Three Financial Statements Workshop

Learn the basics of the income statement, balance sheet, and cash flow statement that are used in financial modeling

Income Statement Items

- **Revenue** – Net Sales, Price times Quantity Sold, Total value of goods and services sold
  - Ex. One Nike Shoe sold contributes $100 to Revenue
- **(-) COGS** – Cost of Goods Sold, Expenses directly related to the production of goods or services
  - Ex. Same Nike Shoe's direct materials, direct labor, and manufacturing overhead
- **Gross Profit** – Revenue minus COGS, amount after direct costs company retains
- **(-) SG&A** – Selling, General & Administrative Expenses; Expenses indirectly related to sales
  - Ex. Nike's Accountant's salaries, Marketing Department
- **(-) R&D** – Research & Development, Activities required to develop new products
  - Ex. Drug manufacturer's lab expenses developing new drug
- **(-) D&A** – Depreciation & Amortization, Noncash accounting expense of using equipment
  - The book value of Nike's HQ building decreases to account for the cost associated with its use
- **Operating Income (EBIT)** – Gross Profit minus Operating Expenses, EBIT
- **(-) Interest Expense** – Mandatory payments to debtholders
- **(+/-) Other Income** – Gains and Losses on sale of assets
- **EBT** – Operating Income minus Interest and Other Income, Earnings Before Taxes
- **(-) Taxes** – Federal, State, International Taxes
- **Net Income** – Metric for a company's profitability

Income Statement Notes

- **Revenue Recognition Principle**: revenue is recognized once a service is delivered
  - Revenues and expenses are not necessarily cash coming in or cash going out
    - Depreciation and amortization are “non-cash expenses”
    - Expenses / revenue can get recognized before it is actually paid
- A lot of income statements will not be laid out with all of these expenses, as they may have some expenses embedded in a different line item
  - Depreciation can be grouped into COGS / operating expenses or it can be broken out as a separate line item
  - The same goes with many operating expenses – some companies will break out each expenses will others will group them into general and administrative as on bucket
- Expenses are tax deductible and correspond to the respective time period or good/service delivered
- In general, to appear on the income statement line items must have 2 criteria:

1. Correspond to the period shown on the Income Statement
2. Must affect the Company’s taxes

Balance Sheet – Snapshot of a Business

Assets = Liabilities + Shareholders' Equity

How a company makes money

Asset: how a company operates – **future economic benefit**

- Current Asset: used in 1 year or less (cash, accounts receivable, inventory)
- Non-current asset: longer than 1 year (equipment, land, patents, goodwill)

How a company funds itself

Liability: financial obligation that a company **owes**

- Current (accounts payable, notes payable) vs. Long Term (LT bonds/notes)

Shareholder's Equity: invested capital, **company's net worth**

- Common Stock, Treasury Stock, Retained Earnings (where net income goes)

XYZ COMPANY
Balance Sheet
12/31/2017

ASSETS	
Current Assets:	
Cash	$12,000
Accounts Receivable	35,000
Inventory	120,000
Prepaid Rent	8,000
Total Current Assets	$175,000
Long-Term Assets	
Land	$126,000
Buildings & Improvements	300,000
Furniture & Fixtures	50,000
General Equipment	125,000
Total Fixed Assets	$601,000
TOTAL ASSETS	$776,000
LIABILITIES	
Current Liabilities:	
Accounts Payable	$60,000
Taxes Payable	25,000
Salaries/Wages Payable	30,000
Interest Payable	25,000
Total Current Liabilities	$140,000
Long Term Liabilities:	
Loan 1	$322,000
Total Long Term Liabilities	$322,000
TOTAL LIABILITIES	**$462,000**
OWNER'S EQUITY	
Paid in Capital	$64,000
Retained Earnings	250,000
TOTAL OWNER'S EQUITY	**$314,000**
TOTAL LIABILITIES & OWNER'S EQUITY	$776,000

