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Financial Statements 101

When you think of financial statements, what comes to mind? Unless you are trained in basic business accounting you might think financial statements are the EKG of a business's economic health. While most examinations of this topic seem complex, it is necessary for every business owner to understand what they are all about. Let's start by looking at what financial statements provide. In this special six-page edition we will examine the main financial statements. They are: (1) balance sheet; (2) income statement; (3) cash flow statement; and (4) the statement of shareholders' equity.

1. The balance sheet shows what a company owns and what it owes at a fixed point in time.
2. The income statement shows how much money a company made and spent over a given period of time.
3. The cash flow statement shows the exchange of money between a company and the outside world also over a period of time.
4. The "statement of shareholders' equity" shows changes in the interests of the company's shareholders over time. Let's look at each of these financial statements in more detail.

1. **The balance sheet** provides detailed information about a company's assets, liabilities and shareholder/s' equity. Let's take a closer look:

Assets are things that a company owns that have value. This typically means they can either be sold or used by the company to make products or provide services that can be sold. Assets include physical property, such as facilities, trucks, equipment and inventory. It also includes things that can't be touched but nevertheless

exist and have value, such as intellectual property, trademarks and patents. Cash itself is an asset and so are investments a company makes.
Liabilities are amounts of money that a company owes to others. 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.

Shareholders' equity is sometimes called capital or net worth. It's the money that would be left if a company sold all its assets and paid off all its liabilities. This leftover money belongs to the shareholders, or the owners, of the company.

Assets are generally listed based on how quickly they can be converted into cash. Current assets are things a company expects to convert to cash within one year. A good example is inventory. Most companies expect to sell their inventory for cash within one year. Noncurrent assets are things a company does not expect to convert to cash within one year or that would take longer than one year to sell. Noncurrent assets include fixed assets. Fixed assets are those assets used to operate the business, but that are not available for sale, such as trucks, office furniture and other property.

Liabilities are generally listed based on their due dates. Liabilities are said to be either current or long-term. Current liabilities are obligations a company expects to pay off within the year. Long-term liabilities are obligations due more than one year in the future.

Shareholders' equity is the amount owners invested in the company's stock plus or minus the company's earnings or losses since inception. Sometimes companies distribute earnings, instead of retaining them. These distributions are called dividends. Public corporations are best known for this return on investment.

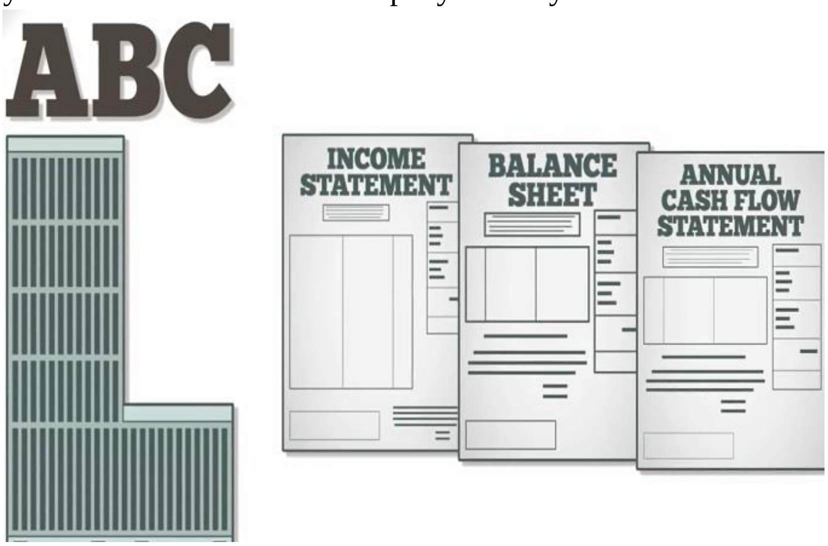
A balance sheet shows a snapshot of a company's assets, liabilities and shareholders' equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period.

2. **The income statement** is a report that shows how much revenue a company earned over a specific time period (usually for a year or some portion of a year). An income statement also shows the costs and expenses associated with earning that revenue. The literal "bottom line"

of the statement usually shows the company's net earnings or losses. This tells you how much the company earned or lost over the period.

