

Understanding Financial Statements:

Financial Statements: What They Reveal About Your Business

A company's financial statements provide a structured view of its performance, financial position, and cash activity. For decision-makers, lenders, and investors, these reports form the foundation for understanding where the business stands today—and where it's headed next by providing information for profitability, liquidity and business risk.

The Core Financial Statements

1. Balance Sheet

The balance sheet presents a snapshot of a company's financial condition at a specific point in time. It outlines:

- **Assets** – Quantifiable resources the business controls that are expected to provide future economic benefits
(e.g., cash, receivables, inventory, equipment, intellectual property).
- **Liabilities** – Quantifiable obligations the company owes to others which may require use of economic resources
(e.g., payables, accrued expenses, short- and long-term debt).
- **Shareholders' Equity** – The residual interest after liabilities are deducted from assets. That's also considered as net worth of the company – what is left after paying all liabilities. Includes profit or loss from Income Statement, transactions with shareholders (stock issues, stock repurchase, dividends) and Other Comprehensive Income items

Assets and liabilities are classified as current (expected to be used or settled within one year) or non-current (long-term resources and obligations).

Current Assets: Includes cash, accounts receivables, inventory and other assets that are likely to be converted into cash or used up within one year. It is considered as short-term economic resources.

Non-Current Assets: Includes property, plant and equipment (Fixed assets), intangible assets such as customer relationship, trademark, intellectual property, goodwill etc. and other assets whose full value will not be realized within the one year.

Current Liabilities: Includes accounts payable, debt, accrued expenses and other obligations that are payable or due in one year.

Non-Current Liabilities: Debt or other liabilities payable or obligations to be satisfied beyond one year
This distinction helps clarify liquidity, leverage, and operational flexibility.



Line Item	Explanation
Assets	
Cash & Cash Equivalents	Cash + highly liquid investments with ≤ 3 -month maturities
Restricted Cash	Cash unavailable for general use due to legal/contractual restrictions
Short-Term Investments	Any investments with more than 3 months but less than one year of maturities
Accounts Receivable (Net)	Amounts owed by customers, shown net of allowance for doubtful accounts and any reserves created for the sales returns
Inventory	Goods held for sale; Depends on industry, it has Raw Material (goods purchased to manufacture the product), Work-in-Progress (goods under manufacturing process) and Finished Goods (goods ready for sale). Measured at lower of cost or net realizable value. Includes any reserves related with excess or obsolete inventory and any reserves for the product expected back as a sales return
Prepaid Expenses	Costs paid in advance for future benefits.
Total Current Assets	All assets owned that will materialize in one year
Property, Plant & Equipment (PP&E)	Long-lived tangible assets - such as land, building, machinery & equipment, furniture & fixture or any other tangible assets that has life over one year. Recorded at cost less depreciation
Intangible Assets	Identifiable intangibles with finite-life assets and indefinite-life assets (patents, software etc) recorded at cost; finite-life assets are amortized over its life and indefinite-life assets tested for impairment
Goodwill	Excess purchase price over fair value of acquired net assets. Tested annually for impairment, not amortized.
Long-Term Investments	Any investments with more than one year of maturities
Other Long-Term Assets	Costs paid in advance or any other assets not categorized above that has future benefits over one year
Total Assets	Total resources that company owns
Liabilities	
Accounts Payable	Amounts owed to suppliers for goods/services
Accrued Liabilities	Expenses incurred but payable within one year (wages, taxes, interest)
Deferred Revenue	Cash received for performance obligations to be satisfied within one year

Line Item	Explanation
Current Portion of Long-Term Debt	Principal due within 12 months.
Total Current Liabilities	All obligations payable in one year
Long-Term Debt	Borrowings due beyond 12 months; includes bonds, loans
Deferred Revenue	Cash received for performance obligations to be satisfied beyond one year
Deferred Tax Assets / Liabilities	Future tax effects of temporary differences beyond one year
Total Liabilities	Total obligations owed by the company
Shareholders' Equity	
Common Stock	Par value of issued shares
Additional Paid-in Capital	Additional capital contributed over par value
Treasury Stock	Cost of repurchased shares
Retained Earnings	Cumulative profits since inception not distributed as dividends
Dividend Distribution	Any amount paid as dividend from cumulative earnings
Other Comprehensive Income (OCI)	Unrealized gains/losses (pensions, FX, hedging) and foreign currency translation (for global companies with different currencies) not in net income.
Total Stockholders' Equity	Sum of all equity components (net worth of the company)
Total Liabilities & Equity	Total obligations + equity = total assets

2. Income Statement

The income statement reflects financial performance over a period of time, showing how revenues transform into profit or loss. It highlights operational efficiency, profitability trends, sustainability of earnings—though it may include subjective estimates due to accounting rules.

