



Understanding Financial Statements

Every decision you make in your company leaves a financial footprint. The numbers provide evidence for every decision made in an organization.

Financial statements are used to show you where a company's money came from, where it went, and where it is now.

There are three separate financial statements.

1. Balance Sheet - shows what a company owns and what it owes at a fixed point in time.
2. Income Statement - shows how much money a company made and spent over a period of time.
3. Cash Flow Statement - shows the exchange of money between a company and the outside world over a period of time.

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Balance Sheet

A balance sheet provides detailed information about a company's assets, liabilities, and shareholder equity. The name "balance sheet" is derived from the fact that these accounts must always be in balance. Assets must always equal the sum of liabilities and shareholders' equity. The equation " $Assets = Liabilities + Shareholder Equity$ " is always true for every balance sheet.

The balance sheet is a snapshot. It takes a photograph of an organization at a given point and time and shows how the organization is performing at that instant. Thus, the more pictures you take of an organization, the more able you are to compare the growth (or retraction) of a company over time.

The balance sheet provides many clues to a firm's current state and future performance.

- Can the firm meet its financial obligations?
- How much money has already been invested in this company?
- Is the company overly indebted?
- What kind of assets has the company purchased with its financing?

Assets

Assets are things that a company owns that have value. Assets can (typically) either be sold or used by the company to make products or provide services that can be sold.

Assets include physical property, such as buildings, trucks, equipment and inventory. They also include intangible assets. Intangible assets are assets that have value, but they can't be touched or seen. They do not have a physical presence, but they do exist and have value. These include things such as trademarks and patents. Money itself is an asset, as are investments that a company has made. Assets are generally listed based on their liquidity. Liquidity basically means how quickly assets can be converted into cash.

Current assets are things the company expects to convert into cash within a year. A good example of current assets is inventory. Most companies expect to sell their inventory within that year. Some common current assets include the following.

1. Cash - Money available immediately, such as in checking accounts, is the most common of all short-term assets. Immediately available usually means money that is available within three months. So if you have a 30 day CD, the balance would be considered cash even though it is not available tomorrow.
2. Accounts receivable – Accounts receivable are money owed to the business for purchases made by customers, suppliers, and other vendors. Accounts receivable are promises to pay made to your organization. These can be considered short term IOU's and are usually paid within 90 days.
3. Notes receivable - Notes receivable are money owed to the business that are longer term in nature. These can be longer than one year, but the current portion, the portion due within one year, are considered current assets. Notes that cannot be collected within one year are considered long-term assets.

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4. Inventory – Inventory is product created by an organization that is for sale to customers. It is the items that have not sold and need to be stored. Inventory has value and is considered a short term asset until the time it is sold.

Non-current assets are things that a company would not expect to sell within a year or have a useful life of greater than a year. They include fixed assets that are not available for sale, such as office furniture, delivery or work trucks, and buildings.

An important concept to understand when discussing non-current assets is depreciation. Non-current assets are used over a period of time. Thus, some of the value of that asset is used each period. The concept of depreciation tries to assess how much value is used each year from non-current assets. This is offset against the asset so the balance sheet will always represent the value remaining in an asset. For example, a car may be considered to have value for 5 years. The simplest depreciation method (there are many different methods) would say that we are using 1/5 of the value of the car each year. Thus, 20% of the value of the car is offset in depreciation each year. In year 2, accumulated depreciation would be 40%, year 3 60%, etc. So most long-term assets lose value over time.

Some common non-current assets include the following.

1. Land - Land is a unique fixed asset. It is not depreciated because land is never considered to be worn out with use.
2. Buildings - Buildings are categorized as fixed assets and are depreciated over time, usually 30 years.
3. Office equipment - This includes office equipment such as copiers, fax machines, printers, and computers used in your business. These are typically depreciated between 3-7 years.
4. Machinery - This figure represents machines and equipment used in your plant to produce your product. Examples of machinery might include lathes, conveyor belts, or a printing press.
5. Vehicles - This would include any vehicles used in your business.
6. Intangibles – These are the assets that you cannot see or touch and include patents and copyrights.

Liabilities

Liabilities are amounts of money that a company owes to others. These can be considered the IOUs that you give to other businesses or entities. This can include all kinds of obligations, like money borrowed from a bank to launch a new product, rent for use of a building, money owed to suppliers for materials, payroll a company owes to its employees, environmental cleanup costs, or taxes owed to the government. Liabilities also include obligations to provide goods or services to customers in the future.

Like assets, liabilities are customarily listed by how quickly the obligation must be paid. Long-term liabilities describe obligations to be paid over more than one year, while short-term liabilities refer to obligations to be paid within a year.

Some of the more common liabilities include:



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1. Accounts Payable – Accounts payable are money you owe to other business for purchases you have made. Accounts payable are promises to pay made by you to other organizations and entities. These can be considered short term IOU's and are usually paid within 90 days.
2. Line of Credit – A line of credit is money you have borrowed from a bank.
3. Deposits – If you have been prepayed for work, the money you have received is considered a liability until you have performed the work.

Shareholder Equity

Shareholder equity is sometimes called capital, net worth, owner's equity, or stockholder's equity. It represents the stockholders' claim to a business' assets after all creditors and debts have been paid. It is calculated by subtracting a company's total liabilities from its total assets.

Shareholder equity usually comes from two places.

1. The cash invested when a company sells stock is equity.
2. A business' accumulated profits that it has not paid out to its shareholders as dividends are a form of equity called retained earnings.

