

one all the information necessary for decision making. But decisions made without a look at financial ratios, the decision is being made without all the available data.

SEE ALSO *Balance Sheets; Cash Flow Statements; Income Statements; Return on Assets*

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FINANCIAL STATEMENTS

Financial statements are written records of a business's financial situation. They include standard reports like the balance sheet, income or profit and loss statements, and cash flow statement. They stand as one of the more essential components of business information, and as the principal method of communicating financial information about an entity to outside parties. In a technical sense, financial statements are a summation of the financial position of an entity at a given point in time. Generally, financial statements are designed to meet the needs of many diverse users, particularly present and potential owners and creditors. Financial statements result from simplifying, condensing, and aggregating masses of data obtained primarily from a company's (or an individual's) accounting system.

FINANCIAL REPORTING

According to the Financial Accounting Standards Board, financial reporting includes not only financial statements but also other means of communicating financial information about an enterprise to its external users. Financial statements provide information useful in investment and credit decisions and in assessing cash flow prospects. They provide information about an enterprise's resources, claims to those resources, and changes in the resources.

Financial reporting is a broad concept encompassing financial statements, notes to financial statements and parenthetical disclosures, supplementary information (such as changing prices), and other means of financial reporting (such as management discussions and analysis, and letters to stockholders). Financial reporting is but one source of information needed by those who make economic decisions about business enterprises.

The primary focus of financial reporting is information about earnings and its components. Information about earnings based on accrual accounting usually provides a better indication of an enterprise's present and continuing ability to generate positive cash flows than that provided by cash receipts and payments.

MAJOR FINANCIAL STATEMENTS

The basic financial statements of an enterprise include the 1) balance sheet (or statement of financial position), 2) income statement, 3) cash flow statement, and 4) statement of changes in owners' equity or stockholders' equity. The balance sheet provides a snapshot of an entity as of a particular date. It lists the entity's assets, liabilities, and in the case of a corporation, the stockholders' equity on a specific date. The income statement presents a summary of the revenues, gains, expenses, losses, and net income or net loss of an entity for a specific period. This statement is similar to a moving picture of the entity's operations during this period of time. The cash flow statement summarizes an entity's cash receipts and cash payments relating to its operating, investing, and financing activities during a particular period. A statement of changes in owners' equity or stockholders' equity reconciles the beginning of the period equity of an enterprise with its ending balance.

Items currently reported in financial statements are measured by different attributes (for example, historical cost, current cost, current market value, net reliable value, and present value of future cash flows). Historical cost is the traditional means of presenting assets and liabilities.

Notes to financial statements are informative disclosures appended to the end of financial statements. They provide important information concerning such matters as depreciation and inventory methods used, details of long-term debt, pensions, leases, income taxes, contingent liabilities, methods of consolidation, and other matters. Notes are considered an integral part of the financial statements. Schedules and parenthetical disclosures are also used to present information not provided elsewhere in the financial statements.

Each financial statement has a heading, which gives the name of the entity, the name of the statement, and the date or time covered by the statement. The

information provided in financial statements is primarily financial in nature and expressed in units of money. The information relates to an individual business enterprise. The information often is the product of approximations and estimates, rather than exact measurements. The financial statements typically reflect the financial effects of transactions and events that have already happened (i.e., historical).

Financial statements presenting financial data for two or more periods are called comparative statements. Comparative financial statements usually give similar reports for the current period and for one or more preceding periods. They provide analysts with significant information about trends and relationships over two or more years. Comparative statements are considerably more significant than are single-year statements. Comparative statements emphasize the fact that financial statements for a single accounting period are only one part of the continuous history of the company.

Interim financial statements are reports for periods of less than a year. The purpose of interim financial statements is to improve the timeliness of accounting information. Some companies issue comprehensive financial statements while others issue summary statements. Each interim period should be viewed primarily as an integral part of an annual period and should generally continue to use the generally accepted accounting principles (GAAP) that were used in the preparation of the company's latest annual report. Financial statements are often audited by independent accountants for the purpose of increasing user confidence in their reliability.

