increase in Inventory		(30,000)
Net Cash From Operations		2,012,000
Cash Flow From Investing		
Equipment		(500,000)
Cash Flow From Financing		
Notes Payable		10,000
Cash Flow for FY Ended 21 Dec 2017		**1,522,000**

From this CFS, we can see that the net cash flow for the 2017 fiscal year was $1,522,000. The bulk of the positive cash flow stems from cash earned from operations, which is a good sign for investors. It means that core operations are generating business and that there is enough money to buy new inventory.

The purchasing of new equipment shows that the company has the cash to invest in itself. Finally, the amount of cash available to the company should ease investors' minds regarding the notes payable, as cash is plentiful to cover that future loan expense.

What Is the Difference Between Direct and Indirect Cash Flow Statements?

The difference lies in how the cash inflows and outflows are determined.

Using the direct method, actual cash inflows and outflows are known amounts. The cash flow statement is reported in a straightforward manner, using cash payments and receipts.

Using the indirect method, actual cash inflows and outflows do not have to be known. The indirect method begins with net income or loss from the income statement, then modifies the figure using balance sheet account increases and decreases, to compute implicit cash inflows and outflows.

Is the Indirect Method of the Cash Flow Statement Better Than the Direct Method?

Neither is necessarily better or worse. However, the indirect method also provides a means of reconciling items on the balance sheet to the net income on the income statement. As an accountant prepares the CFS using the indirect method, they can identify increases and decreases in the balance sheet that are the result of non-cash transactions.

It is useful to see the impact and relationship that accounts on the balance sheet have to the net income on the income statement, and it can provide a better understanding of the financial statements as a whole.

What Is Included in Cash and Cash Equivalents?

Cash and cash equivalents are consolidated into a single line item on a company's balance sheet. It reports the value of a business's assets that are currently cash or can be converted into cash within a short period of time, commonly 90 days. Cash and cash equivalents include currency, petty cash, bank accounts, and other highly liquid, short-term investments. Examples of cash equivalents include commercial paper, Treasury bills, and short-term government bonds with a maturity of three months or less.

The Bottom Line

A cash flow statement is a valuable measure of strength, profitability, and the long-term future outlook of a company. The CFS can help determine whether a company has enough liquidity or cash to pay its expenses. A company can use a CFS to predict future cash flow, which helps with budgeting matters.

For investors, the CFS reflects a company's financial health, since typically the more cash that's available for business operations, the better. However, this is not a rigid rule. Sometimes, a negative cash flow results from a company's growth strategy in the form of expanding its operations.

By studying the CFS, an investor can get a clear picture of how much cash a company generates and gain a solid understanding of the financial well-being of a company.

Statement of Changes in Shareholder Equity

The statement of changes in equity tracks total equity over time. This information ties back to a balance sheet for a same period; the ending balance on the change of equity statement is equal to the total equity reported on the balance sheet.

The formula for changes to shareholder equity will vary from company to company; in general, there are a couple of components:

- Beginning equity: this is the equity at the end of the last period that simply rolls to the start of the next period.
- (+) Net income: this is the amount of income the company earned in a given period. The proceeds from operations are automatically recognized as equity in the company, and this income is rolled into retained earnings at year-end.
- (-) Dividends: this is the amount of money that is paid out to shareholders from profits. Instead of keeping all of a company's profits, the company may choose to give some profits away to investors.
- (+/-) Other comprehensive income: this is the period-over-period change in other comprehensive income. Depending on transactions, this figure may be an addition or subtraction from equity.

