CORPORATE BOARDS **USA**

Boardroom Fundamentals 201
Module 5: Understanding Financial Statements

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Understanding Financial Statements

While not required to be financial experts, board members should have a basic understanding of the company's financial health, including

- Components of its assets, liabilities and equity
- The drivers of its profitability
- Sources and uses of company cash
- Any red flags in financial reporting

Basic Financial Statements Contain

Balance Sheet

- Displays assets (resources owned) and liabilities (debts owed) at a point in time (quarter-end, year-end)
- Computes shareholders’ equity (net worth)
- Assets = Liabilities + Shareholders’ Equity

Basic Financial Statements Contain

Income Statement

- Illustrates profitability (loss) over a period of time (quarter or year)
- Calculates revenues, expenses and taxes to derive bottom line net income
- Net income is used to derive earnings per share, a common metric used to assess financial strength

Basic Financial Statements Contain

Statement of Cash Flows

- Analyzes how a company uses its cash and breaks down cash flows from operating activities, investment activities and financial activities
- Distinct from profitability in that the statement of cash flows shows inflows and outflows of company cash, not the profit remaining after deducting expenses from income
- Important measure of the cash position of a company (which activities produce cash, how is cash invested, how much cash is used to finance the business)

Basic Financial Statements Contain

Notes to Financial Statements

- Provide detailed descriptions of the major components of assets, liabilities and net income
- Discuss key accounting principles and policies
- Typically include information not directly related to the financial statements, such as contingencies, commitments and stock-based compensation plans to give a complete picture of the financial status of the company

Red Flags in Financial Reporting

Board members should be alert to red flags, including the following:

- Management focus on short-term revenue growth or one-time gains
- Inability or unwillingness of management to explain sources and uses of funds
- Complexity of financing transactions using numerous corporate entity vehicles or subsidiaries
- Heavy reliance on tax shelters or structures
- Revenue or income materially higher than peers
- Frequent changes in accounting elections
- Frequent disputes with independent public accountants
- Weak internal control environment

Existence of these items does not necessarily mean that fraud is occurring but should cause directors to raise questions and receive satisfactory explanations.

Questions?

Contact Linda via email → **lindaiannone35@gmail.com**

End of Module 5

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