Understanding Financial Statements: Making More Authoritative Decisions

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Understanding Financial Statements

Making More Authoritative Decisions

Key Topics Covered in This Chapter

- *Balance sheets*
- *Income statements*
- *Cash flow statements*
- *Financial leverage*
- *The financial structure of the firm*
- *Interpreting financial statements*

WHAT DOES your company own, and what does it owe to others? What are its sources of revenue, and how has it spent its money? How much profit has it made? What is the state of your company's financial health? This chapter will help you answer those questions by explaining the three essential financial statements: the balance sheet, the income statement, and the cash flow statement. The chapter will also help you understand some of the managerial issues implicit in these statements and broaden your financial know-how through discussion of two important concepts: financial leverage, and the financial structure of the firm.

If you're a line manager, you might be thinking "I don't need to know about that stuff. That's for senior management, not me." If you believe this, think again. The ability to read and interpret financial statements has become more and more necessary as accountability and decision-making authority are pushed down to lower levels. The language of financial statements is also important to managers at every level. When the conversation turns to "current liabilities," "profit margin," "financial leverage," and "working capital," you must know precisely the meaning of these terms. Indeed, the language of modern business draws heavily on the accounting terminology used in financial statements. Familiarity with the language and meaning of financial statements will make you a valued colleague in the higher circles of your organization. For the small business owner-manager, this understanding of financial statements is an absolute must.

Why Financial Statements?

Financial statements are the essential documents of business. Managers use them to assess performance and identify areas in which intervention is required. Shareholders use them to keep tabs of how well their capital is being managed. Outside investors use them to identify opportunities. And lenders and suppliers routinely examine financial statements to determine the creditworthiness of the companies with which they deal.

Publicly traded companies are required by the Securities and Exchange Commission (SEC) to produce financial statements and make them available to everyone as part of the full-disclosure requirement the SEC places on publicly owned and traded companies. Companies not publicly traded are under no such requirement, but their private owners and bankers expect financial statements nevertheless.

Financial statements—the balance sheet, income statement, and cash flow statement—follow the same general format from company to company. And though specific line items may vary with the nature of a company's business, the statements are usually similar enough to allow you to compare one business's performance against another's.

The Balance Sheet

Most people go to a doctor once a year to get a checkup—a snapshot of their physical well-being at a particular time. Similarly, companies prepare balance sheets as a way of summarizing their financial positions at a given point in time, usually at the end of the month, the quarter, or the fiscal year.

In effect, the *balance sheet* describes the assets controlled by the business and how those assets are financed—with the funds of creditors (liabilities), with the capital of the owners, or with both. A balance sheet reflects the following basic accounting equation:

Assets = Liabilities + Owners' Equity

Assets in this equation are the things in which a company invests so that it can conduct business. Examples include cash and financial instruments, inventories of raw materials and finished goods, land, buildings, and equipment. Assets also include monies owed to the company by customers and others—an asset category referred to as *accounts receivable*.

Now look at the other side of the equation, starting with liabilities. To acquire its necessary assets, a company often borrows money or promises to pay suppliers for various goods and services. Monies owed to creditors are called *liabilities*. For example, a computer company may acquire $1 million worth of motherboards from an electronic parts supplier, with payment due in thirty days. In doing so, the computer company increases its inventory assets by $1 million and its liabilities—in the form of *accounts payable*—by an equal amount. The equation stays in balance. Likewise, if the same company were to borrow $100,000 from a bank, the cash infusion would increase its assets by $100,000 and its liabilities by the same amount.

Owners' equity, also known as shareholders' or stockholders' equity, is what is left over after total liabilities are deducted from total assets. Thus, a company that has $3 million in total assets and $2 million in liabilities would have owners' equity of $1 million.