In ExxonMobil's statement of changes in equity, the company also records activity for acquisitions, dispositions, amortization of stock-based awards, and other financial activity. This information is useful to analyze to determine how much money is being retained by the company for future growth as opposed to being distributed externally.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	ExxonMobil Share of Equity						
	Common Stock	Earnings Reinvested	Accumulated Other Comprehensive Income	Common Stock Held in Treasury	ExxonMobil Share of Equity	Non-controlling Interests	Total Equity
				(millions of dollars)			
Balance as of December 31, 2018	15,258	421,653	(19,564)	(225,553)	191,794	6,734	198,528
Amortization of stock-based awards	697	—	—	—	697	—	697
Other	(318)	—	—	—	(318)	489	171
Net income (loss) for the year	—	14,340	—	—	14,340	434	14,774
Dividends - common shares	—	(14,652)	—	—	(14,652)	(192)	(14,844)
Other comprehensive income	—	—	71	—	71	154	225
Acquisitions, at cost	—	—	—	(594)	(594)	(331)	(925)
Dispositions	—	—	—	312	312	—	312
Balance as of December 31, 2019	15,637	421,341	(19,493)	(225,835)	191,650	7,288	198,938
Amortization of stock-based awards	696	—	—	—	696	—	696
Other	(645)	—	—	—	(645)	692	47
Net income (loss) for the year	—	(22,440)	—	—	(22,440)	(811)	(23,251)
Dividends - common shares	—	(14,865)	—	—	(14,865)	(188)	(15,053)
Cumulative effect of accounting change	—	(93)	—	—	(93)	(1)	(94)
Other comprehensive income	—	—	2,788	—	2,788	68	2,856
Acquisitions, at cost	—	—	—	(405)	(405)	(68)	(473)
Dispositions	—	—	—	464	464	—	464
Balance as of December 31, 2020	15,688	383,943	(16,705)	(225,776)	157,150	6,980	164,130
Amortization of stock-based awards	534	—	—	—	534	—	534
Other	(476)	—	—	—	(476)	115	(361)
Net income (loss) for the year	—	23,040	—	—	23,040	558	23,598
Dividends - common shares	—	(14,924)	—	—	(14,924)	(224)	(15,148)
Other comprehensive income	—	—	2,941	—	2,941	228	3,169
Acquisitions, at cost	—	—	—	(155)	(155)	(551)	(706)
Dispositions	—	—	—	467	467	—	467
Balance as of December 31, 2021	15,746	392,059	(13,764)	(225,464)	168,577	7,106	175,683

Consolidated Statement of Changes in Equity, ExxonMobil (2021).

Statement of Comprehensive Income

An often less utilized financial statement, a statement of comprehensive income summarizes standard net income while also incorporating changes in other comprehensive income (OCI). Other comprehensive income includes all unrealized gains and losses that are not reported on the income statement. This financial statement shows a company's total change income, even gains and losses that have yet to be recorded in accordance to accounting rules.

Examples of transactions that are reporting on the statement of comprehensive income include:

- Net income (from the statement of income).
- Unrealized gains or losses from debt securities
- Unrealized gains or losses from derivative instruments
- Unrealized translation adjustments due to foreign currency
- Unrealized gains or losses from retirement programs

In the example below, ExxonMobil has over $2 billion of net unrecognized income. Instead of reporting just $23.5 billion of net income, ExxonMobil reports nearly $26 billion of total income when considering other comprehensive income.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	2021	2020	2019
		(millions of dollars)	
Net income (loss) including noncontrolling interests	23,598	(23,251)	14,774
Other comprehensive income (loss) (net of income taxes)			
Foreign exchange translation adjustment	(872)	1,916	1,735
Adjustment for foreign exchange translation (gain)/loss included in net income	(2)	14	—
Postretirement benefits reserves adjustment (excluding amortization)	3,118	30	(2,092)
Amortization and settlement of postretirement benefits reserves adjustment included in net periodic benefit costs	925	896	582
Total other comprehensive income (loss)	3,169	2,856	225
Comprehensive income (loss) including noncontrolling interests	26,767	(20,395)	14,999
Comprehensive income (loss) attributable to noncontrolling interests	786	(743)	588
Comprehensive income (loss) attributable to ExxonMobil	25,981	(19,652)	14,411

The information in the Notes to Consolidated Financial Statements is an integral part of these statements.

Consolidated Statement of Comprehensive Income, Exxon Mobil 2021.