Income statements also report earnings per share (or "EPS"). This calculation tells you how much money shareholders would receive if the company decided to distribute all the net earnings for the period. (Companies almost never distribute all their earnings. Usually they reinvest them in the business.)

To understand how income statements are set up, think of them as a set of stairs. You start at the top with the total amount of sales made during the accounting period. Then you go down, one step at a time. At each step, you make a deduction for certain costs or other operating expenses associated with earning the revenue. At the bottom of the stairs, after deducting all the expenses, you learn how much the company actually earned or lost during the accounting period. People often call this "the bottom line."



At the top of the income statement is the total amount of money brought in from sales of products or services. This top line is often referred to as gross revenues or sales. It's called "gross" because expenses have not been deducted from it yet. So, the number is "gross" or unrefined.

The next line is money the company doesn't expect to collect on certain sales. This could be due, for example, to sales discounts or merchandise returns.

When you subtract the returns and allowances from the gross revenues, you arrive at the company's net revenues. It's called "net" because, if you can imagine a net, these revenues are left in the net after the deductions for returns and allowances have come out.

Moving down the stairs from the net revenue line, there are several lines that represent various kinds of operating expenses. Although these lines can be reported in various order, the next line after net revenues typically shows the costs of the sales. This number tells you the amount of money the company spent to produce the goods or services it sold during the accounting period.

The next line subtracts the costs of sales from the net revenues to arrive at a subtotal called "gross profit" or sometimes "gross margin." It's considered "gross" because there are certain expenses that haven't been deducted from it yet.

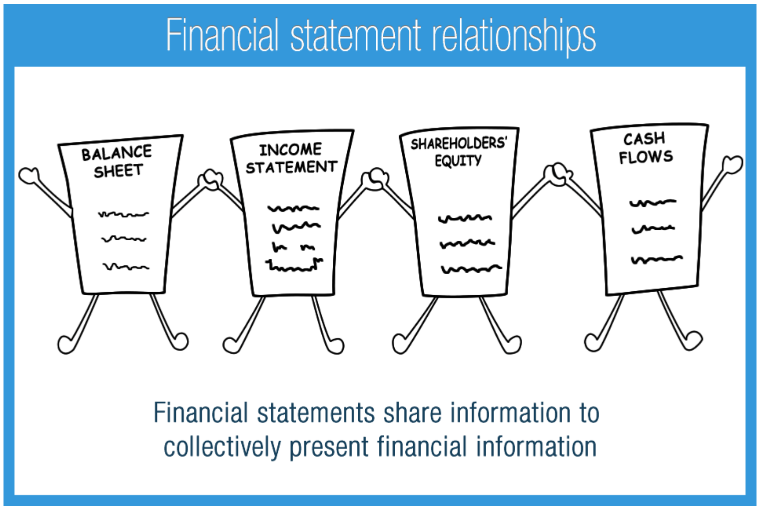
The next section deals with operating expenses. These are expenses that go toward supporting a company's operations for a given period – for example, salaries of administrative personnel and costs of researching new products. Marketing expenses are another example. Operating expenses are different from "costs of sales," which were deducted above, because operating expenses cannot be linked directly to the production of the products or services being sold.

Depreciation is also deducted from gross profit. Depreciation considers the wear and tear on some assets, such as machinery, tools and furniture, which are used over the long term. Companies spread the cost of these assets over the periods they are used. This process of spreading these costs is called depreciation or amortization. The "charge" for using these assets during the period is a fraction of the original cost of the assets.

After all operating expenses are deducted from gross profit, you arrive at operating profit before interest and income tax expenses. This is often called "income from operations."

Next companies must account for interest income and interest expense. Interest income is the money companies make from keeping their cash in interest-bearing savings accounts, money market funds and the like. On the other hand, interest expense is the money companies paid in interest for money they borrow. The interest income and expense are then added or subtracted from the operating profits to arrive at operating profit <u>before</u> income tax.

Finally, income tax is deducted and you arrive at the bottom line: net profit or net losses. (Net profit is also called net income or net earnings.) This tells you how much the company earned or lost during the accounting period. Did the company make a profit or did it lose money?



<u>Earnings per share or EPS:</u> Most income statements include a calculation of earnings per share or EPS. This calculation tells you how much money shareholders would receive for each share of stock they own if the company distributed all its net income for the period. To calculate EPS, you take the total net income and divide it by the number of outstanding shares of the company.

