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Curso de inglés económico, de finanzas y tributos
Module 11

Financial Statements

What is a financial statement?

Financial statements can be defined as reports containing financial information about an organization. They may be combined with a supplementary statement to depict the financial status or performance of the organization (for example, an inflation-adjusted financial statement).

The financial statements are:

- The balance sheet
- The income statement
- The statement of changes in financial position (Cash Flow statement)

The balance sheet

This is a statement showing a company's financial position at the end of an accounting period. It is useful to financial statement users because it indicates the resources the entity has and what it owes.

This document has two halves. The totals of both halves are always the same, so they balance. One half shows business's assets, the things owned by the company, and the other half shows the Company's liabilities, obligations to pay other organizations or individuals, and its capital or shareholders' equity. The accounting equation for the balance sheet is: Assets equals Liabilities plus Capital or Shareholders' Equity.

American and continental European companies usually put assets on the left and capital and liabilities on the right. In Britain, this was traditionally the other way round, but now most British companies use a vertical format, with assets at the top, and liabilities and capital below.

Assets

An asset is something owned by the Company and will bring future economic benefits. In accounting, assets are generally divided into current and fixed assets (or non-current assets).

Current assets are things that will be used by the business in the near future; they include cash - money in the bank, investments that can easily be turned into money – debtors (BrE) or Accounts Receivable (AmE), money that customers owe and have to pay in the near future, and stocks of goods that are going to be sold.

On the other hand, **fixed assets**, which include equipment, machinery, buildings and land, will continue to be used by the business for a long time.

Assets can also include **intangible assets**, things which you cannot see. For example, Company's goodwill (good reputation with existing customers) and Company's brands.

Accounts Receivable//Receivables

This account consists of claims held against customers and others for money, goods, or services.

If collection is expected in one year or less (or in the normal operating cycle of the business if longer), they are classified as **Current Assets**.

They are classified in the balance sheet as Trade or Nontrade.
Trade receivables are debts from customers for merchandise sold or services performed in the ordinary course of business. **Nontrade receivables** come from other types of transactions and may be written promises to pay monies or deliver services. Examples are advances to employees, claims against other entities (i.e., tax refunds, insurance receipts), deposits, and financial receivables (i.e., interest receivable, dividend receivable).

Fixed Assets – Appreciation & Depreciation

Within the group of fixed assets, we can find land. In terms of valuation, land is usually not depreciated because it tends to appreciate (gain value).

In Britain, companies occasionally revalue, calculate a new value for appreciating fixed assets in their balance sheets. The revaluation is at either **current replacement cost** (how much it would cost to buy new ones), or at **net realizable value**, how much they could be sold for.

Appreciation is only recorded in countries that use inflation accounting systems. Companies in countries which use historical cost accounting, which means recording only the original purchase price of assets, do not usually record an estimated market value (the Price at which something could be sold today).

We have seen that fixed assets can gain value over the time. But it can lose value as they wear out, become unusuable or obsolete, out of date, and eventually have little or no value. Consequently, fixed assets are **depreciated**: their value on a balance sheet is reduced each year by a charge against profits on the profits and loss account. This means that part of the cost of the asset is deducted from the profits each year.

The accounting technique of depreciation makes it unnecessary to charge the whole cost of a fixed asset against profits in the year of purchase. Instead, it is charged during all the years it is used.

There are various depreciation systems for fixed assets. The most common one is **the straight-line method,** which means charging equal annual amounts against profit during the lifetime of the asset (e.g. deducting 10% of the cost of an asset's value from profits every year for 10 years).

European countries allow **Accelerated Depreciation:** business can deduct the whole cost of an asset in a short time. These allowances are an incentive to investment, as companies deduct the entire cost of an asset in a single year, reducing its profits, and therefore the amount of tax they have to pay. Consequently, new assets can be valued at zero on balance sheets.