Prepared on an accrual basis, it recognizes revenue when it is earned and expenses incurred associated with the revenue generated or period expenses. Generally it is more relevant than cash flows and provide better measure of sustainable or recurring operations.

Some businesses prepare on cash basis i.e. when they receive cash for the revenue or spend cash for the expenses. This will not represent true picture of the financial performance due to timing difference of cash receipts and paid.

Line Item	Explanation
Net Sales / Revenue	Income earned from goods/services, recognized when performance obligations are satisfied. Includes any reserves related with sales return or discount
Cost of Goods Sold	Direct costs of producing inventory or providing services; includes materials, labor, and allocated overhead. Includes reserves related with excess and obsolete inventory and potential receipt of products due to sales return.
Gross Profit	Net Sales – COGS.
Selling, General & Administrative (SG&A)	Non-production operating expenses: salaries, marketing, admin, office expenses
Research & Development	Costs for product research; generally expensed as incurred
Depreciation & Amortization	Allocation of tangible (PP&E) and intangible (finite-life) asset costs over their useful lives
Total Operating Expenses	Total expenses incurred to run operations
Operating Income	Profit from operations before interest/taxes.
Interest Expense / Income	Borrowing costs or income earned from cash investments
Other Income / Expense	Gains/losses not part of core operations (FX, asset sales, litigation) and any other non-operating income/expenses
Profit Before Tax	Profit or loss incurred before income tax obligations
Income Tax Expense	Taxes based on taxable income
Net Income (Loss)	Bottom-line profit after all expenses.

3. Statement of Cash Flows

While the income statement shows profitability, the cash flow statement shows actual cash movement. It breaks cash activity into:

- Operating activities – Day-to-day business operations
- Investing activities – Purchases or sales of long-term assets
- Financing activities – Debt, equity, dividends, and related transactions

This statement helps assess liquidity, solvency, and the company’s ability to generate cash to support growth. Operating section may be prepared using direct or indirect method.

Due to accrual method profit or loss on the income statement will not equal change in cash due to operating activities in the same period, but will over the long term.

To get simple understanding of cashflows with balance sheet:

Any decrease in assets or increase in liabilities = Increase in cashflow

(when company sells inventory or assets or receive any payment against accounts receivables, it will reduce the assets but increase the cash and when the liabilities or debt goes up, it will receive the cash or delay the payments which will resulted into increase in cash)

Any increase in assets or decrease in liabilities = Decrease in cashflow

(when company purchase assets or inventory and increase accounts receivables or make payment of any liabilities or debt it will consume cash)

Line Item	Explanation
Net Income	Starting point for operating cash flows (indirect method).
Depreciation & Amortization	Non-cash expenses added back
Stock-Based Compensation	Expense added back (non-cash) for employees stock comp
Changes in Working Capital	AR, AP, inventory, accrued expenses. It is an operating liquidity indicator
Cash Flows from Operations	Cash provided/used by operating activities. Most important cash flow indicator
Capital Expenditures	Cash spent to purchase fixed assets
Acquisitions / Disposals	Cash used for or generated from business purchases/sales.
Cash Flow from Investing Activities	Net inflow/outflow from investing activities.
Proceeds from Debt Issuance	Borrowings raised (financing).
Repayment of Debt	Reduction of outstanding borrowings.
Issuance/Repurchase of Shares	Equity raised/repurchased from shareholders.
Dividends Paid	Cash distributions to shareholders.
Cash Flows from Financing Activities	Net cash related to debt and equity financing. Shows how business is funded
Net Change in Cash	Net increase/decrease from CFO + CFI + CFF. Summarize the total cash movements
Ending Cash Balance	Cash available at period-end.



Integration Across Statements

The four statements are interconnected.

For example:

- Net income flows into retained earnings.
- Cash flow from operations helps explain changes in balance sheet accounts.
- Equity changes reconcile beginning and ending balance sheet positions.

Understanding these relationships provides a holistic view of financial health—not just isolated metrics.