Exploratory Note 7

The Income Statement, Balance Sheet, and Statement of Cash Flows

INTRODUCTION

Sound decision-making in an entrepreneurial context demands organized and timely financial data. Of course, not all startup firms will be concerned with the same financial measures—firms with high-growth potential, for instance, may be willing to sacrifice short- and medium-term profitability for long-term value while firms with lesser opportunities are likely to be more myopic. For firms with outside funding, the importance of financial statements increases even further as they constrain managerial action, mitigate asymmetries, and establish a foundation for performance evaluation, among other things. A general understanding of the basic financial statements, methods of analysis, and practice when it comes to drafting them is a must for all entrepreneurs.

THE INCOME STATEMENT AND BALANCE SHEET

To begin, we need to be particularly aware of the income statement (profit and loss statement) and the balance sheet. These financial statements ought to be familiar to you from prior work in accounting and finance, but a reminder is in order. An example income statement (both in dollars and common-sized):

Table 19.1

Consolidated statement of income for Hewlett-Packard, 2009

	$ Million	Percent of Revenue
Operating revenues		
Net sales	$114,552	100.0%
Operating expenses		
Cost of goods sold	82,751	72.2
Selling, general & administrative expenses	11,613	10.1
Research & development expenses	2,819	2.5
Depreciation	4,773	4.2
Operating income	12,596	11.0
Other income (expense)	(2,460)	−2.1
Earnings before interest and income taxes	$10,136	8.8%
Interest expense	721	0.6
Taxable income	$ 9,415	8.2%
Taxes	1,755	1.5
Net income	$7,660	6.7%
Allocation of net income		
Dividends	766	0.7
Addition to retained earnings	6,894	6.0

Note: Sums subject to rounding error.

Source: Hewlett-Packard *Annual Report,* year ending October 2009. © 2009 Hewlett-Packard Development Company, L.P.

What is the basic income statement equation?

How do you define cost of goods sold (COGS)?

What is depreciation? Does it matter?

A major benefit of debt relative to equity is highlighted in the income statement. What is it?

Is net income everything in business? Why might it be misleading?

And an example balance sheet (both in dollars and common-sized):

Assets	$ Million	Percent of Total Assets	Liabilities and Shareholders' Equity	$ Million	Percent of Total Assets
Current assets					
Cash and marketable securities	$13,334	11.6%	Current liabilities		
Receivables	19,212	16.7	Debt due for repayment	$ 1,850	1.6%
Inventories	6,128	5.3	Accounts payable	33,862	29.5
Other current assets	13,865	12.1	Other current liabilities	7,291	6.4
Total current assets	$52,539	45.8%	Total current liabilities	$43,003	37.5%
Fixed assets			Long-term debt	13,980	12.2
Tangible fixed assets			Other long-term liabilities	17,299	15.1
Property, plant, and equipment	$11,262	9.8%			
Long-term investments	11,289	9.8	Total liabilities	74,282	64.7
Total tangible fixed assets	$22,551	19.6%	Shareholders' equity:		
Intangible fixed assets			Common stock and other paid-in capital	10,581	9.2
Goodwill	$33,109	28.8%	Retained earnings	29,936	26.1
Other intangible assets	6,600	5.7	Total shareholders' equity	$40,517	35.3%
Total intangible fixed assets	$39,709	34.6%	Total liabilities and shareholders' equity	$114,799	100.0%
Total fixed assets	62,260	54.2			
Total assets	$114,799	100.0%			

Table 19.2

Consolidated balance sheet for Hewlett-Packard, 2009

Note: Column sums subject to rounding error.
Source: Hewlett-Packard *Annual Report,* year ending October 2009. © 2009 Hewlett-Packard Development Company, L.P.

What is the basic balance sheet equation?

What are current assets? How are they organized?

What is liquidity and why is it important? How does it relate to the prior question?

What are fixed assets and why are they often important?

Are all successful companies heavy in fixed assets?

What are intangible fixed assets? Why do they matter?

What are current liabilities? How are they organized?

What is net working capital? Why does it matter?

What is the term for a firm that has negative shareholder's equity? Can a firm operate if shareholder's equity is negative?

THE STATEMENT OF CASH FLOWS

The income statement and balance sheet are critical; however, they are stated on an accrual basis. What does this mean?

In an entrepreneurial setting, why might accrual accounting lead practitioners astray?

In contrast, the statement of cash flows tracks the cash implications of transactions. For example, if goods are sold now, with payment due in 60 days, the income statement will treat the revenue as generated when the sale occurs, and the balance sheet will be immediately augmented by accounts receivable, but the statement of cash flows will not show an increase in available cash until the bill is paid. An example statement of cash flows:

Table 19.3

Statement of cash flows for Home Depot

	$ Million
Cash provided by operations	
Net income	$ 3,883
Adjustments to net income	
Depreciation	1,682
Changes in working capital	
Decrease (increase) in receivables	(170)
Decrease (increase) in inventories	256
Increase (decrease) in other current liabilities	405
Changes due to other operating activities	595
Total adjustments	$ 2,768
Cash provided by operations	6,651
Cash flows from investments	
Gross investment in tangible fixed assets	$(1,221)
Investments in other assets	92
Cash provided by (used for) investments	$(1,129)
Cash Provided by (Used for) Financing Activities	
Additions to (reductions in) long-term debt	$ 966
Net issues (repurchases of) shares	(3,164)
Dividends	(1,632)
Other	(218)
Cash provided by (used for) financing activities	$(4,048)
Net increase in cash	$ 1,474

Source: Home Depot *Annual Report*, year ending January 2012.

Notice that the first entry is net income followed by adjustments for components of income which has been recognized but for which cash has not yet changed hands.

Why is an increase in accounts receivable subtracted away?

What is a decrease in other current liabilities subtracted away?

Why is gross investment subtracted away?

Why are the proceeds from the issuance of new securities added back?

Especially for young startups that are burning money, the statement of cash flows (or a similarly functioning burn model) is critical. In the end, no matter how good an idea may be, if cash only flows out, success is unlikely to be realized.

CONCLUSIONS

This first note of the evening is designed to reintroduce you to the basic financial statements. In the next note, we take things a step further by analyzing financial ratios.