

# FINANCE FOR NON-FINANCIAL PROFESSIONALS, MANAGERS, & OWNERS

MODULE #2

## Financial Statements



Starting with  
Cash Flow



The Big "3"  
Financial  
Statements



Additional Financial  
Statement Essentials



# EXPLANATION OF HELPFUL ICONS

This icon asks you keep in mind an important point that is central in the explanation of the topic at hand and something to **remember** throughout all of the content presented.



This icon serves as a bookmark tagging a helpful or **great tip** to keep in mind as you move through the course content as well as applying the financial concepts learned in the real world.



This icon serves as a bookmark tagging an extremely significant or **key concept**, idea, or point that will resonate not just with the material being presented but throughout all of the course content.



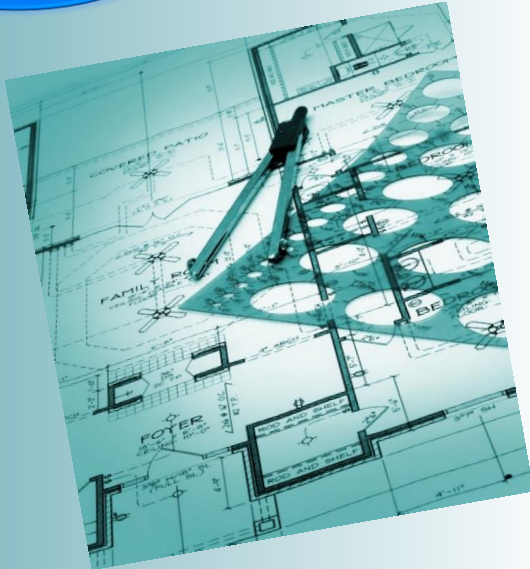
As you may surmise, this icon serves as a “red light” or **warning** that the going gets a little heavier here. You may have to slow down and digest this material more carefully and ponder it more than usual.



Let's Begin:  
Our Vision!

# FINANCIAL STATEMENTS

## THE HEART OF THE MATTER



Financial statements represent the heart and soul of the company's financial performance. Just like a body depends on the heart for its well being, the financial report is dependent on on the financial statements.



### A Base

Are the base or foundation of the report, everything revolves around them.

### A Statement

Are a "statement" of performance, condition, & well being!

### A Purpose

To assist external parties and internal business managers with making informed business decisions. Period!

# FINANCIAL STATEMENTS LEARNING OBJECTIVES

## Part 1: Starting With Cash Flow:

- The Importance of Cash Flow
- What Does Cash Flow Not Tell You
- Two Simple Rules (Almost)

## Part 2: The Big Three Financial Statements:

- First Up, The Income Statement (or P&L)
- Next Up, The Statement of Cash Flows
- Last but Not Least, The Balance Sheet

## Part 3: Additional Financial Statement Essentials:

- Three Key Attributes & Financial Statement Jargon
- Other Financial Statements
- The Non-Finance Professionals' Financial Responsibility

# FINANCIAL STATEMENTS – STARTING WITH CASH FLOW

Why Start with Cash Flows? Most difficult to understand and/or overlooked by third parties but often is the most important!

First

- The ability to support on-going operations and business growth.

Second

- An assessment of management's performance in terms of properly managing company assets and liabilities.

Third

- The ability to service debt (i.e., pay outstanding obligations and liabilities).

Fourth

- The core measurement or tool used to value a business.





# FINANCIAL STATEMENTS – STARTING WITH CASH FLOW

What does the Cash Flow Statement  
not tell you!

First

- The financial condition of a business at a point in time. Solvency and liquidity. This is the role of the balance sheet.

Second

- The profit earned or loss suffered by a business over a period of time. This is the role of the income statement.



# FINANCIAL STATEMENTS – STARTING WITH CASH FLOW

Two Simple Rules to help Understand Cash Flows.

## Sources of Cash - Credits

- Recording a sale to a customer.
- Increase to a Liability (e.g., New Loan).
- Increase in Stockholder's Equity (e.g., sale of stock).