Every financial statement is prepared on the basis of several accounting assumptions: that all transactions can be expressed or measured in dollars; that the enterprise will continue in business indefinitely; and that statements will be prepared at regular intervals. These assumptions provide the foundation for the structure of financial accounting theory and practice, and explain why financial information is presented in a given manner.

Financial statements also must be prepared in accordance with generally accepted accounting principles, and must include an explanation of the company's accounting procedures and policies. Standard accounting principles call for the recording of assets and liabilities at cost; the recognition of revenue when it is realized and when a transaction has taken place (generally at the point of sale), and the recognition of expenses according to the matching principle (costs to revenues). Standard accounting principles further require that uncertainties and risks related to a company be reflected in its accounting reports and that, generally, anything that would be of interest to an informed investor should be fully disclosed in the financial statements.

ELEMENTS OF FINANCIAL STATEMENTS

The Financial Accounting Standards Board (FASB) has defined the following elements of financial statements of business enterprises: assets, liabilities, equity, revenues, expenses, gains, losses, investment by owners, distribution to owners, and comprehensive income. According to FASB, the elements of financial statements are the building blocks with which financial statements are constructed. These FASB definitions, articulated in its "Elements of Financial Statements of Business Enterprises," are as follows:

- **Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
- **Comprehensive income** is the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.
- **Distributions to owners** are decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities to owners. Distributions to owners decrease ownership interest or equity in an enterprise.
- **Equity** is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business entity, equity is the ownership interest.
- **Expenses** are outflows or other uses of assets or incurring of liabilities during a period from delivering or producing goods or rendering services, or carrying out other activities that constitute the entity's ongoing major or central operation.
- **Gains** are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owner.
- **Investments by owners** are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interest (or equity) in it.
- **Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

- **Losses** are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.
- **Revenues** are inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

SUBSEQUENT EVENTS

In accounting terminology, a subsequent event is an important event that occurs between the balance sheet date and the date of issuance of the annual report. Subsequent events must have a material effect on the financial statements. A "subsequent event" note must be issued with financial statements if the event (or events) is considered to be important enough that without such information the financial statement would be misleading if the event were not disclosed. The recognition and recording of these events often requires the professional judgment of an accountant or external auditor.

Events that effect the financial statements at the date of the balance sheet might reveal an unknown condition or provide additional information regarding estimates or judgments. These events must be reported by adjusting the financial statements to recognize the new evidence. Events that relate to conditions that did not exist on the balance sheet date but arose subsequent to that date do not require an adjustment to the financial statements. The effect of the event on the future period, however, may be of such importance that it should be disclosed in a footnote or elsewhere.

PERSONAL FINANCIAL STATEMENTS

The reporting entity of personal financial statements is an individual, a husband and wife, or a group of related individuals. Personal financial statements are often prepared to deal with obtaining bank loans, income tax planning, retirement planning, gift and estate planning, and the public disclosure of financial affairs.

For each reporting entity, a statement of financial position is required. The statement presents assets at estimated current values, liabilities at the lesser of the discounted amount of cash to be paid or the current cash settlement amount, and net worth. A provision should also be made for estimated income taxes on the differences between the estimated current value of assets. Comparative statements for one or more periods should

be presented. A statement of changes in net worth is optional.

DEVELOPMENT STAGE COMPANIES

A company is considered to be a development stage company if substantially all of its efforts are devoted to establishing a new business and either of the following is present: 1) principal operations have not begun, or 2) principal operations have begun but revenue is insignificant. Activities of a development stage enterprise frequently include financial planning, raising capital, research and development, personnel recruiting and training, and market development.

A development stage company must follow generally accepted accounting principles applicable to operating enterprises in the preparation of financial statements. In its balance sheet, the company must report cumulative net losses separately in the equity section. In its income statement it must report cumulative revenues and expenses from the inception of the enterprise. Likewise, in its cash flow statement, it must report cumulative cash flows from the inception of the enterprise. Its statement of stockholders' equity should include the number of shares issued and the date of their issuance as well as the dollar amounts received. The statement should identify the entity as a development stage enterprise and describe the nature of development stage activities. During the first period of normal operations, the enterprise must disclose its former developmental stage status in the notes section of its financial statements.

