

Four Financial Statements and Their Role in Business Analysis

Posted on September 30, 2019

Introduction

Financial statements are structured reports that explain an organization's financial position, performance, cash movements, and changes in owners' interests. They support decisions by investors, lenders, managers, employees, regulators, suppliers, and other stakeholders. The four primary statements commonly discussed are the statement of financial position, the statement of profit or loss and other comprehensive income, the statement of cash flows, and the statement of changes in equity. A complete set also includes notes containing accounting policies, judgments, risks, and detailed explanations. These statements are connected, and none provides a complete picture alone. Understanding their purpose and relationships is more useful than memorizing their titles (IFRS Foundation, "IAS 1"; IFRS Foundation, *Conceptual Framework*).

The Reporting Framework

Financial reporting follows standards designed to make information relevant, faithfully represented, comparable, verifiable, timely, and understandable. Under International Financial Reporting Standards, IAS 1 currently describes a complete set of statements, while IFRS 18 will replace IAS 1 for annual periods beginning on or after 1 January 2027, with earlier application permitted. United States companies generally follow standards issued by the Financial Accounting Standards Board and filing requirements of the Securities and Exchange Commission. The frameworks differ in some details, but both aim to provide decision-useful information. Statements also depend on estimates and judgments, so standardized presentation does not eliminate uncertainty or managerial discretion (IFRS Foundation, "IAS 1"; IFRS Foundation, "IFRS 18"; Financial Accounting Standards Board).

Statement of Financial Position

The statement of financial position, often called the balance sheet, reports assets, liabilities, and equity at a specific date. Assets are resources controlled by the entity that can produce future economic benefits, while liabilities are present obligations expected to require a transfer of resources. Equity is the residual interest after liabilities are deducted from assets. The accounting equation—assets equal liabilities plus equity—explains why the statement balances. Current and noncurrent classification helps users evaluate operating cycles and liquidity, although some institutions use other formats. A balance sheet is a snapshot, so it should be compared across periods

and read with cash-flow and profit information (IFRS Foundation, “IAS 1”; IFRS Foundation, *Conceptual Framework*).

Understanding Assets

Assets include cash, receivables, inventories, property, equipment, investments, right-of-use assets, and intangible resources recognized under the applicable standards. Their reported values may come from [historical cost](#), depreciation, amortization, fair value, impairment testing, or other measurement rules. Not every valuable resource appears on the balance sheet. Internally developed reputation, workforce capability, or brands may be economically important but fail recognition criteria. Users should therefore avoid treating total assets as a complete measure of organizational value. They should examine asset quality, collectability, useful lives, impairment assumptions, concentration, and how effectively resources produce cash flows. The notes often contain information necessary to interpret the headline amounts (IFRS Foundation, *Conceptual Framework*; Penman, 2020).

Understanding Liabilities and Liquidity

Liabilities include trade payables, loans, leases, taxes, employee obligations, provisions, and deferred items. Classification and maturity affect assessments of liquidity and solvency. A company can report profit while struggling to meet near-term obligations if cash collection is slow or debt payments are concentrated. Conversely, a large liability may be manageable when supported by stable cash flows and long maturities. Users should examine interest rates, covenants, collateral, refinancing risk, contingencies, and commitments. Provisions involve estimates about uncertain timing or amount, so the notes are essential. The balance sheet supports ratios such as current ratio and debt-to-equity, but ratios require industry and accounting context (Penman, 2020).

Statement of Profit or Loss and Other Comprehensive Income

The income statement reports revenue, expenses, and profit or loss over a period. Revenue reflects income arising from ordinary activities, while expenses include costs consumed in generating revenue and operating the business. Depending on the framework and presentation, the statement may show gross profit, operating profit, finance costs, tax, and net profit. Other comprehensive income contains specified gains and losses that standards require outside profit or loss, such as certain remeasurements or value changes. Profit is not the same as cash because accrual accounting recognizes economic activity when it occurs rather than only when money is received or paid. This distinction is central to financial analysis (IFRS Foundation, “IAS 1”; SEC, “Beginners’ Guide to Financial Statements”).

Revenue Quality and Expense Recognition

Revenue growth is attractive, but users must ask how revenue was recognized, whether customers can pay, whether returns are likely, and whether growth required unsustainable incentives. Expenses should be matched with activities under the relevant standards, yet classification choices can affect reported margins. Capitalizing a cost records an asset and spreads expense over future periods, while expensing it immediately reduces current profit. Depreciation and amortization allocate recognized asset costs but do not represent current cash payments. Analysts therefore examine accounting policies, unusual items, estimates, and changes in classification. A strong income statement reflects sustainable operations rather than one-time gains, aggressive assumptions, or delayed recognition of losses (Penman, 2020).

Statement of Cash Flows

The cash-flow statement explains changes in cash and cash equivalents through operating, investing, and financing activities. Operating **cash flows** relate mainly to core revenue-producing activities. Investing cash flows include purchases and sales of long-term assets and investments. Financing cash flows reflect transactions with lenders and owners, such as borrowing, repayment, share issuance, or dividends. The statement can be prepared using the direct method, which reports major cash receipts and payments, or the indirect method, which reconciles profit to operating cash flow. Cash flow helps users evaluate liquidity, financial flexibility, earnings quality, and the organization's ability to fund operations, investment, and distributions (SEC, "Beginners' Guide to Financial Statements"; Penman, 2020).