Assets − Liabilities = Owners' Equity
$3,000,000 − $2,000,000 = $1,000,000

If $500,000 of this same company's uninsured assets burned up in a fire, its liabilities would remain the same, but its owners' equity—what's left after all claims against assets are satisfied—would be reduced to $500,000:

Assets − Liabilities = Owners' Equity
$2,500,000 − $2,000,000 = $500,000

Thus, the balance sheet "balances" a company's assets and liabilities. Notice, for instance, how the total assets equal total liabilities plus owners' equity in the balance sheet of Amalgamated Hat Rack, our example company (table 14-1). The balance sheet also describes how much the company has invested in assets, and where the money is

TABLE 14-1

Amalgamated Hat Rack Balance Sheet as of December 31, 2002

	2002	2001	Increase (Decrease)
Assets			
Cash and marketable securities	$355,000	$430,000	$(75,000)
Accounts receivable	$555,000	$512,000	$43,000
Inventory	$835,000	$755,000	$80,000
Prepaid expenses	$123,000	$98,000	$25,000
Total current assets	$1,868,000	$1,795,000	$73,000
Gross property, plant, and equipment	$2,100,000	$1,900,000	$200,000
Less: accumulated depreciation	$333,000	$234,000	$(99,000)
Net property, plant, and equipment	$1,767,000	$1,666,000	$101,000
Total assets	$3,635,000	$3,461,000	$174,000
Liabilities and Owner's Equity			
Accounts payable	$450,000	$430,000	$20,000
Accrued expenses	$98,000	$77,000	$21,000
Income tax payable	$17,000	$9,000	$8,000
Short-term debt	$435,000	$500,000	$(65,000)
Total current liabilities	$1,000,000	$1,016,000	$(16,000)
Long-term debt	$750,000	$660,000	$90,000
Total liabilities	$1,750,000	$1,676,000	$74,000
Contributed capital	$900,000	$850,000	$50,000
Retained earnings	$985,000	$935,000	$50,000
Total owner's equity	$1,885,000	$1,785,000	$100,000
Total liabilities and owner's equity	$3,635,000	$3,461,000	$174,000

Source: HMM Finance.

invested. Further, the balance sheet indicates how much of those monetary investments in assets comes from creditors (liabilities) and how much comes from the owners (equity). Analysis of the balance sheet can give you an idea of how efficiently a company is utilizing its assets and how well it is managing its liabilities.

Balance sheet data is most helpful when compared with the same information from one or more previous years. Consider the balance sheet of Amalgamated Hat Rack. First, this statement represents the company's financial position at a moment in time: December 31, 2002. A comparison of the figures for 2001 against those for 2002 shows that Amalgamated is moving in a positive direction: It has increased its owners' equity by nearly $100,000.

Assets

You should understand some details about this particular financial statement. The balance sheet begins by listing the assets most easily converted to cash: cash on hand and marketable securities, receivables, and inventory. These are called *current assets*. Generally, current assets are those that can be converted into cash within one year.

Next, the balance sheet tallies other assets that are tougher to convert to cash—for example, buildings and equipment. These are called plant assets or, more commonly, *fixed assets* (because it is hard to change them into cash).

Since most fixed assets, except land, depreciate—or become less valuable—over time, the company must reduce the stated value of these fixed assets by something called accumulated depreciation. Gross property, plant, and equipment minus accumulated depreciation equals the current book value of property, plant, and equipment.

Some companies list *goodwill* among their assets. If a company has purchased another company for a price above the fair market value of its assets, that so-called goodwill is recorded as an asset. This is, however, strictly an accounting fiction. Goodwill may also represent intangible things such as brand names or the acquired company's excellent reputation. These may have real value. So too can other intangible assets, such as patents.

Finally, we come to the last line of the balance sheet, total assets. Total assets represents the sum of both current and fixed assets.

Liabilities and Owners' Equity

Now let's consider the claims against those assets, beginning with a category called current liabilities. *Current liabilities* represent the claims of creditors and others that typically must be paid within a year; they include short-term IOUs, accrued salaries, accrued income taxes, and accounts payable. This year's repayment obligation on a long-term loan is also listed under current liabilities.

Subtracting current liabilities from current assets gives you the company's net working capital. *Net working capital* is the amount of money the company has tied up in its current (short-term) operating activities. Just how much is adequate for the company depends on the industry and the company's plans. In its most recent balance sheet, Amalgamated had $868,000 in net working capital.

Long-term liabilities are typically bonds and mortgages—debts that the company is contractually obligated to repay, with respect to both interest and principal.