Nonprofit Financial Statements

Nonprofit organizations record financial transactions across a similar set of financial statements. However, due to the differences between a for-profit entity and a purely philanthropic entity, there are differences in the financial statements used. The standard set of financial statements used for a nonprofit entity include:

- Statement of Financial Position: this is the equivalent of a for-profit entity's balance sheet. The largest difference is nonprofit entities do not have equity positions; any residual balances after all assets have been liquidated and liabilities have been satisfied is called 'net assets'.
- Statement of Activities: this is the equivalent of a for-profit entity's statement of income. This report tracks the changes in operation over time including the reporting of donations, grants, event revenue, and expenses to make everything happen.
- Statement of Functional Expenses: this is specific to non-profit entities. The statement of functional expenses reports expenses by entity function (often broken into administrative, program, or fundraising expenses). This information is distributed to the public to explain what proportion of company-wide expenses are related directly to the mission.
- Statement of Cash Flow: this is the equivalent of a for-profit entity's statement of cash flow. Though the accounts listed may vary due to the different nature

of a nonprofit organization, the statement is still divided into operating, investing, and financing activities.

The purpose of an external auditor is to assess whether an entity's financial statement have been prepared in accordance with prevailing accounting rules and whether there are any material misstatements impacting the validity of results.

Limitations of Financial Statements

Although financial statements provide a wealth of information on a company, they do have limitations. The statements are open to interpretation, and as a result, investors often draw vastly different conclusions about a company's financial performance.

For example, some investors might want stock repurchases while other investors might prefer to see that money invested in long-term assets. A company's debt level might be fine for one investor while another might have concerns about the level of debt for the company.

When analyzing financial statements, it's important to compare multiple periods to determine if there are any trends as well as compare the company's results to its peers in the same industry.

Last, financial statements are only as reliable as the information being fed into the reports. Too often, its been documented that fraudulent financial activity or poor control oversight have led to misstated financial statements intended to mislead users. Even when analyzing audited financial statements, there is a level of trust that users must place into the validity of the report and the figures being shown.

What Are the Main Types of Financial Statements?

The three main types financial statements are the balance sheet, the income statement, and the cash flow statement. These three statements together show the assets and liabilities of a business, its revenues and costs, as well as its cash flows from operating, investing, and financing activities.

What Are the Main Items Shown in Financial Statements?

Depending on the corporation, the line items in a financial statement will differ; however, the most common line items are revenues, costs of goods sold, taxes, cash, marketable securities, inventory, short-term debt, long-term debt, accounts receivable, accounts payable, and cash flows from investing, operating, and financing activities.

What Are the Benefits of Financial Statements?

Financial statements show how a business operates. It provides insight into how much and how a business generates revenues, what the cost of doing business is, how efficiently it manages its cash, and what its assets and liabilities are. Financial statements provide all the detail on how well or poorly a company manages itself.

How Do You Read Financial Statements?

Financial statements are read in several different ways. First, financial statements can be compared to prior periods to better understand changes over time. For example, comparative income statements report what a company's income was last year and what a company's income is this year. Noting the year-over-year change informs users of the financial statements of a company's health.

Financial statements are also read by comparing the results to competitors or other industry participants. By comparing financial statements to other companies, analysts can get a better sense on which companies are performing the best and which are lagging the rest of the industry.

What Is GAAP?

Generally Accepted Accounting Principles (GAAP) is the set of rules in which United States companies must prepare their financial statements. It is the guidelines that explain how to record transactions, when to recognize revenue, and when expenses must be recognized. International companies may use a similar but different set of rules called International Financial Reporting Standards (IFRS).

The Bottom Line

Financial statements are the ticket to external evaluation of a company's financial performance. The balance sheet reports a company's financial health through its liquidity and solvency, while the income statement reports a company's profitability. A statement of cash flow tie these two together by tracking sources and uses of cash. Together, financial statements communicate how a company is doing over time and against its competitors.

Why do we need 3 types of financial statements?

The balance sheet, income statement, and cash flow statement each offer unique details with information that is all interconnected. Together the three statements give a comprehensive portrayal of the company's operating activities

The Three Major Financial Statements: How They're Interconnected

The information found on the financial statements of an organization is the foundation of corporate accounting. This data is reviewed by management, investors, and lenders for the purpose of assessing the company's financial position.

Data found in the balance sheet, the income statement, and the cash flow statement is used to calculate important financial ratios that provide insight on the company’s financial performance and potential issues that may need to be addressed. The balance sheet, income statement, and cash flow statement each offer unique details with information that is all interconnected. Together the three statements give a comprehensive portrayal of the company’s operating activities.