Why Profit and Cash Differ

A profitable company may have negative operating cash flow because it sells on credit, builds inventory, pays suppliers faster, or recognizes noncash income. A company with a loss may generate cash by collecting old receivables, reducing inventory, delaying payment, or recording large noncash expenses. These differences are not automatically good or bad. They reveal timing and the operating model. Persistent profit without corresponding cash may signal weak collection, aggressive revenue recognition, or high working-capital needs. Strong cash generated by cutting inventory or delaying suppliers may not be sustainable. Reconciliation between profit and operating cash flow is therefore one of the most informative parts of the statements (Penman, 2020).

Statement of Changes in Equity

The statement of changes in equity reconciles opening and closing balances for share capital, **retained earnings**, reserves, and other equity components. It shows profit or loss, other

comprehensive income, dividends, share issues, repurchases, ownership transactions, and corrections or policy changes affecting equity. This statement explains how value attributable to owners changed and distinguishes performance from direct transactions with owners. Retained earnings do not represent cash held in a separate account; they are accumulated accounting profits reduced by distributions and adjustments. Users should examine whether equity growth comes from profitable operations, new capital, asset revaluation, currency effects, or reduced dividends because each source has different implications (IFRS Foundation, “IAS 1”).

Notes to the Financial Statements

The notes are part of the financial statements rather than optional background. They explain material accounting policies, judgments, estimation uncertainty, segment information, financial instruments, related parties, taxes, leases, commitments, contingencies, and detailed line items. A headline number may be impossible to understand without its note. For example, debt risk depends on maturity, currency, interest, security, and covenants, not merely the total balance. Notes also disclose changes in policy and significant assumptions used in impairment or valuation. Investors who read only the primary statements may miss the information most relevant to risk. Effective analysis moves repeatedly between totals and supporting disclosures (IFRS Foundation, “IAS 1”; SEC, “Beginners’ Guide to Financial Statements”).

How the Statements Connect

The statements form an integrated system. Net profit affects retained earnings in the statement of changes in equity. The closing cash balance in the cash-flow statement agrees with cash on the statement of financial position. Purchasing equipment reduces cash or increases liabilities and creates an asset that later generates depreciation expense. Credit sales increase revenue and receivables before cash is collected. Borrowing increases cash and debt without creating revenue. These links allow users to test whether the financial story is coherent. They also show why one statement cannot be evaluated in isolation. Profitability, liquidity, solvency, and capital structure describe different aspects of the same organization (Penman, 2020).

Comparative Analysis and Ratios

Financial statements become more meaningful when compared over time, with budgets, and with similar organizations. Common measures include gross margin, operating margin, return on assets, return on equity, current ratio, debt ratios, receivable days, inventory turnover, and free cash flow. Ratios are analytical tools rather than conclusions. Different accounting policies, business models, seasons, currencies, and one-time events can make direct comparison misleading. A retailer naturally has different inventory patterns from a software business, while a bank’s balance sheet requires

specialized measures. Users should examine trends, definitions, and reconciliations and should avoid selecting only metrics that support a preferred financial narrative (Penman, 2020).

Limitations of Financial Statements

Financial statements are historical and estimated representations, not exact measurements of future value. They may omit important internally generated intangible resources, social impacts, environmental risks, employee capability, and strategic uncertainty. Inflation and changing market conditions can reduce comparability of historical costs. Management makes judgments about useful lives, provisions, expected credit losses, valuations, and impairment. Audits provide reasonable rather than absolute assurance and do not guarantee business success. Statements can also be difficult for nonexperts, creating dependence on summaries and alternative performance measures. Users should combine financial reports with governance information, industry analysis, cash forecasts, and nonfinancial evidence while maintaining informed professional skepticism (IFRS Foundation, *Conceptual Framework*; Penman, 2020).

IFRS 18 and the Changing Presentation of Performance

IFRS 18, issued in 2024 and effective from 2027, will introduce defined subtotals in the statement of profit or loss, including operating profit and profit before financing and income taxes. It also requires disclosures about management-defined performance measures used in public communications and adds principles for aggregation and disaggregation. The standard aims to improve comparison and transparency, particularly where companies use alternative profit measures. It does not replace the need to understand business models or estimates, and transition may change presentation without changing underlying economics. Students and analysts should distinguish current reporting requirements from forthcoming standards and monitor how comparative information is restated (IFRS Foundation, “IFRS 18”).

Conclusion

The four primary financial statements answer different but connected questions. The statement of financial position shows resources, obligations, and equity at a date. The income statement explains financial performance over a period. The cash-flow statement shows how cash was generated and used, while the statement of changes in equity explains movements in owners’ interests. Notes provide the policies, estimates, risks, and detail required to interpret all four. Reliable analysis combines the statements, compares periods, evaluates accounting choices, and recognizes limitations. Financial reports do not simply “show the money.” They present a structured explanation of how an organization creates, finances, measures, and distributes economic value (IFRS Foundation,

“IAS 1”; SEC, “Beginners’ Guide to Financial Statements”; Penman, 2020).

References

1. IFRS Foundation. “IAS 1 Presentation of Financial Statements.” IFRS Accounting Standards.
2. IFRS Foundation. “IFRS 18 Presentation and Disclosure in Financial Statements.” Issued 2024, effective 1 Jan. 2027.
3. IFRS Foundation. *Conceptual Framework for Financial Reporting*. Revised 2018.
4. Financial Accounting Standards Board. *Accounting Standards Codification*. FASB.
5. United States Securities and Exchange Commission. “Beginners’ Guide to Financial Statements.” SEC Investor Education.
6. Penman, Stephen H. *Financial Statement Analysis and Security Valuation*. 6th ed., McGraw-Hill, 2020.