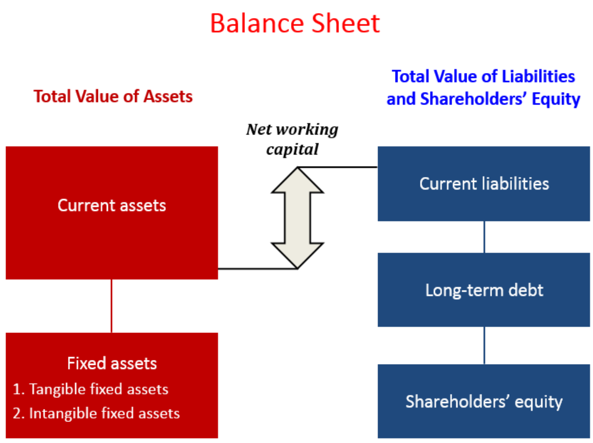
: CH2- FINANCIAL STATEMENTS, TAXES AND CASH FLOWS

BALANCE SHEET

- BALANCE SHEET- snapshot of the firm's assets and liabilities at a given point in time
    - ASSETS = LIABILITIES + SHAREHOLDERS EQUITY
    - ASSETS – LIABILITIES = SHAREHOLDERS EQUITY
- ASSETS:
    - Either current (cash on hand or something that has a life less than 1yr) or non-current (relatively long life, more than 1yr. can be tangible or intangible)
- LIABILITIES
    - Current liabilities – debt or other obligations due for payment within 1yr (accounts payable)
    - Non-current liability- paid after 1yr is a long term debt.
- SHAREHOLDERS EQUITY
    - The difference between total value of assets and the total value of liabilities. Reflects that if the firm were to sell all of its assets and use the money to pay debts, then whatever residual value remains belongs to the shareholders.
- NET WORKING CAPITAL (NWC)
    - NWC = current assets – current liabilities
    - Is positive when the cash that will be received over the next 12 months exceeds the cash that will be paid out.



- BALANCE SHEET NOTES
    - LIQUIDITY – ability to convert to cash quickly without a significant loss in value. Non-current assets are more illiquid. The more liquid a company is, the less financial distress, although they earn a lower return. Therefore there is a trade-off between illiquid and liquid assets.
    - DEBT VS EQUITY- use of debt in a firm's capital structure is financial leverage or 'gearing'. The more debt a firm has (as % of assets), the greater the degree of financial leverage → increases the potential reward to shareholders and increases the potential for financial distress and business failure.
    - MARKET VALUE VS BOOK VALUE- Market value is the price at which the assets, liabilities or equity can actually be bought or sold. Book value- generally not what the assets are actually worth (what the firm paid for them, no matter how long ago they were bought or how much they are worth today)

INCOME STATEMENT

- Measures the performance of a firm over a specified period of time.
    - **REVENUES – EXPENSES = INCOME**
- Income statement shows revenue when it accrues, not necessarily when the cash comes in. Matching Principle: shows revenue when it is realised and matches the expenses required to generate the revenue. The income statement may not be representative of the actual cash inflows and outflows that occurred during the specified period.
- Non-cash items- expenses charged against the revenues that do not directly affect cash flow, such as depreciation. Depreciation deduction is another form of the matching principle.
- Depreciation is added back to gather a true sense of operating income (EBIT) because depreciation is a non cash item