

Understanding Financial Statements

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Basic Definitions

- ▶ **Asset** - Something of value you own.
- ▶ **Equity** - Claim to those assets.
- ▶ **Liability** - Something you owe.
- ▶ **Liability is an equity.** Creditors' claim to assets. (They have first dibs).
- ▶ **Owners Equity** - Owners' claim to assets. The amount left over after liabilities are deducted.

Basic Accounting Equation

Assets = Equities

or

Assets = Liabilities + Owners' Equity

MUST ALWAYS BALANCE. ALWAYS.

Example...Our friend **Joe**

- ▶ **Joe** has a \$20 bill. He does not owe anyone.
- ▶ \$20 asset = \$0 liability + \$20 owners' equity.
- ▶ **Joe** borrows \$5 from **Sam**.
- ▶ \$25 asset = \$5 liability + \$20 owners' equity.
- ▶ **Joe** rakes leaves for one hour and earns \$10.
- ▶ \$35 asset = \$5 liability + \$30 owners' equity.
- ▶ **Joe** pays **Sam** back what he owes him.
- ▶ \$30 asset = \$0 liability + \$30 owners' equity.

BALANCED!

Balance Sheets

Balance Sheet
is like a photograph.
Captures the status of a
business at a point in time.



Definitions - Assets

Common Assets: include cash, accounts receivable, inventory, property, buildings, equipment, and other assets (including intangibles).

- ▶ **Accounts Receivable:** Amounts owed by customers to whom we have extended credit.
- ▶ **Inventory:** Items purchased or manufactured by us to sell to our customers.
- ▶ **Fixed Assets:** Long term assets we purchased. Includes buildings, vehicles, and equipment.
- ▶ **Intangible Assets:** Items that companies invest but have no physical presence. Examples include trademarks, trade names, logos, etc.

Definitions - Assets

- ▶ Different classifications of assets are:
 - ▶ **Current Assets** - Assets to be converted to cash or consumed within the next year.
 - ▶ **Fixed Assets** - purchased by the business to be used over multiple years. Property, plant, and equipment.
 - ▶ **Intangible Assets** - see above.
 - ▶ **Other** - Assets not able to fit in the above classes.

Definitions - Liabilities

- ▶ **Liabilities** are classified as either Current or Long-Term.
 - ▶ **Current Liabilities:** To be paid within the next year or less.
 - ▶ **Long-Term Liabilities:** To be paid but not until at least one year from now.

Current listed first.

Stockholders' Equity

- ▶ **Original money** invested by owners usually in common stock.
- ▶ **Retained Earnings:** Past accumulated earnings of the business that have not been paid out to the owners' in dividends. All earnings from inception **RETAINED** in the business.

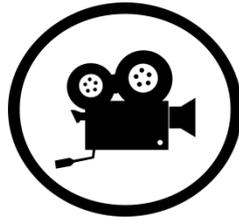
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Joe's Income Statement

- ▶ **Joe** is hungry and buys a candy bar for \$2.
- ▶ \$28 asset = \$0 liability + \$28 owners' equity.
- ▶ **Income statement** explains part of the change in owners' equity.
- ▶ Revenue \$10
- ▶ Expenses (\$2)
- ▶ Net Income \$8

Income Statements

Income Statements are like a movie. It shows how the plot changes from the beginning to the end of the period.



Joe started with \$20 equity but ended with \$28 equity. **Income Statement** explained the \$8 difference.

Income Statement

- ▶ Heading tells us what period of time being covered. Usually month, quarter, or year.
- ▶ Major sections are Revenue and Expenses.
- ▶ Gross Sales less returns and allowances resulting in Net Sales.
- ▶ Sales can be lumped together or broken down into different categories. Who is your audience?

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Cost of Goods Sold

- ▶ This is the first section of expenses for companies that sell either finished products purchased from their suppliers or products they create/manufacture from raw materials.
- ▶ Basic formula is:
 - Inventory at the beginning of period
 - + Inventory purchased during the period
 - Inventory remaining at the end of the period
 - = Cost of Goods Sold for the period**

Gross Profit

- ▶ Basic formula for this section:

Net Sales - Cost of Goods Sold = Gross Profit

This would be what we would have as a profit **IF** there were no operating expenses.

Operating Expenses

- ▶ Salaries
- ▶ Insurance
- ▶ Utilities
- ▶ Rents
- ▶ Depreciation
- ▶ Repairs & Maintenance
- ▶ Interest
- ▶ Taxes-Payroll and Others
- ▶ Supplies
- ▶ Employee Benefits
- ▶ Etc., Etc.

Other Income-Expenses

This section is for income and expenses that do not normally occur in operations.

- ▶ Investment Income
- ▶ Interest Income
- ▶ Income from scrap metal
- ▶ Loss on sale of equipment
- ▶ Expenses for opening a new branch

Net Income or Loss

Net Sales - Cost of Goods Sold = Gross Profit

**Gross Profit - Operating Expenses = Net Income from
Operations**

then

**Net Income from Operations + Other Income
- Other Expenses =
Net Income(Loss)**

Sections of Cash Flow Statement

- ▶ Cash Flows from Operations.
- ▶ Cash generated or used from Investing Activities. Primarily from buying or disposing of fixed assets.
- ▶ Cash generated or used from Financing Activities. Purchase of additional shares of stock or cash dividends.

Cash Flow Statement ???s

“Income Statement shows a net income, but the cash balance has declined!”

- ▶ This can be explained by one word-TIMING.
 - ▶ Sales revenue recorded but not paid by customer (Accounts Receivable).
 - ▶ Expenses recorded but not paid by us (Accounts Payable).
 - ▶ Property and Equipment purchased.
 - ▶ Money borrowed from bank.
 - ▶ Non-cash expenses (Depreciation Expense).
 - ▶ Dividends paid to owners.
 - ▶ Additional stock purchased by owners.

Cash Flow Statements

Decrease in cash not necessarily a bad thing.

Statement of Cash Flows helps explain why cash went up or down during the period.

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