REMEMBER:

- The information found on the financial statements of an organization is the foundation of corporate accounting.
- Also referred to as the statement of financial position, a company's balance sheet provides information on what the company is worth from a book value perspective.
- A company's income statement provides details on the revenue a company earns and the expenses involved in its operating activities.
- The cash flow statement provides a view of a company’s overall liquidity by showing cash transaction activities.

The Balance Sheet

Also referred to as the statement of financial position, a company's balance sheet provides information on what the company is worth from a book value perspective. The balance sheet is broken into three categories and provides summations of the company's assets, liabilities, and shareholders' equity on a specific date.

Generally, a comprehensive analysis of the balance sheet can offer several quick views. In order for the balance sheet to ‘balance,’ assets must equal liabilities plus equity. Analysts view the assets minus liabilities as the book value or equity of the firm. In some instances, analysts may also look at the total capital of the firm which analyzes liabilities and equity together. In the asset portion of the balance sheet, analysts will typically be looking at long-term assets and how efficiently a company manages its receivables in the short term.

There are a variety of ratios analysts use to gauge the efficiency of a company’s balance sheet. Some of the most common include asset turnover, the quick ratio, receivables turnover, days to sales, debt to assets, and debt to equity.

The Income Statement

A company's income statement provides details on the revenue a company earns and the expenses involved in its operating activities. Overall, it provides more granular detail on the holistic operating activities of a company. Broadly, the income statement shows the direct, indirect, and capital expenses a company incurs.

Starting with direct, the top line reports the level of revenue a company earned over a specific time frame. It then shows the expenses directly related to earning that revenue. Direct expenses are generally grouped into cost of goods sold or cost of sales, which represents direct wholesale costs. Costs of sales are subtracted from revenue to arrive at gross profit. Gross profit is then often analyzed in comparison to total sales to identify a company's gross profit margin.

Indirect expenses are also an important part of the income statement. Indirect expenses form a second category and show all costs indirectly associated with the revenue-generating activities of a firm. These costs can include salaries, general and administrative expenses, research and development, and depreciation and amortization. Together these indirect expenses are subtracted from gross profit to identify operating income.

The final category on the income statement factors in capital expenses. The last expenses to be considered here include interest, tax, and extraordinary items. The subtraction of these items results in the bottom line net income or the total amount of earnings a company has achieved.

Offering a great deal of transparency on the company's operating activities, the income statement is also a key driver of the company's other two financial statements. Net income at the end of a period becomes part of the company's stockholders' equity as retained earnings. Net income is also carried over to the cash flow statement where it serves as the top line item for operating activities. Sales booked during the period are also added to the company's short-term assets as accounts receivable.

On the income statement, analysts will typically be looking at a company's profitability. Therefore, key ratios used for analyzing the income statement include gross margin, operating margin, and net margin as well as tax ratio efficiency and interest coverage.

The Cash Flow Statement

The cash flow statement provides a view of a company's overall liquidity by showing cash transaction activities. It reports all cash inflows and outflows over the course of an accounting period with a summation of the total cash available.

Standard cash flow statements will be broken into three parts: operating, investing, and financing. This financial statement highlights the net increase and decrease in total cash in each of these three areas.

The operating portion shows cash received from making sales as part of the company's operations during that period. It also shows the operating cash outflows that were spent to make those sales. For example, the cash paid for rent, salaries, and administration.

The other two portions of the cash flow statement, investing and financing, are closely tied with the capital planning for the firm which is interconnected with the liabilities and equity on the balance sheet. Investing cash activities primarily focus on assets and show asset purchases and gains from invested assets. The financing cash activities focus on capital structure financing, showing proceeds from debt and stock issuance as well as cash payments for obligations such as interest and dividends.

A Comprehensive View

All three accounting statements are important for understanding and analyzing a company's performance from multiple angles. The income statement provides deep insight into the core operating activities that generate earnings for the firm. The balance sheet and cash flow statement, however, focus more on the capital management of the firm in terms of both assets and structure.

Overall, top-performing companies will achieve high marks in operating efficiency, asset management, and capital structuring. Management is responsible for overseeing these three levers in a way that serves the best interest of the shareholders, and the interconnected reporting of these levers is what makes financial statement reporting so important.

