

# **Understanding Financial Statements**

Prepared For: Legal Education Society of Alberta

*Understanding and Analyzing Financial Statements*

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## UNDERSTANDING FINANCIAL STATEMENTS

### PART I – THE ANNUAL STATEMENT

#### A. The Importance of Financial Statements

A lawyer with little or no training in accounting usually finds it difficult to make sense of a corporation's Financial Statements. For lawyers practicing in the area of Family Law or involved in other areas, this can be perplexing as many of our clients have an interest in a corporation or corporations. In particular, understanding Financial Statements is required to enable Family Law lawyers to ascertain the income of the parties and the value of a corporate interest.

#### B. What is in the Statements

A corporation's management is responsible for the preparation of Financial Statements.

In general, Financial Statements are divided into five sections:

1. Balance Sheet
2. Statement of Retained Earnings
3. Income Statement
4. Cash Flow Statement
5. Notes to Financial Statements

Financial Statements are usually prepared at the same date each year. They can be prepared more than once a year and many corporations prepare Financial Statements on a monthly or quarterly basis for internal use.

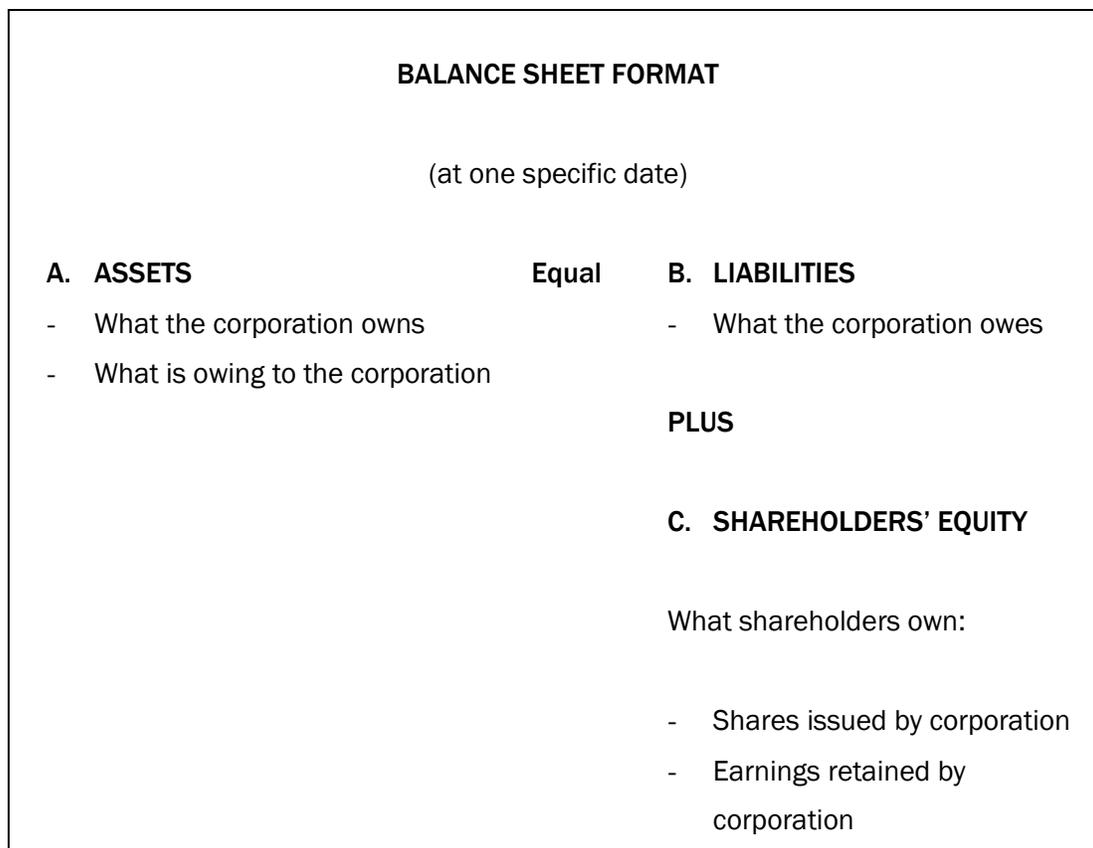
#### 1. *Balance Sheet*

The Balance Sheet shows a corporation's financial position at a specific date, normally the closing day of the corporation's financial year.

One side of the balance sheet shows what the corporation owns and what is owing to the corporation. These items are called *assets* which includes cash in the bank, accounts receivable, inventory (whether made up of raw materials, goods and process or finished goods ready for sale), work in progress, investments, property plant equipment (land, buildings, equipment), intangible assets, patents, good will, etc. The other side of the balance sheet shows (1) what the corporation owes, whether current or long term

(called *liabilities*) and (2) the *shareholders' equity* or the *net worth* of the corporation which belongs to the shareholders. The shareholders' equity represents the excess of the corporation's assets over its liabilities. Accordingly, the corporation's total assets are equal to the sum of the corporation's liabilities plus the shareholders' equity.

The following diagram illustrates the basic format of the balance sheet.



Several important points should be kept in mind when examining a Balance Sheet. *First*, it shows the assets and liabilities of a corporation on one date. It also shows the Shareholders equity being the difference between the assets and liabilities. Shareholders equity belongs to the Shareholder's and is usually made up of the Share Capital plus retained earnings and sometimes contributed surplus. Aspects of this equity may or may or may not be taxable. In annual reports, that date is the last day of the corporation's fiscal year. *Second*, the Balance Sheet does not show how much money a corporation took in during the year, how much money it paid out, nor how much money was left as profit or how much loss was incurred. This information is provided in the income statement.