## Uses of Cash - Debits

- Incurring a business expense (e.g., advertising).
- Purchasing an asset (e.g., computers).

## Exceptions to every Rule

- Depreciation, & Amortization Expense (non-cash).
- Employee stock option expense (non-cash).



A number of accounting transactions involve both a debit and a credit and as such, have no immediate impact on Cash. Example, incurring an expense (a debit) but not paying for 30 days so a liability increases (a credit).

Part 2:  
The Big Three

# FINANCIAL STATEMENTS – 1<sup>ST</sup> UP, THE INCOME STATEMENT

The Income Statement (A.K.A. Profit & Loss Statement, or “P&L”).

## Purpose

- Reports the “financial performance” or whether a business generated a profit or loss over a period of time (e.g., one year or 12 months).

## Presents

- Sales revenue (what a business sold), expenses (what costs or expenses a business incurred), and whether a net profit ( $\text{Sales} > \text{expenses}$ ) or a net loss ( $\text{Sales} < \text{expenses}$ ) was realized.



Profits  $\neq$  success and likewise, losses  $\neq$  failure. Best measured against “expectations”.



# FINANCIAL STATEMENTS – 1<sup>ST</sup> UP, THE INCOME STATEMENT

## Typical Income Statement Format, 7 Steps

1. **Sales Revenue, net** is reported at the top of the income statement.
2. **Costs of goods sold** is reported next, just under sales revenue.
3. **Gross profit or gross margin** is then reported and is calculated by subtracting costs of goods sold from net revenue.
4. Business **operating expenses** (or often referred to as selling, general, & administrative expenses, “SG&A”), are then listed.
5. **Operating income** is then reported and is calculated by subtracting operating expenses from the gross profit.
6. Next up are **other expenses and income** (e.g., depreciation expense, interest expense, income taxes, etc.) which are presented just below operating income.
7. Finally, **net profit or loss** is reported which is calculated by subtracting other expenses and income from operating income.

Refer to slide 10 for an example of  
a standard income statement.

Part 2:  
The Big Three

# FINANCIAL STATEMENTS – 1<sup>ST</sup> UP, THE INCOME STATEMENT

Notice the order of presentation, steps 1 through 7 starting with Sales Revenue and ending with Net Profit (Loss).

The Company's net income or profit does not equal positive cash flow (refer to slide 13, line 5).

Income Statement For the Twelve Month Period Ending (all numbers in thousands)				12/31/2012	12/31/2013
Sales Revenue, Net	1			\$51,615	\$55,902
Costs of Goods Sold	2			<u>(\$23,179)</u>	<u>(\$26,122)</u>
Gross Profit	3			<u>\$28,436</u>	<u>\$29,780</u>
Gross Margin	3			<u>55.1%</u>	<u>53.3%</u>
Total Operating Expenses	4			<u>\$24,165</u>	<u>\$25,665</u>
Operating Income	5			<u>\$4,271</u>	<u>\$4,115</u>
Depreciation & Amortization Expense	6			\$1,720	\$2,295
Interest Expense	6			\$150	\$350
Other Expenses (Income)	6			<u>\$250</u>	<u>\$1,000</u>
Net Profit (Loss) before Income Taxes				<u>\$2,151</u>	<u>\$470</u>
Income Tax Expense (benefit)	6			<u>\$753</u>	<u>\$165</u>
Net Profit (Loss)	7			<u>\$1,398</u>	<u>\$305</u>
Shares Outstanding				<u>1,500</u>	<u>1,500</u>
Earnings (Loss) Per Share				<u>\$0.93</u>	<u>\$0.20</u>

Comparative income statements for the two most recent fiscal years ending (covering 12 months each) have been provided.

Also notice another simple calculation and important piece of information, earnings per share.

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Part 2:  
The Big Three

# FINANCIAL STATEMENTS – NEXT UP, THE STATEMENT OF CASH FLOWS

The Statement of Cash Flows (A.K.A. the Cash Flow Statement).