Amortization vs Depreciation

Amortization implies the spreading of an intangible asset's cost over that asset's useful life. For example, a patent on a piece of medical equipment usually has a life of 17 years. The cost involved with creating the medical equipment is spread out over the life of the patent, with each portion being recorded as an expense on the company's income statement.

Depreciation means prorating a tangible asset's cost over that asset's life. For example, an office building can be used for a number of years before it becomes run down and is sold. The cost of the building is spread out over the predicted life of the building.

When preparing a balance sheet statement, a company may think that debt will not be paid. In this case, it anticipates the loss, which means taking action in preparation for the loss happening. It will **write off,** or abandon, the sum as a bad debt, and make provisions by charging a corresponding amount against profits; that is, deducting the amount of the debt from the year's profits.

Provision vs Allowance

Provision and allowance are different concepts.

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A **provision** includes a future and certain event but uncertain as to dates and amounts. For example, provision for liabilities and charges: these amounts are retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred, but uncertain as to amount or as to the date on which it will arise. The two most important provisions of this kind are for deferred taxation and provision for pensions.

An **allowance** includes a future event which is uncertain. For example, allowance for doubtful accounts or bad debts is a provision for possible uncollectibility associated with accounts receivable.

In the balance sheet, the item accounts receivable is reduced by the allowance account to obtain net receivables -the amount expected to be collected (realizable value).

For example, if gross receivables are $100,000 and the allowance account balance is $5,000, the current asset section of the balance sheet shows:

Accounts receivable $100,000

Minus: allowance for bad debts $5,000

Net receivable $ 95,000

Liabilities

Liabilities are amounts of money that a company owes. They are generally divided into two types – long-term and current.

Current liabilities are expected to be paid within a year of the date of the balance sheet. They include: short term debt, creditors or accounts payable (suppliers of goods or services who are not paid at the time of purchase), and accrued liabilities, expenses accrue (accumulated) from daily transactions but usually recorded only when they are paid. Examples of these are taxes and utility bills, salaries paid to employees and interest paid on notes payable.

Long-term or non-current liabilities are a business's long-term financial obligations that are not due within the present accounting year. Examples of these include: long-term borrowing, bonds payable, long-term lease obligations, deferred taxes (to be paid as tax in the future, but not now).

Shareholders' Equity

It consists of all the money belonging to shareholders. It is recorded on the same part of the balance sheet as liabilities, because it is money belonging to the shareholders and not the company. It is the same as the company's net assets, or assets minus liabilities.

This item includes:

- *The original share capital* – the money from shares issued by the company;
- *Retained earnings* - profits from previous years which have not been distributed to shareholders;
- *Reserves* - funds set aside from share capital and earnings, retained for emergencies or other future needs.

Cash Flow Statement

British and American companies also produce a cash flow statement. This gives details of cash flows – money coming into and leaving the business, relating to operations, investing and financing (issuing or repaying debt, issuing shares). It shows how effectively a Company generates and manages cash.

Other names used for it are: funds flow statement and source and application of funds statement.

British companies also have to produce a **Statement of Total Recognized Gains and Losses** (STRGL), showing any gains and losses that are not included in the profit and loss account, such as the revaluation of fixed assets.

Income Statement (AmE) // Profit and Loss Account (BrE)

Companies' annual reports contain a profit and loss account. This is a financial statement which shows the difference between the revenues and expenses of a period.

Non-profit organizations such as charities, public universities and museums generally produce an **Income and Expenditure Account**. If they have more income than expenditure this is called a **surplus** rather than a profit.

At the top of these statements is total sales revenue or **turnover**: the total amount of money received. Next is the cost of sales, also known as **Cost of Goods Sold** (COGS): the costs associated with making the products that have been sold, such as raw materials, labour and Factory expenses. The difference between the sales revenue and the cost of sales is **gross profit**.