. The most common types of financial analysis are vertical analysis, horizontal analysis, leverage analysis, growth rates, profitability analysis, liquidity analysis, efficiency analysis, cash flow, rates of return, valuation analysis, scenario and sensitivity analysis, and variance analysis.

What is vertical analysis of financial statements?

Vertical analysis is a method of financial statement analysis in which each line item is listed as a percentage of a base figure within the statement. In accounting, a vertical analysis is used to show the relative sizes of the different accounts on a financial statement. For example, when a vertical analysis is done on an income statement, it will show the top-line sales number as 100%, and every other account will show as a percentage of the total sales number

Whereas vertical analysis analyzes a particular financial statement using only one base financial statement of the reporting period, horizontal analysis compares a specific financial statement with other periods or the cross-sectional analysis of a company against another company

What is horizontal analysis of financial statements?

Horizontal analysis is used in the review of a company's financial statements over multiple periods. It is usually depicted as percentage growth over the same line item in the base year. Horizontal analysis allows financial statement users to easily spot trends and growth patterns.

Why is it important to use both vertical and horizontal analysis when analyzing financial statements?

The horizontal and vertical analysis are other components of financial statement analysis aside from the normal profitability and liquidity ratios. The horizontal analysis helps the company is comparing the balance sheet, and the income statement results from one period to another, by setting a base year.

What is the difference between vertical and horizontal analysis?

Given these descriptions, the main difference between vertical analysis and horizontal analysis is that vertical analysis is focused on the relationships between the numbers in a single reporting period, while horizontal analysis spans multiple reporting periods.

What is vertical analysis of financial statements?

Vertical analysis is a method of financial statement analysis in which each line item is listed as a percentage of a base figure within the statement.

Whereas vertical analysis analyzes a particular financial statement using only one base financial statement of the reporting period, horizontal analysis compares a specific financial statement with other periods or the cross-sectional analysis of a company against another company.

What is the purpose of horizontal and vertical analysis?

The primary aim of horizontal analysis is to keep a track on the behaviour of the individual items of the financial statement over the years. Conversely, the vertical analysis aims at showing an insight into the relative importance or proportion of various items on a particular year's financial statement.

In the vertical analysis of financial statements, the percentage is calculated by using the below formula:

1. Vertical Analysis formula = Individual Item / Base Amount *100.
2. Vertical Analysis Formula(Income Statement) = Income Statement Item / Total Sales * 100.

There are several techniques used by analysts to develop a fair understanding of a company's financial performance over a period. The three most commonly practised methods of financial analysis are – horizontal analysis, vertical analysis, and ratio and trend analysis.

Vertical analysis simplifies the correlation between single items on a balance sheet and the bottom line, as they are expressed in a percentage. A company's management can use the percentages to set goals and threshold limits. How do you perform a horizontal analysis of financial statements?

How to perform Horizontal Analysis?

1. Select Time Periods. First, decide which periods you will be comparing, carefully choosing comparable periods. ...
2. Gather Data. The next step is to identify the data you need. ...
3. Calculate the Percentage Change. ...
4. Analyze & Compare Results.

How do you analyze vertical analysis on a balance sheet?

When you conduct vertical analysis, you analyze each line on a financial statement as a percentage of another line. Vertical analysis is therefore a proportional analysis method. On an income statement you conduct vertical analysis by converting each line into a percentage of gross revenue.

What is horizontal analysis used for?

Horizontal analysis is a process used in financial statements such as comparing line items across several years for the purpose of tracking the firms progress and historical performance. In other words, analysts use this type of analysis to compare performance metrics or accounts over a given period.

Which tool is used in horizontal analysis?

Answer. Trend Analysis: It is an important tool of horizontal analysis. Under this analysis, ratios of different items of the financial statements for various periods are calculated and the comparison is made accordingly.

How do you write a horizontal analysis?

Horizontal Analysis (%) = [(Amount in Comparison Year – Amount in Base Year) / Amount in Base Year] * 100

1. The overall growth has been relatively higher in the year 2018 compared to that of the year 2017. ...
2. Further, it is also noticed that the operating income moves in tandem with the revenue growth, which is a good sign.

What are the four tools for financial analysis?

- #1 – Common Size Statements.