## Purpose

- Reports how a business generates and consumes cash over a period of time (e.g., one year or 12 months, like the income statement).

## Presents

- Operating sources/uses of cash (associated more closely with internal business operations) and investing sources/uses of cash & financing sources/uses of cash (associated more closely with external business activities).



Remember this statement: In the Black but where's the Green? What this means is that a company generated a profit but did not produce positive cash flow.

# FINANCIAL STATEMENTS – NEXT UP, THE STATEMENT OF CASH FLOWS

## Typical Statement of Cash Flows Format, 5 Steps

### #1 Cash Flow from Operating Activities

This is listed first, and includes the company's net income or loss plus depreciation and amortization expense and plus or minus other non-cash transactions.

### #2 Changes in Working Capital

Increases or decreases in current assets and current liabilities are listed next with a subtotal then offered that presents ***cash flow from operating activities***.

### #3 Cash Flow from Investing Activity

This typically represent uses of cash invested in purchases of machinery & equipment, intangible assets (e.g., patents), and other investments.

### #4 Cash Flow from Financing Activity

This typically represent sources of cash such as securing a new loan, selling equity in the company, and other financing activity.

### #5 Net Increase or Decrease in Cash

The net increase or decrease in cash flow is then calculated at the bottom of the statement. It sums the current period net change in cash flow, adds it to the beginning cash balance, then calculates the ending cash balance.

Part 2:  
The Big Three

# FINANCIAL STATEMENTS – NEXT UP, THE STATEMENT OF CASH FLOWS

Net profit is reported first (which agrees to the company's net income in slide 10, line 7), then depreciation expense is added along with changes (positive and negative) in the company's net working capital to calculate cash flow from operating activities.

Statement of Cash Flows For the Twelve Month Period Ending (all numbers in thousands)		12/31/2012	12/31/2013
Net Income (loss)	1	<u>\$1,398</u>	<u>\$305</u>
Operating Activities, Cash provided or used:			
Depreciation & Amortization	1	\$1,720	\$2,295
Decrease (increase) in accounts receivable	2	(\$557)	(\$536)
Decrease (increase) in inventory	2	(\$378)	(\$416)
Decrease (increase) in other current assets	2	(\$50)	\$0
Increase (decrease) in trade payables	2	\$173	\$185
Increase (decrease) in accrued liabilities	2	\$63	\$63
Increase (decrease) in other liabilities	2	(\$15)	(\$196)
Net Cash Flow from Operating Activities	2	<u>\$2,354</u>	<u>\$1,700</u>
Investing Activities, Cash provided or used:			
Capital Expenditures	3	(\$5,000)	(\$750)
Investments in Other Assets	3	<u>\$0</u>	<u>(\$7,500)</u>
Net Cash Flow from Investing Activities	3	<u>(\$5,000)</u>	<u>(\$8,250)</u>
Financing Activities, Cash provided or used:			
Sale (repurchase) of Equity	4	\$5,000	\$0
Proceeds from Issuance of Debt	4	\$0	\$5,000
Repayments of Long-term Debt	4	(\$1,000)	(\$1,000)
Other Financing Activities	4	<u>\$250</u>	<u>\$0</u>
Net Cash Flow from Financing Activities	4	<u>\$4,250</u>	<u>\$4,000</u>
Other Cash Flow Adjustments - Asset Impairment	5	<u>\$0</u>	<u>\$0</u>
Net Increase (decrease) in Cash & Equivalents	5	<u>\$1,604</u>	<u>(\$2,550)</u>
Beginning Cash & Equivalents Balance	5	<u>\$2,682</u>	<u>\$4,286</u>
Ending Cash & Equivalents Balance	5	<u>\$4,286</u>	<u>\$1,736</u>

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The company has made significant investments in equipment and other assets over the past two years. Where did the cash come from?

The Company's net cash flow does not equal its net income or profit (refer to slide 10, line 7).

Part 2:  
The Big Three

# FINANCIAL STATEMENTS – LAST BUT NOT LEAST, THE BALANCE SHEET

The Balance Sheet (A.K.A. the Statement of Financial Condition)

## Purpose

- Represents the “financial condition” of a business at a point and time.

