Module 17 Article

The 3 Financial Statements

Basics Of Accounting

Accounting describes the maintenance and analysis of the documents that give a complete overview of a company's financial performance and a snapshot of its position at a point in time. In general, financial statements shed light on everything money-related at a company. There are three main financial statements, which are the balance sheet, income statement, and cash flow statement. These documents go hand in hand yet provide different views of a company's financial position and are all crucial in evaluating a company.

High Level Overview

The income statement shows how much money a company spends and earns over a period of time. A balance sheet shows a snapshot of what a company owns and owes - referred to as its "assets" and "liabilities"- at a set point in time. The final document, the cash flow statement, shows how a company's cash flows are spent and earned.

A Balancing Act: The Balance Sheet

The balance sheet is a snapshot of a company's assets, liabilities, and shareholder's equity. An "asset" is something that a company owns that has value. This can include inventory, equipment, or just plain cash.

A liability on the other hand is essentially another word for debt - it is an amount of money that a company owes to others. This can include all sorts of obligations such as lines of credit, rent for a building, payroll, and more. "Shareholder's Equity" is the money a company would have left over if it sold all of its assets and paid off all of its liabilities.

The three components of the balance sheet create the standard accounting equation. Assets= Liabilities + Shareholder's equity. This means that assets have to balance with Liabilities and Shareholder Equity. When reading a balance sheet there are multiple ways to distinguish between the assets and liabilities. Typically the Assets will be listed, first followed by Liabilities and Shareholder's Equity. Sometimes Assets are on the left side of the sheet and Liabilities are on the right. Within these respective categories, there is a specific order of listing.

FOR EXAMPLE: Assets are listed in the order of ease with which they can be converted to cash. This means cash would be near the top while something like a patent would be near the bottom. For liabilities, line items are listed based when the money is owed. If a company has a loan due next week it would be at the top, compared to a fifteen year loan which would be close to the bottom.

The Shareholder's Equity section consists of the amount of money raised from shareholders as well as the difference in a company's profits and losses since inception. This is known as "retained earnings", and it tracks the amount that the company has made over time. Some companies pay their retained earnings out to shareholders as dividends.

Don't Fudge the Numbers: Income Statements
The income statement looks at a company's financial performance over a specific period of time, usually per year or quarter. It includes the company's revenues in addition to the costs/expenses associated with generating said revenue.

The last line on the income statement - creatively referred to as the "bottom line" - shows the company's net earnings or losses during the given time period.

One of the reasons the income statement is so important is it provides the numbers to calculate a company's earnings per share (EPS). EPS is a useful number as it shows how much money would be allocated to each stock if the company distributed all of their earnings that year. Of course this never actually happens, but it is a good metric to compare a company's performance.

Determining Profitability
Usually the income statement starts with the total revenue earned for the period. The following lines deduct various expenses from the period, slowly whittling down the revenue number to show you the profit at the "bottom line". Not all income statements follow this exact route and some need a closer look, but they all follow the same general idea.

A company's total revenues before expenses are called the "gross" revenue. The first deductions from the gross revenue will be for doubtful accounts/write-offs and for returns. The new number after these deductions is called net revenue.",
The next set of deductions, "cost of sales", covers all of the costs to create the goods or services sold. Once this deduction is removed from the net revenue it becomes "gross profit".

The final step is deducting all operating expenses. These include all of the costs required for the company to run, such as salaries and marketing costs. These differ from cost of sale expenses because they are not directly attributed to a given product or service, but are required for everything to operate. The number left after deducting all of these costs is called the "operating profit".

Spending Wisely: Cash Flow Statement
Cash flow statements show a company's inflow and outflow of cash during a certain period. The key difference between the income and cash flow statements is that a cash flow statement only describes where cash goes, and does not follow specific revenue recognition practices.

However, the cash flow statement is similar to the income statement in how it captures a representation of a period in time rather than a point in time like the balance sheet. A cash flow statement typically is broken up into three separate parts: Operating Activities, Investing Activities, and Financing Activities. These all factor into the bottom line, which shows the final cash flow from the company.

- **Operating Activities**: This section of the cash flow statement looks at the cash flow from the company's net income or loss. This involves reconciling the net income with the actual cash received or used in the operation of the company. This would require adjusting all non-cash items on the income statement like depreciation. It also includes anything that requires cash that was not included as a revenue or expense in the income statement.
- **Investing Activities**: This includes the purchase or sales of long-term assets like property or equipment. It also includes the sale or purchasing of investment securities if there is a cash component involved. If a company bought equipment it would have a negative cash flow for this section. If it sold equipment they would have a positive cash flow.
- **Financing Activities**: This portion of the Cash Flow Statement includes selling or purchasing securities if there is a cash component. It also includes loaning money from a bank and likewise, paying off the loan.

The Bottom Line

The three financial statements provide a comprehensive overview of a company's financial state. The Balance Sheet shows a company's assets, liabilities and equity. The income statement shows financial performance during a specific period. The cash flow statement shows the inflows and outflows of cash from a company during a specific period.