Go Figure!

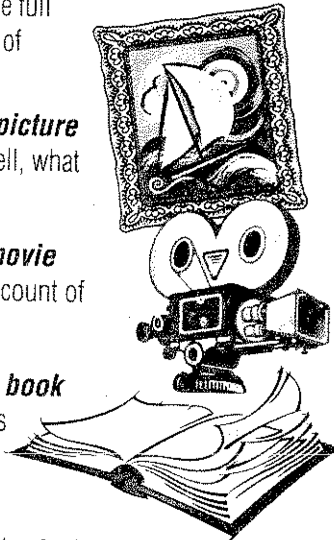
Information in Financial Statements

Objective

A

What's the Story?

What could you do to get the full story from the best sources of information?



- You could look at the ***picture*** that shows, in a nutshell, what the story is about.
- You could watch the ***movie*** that gives a running account of the story's events.
- Or, you could read the ***book*** that reveals the details you just can't get anywhere else.

Even if you have to stand in line for hours to get just one picture, one movie ticket, or one copy of the book, you might not mind if you *definitely* want the information.

In the same way, investors would want to spend time with a company's **financial statements**—if they *definitely* want to learn about the company's financial situation. (After all, their money is on the line.) To find out everything they can, investors look at *all three* elements: the balance sheet, the income statement, and the cash flow statement.

Let's take a look at each.

Objectives:

A. **Discuss the elements of a company's financial statements.**

B. **Explain the purpose of the notes to the financial statements.**

Balance Sheet—The Picture

The **balance sheet** provides investors a freeze-frame of one moment in time—a "picture" of the company's financial situation on a particular date. The way a balance sheet is presented makes it stand out from the other financial statements. On the left (or top) are the assets, and on the right (or bottom) are the liabilities and stockholders' equity. The two sides must *balance,* or equal each other, according to this formula:

Assets = Liabilities + Equity

BALANCE SHEET
(December 31, 20XX)

Assets		**Liabilities & Equity**	
Current Assets	$120,000	Current Liabilities	$420,000
Cash			
Accounts Receivable			
Property and Equipment	$560,000	Long-term Liabilities	$34,000
Other Assets	$14,000	Stockholders' Equity	$240,000
Goodwill			
	$694,000		$694,000

So, what exactly *are* assets, liabilities, and equity? **Assets** are whatever brings value to the company—such as cash, property, or a well-known brand. **Liabilities** are whatever the company owes to others, such as debts to be paid over time. **Equity** is what's left over when you subtract the liabilities from the assets. It's the company's actual net worth.

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Objective A

Let's take a closer look at the two sides of the balance sheet.

Assets. At the very least, assets are made up of three main categories:

- Current assets
- Property and equipment
- Other assets

Current assets include money the company has right now (cash) *and* money that should be coming in within the next year (accounts receivable). The **property and equipment** category includes exactly what you'd expect: land, buildings, and machinery. **Other assets** include any assets *not* considered part of the first two categories, such as goodwill.

Liabilities. You'll find three categories on the liabilities side, too. They are:

- Current liabilities
- Long-term liabilities
- Stockholders' equity

Current liabilities are debts owed within a year, such as short-term loans and accounts payable. **Long-term liabilities** are debts owed over a long period of time, such as a mortgage. The **stockholders' equity** is the net worth (or book value) of the company. It's what the stockholders (also called shareholders) have left after the liabilities have been subtracted from the assets.

In all, the balance sheet shows investors a "picture" of the company's financial situation at a specific moment.

Income Statement—The Movie

The **income statement** provides investors with a feature-length "movie" of how profitable the business has been during a period of time, usually a year. It primarily communicates the company's profit or loss.

On the income statement, you can find the main parts of the company's financial story in these categories:

- Sales
- Cost of goods sold/ Cost of sales
- Gross profit
- Operating expenses
- Operating profit
- Interest expense
- Pre-tax profit
- Income-tax expense
- Net income
- Earnings per share

The categories are arranged in a general larger-to-smaller format, with some "totals" sprinkled in along the way. The idea is to subtract specific expenses from sales, resulting in the net income.

INCOME STATEMENT

(Period ending December 31, 20XX)

Sales	$350,000
Cost of goods sold/Cost of sales	$175,000
Gross profit	$175,000
Operating expenses	$25,000
Operating profit	$150,000
Interest expense	$32,000
Pre-tax profit	$118,000
Income-tax expense	$52,500
Net income	$65,500
Earnings per share	$2
[*35,000 shares outstanding*]	

Sales. The money a company receives in return for its products is its **sales** income. In many cases, the firm's entire income comes from sales. Since some companies bring in money in additional ways, this category can also be called *revenues,* a term that means "money coming in."

Cost of goods sold or **cost of sales.** Getting a product ready to sell costs money. The **cost of goods sold (COGS)** can include a good's raw materials, the money it takes to manufacture and package the good, and the money needed to transport the good (or otherwise prepare it for sale). You mainly find COGS in financial statements from manufacturing firms. Many businesses that purchase—not produce—products use the term **cost of sales** to describe pre-sale product-related costs, if any. Whatever the situation, if a company spends money directly on a product before selling it, you'll find the cost in this category.

Gross profit. When you subtract the cost of goods sold (or the cost of sales) from the company's sales, you get the **gross profit.** Looking at this category helps you to see—at a glance—if the company is spending a large amount of its sales income on preparing products for sale.

Operating expenses. The cost of goods sold (or the cost of sales) isn't the only expense involved in running a business. There are also mortgage, utilities, administrative, and selling

costs. Whatever a business spends to keep itself running can be found in the category called **operating expenses.**

Operating profit. By subtracting operating expenses from gross profit, you can see whether a company is run efficiently compared to other companies in the same industry. The **operating profit** tells you how much money the business has to work with before it pays interest and taxes.