## Presents

- Assets (what a business owns), Liabilities, (what a business owes), and Owners’ Equity (total assets less total liabilities).



The balance sheet must balance, or simply,  $\text{Total Assets} = \text{Total Liabilities} + \text{Total Equity}$ .



# FINANCIAL STATEMENTS – LAST BUT NOT LEAST, THE BALANCE SHEET

## Typical Balance Sheet Format, 3 Steps + 1

### **Assets**

Represent financial claims and ownership rights a company has on property (tangible or intangible), and are presented on the left side of the balance sheet.



### **Liabilities**

Represent financial obligations or debts a company owes, and are presented on the right side of the balance sheet.



### **Stockholder's Equity**

Represents the sources of ownership of the company, and is presented on the right side of the balance sheet, below liabilities, to emphasize that owners of a business have a secondary or lower claim on the assets (after liabilities are satisfied).

### **And the Plus 1**

Assets are listed in the order of how quickly the asset can be turned into cash.  
Liabilities are listed in the order of how quickly cash will be required to satisfy the obligation & by legal claim status.  
Thus, current assets are listed before long-term assets and current liabilities are listed before long-term liabilities.

*Refer to slide 16 for an example of  
a standard balance sheet.*

Part 2:  
The Big Three

# FINANCIAL STATEMENTS – LAST BUT NOT LEAST, THE BALANCE SHEET

Assets are presented on the left side of the balance sheet and liabilities and equity on the right side.

Balance Sheet Period Ending (all numbers in thousands)	12/31/2012	12/31/2013	Balance Sheet Period Ending (all numbers in thousands)	12/31/2012	12/31/2013
<b>Assets</b>			<b>Liabilities</b>		
Current Assets:			Current Liabilities:		
Cash & Equivalents	\$4,286	\$1,736	Accounts Payable	\$1,973	\$2,158
Accounts Receivable, Net	\$6,452	\$6,988	Accrued Expenses	\$718	\$781
Inventory, LCM	\$4,159	\$4,575	Current Portion of Debt	\$1,000	\$1,000
Prepaid Expenses	<u>\$300</u>	<u>\$300</u>	Other Current Liabilities	<u>\$251</u>	<u>\$55</u>
Total Current Assets	<u>\$15,197</u>	<u>\$13,599</u>	Total Current Liabilities	<u>\$3,942</u>	<u>\$3,994</u>
Long-Term Operating & Other Assets:			Long-term Liabilities:		
Property, Plant, & Equipment	\$12,200	\$12,950	Notes Payable, Less Current Portion	\$2,000	\$6,000
Accumulated Depreciation	<u>(\$2,585)</u>	<u>(\$3,880)</u>	Other Long-term Liabilities	<u>\$500</u>	<u>\$500</u>
Net Property, Plant, & Equipment	<u>\$9,615</u>	<u>\$9,070</u>	Total Long-Term Liabilities	<u>\$2,500</u>	<u>\$6,500</u>
Intangible Assets & Goodwill, Net	\$1,000	\$7,500	<b>Total Liabilities</b>	<u>\$6,442</u>	<u>\$10,494</u>
Other Assets	<u>\$100</u>	<u>\$100</u>	<b>Stockholders' Equity</b>		
Total Long-Term Operating & Other Assets	<u>\$10,715</u>	<u>\$16,670</u>	Capital Stock	\$15,000	\$15,000
<b>Total Assets</b>	<u>\$25,912</u>	<u>\$30,269</u>	Retained Earnings	<u>\$4,470</u>	<u>\$4,775</u>
			<b>Total Stockholder's Equity</b>	<u>\$19,470</u>	<u>\$19,775</u>
			<b>Total Liabilities &amp; Stockholders Equity</b>	<u>\$25,912</u>	<u>\$30,269</u>

Current assets and liabilities are considered  $\leq 12$  months. Long-term  $> 12$  months.

Total assets = total liabilities + total equity.