FRAUDULENT FINANCIAL REPORTING

Fraudulent financial reporting is defined as intentional or reckless reporting, whether by act or by omission, that results in materially misleading financial statements. Fraudulent financial reporting can usually be traced to the existence of conditions in either the internal environment of the firm (e.g., inadequate internal control), or in the external environment (e.g., poor industry or overall business conditions). Excessive pressure on management, such as unrealistic profit or other performance goals, can also lead to fraudulent financial reporting.

The legal requirements for a publicly traded company when it comes to financial reporting are, not surprisingly, much more rigorous than for privately held firms. And they became even more rigorous in 2002 with the passage of the Sarbanes-Oxley Act. This legislation was passed in the wake of the stunning bankruptcy filing in 2001 by Enron, and subsequent revelations about fraudulent accounting practices within the company. Enron was only the first in a string of high-profile bankruptcies. Serious allegations of accounting fraud followed

and extended beyond the bankrupt firms to their accounting firms. The legislature acted quickly to fortify financial reporting requirements and stem the decline in confidence that resulted from the wave of bankruptcies. Without confidence in the financial reports of publicly traded firms, no stock exchange can exist for long.

The Sarbanes-Oxley Act is a complex law that imposes heavy reporting requirements on all publicly traded companies. Meeting the requirements of this law has increased the workload of auditing firms. In particular, Section 404 of the Sarbanes-Oxley Act requires that a company's financial statements and annual report include an official write-up by management about the effectiveness of the company's internal controls. This section also requires that outside auditors attest to management's report on internal controls. An external audit is required in order to attest to the management report.

Private companies are not covered by the Sarbanes-Oxley Act. However, analysts suggest that even private firms should be aware of the law as it has influenced accounting practices and business expectations generally.

AUDITING

The preparation and presentation of a company's financial statements are the responsibility of the management of the company. Published financial statements may be audited by an independent certified public accountant. In the case of publicly traded firms, an audit is required by law. For private firms it is not, although banks and other lenders often require such an independent check as a part of lending agreements.

During an audit, the auditor conducts an examination of the accounting system, records, internal controls, and financial statements in accordance with generally accepted auditing standards. The auditor then expresses an opinion concerning the fairness of the financial statements in conformity with generally accepted accounting principles. Four standard opinions are possible:

1. **Unqualified opinion**—This opinion means that all materials were made available, found to be in order, and met all auditing requirements. This is the most favorable opinion that can be rendered by an external auditor about a company's operations and records. In some cases, a company may receive an unqualified opinion with explanatory language added. Circumstances may require that the auditor add an explanatory paragraph to his or her report. When this is done the opinion is prefaced with the term, "explanatory language added."
2. **Qualified opinion**—This type of opinion is used for instances in which most of the company's financial

materials were in order, with the exception of a certain account or transaction.

3. **Adverse opinion**—An adverse opinion states that the financial statements do not accurately or completely represent the company's financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Such an opinion is obviously not good news for the business being audited.
4. **Disclaimer of opinion**—A disclaimer of opinion states that the auditor does not express an opinion on the financial statements, generally because he or she feels that the company did not present sufficient information. Again, this opinion casts an unfavorable light on the business being audited.

The auditor's standard opinion typically includes the following statements, among others:

The financial statements are the responsibility of the company's management; the audit was conducted according to generally accepted auditing standards; the audit was planned and performed to obtain reasonable assurance that the statements are free of material misstatements, and the audit provided a reasonable basis for an expression of an opinion concerning the fair presentation of the audit. The audit report is then signed by the auditor and a principal of the firm and dated.

SEE ALSO *Annual Report; Audits, External; Balance Sheets; Cash Flow Statements; Income Statements*

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FIREWALLS

A firewall is a computer security device that is situated between a small business's internal network and the Internet. It can work at either the software or the