Balance Sheet Items

Assets

- **Cash & Cash Equivalents** – most liquid assets and can include Treasury bills and short-term certificates of deposit, as well as hard currency
- **Accounts Receivable** – refers to the money that customers owe the company, includes an allowance for doubtful accounts which is customers that are not expected to pay
  - Ex: If I Venmo request James $10 and he has not accepted it then I would have $10 accounts receivable
- **Inventory** – goods available for sale, valued at the lower cost of what they were purchased at or the market cost
  - Ex: All the merchandise on the shelves and in the warehouse for Dollar General is considered inventory
- **Property, Plant, and Equipment (PPE)** – fixed assets that are capital-intensive and capitalized when purchased – this can contain a number of different items and is dependent on the Company
  - Ex: Dollar General's physical buildings and distribution centers are PPE
- **Goodwill** – the excess paid for any asset or Company that is acquired at an amount in excess of the balance sheet amount
  - Ex: Say Instagram had assets in total of $100 million and Facebook acquired them for $1 billion, they would add those $100 million of assets to Facebook's balance sheet along with $900 million of Goodwill
- **Other Assets** – most other balance sheets will have some combination of other assets, and it is up to you to decide if these are important
  - Some companies will group other assets into a line item literally called "Other assets" – you can check the notes and find out what this line item exactly includes

Balance Sheet Items

Liabilities

- **Accounts Payable –** any payments due to other companies for the purchase of their goods on credit
  - Ex**:** Going back to the Accounts Receivable example, James now has $10 of accounts payable due to me
- **Current Portion of Long-Term Debt** – any long-term debt payments that are due within the coming 12 months
- **Other Liabilities** – similar to other assets, companies will have other liabilities that they group into an other liabilities account – this can include other payables such as wages
  - You can check the notes and find out what this line item exactly includes
- **Long-Term Debt** – refers to the money that customers owe the company, includes an allowance for doubtful accounts which is customers that are not expected to pay
  - Ex: If I Venmo request James $10 and he has not accepted it then I would have $10 accounts receivable

Stockholder's Equity

- **Common Stock** – this is the par amount of stock issued and will not change unless more stock is issued (typically something small like $0.01 per share
- **Retained Earnings** – this is the amount of earnings not paid out to shareholders and kept to reinvest in the business
  - Retained Earnings = Net Income – Dividends
- **Additional Paid in Capital** – this is the value of stock issued in excess to the Common Stock amount
  - Ex: If a Company issues 100 shares with par value of $0.01 for $10 each then the Common Stock will increase by $1 while Additional Paid in Capital increases by $999 ($100 x 10 - $1)

Statement of Cash Flows

- The statement of cash flows, or the cash flow statement, is a financial statement that summarizes the amount of cash and cash equivalents entering and leaving a company
- The cash flow statement (CFS) measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses
- The cash flow statement complements the balance sheet and income statement and is a mandatory part of a company's financial reports since 1987
- Many firms will ask you:
  - What is the most important statement? The answer is: The Cash Flow Statement
  - If you could only have two statements which would you have? The answer is: Income Statement and Balance Sheet
    - This is because you can build the Cash Flow Statement from these other two statements

Structure of Statement of Cash Flows

- **Cash Flows from Operating Activities**
  - Operating activities on the CFS include any sources and uses of cash from business activities. In other words, it reflects how much cash is generated from a company's products or services
  - Examples of Operating Activities: receipts from sales of goods or services, interest payments, income tax payments, salary and wage payments to employees, rent payments
- **Cash Flows from Investing Activities**
  - Investing activities include any sources and uses of cash from a company's investments
  - Examples of Investing Activities: Purchase of sale of an asset, loans made to vendors or received from customers, or any payments related to a merger or acquisition
  - Usually, cash changes from investing are a "cash out" item, because cash is used to buy new equipment, buildings, or short-term assets such as marketable securities
  - However, when a company divests an asset, the transaction is considered "cash in" for calculating cash from investing
- **Cash Flows from Financing Activities**
  - Cash from financing activities include the sources of cash from investors or banks, as well as the uses of cash paid to shareholders
  - Examples of Financing Activities: Payment of dividends, payments for stock repurchases, and the repayment of debt principal (loans)
  - Changes in cash from financing are "cash in" when capital is raised, and they're "cash out" when dividends are paid