- #2 – Comparative Financial Statement.
- #3 – Ratio Analysis.
- #4 – Benchmarking.

What is the other name for vertical analysis?

Vertical analysis, also known as common-size analysis, is used to evaluate a firm's financial statement data within an accounting period. This tool uses one line item on the statement as a base against which to evaluate all other items in the same statement.

What are the 5 components of financial analysis?

5 Key Elements of a Financial Analysis

Revenues. Revenues are probably your business's main source of cash. ...

Profits. If you can't produce quality profits consistently, your business may not survive in the long run. ...

Operational Efficiency. ...

Capital Efficiency and Solvency. ...

Liquidity.

<u>6 Steps to an Effective Financial Statement Analysis</u>There are generally six steps to developing an effective analysis of financial statements.

1. Identify the industry economic characteristics. ...
2. Identify company strategies. ...
3. Assess the quality of the firm's financial statements. ...
4. Analyze current profitability and risk. ...
5. Prepare forecasted financial statements. ...
6. Value the firm.

For any financial professional, it is important to know how to effectively analyze the financial statements of a firm.

This requires an understanding of three key areas:

1. The structure of the financial statements
2. The economic characteristics of the industry in which the firm operates and
3. The strategies the firm pursues to differentiate itself from its competitors.

There are generally six steps to developing an effective analysis of financial statements.

1. IDENTIFY THE INDUSTRY ECONOMIC CHARACTERISTICS.

First, determine a value chain analysis for the industry—the chain of activities involved in the creation, manufacture and distribution of the firm's products and/or services. Techniques such as Porter's Five Forces or analysis of economic attributes are typically used in this step.

2. IDENTIFY COMPANY STRATEGIES.

Next, look at the nature of the product/service being offered by the firm, including the uniqueness of product, level of profit margins, creation of brand loyalty and control of costs. Additionally, factors such as supply chain integration, geographic diversification and industry diversification should be considered.

3. ASSESS THE QUALITY OF THE FIRM'S FINANCIAL STATEMENTS.

Review the key financial statements within the context of the relevant accounting standards. In examining balance sheet accounts, issues such as recognition, valuation and classification are keys to proper evaluation. The main question should be whether this balance sheet is a complete representation of the firm's economic position. When evaluating the income statement, the main point is to properly assess the quality of earnings as a complete representation of the firm's economic performance. Evaluation of the statement of cash flows helps in understanding the impact of the firm's liquidity position from its operations, investments and financial activities over the period—in essence, where funds came from, where they went, and how the overall liquidity of the firm was affected.

4. ANALYZE CURRENT PROFITABILITY AND RISK.

This is the step where financial professionals can really add value in the evaluation of the firm and its financial statements. The most common analysis tools are key financial statement ratios relating to liquidity, asset management, profitability, debt management/coverage and risk/market valuation. With respect to profitability, there are two broad questions to be asked: how profitable are the operations of the firm relative to its assets—independent of how the firm finances those assets—and how profitable is the firm from the perspective of the equity shareholders. It is also important to learn how to disaggregate return measures into primary impact factors. Lastly, it is critical to analyze any financial statement ratios in a comparative manner, looking at the current ratios in relation to those from earlier periods or relative to other firms or industry averages.

5. PREPARE FORECASTED FINANCIAL STATEMENTS.

Although often challenging, financial professionals must make reasonable assumptions about the future of the firm (and its industry) and determine how these assumptions will impact both the cash flows and the funding. This often takes the form of pro-forma financial statements, based on techniques such as the percent of sales approach.

6. VALUE THE FIRM.

While there are many valuation approaches, the most common is a type of discounted cash flow methodology. These cash flows could be in the form of projected dividends, or more detailed techniques such as free cash flows to either the equity holders or on enterprise basis. Other approaches may include using relative valuation or accounting-based measures such as economic value added.

THE NEXT STEPS

Once the analysis of the firm and its financial statements are completed, there are further questions that must be answered. One of the most critical is: “Can we really trust the numbers that are being provided?” There are many reported instances of accounting irregularities. Whether it is called aggressive accounting, earnings management, or outright fraudulent financial reporting, it is important for the financial professional to understand how these types of manipulations are perpetrated and more importantly, how to detect them.