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Balance sheets are prepared as of a “point in time” or close of business on the last day of the income statement reporting period. E.G., a company’s fiscal year ends on 12/31/13 so the balance sheet would be prepared as of that date.

# FINANCIAL STATEMENTS – ADD. FINANCIAL STATEMENT ESSENTIALS

## Three Key Attributes

### **Plural:**

The term financial statements is “plural” and means that the “financials” (as financial statements are often referred to) include all of the Big Three Financial Statements (at a minimum).

### **Comparative:**

Information is provided by many businesses that offer multiple years or periods of financial information to compare operating results (e.g., 2011 income statement compared to 2012).

### **Consistent:**

Financial Statements need to be presented on a consistent basis, using the same accounting policies, procedures, and reporting methods.

# FINANCIAL STATEMENTS – ADD. FINANCIAL STATEMENT ESSENTIALS

## Financial Statement Jargon & Lingo

### Colors

**Black** – In the black means the company generated a profit.

**Red** – In the red means the company incurred a loss.

**Green** – Produced positive cash flow (or lots of green Dollars).

### Lines & Ex's

**Top** – The “Top” line refers to a company’s total sales revenue.

**Bottom** – The “Bottom” line refers to a company’s net profit or loss.

**Op. Ex** – Short for a company’s total operating or selling, general, & administrative expenses.

**Cap. Ex** – Short for a company’s total expenditures made on capital assets (e.g., equipment, computers, etc.).

### Books

**Books & Records** – Refers to a company’s accounting for and record of all financial transactions.

**Cooking the Books** – Refers to a company potentially misstating its financial performance on purpose (i.e., committing fraud).

**Creative Accounting** – Refers to a company using “aggressive” accounting policies (i.e., “massaging” the numbers).

# FINANCIAL STATEMENTS – ADD. FINANCIAL STATEMENT ESSENTIALS

## **Statement of Retained Earnings:**

This financial statement presents information on how a company has re-invested earnings (i.e., Profits) versus how a company may distribute earnings (i.e., dividends).

## Other Financial Statements

## **Statement of Stockholders' Equity:**

For larger companies, with a more complex and active equity structure, a statement of stockholders' equity may be provided (reporting all activity related to the Company's ownership).

## **Supplemental Reports:**

A number of companies like to attach supplemental financial statements or reports which provide more detail to support information presented in one of the big three financial statements.



These other financial statements may be provided but should always accompany the big three financial statements and not replace the big three.

# FINANCIAL STATEMENTS – ADD. FINANCIAL STATEMENT ESSENTIALS

## The Non-Finance Professionals' Financial Responsibility

### Return on Capital

- Remember, There's no such thing as a free lunch! A return on capital must be generated.

### Risk Reward Relationship

- This simple relationship should always hold. The higher the risk, the higher the required return.

### Profit and Cash Flow as Measurements

- Net Profit and internal cash flows are the two most common metrics used to determine financial returns.

### Financial Statements as a Tool

- The big three financial statements provide the necessary financial information on which to evaluate and analyze the financial operating results.

### Safeguard Company Assets

- Company assets must be safeguarded at all times, especially in the digital age as information and intellectual property (IP) represent invaluable business assets!



In Closing –  
Three Keys

# FINANCIAL STATEMENTS – UNDERSTAND, TRUST, & RELY

## Understand

It is important to understand the ***Income Statement*** and whether a company is profitable or not, but remember this represents just one element of a business's financial condition and tells only a portion of its financial health and performance story.

## Trust

Appropriately, the quick and frequently used reference or acronym for the ***Balance Sheet*** is "BS." So without going into a great deal here, it is of critical importance that you trust the balance sheet. That is, you need to make sure the assets listed on the balance sheet are not lying and its liabilities presented are telling the whole truth.

## Most importantly, Rely

Understand the P&L and trust the BS but most importantly, rely on the ***Cash Flow Statement***. The cash flow statement is the life blood of every business and offers invaluable insight of the financial condition of a business as to how it produces and consumes cash, in good times and bad.