By Steven Orpurt

**The Role of Financial Statements**

The purpose of financial statements is to convey to interested readers a cohesive financial report on the business activities of an economic entity. Financial statements are cohesive because they integrate with each other and include both numbers (the financial statements themselves) and written descriptions (notes, often called footnotes) of business activities. The term “economic entity” is used because many enterprises produce consolidated financial statements, with the word consolidated signaling that more than one legal entity is included in them. General Electric, for example, likely consists of thousands of legal corporations, all consolidated into a single set of financial statements reporting on the economic entity known as GE.

**Key concept:** financial statements are cohesive financial reports on entity business activities.

**A Core Concept to Understand Financial Statements**

To read and comprehend financial statements, you need to understand the business operations of the entity itself. Broadly speaking, managers of every entity engage in three business activities:

1. They obtain financing
2. They invest in order to operate
3. They conduct operations

“Obtain financing” means that managers sell (issue) debt to investors to obtain cash or take out a loan from a bank also to obtain cash. In addition, managers can obtain financing by selling shares of stock in the entity (i.e. sell shares of a business) to investors to obtain cash. Once the cash is received managers use the cash proceeds to invest in assets. While managers of manufacturing entities invest in factories (plant) and equipment, managers of service entities may invest almost exclusively in software. Amazon, for example, invests heavily in its website capabilities. Managers also invest in their entity’s operations. Walmart, for example, invests in its inventory while Boeing invests in financing its customers’ purchases of airplanes.

**Key concept:** To read and comprehend financial statements, you first need to understand an entity’s business activities. Warren Buffett, the legendary investor (who is an expert financial statement analyzer), is outspoken in stating that he doesn’t invest in businesses that he doesn’t readily understand.

**Principal Financial Statements**

The financial statements consist of a:

1. Balance sheet, also named a statement of financial position as of a date (e.g. December 31, 2016)
2. Income statement or statement of earnings or statement of operations
3. Statement of cash flows
4. Statement of shareholders’ equity
5. Notes to the financial statements

**The Balance Sheet (The Statement of Financial Position)**

Figure 1 illustrates a balance sheet for ABC Corporation. Notice that it lists and totals ABC’s assets. Future articles will describe many different types of assets, discuss how they are measured, and offer guidance on how to interpret them.

Since an entity such as ABC is inanimate, its assets are claimed by (i.e. belong to) other entities or individuals who have either loaned funds to ABC or invested in equity shares of ABC. That means that ABC’s assets are equal to claims on the assets. In other words, an entity’s assets equal its liabilities plus shareholders’ equity. In symbols, A = L + SE. Thus the name balance sheet.

|  |  |  |  |
| --- | --- | --- | --- |
| ABC Corp  Statement of Financial Position  (Balance Sheet)  As of December 31, 2016 | | | |
|  | |  |  |
| Assets | | Liabilities |  |
| Various asset accounts | $xxx | Various liability accounts | $xx |
|  |  |  |  |
|  |  | Shareholders’ Equity |  |
|  |  | Various shareholders’ equity accounts | x |
|  |  |  |  |
| Total Assets | $xxx | Total Liabilities and Shareholders’ Equity | $xxx |

Figure 1. A Simple Balance Sheet

**Utilizing This Knowledge**

The balance sheet is an excellent starting point to understand the financial performance of an entity. With an understanding of the business, as a reporter you could:

* Identify assets controlled by the entity and ask whether that portfolio of assets makes sense given the entity’s business. For example, Apple Inc. has cash and marketable securities totaling $230 billion (of $305 billion in total assets), far more than is needed to operate. Analysts speculate about what Apple might eventually do with these excess funds.
* Does an entity finance itself primarily with long-term debt or short-term debt? Is the level of liabilities appropriate for the assets and operations of the entity?
* Some firms do not issue much, if any, debt, and are financed with shareholders’ equity. By not issuing debt, however, entities give up tax deductible interest payments in the U.S. and many other countries. Has the entity been overly conservative in its financing approach? Historically Apple Inc. has been conservative in the eyes of many investors but recently has been issuing debt, despite its large cash and investment holdings.