There are many other costs or expenses that have to be deducted such as rent, electricity and office salaries. These are often grouped together as **selling, general and administrative expenses.**

The statement also usually shows earnings before interest, tax, depreciation and amortization, known as **EBITDA**. An example of this is as follows:
A retail company generates $100 million in revenue and incurs $40 million in product cost and $20 million in operating expenses. Depreciation and amortization expense amounts to $10 million, yielding an operating profit of $30 million. The interest expense is $5 million, leading to earnings before taxes of $25 million. With a 20% tax rate, net income equals $20 million after $5 million in taxes are subtracted from pretax income.
Using the EBITDA formula, we add operating profit to depreciation and amortization expense to get EBITDA of $40 million ($30 million + $10 million). The EBITDA figure is more objective because depreciation and amortization expenses can vary depending on which system a Company uses.

This statement also shows earnings before interest and tax, known as **EBIT**. It measures the profit a company generates from its operations, making it synonymous with "operating profit." By ignoring tax and interest expenses, it focuses solely on a company's ability to generate earnings from operations, ignoring variables such as the tax burden and capital structure.

After all the expenses and deductions is the net profit, often called the **bottom line**. This profit can be distributed as dividends (unless the Company has to cover past losses), or transferred to reserves.

Revenue, Income, Profit, Earnings, Gains or Proceeds?

Revenue refers to money that enters into the company arising from their specific activity. This is equivalent to **income**.
Also, the term **revenues** is related to money collected by the government ("public revenues").

The term **Profits** is the result of total revenue minus total expenses. **Earnings** and **gains** are synonyms of profits.

Another similar term is **Proceeds**, which is defined as funds received from the sale of assets or issuance of securities, such as capital stock or bonds.

Annual Report

An annual publication that public corporations must provide to shareholders to describe their operations and financial conditions.

An annual report will contain the following sections:

- Financial Highlights
- A Letter to the Shareholders
- Management's Discussion and Analysis
- Financial Statements and Notes to Financial Statements
- The Auditor's Report
- A Summary of Financial Data and Corporate Information.

Cost Accounting

Definition

Cost accounting involves calculating the costs of different products or services, so that Company managers can know what price to charge for particular products and services and which are the most profitable.

Kinds of Costs

Direct costs, those that can be directly related to the production of particular units of a product, are quite easy to calculate. Examples include manufacturing materials and wages.

But there are also **indirect costs or overheads**, costs and expenses that cannot be identified with particular manufacturing process or units of production. Examples include company offices' or factories' rent or property taxes, electricity costs, the maintenance department, the Factory canteen, managers' salaries, among others. Costs such as these are often grouped together on the statements as Selling, general and administrative expenses.

Companies also differentiate between fixed costs and variable costs.

Fixed costs are those which do not change in the short term, even if the production level changes, such as rent and interest payments.

Variable costs are those that change in proportion to the volume of production, such as components and raw materials, and overtime payments.

Allocating Costs

Manufacturing companies have to find a way of allocating fixed and variable costs to the products they make, they need to divide up the costs and charge them to the different products.

Absorption costing attempts to charge all direct costs and all production costs, and sometimes all indirect costs, to each of the Company's products or services.

Activity-based costing calculates all the costs connected with a particular activity, for example, product design, manufacturing, distribution, even if they are carried out by different departments in the Company.

Breakeven Analysis

When a company needs to decide if a product or service would be profitable to be produced or offered, they do a breakdown analysis. This compares **expected sales** of a new product with **expected costs** at various production levels.
The **breakeven point** is the sales volume (the number of units sold) at which the company covers its costs, paying all its expenses. To make a profit, it is necessary to sell more than this.

Historical Cost & Inflation

Accounting Standards provide information which allows shareholders to make sound financial decisions. This is one reason why in many countries accounting follows the **Historical Cost Principle**.

Companies record the **original purchase price** of assets and not their **estimated current selling price** or **replacement cost.** This is more objective, and the current value is not important if the business is going concern, it will continue to do business, its assets are not going to be sold, or do not currently need to be replaced.

However, some countries with regular high inflation use inflation accounting systems which take into account changing prices. One system used is **Replacement Cost Accounting,** which values all assets at their current replacement cost.