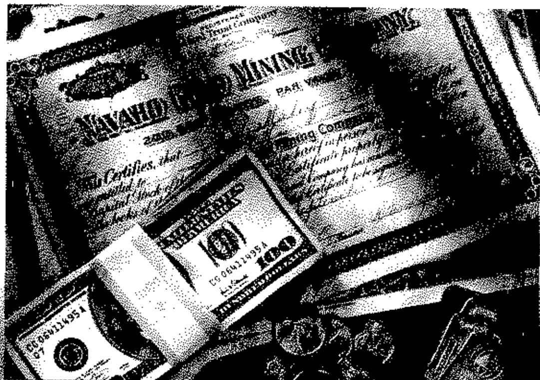
Interest expense/income. Since businesses must pay for the money they borrow, the interest expense is accounted for here. Interest can also come *into* the company from loans to other businesses. In this case, interest is not expense but income.

Pre-tax profit. Subtracting the interest expense from the operating profit gives you the company's **pre-tax profit.** If you want to see how much money a company has to work with before paying taxes, look in this category. The pre-tax profit is significant because it represents the profit totally within management's control. (The only item left is taxes, and no one can really control them.)

Income-tax expense. Income taxes can vary from year to year, but all businesses are required to pay them. How much they pay depends on their level of income and the state in which they're incorporated.

Net income. When you subtract income-tax expense from pre-tax profit, you're left with the bottom line: **net income.** This amount is sometimes called *net profit* or *net earnings*—because it represents the overall excess or shortage for the year. By answering the question, "Is the business profitable?" this category is the most important item on the income statement. You can think of it as the main point of the company's financial story.

Earnings per share (EPS). Many income statements include one more thing. They calculate the **earnings per share**—dividing the company's net income by the number of its outstanding shares of common stock. The result shows the excess or shortage applied to *one* share of the company. It's similar to a "what this means to you" section. If you're an investor in the company, you'll want to know how the net income affects *your* investment.



Cash Flow Statement—The Book

But, investors can't get the *full* story from simply the balance sheet (the picture) and the income statement (the movie). It's the company's **cash flow statement**, the book, that provides the details necessary to determine specifically where the company's money came from, and where it went, over a period of time.

CASH FLOW STATEMENT

(Period ending December 31, 20XX)

Cash from Operations:	
Pre-tax profit	$118,000
Additions to Cash	
Depreciation	$2,500
Decrease in accounts receivable	$3,700
Increase in taxes payable	$2,050
Subtractions from Cash	
Decrease in accounts payable	($14,350)
Increase in inventory	($17,920)
Net cash from operations	**$93,980**
Cash from Investing:	
Equipment	($57,500)
Cash from Financing:	
Notes payable	$6,450
Net increase or decrease in cash	**$42,930**

The cash flow statement separates cash income and outflow into three categories:

- Operations—the cash the business uses to stay in operation
- Investing—the cash the business puts into investments
- Financing—the cash the business owes to others

These three categories show investors the *exact* income and outflow of cash, as the bank sees it: *Here,* some money came in; *there,* some money went out. This means that money that's expected to come in is not counted until it actually arrives, unlike the way the balance sheet and the income statement report income.

In fact, the balance sheet and the income statement leave investors with unanswered questions, such as, "How does the company handle its cash?" or, "What kind of spending habits characterize the company?" Only the cash flow statement provides the answers to these questions. And, the answers tell a lot about whether having cash on hand is important to a business.

Not only should cash be important to a business, but cash should also come primarily from operations—meaning that a company's operations should be able to support the business over the long term. From the cash flow statement, investors can see if the company is relying on cash from somewhere else (from investments or financing), instead of relying on cash from operations.

In short, the cash flow statement gives investors the details they need in a format that reveals how the company handles its money. It's the final piece of information for investors who want the full story.

Read the Fine Print

Just as the fine print on a television advertisement mentions information you don't hear from the narrator, the notes to the financial statements mention information you don't see in the statements themselves. This means that without the notes, the statements could be somewhat misleading—because they describe only *part* of the story. So, to be complete, the financial statements must always include the notes.

But besides that, what makes the notes necessary? The notes are necessary for informing investors about things they need to know, such as:

- Which methods are used
- How the statements have been consolidated
- Which obligations the company has
- What might affect the earnings per share

By making investors aware of these things, companies reveal (or disclose) what's going on behind the scenes to make the numbers what they are. And, this makes it easier to evaluate the numbers—correctly.

Let's take a look at the information the notes disclose.

Which methods are used. Since accounting can be performed in different ways, it's important for investors to know which method of accounting has been used: cash or accrual. Cash accounting counts the money "in hand," whereas accrual accounting counts money that is expected to come in at a later time. Other methods, such as depreciation and inventory valuation, are also included here.

How the statements have been consolidated. If a company "owns" several smaller companies, or divisions, it may put together one *overall* set of financial statements. Of course, investors want to know how the company has accomplished this.

Which obligations the company has. Does the company have a pension plan to pay for? Are there any pending lawsuits? And, what exactly are the interest rates and maturity dates for the bonds the company has issued? Answers to these questions provide insight into what the company owes (or might owe) to others, now or in the future.

What might affect the earnings per share. If there are stock options or employee stock ownership plans, companies mention these in the notes, too—so that investors are aware of what might influence the earnings per share.

Reading the notes should be a universal practice. A successful investor makes a point to pay close attention to the fine print.