3. **The cash flow statement** shows a company's inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you whether a company made a profit, a cash flow statement can tell you whether the company generated cash. A cash flow statement shows changes over time rather than absolute dollar amounts at a point in time. It uses and reorders the information from a company's balance sheet and income statement. The bottom line of the cash flow statement shows the net increase or decrease in cash for the period. Generally, cash flow statements are divided into three main parts. Each part reviews the cash flow from one of three types of activities: (1) operating activities; (2) investing activities; and (3) financing activities.

Operating activities: The first part of a cash flow statement analyzes a company's cash flow from net income or losses. For most companies, this section of the cash flow statement reconciles the net income (as shown on the income statement) to the actual cash the company received from or used in its operating activities. To do this, it adjusts net income for any non-cash items (such as adding back depreciation expenses) and adjusts for any cash that was used or provided by other operating assets and liabilities.

Investing activities: The second part of a cash flow statement shows the cash flow from all investing activities, which generally include purchases or sales of long-term assets, such as property, plant and equipment, as well as investment securities. If a company buys a piece of machinery, the cash flow statement would reflect this activity as a cash outflow from investing activities because it used cash. If the company decided to sell off some investments from an investment portfolio, the proceeds from the sales would show up as a cash inflow from investing activities because it provided cash.

Financing activities: The third part of a cash flow statement shows the cash flow from all financing activities. Typical sources of cash flow include cash raised by selling stocks and bonds or borrowing from banks. Likewise, paying back a bank loan would show up as a use of cash flow.

The statement of shareholders' equity: The statement of shareholders' equity is a financial document a company issues as part of its balance sheet. It highlights the changes in value to stockholders' or shareholders' equity, or ownership interest in a company, from the beginning of a given accounting period to the end of that period. Typically, the statement of shareholders' equity measures changes from the beginning of the year through the end of the year.

In its simplest form, shareholders' equity is determined by calculating the difference between a company's total assets and total liabilities. The statement of shareholders' equity highlights the business activities that contribute to whether the value of shareholders' equity goes up or down. The statement of shareholders' equity typically includes the following components:

- **Preferred stock**. This is a special type of stock, or ownership stake in a company, that offers holders a higher claim on a company's earnings and assets than those who own the company's common stock. Preferred stockholders will typically be entitled to dividends before holders of common stock can receive theirs. Preferred stock is usually listed on the statement of shareholders' equity at par value, or face value, which is the amount at which it is issued or redeemable. Holders of preferred stock do not have voting rights in the issuing company.

- **Common stock**. This is a type of stock, or ownership stake in a company, that comes with voting rights on corporate decisions. Common stockholders are lower down on the list of priorities when it comes to paying equity holders. If a company needs to liquidate, holders of common stock will get paid after preferred stockholders and bondholders. Like preferred stock, common stock is typically listed on the statement of shareholders' equity at par value.
- **Treasury stock**. Treasury stock is stock that the issuing company repurchases. A company might repurchase its own stock to avoid a hostile takeover or boost its stock price. Shareholders' equity is reduced by the amount of money spent to repurchase the shares in question.
- **Additional paid-up capital**. Also known as contributed capital, additional paid-up capital is the excess amount investors pay over the par value of a company's stock.
- **Retained earnings**. Retained earnings are the total earnings a company has brought in that have not yet been distributed to shareholders. This figure is calculated by subtracting the amount paid out in shareholder dividends from the company's total earnings since inception. A company that's been profitable for quite some time will probably show a large amount of retained earnings.
- **Unrealized gains and losses**. Unrealized gains and losses reflect the changes in pricing for investments. An unrealized gain occurs when an investment gains in value but hasn't been cashed in. Similarly, an unrealized loss occurs when an investment loses value but has yet to be sold off.

In summary, we know this edition of The Monday Motivator may not motivate many of us. However, understanding this basic crash course in business finance is in the best interest of any business owner. We recommend you print this and carry it with you for a month or two. Read it when having your tea, coffee or even, dare we suggest it, wine. Better yet, make copies and share it with your key team members even if they ask you what that degree in business left out that this business journal is going to reveal. No quiz necessary, but have some fun with it by giving away something to participants who offer up correct answers to a few business finance related questions.

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