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Income Statement

An income statement measures a company's financial performance over a specific accounting period. It shows the net profit or loss incurred over that period, typically over a fiscal quarter or year, by subtracting expenses from revenues. Unlike the snapshot in time qualities of the balance sheet, the income statement measures performance over a period of time.

An income statement is divided into two major sections, revenue and expenses.

Revenues

There are two types of revenue on an income statement. The first is operating revenue and is the primary source of revenue. It is usually the first line items on an income statement and usually has a title called sales revenues or sales. The secondary revenues are non-operating revenues the organization generates in the normal course of business. It is revenue earned, but not earned via the core business of the organization. Non-operating revenue will typically show up towards the bottom of an income statement so organizations can see how they are operating based on operating revenue.

Primary Revenue (Operating Revenue)

Primary revenue items are those that are a direct result of regular business operations. For example, if a business creates sports equipment, then the operating items section would present the revenues from the sale of sports equipment. For retailers, manufacturers, wholesalers, and distributors the revenues generating from their primary activities are referred to as sales revenues or sales.

Do not confuse revenues with the receipt of payment. Sales revenues are recognized in the period in which they are earned or delivered, not in the period when payment is collected. Payment could be collected before or after the work is performed, but it will only become revenue when it is earned. In other words, revenue is money earned, while receipts are money received. There is a big difference between the two.

Secondary Revenue (Non-Operating Revenue)

Non-operating items are those that are not tied directly to a company's regular operations. For example, if the sport equipment company sold a factory and some old plant equipment, the funds received would be shown in the non-operating section. They also include revenues resulting from buying and selling merchandise not related to primary operations. As a result, they are reported on the income statement separate from the retailer's primary activity of sales revenues.

Expenses

Like revenues, expenses are also separated into primary and secondary categories.

Primary Expenses (Operating Expenses)

Expenses involved in primary activities are expenses that are incurred in order to earn normal operating revenues.

- Do not confuse expenses with the payment for an expense. Expenses and the payments for those expenses can occur at different times. The income statements or profit and loss statements of merchandisers and manufacturers will often use a separate line for the

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cost of goods sold, while the other expenses involved in their primary activities will either be grouped together as operating expenses or subdivided into the categories selling and administration.

Secondary Expenses (Non-operating Expenses)

Expenses from secondary expenses are referred to as non-operating expenses. Anything that costs money and is not part of the normal operating procedure would be considered a secondary expense. For example, interest expense is a non-operating expense because it involves the finance function of the business, rather than the primary activities of buying/producing and selling.

An income statement typically flows as follows:

- Sales – These are actual sales from operations
- Cost of Goods Sold (COGS) – These are the costs associated with actually creating a product and usually include materials, labor, and other indirect costs.
- Non-Operating Revenue – These could be a multitude of things: rent revenue, interest, etc.
- Gross Profit – Gross profit is a widely looked at number and is simply sales minus cost of goods sold. Gross profit is how much money you are making after costs of making a product.
- Expenses – This is usually a list of other associated expenses and can include: sales & marketing, occupancy, payroll, utilities, travel, etc.
- EBIT – EBIT is a key number and shows how well your organization is operating. EBIT excludes interest and taxes. These are considered non-operating expenses.
- Interest, Taxes – Interest and taxes are considered non-operating expenses. Taxes are generally anywhere from 25-40% of EBIT.
- Net Income/Loss – When people refer to the bottom line, this is what they are talking about. Net Income/Loss is the number left after all revenues and expenses are accounted for.

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Cash Flow Statement

The cash flow statement is perhaps the most difficult of the statements to understand. It is often ignored in favor of the balance sheet and income statement. However, the cash flow statement is a critical financial statement. As the overused slogan says, cash is king. It truly is. The cash flow statement helps an organization keep track of the flow of cash. It helps sort incoming and outgoing sources of cash. Cash flow statements organize and report cash generated and used into three categories.

Operating activities	Converts the items related to operating the organization to cash.
Investing activities	Reports the purchase and sale of long-term investments, property, buildings, and equipment.
Financing activities	Reports the issuance and repurchase of the company's own stocks and bonds and the payment of dividends.

1. Operating Activities

The first line in operating activities is net income from operations. Operating activities include cash receipts from selling goods or providing services, income from items such as interest and dividends, and cash payments for inventory, payroll, taxes, interest, utilities, and rent. The net amount of cash provided by operating activities is a key figure on a statement of cash flows.

Cash Receipts

- sale of goods or services
- interest revenue
- dividend revenue
- Accounts Receivable

Cash Payments

- inventory purchases
- payroll
- taxes interest expense
- other (utilities, rent, etc..)

2. Investing Activities

Investing activities include transactions and events involving the purchase and sale of securities land, buildings, equipment, and other assets not generally held for resale, plus the making and

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collecting of loans. Investing activities are not classified as operating activities because they have an indirect relationship to the central, ongoing operation of the business.

Cash receipts

- sale of plant assets
- sale of a business segment
- sale of investments in equity securities of other entities or debt securities
- collection of principal on loans made to other entities

Cash Payments

- purchase of plant assets
- purchase of equity securities of other entities or debt securities
- loans to other entities

3. Financing Activities

All financing activities deal with the flow of cash to or from the business owners and creditors. For example, cash proceeds from issuing capital stock or bonds would be classified under financing activities. Likewise, payments to repurchase stock or to retire bonds and the payment of dividends are financing activities as well.

Cash receipts

- issuance of own stock
- borrowing

Cash payments

- dividends to stock holders
- repaying principal amounts borrowed
- repurchasing business' own stock