Never spend your money before you have earned it.

Thomas Jefferson

Module Three: Understanding Financial Statements

Financial statements are the communication tools for the organization. There are many aspects of a business's financial dealings reported in financial statements. Revenues coming in and expenses going out are key data that require reporting. Tangible items like equipment, property, and cash reserves are also reported in financial statements. Understanding these financial statements opens the door to analyzing finance data for budgeting, controlling, and making decisions.

This module will discuss the following topics:

- Balance sheets
- Income statements
- Statement of retained earnings
- Statement of cash flows
- Annual reports

The two most widely known statements are the balance sheet and income statement.

Balance Sheets

The balance sheet is a report on the financial condition of an organization and is required by GAAP. In the balance sheet, assets are expressed in terms of liabilities and capital, which must equal each other.

Assets are the cash on hand, properties owned, and monies owed to the organization and can be liquidated and pay the organization's debt.

Liabilities are the debts the organization owes to their creditors and this goes against assets. In addition, the organization's assets belong to the owners, this is called capital, and this goes against the assets.

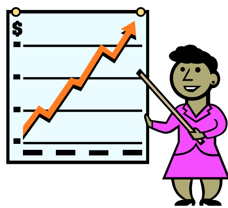
The balance sheet can reveal a lot about a company. The level of debt the companies owes against what it owns in cash and properties could reveal a liquidity problem.

Furthermore, if a company has no debts and huge level of assets, this may be a sign that the company is not running efficiently and is allowing the assets to remain idle instead of using it for a return.

Balance sheets are usually set up as columns always comparing the assets versus the liabilities and capital. Many times balance sheets will show the previous month or year's data for comparison.

Later in this course, you will get a chance to use the figures from the balance sheet to determine specific financial ratios that will help you understand the organization's financial condition.

Income Statements (AKA Profit & Loss Statements)



The income statement is a summary of the income and expenses of an organization in a given period and is required by GAAP. Usually companies create monthly and yearly income statements.

Income statements list all the areas where income is generated. Sometimes, the income is categorized certain categories:

- Income from sales
- Income from interest
- Income from investments

The income statement also contains the expenses and this can be categorized too:

- Dividend expense
- Operating expense
- Cost of goods sold
- Taxes

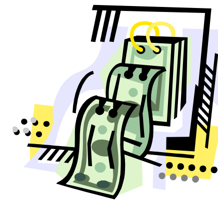
The net income or loss is calculated by subtracting the expenses from the income. This number represents the income or loss after all expenses are applied. This number is usually incorporated into the statement of retained earnings discussed later in this module.

The income statement gives you the ability to determine how well the company is bringing in income. If the expenses are greater than the income then the net income will become the net loss, which subtracts from the owner's equity in the statement of retain earnings.

The income statement is also called the Profit and Loss Statement because it indicates by the calculations mention earlier.

The format of the income statement is usually in column format and it can be presented along with the previous month or year's information for quick comparisons. In addition, you may see the changes expressed in percentages.

Statement of Retained Earnings



The statement of retained earnings can appear on a balance sheet, income statement or a separate financial report. This report is required by GAAP and it reports the change in owner's equity from one period to another.

The basic components of the statement of retained earnings include the following:

- Beginning balance
- Net Income/loss
- Dividends paid
- Ending balance

The resulting calculation is then applied to the owner's equity under the capital heading on the balance sheet.

Statement of Cash Flows

The statement of cash flows helps to determine how cash flowed in and out of the company. This is considered a mandatory financial report. The statement of cash flows does not factor in cash flows from credit transactions or accounting maneuvers like depreciation expense. The statement of cash flows can be a complicated report to produce, but understanding it is not so difficult.

There are three main components of the statement of cash flows. They are the following:

- Cash flow from operations
- Cash flow from investing
- Cash flow from financing

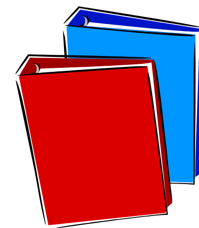
When the cash flow reveals that the majority of the cash flowing in is from operations, this is a good sign for regulators, stockholders, and investors.

A negative cash flow does not necessarily mean the company is doing poorly. There could have been a large investment in equipment or inventory. Negative cash flow situations require more analyzing to determine why it is negative.

However, a negative cash flow resulting from poor operations could be a sign of a company going bankrupt. Understanding the cash flow will help you understand how the company is obtaining the cash and how they are using the cash.

Annual Reports

The annual report is an annual document that provides a comprehensive report on the financial activities of the past year of an organization. Along with the financial reports are reports from key people in and out of the organization.



Here are the basic components of an annual report:

- Chairman's report
- CEO's report
- Auditor's report
- Mission statement
- Corporate governance statement
- Statement of director's responsibilities
- Balance sheet
- Statement of retained earnings
- Income statement
- Cash flow statement
- Notes to the financial statements
- Accounting policies

Investors and stockholders use the annual report and the government reviews these reports for compliance to regulations. Understanding that all company activities eventually is incorporated into the annual report.

As a manager, you may not see the relevance of the annual report for your daily job, but realizing how you run your department may reflect on this annual report makes it worthwhile to know what reports go into the annual report.

Case Study

James needed to create financial statement for the previous quarter. He started with a balance sheet, which showed the balance of liabilities and assets within the company. Next, he created an income statement. This showed the profits and losses of the company. Finally, he created a cash flow statement, which showed the money coming in and money going out. While the company had been seeing a negative cash flow, James knew it was because of investments within the company, and that the cash flow would return to normal. At the end of the year, all of the data collected from the reports was combined into the annual report that went out to the company's key players and shareholders.