Understanding Financial Reporting

By BNET Editorial
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Financial reporting, done annually by private enterprises and quarterly by public companies, offers essential information about the financial health of an organization. Interested parties often use this information to support investing and financing decisions. Companies prepare their reports in an agreed format, including a balance sheet, income statement, cash flow statement, and footnotes as required.

Financial statements must comply with *Generally Accepted Accounting Principles* (GAAP), and are typically prepared on an accrual basis. The footnotes provide details that cannot be gleaned from the statement itself, or involve some kind of qualitative analysis.

Annual statements must be audited—usually by a public accountant, who will conclude whether the statements are an accurate reflection of the company's true financial position. Investors may find this appraisal useful to their decision-making process, as well.

What You Need to Know

Do financial reports contain anything other than statements and footnotes?

Of course! As part of their annual and quarterly reports, public companies registered with the Securities and Exchange Commission (SEC) must present a management discussion and analysis (MD&A) of the company's operating results, cash flow, and financial health. This should include management's view of the company's outlook, including how it is expected to perform, any assumptions made, and future economic circumstances.

When do companies file their reports, and with whom?

Most private companies complete their audited statements between 90 and 120 days after their financial year end. Exactly when may depend on factors like shareholder or bank credit facility agreements, or loan covenants—these can also influence how the statements are distributed.

Public companies are legally obliged to file annual reports with the Registrar of Companies within seven months of the financial year end. Public companies should also file their annual and half-yearly interim reports with the SEC within 90 days of their financial year end (or for quarterly reports, within 45 days of the quarter end), although this is not a legal requirement. All financial statements must be filed electronically with the SEC, while shareholders may receive hard copies or download them from the company web site.

What do footnotes typically reveal?

The footnotes to financial statements usually disclose details of accounting policy, depreciation and contingency arrangements, agreements relating to loans and leases, pension obligations, related-party transactions and legal agreements, expenditure on research and development, inventory details and significant events that occur after the statement date. The Financial Accounting Standards Board (FASB) publishes a comprehensive list of possible footnote disclosures on its web site.

What to Do

Understand the Objectives of Financial Reporting

A financial report aims to provide information about a company's performance and the effectiveness of its management over a given period. Specifically, it should:

- provide information that can be used to support decisions about investment or financing
- be easily understood by people who are reasonably well acquainted with business and finance
- help current and future investors and creditors evaluate likely income from expected dividends or interest, and from the sale or maturity of securities (including timings)
- provide information about a company's economic resources, including claims to those resources, and how they are affected by particular transactions, circumstances and events.

Know the Structure of a Financial Report

There are usually three financial statements and associated footnotes in a financial report:.

- financial position statement (balance sheet)
- statement of income (profit and loss account)
- cash flow statement
- notes to these statements.

Typically, financial statements are comparative—that is, they display at least two years of figures to enable relative judgments to be formed. For companies with several strands of business that are each accounted for separately, financial statements represent its combined results.

- *Balance sheet*: this lists the company's assets, liabilities and equity on a given date. It is therefore a snapshot that reveals the level of liquidity, financial leverage, and net assets at a specific time.
- *Income statement*: this sums up how profitable a company has been over a particular time period, by revealing information about income and expenditure. Comparing consecutive balance sheets shows how assets, liabilities, and equity have changed during a particular time frame, while the income statement reveals why.
- *Cash flow*: This statement shows cash receipts and cash payments arising from the company's operations, investments and financing arrangements—enabling investors and creditors to evaluate current and future returns. It also aims to resolve any changes in cash flow between reporting periods.

Any key information not already summarized in these statements is disclosed in footnotes. These enable companies to elaborate or explain aspects of their statements—for example, they may highlight the effect of certain financing arrangements or significant contractual terms, or simply augment the basic figures with additional data. Analysts and investors look carefully at footnotes for any information that could clarify complex transactions, or affect future financial decisions.

Understand the Purpose of Auditing Accounts

Financial statements and footnote disclosures are independently audited—for publicly registered companies, this is a requirement set out by the SEC. Auditing involves an accountant checking statements to ensure there are no errors or false information, and giving an opinion about whether the reports accurately reflect the financial health of the organization. The accountant's opinion should always be taken into account if it is presented as part of a financial report.

What to Avoid

Financial Reports Aren't Appropriate For the Audience

It's essential that a financial report can be used by its intended recipients—such as investors or financiers. By meeting accounting standards and following industry practice in relation to reporting, presenting and disclosing information, companies can ensure that their reports are as accessible as possible to the people who need to read them.

There Is No Consistency across Sectors

Most companies put their financial reports together and report their results according to Generally Accepted Accounting Principles (GAAP). These help to ensure consistency in financial reporting and enables meaningful comparisons to be made between different accounting periods and different companies in the same sector

Where to Learn More

Web Sites:

U.S. Securities and Exchange Commission: www.sec.gov

Financial Accounting Standards Board: www.fasb.org

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