

## **Module 4 – Chapter 2 – Financial Statements**

Financial statements are reports that provide information about a company's financial performance and position. There are three main types of financial statements: the balance sheet, the income statement, and the statement of cash flows.

The balance sheet, also known as the statement of financial position, shows a company's assets, liabilities, and equity at a specific point in time. Assets are resources owned by the company, such as cash, investments, and property. Liabilities are obligations the company owes, such as loans and taxes. Equity is the difference between assets and liabilities, and represents the ownership interest of the company's shareholders.

The income statement, also known as the profit and loss statement, shows a company's revenues and expenses over a specific period of time, usually a month or a year. Revenues are the money the company earns from selling products or services. Expenses are the costs the company incurs in order to generate those revenues, such as cost of goods sold, selling and administrative expenses, and interest expense. The difference between revenues and expenses is the company's net income or loss.

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The statement of cash flows shows how a company's cash inflows and outflows changed during a specific period of time. It is divided into three sections: cash flows from operating activities,

cash flows from investing activities, and cash flows from financing activities. Operating activities include the company's day-to-day business operations, such as selling products and paying bills. Investing activities include the company's investments in long-term assets, such as property and equipment, and the sale of those assets. Financing activities include the company's financing transactions, such as borrowing money or issuing stock.

To read and interpret financial statements, it is important to understand the following concepts:

**Liquidity:** This refers to a company's ability to pay its short-term debts and obligations. A company with high liquidity has a lot of cash and other assets that can be easily converted to cash, such as accounts receivable and inventory. A company with low liquidity may have difficulty paying its bills in the short term.

**Solvency:** This refers to a company's ability to meet its long-term financial obligations. A company with high solvency has a strong financial position, with a healthy balance between assets and liabilities. A company with low solvency may have difficulty meeting its long-term financial commitments.

**Leverage:** This refers to a company's use of debt to finance its operations and growth. A company with high leverage has a lot of debt relative to its equity. This can be risky because the

company may have difficulty paying its debts if its profits decline. A company with low leverage has less debt and may be less risky.

**Profitability:** This refers to a company's ability to generate profits. A company with high profitability is generating a lot of revenue and has low expenses, resulting in high net income. A company with low profitability is generating less revenue or has high expenses, resulting in low net income.

By carefully reviewing and analyzing financial statements, you can gain a better understanding of a company's financial health and make informed decisions about whether to invest in or do business with the company.

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