According to the aforementioned accounting equation, total assets must equal total liabilities plus owners' equity. Thus, subtracting total liabilities from total assets, the balance sheet arrives at a figure for the owners' equity. Owners' equity comprises *retained earnings* (net profits that accumulate on a company's balance sheet after any dividends are paid) and contributed capital (capital received in exchange for shares).

Historical Values

The values represented in many balance sheet categories may not correspond to their actual market values. Except for items such as cash, accounts receivable, and accounts payable, the measurement of each classification will rarely be equal to the actual current value or cash value shown. This is because accountants must record most items at their historic cost. If, for example, XYZ's balance sheet indicated

land worth $700,000, that figure would represent what XYZ paid for the land way back when. If the land was purchased in downtown San Francisco in 1960, you can bet that it is now worth immensely more than the value stated on the balance sheet. So why do accountants use historic instead of market values? The short answer is that it represents the lesser of two evils. If market values were mandated, then every public company would be required to get a professional appraisal of every one of it properties, warehouse inventories, and so forth—and would have to do so every year. And how many people would trust those appraisals? So we're stuck with historic values on the balances sheet.

Managerial Issues

Though the balance sheet is prepared by accountants, it represents a number of important issues for managers.

WORKING CAPITAL Financial managers give substantial attention to the level of working capital, which naturally expands and contracts with sales activities. Too little working capital can put a company in a bad position: The company may be unable to pay its bills or to take advantage of profitable opportunities. Too much working capital, on the other hand, reduces profitability, since that capital has a carrying cost—it must be financed in some way, usually through interest-bearing loans.

Inventory is one component of working capital that directly affects many managers who are not involved in finance. Like working capital in general, inventory must be balanced between too much and too little. Having lots of inventory on hand solves many business problems: The company can fill customer orders without delay, and a robust inventory provides a buffer against potential production stoppages and strikes. The flip side of plentiful inventory is financing cost and the risk of deterioration in the market value of the inventory itself. Every excess widget in the stockroom adds to the company's financing costs, which reduces profits. And every item that sits on the shelf may become obsolete or less salable as time goes by—again,

with a negative impact on profitability. The personal computer business provides a clear example of how excess inventory can wreck the bottom line. Some analysts estimate that the value of finished-goods inventory melts away at a rate of approximately 2 percent *per day*, because of technical obsolescence in this fast-moving industry.

FINANCIAL LEVERAGE You have probably heard someone say, "It's a highly leveraged situation." Do you know what "leveraged" means in the financial sense? *Financial leverage* refers to the use of borrowed money in acquiring an asset. We say that a company is highly leveraged when the percentage of debt on its balance sheet is high relative to the capital invested by the owners. For example, suppose that you paid $400,000 for an asset, using $100,000 of your own money and $300,000 in borrowed funds. For simplicity, we'll ignore loan payments, taxes, and any cash flow you might get from the investment. Four years go by, and your asset has appreciated to $500,000. You decide to sell. After paying off the $300,000 loan, you end up with $200,000 in your pocket (your original $100,000 plus a $100,000 profit). That's a gain of 100 percent on your personal capital, even though the asset increased in value by only 25 percent. Financial leverage made this possible. In contrast, if you had financed the purchase entirely with your own funds ($400,000), then you would have ended up with only a 25 percent gain. (*Operating leverage*, in contrast, refers to the extent to which a company's operating costs are fixed versus variable. For example, a company that relies heavily on machinery and very few workers to produce its goods has a high operating leverage.)

Financial leverage creates an opportunity for a company to gain a higher return on the capital invested by its owners. In the United States and most other countries, tax policy makes financial leverage even more attractive by allowing businesses to deduct the interest paid on loans. But leverage can cut both ways. If the value of an asset drops (or fails to produce the anticipated level of revenue), then leverage works against its owner. Consider what would have happened in our example if the asset's value had dropped by $100,000, that is, to $300,000. The owner would have lost his or her entire $100,000 investment after repaying the initial loan of $300,000.

FINANCIAL STRUCTURE OF THE FIRM The negative potential of financial leverage is what keeps CEOs, their financial executives, and board members from maximizing their debt financing. Instead, they seek a financial structure that creates a realistic balance between debt and equity on the balance sheet. Although leverage enhances a company's potential profitability as long as things go right, managers know that every dollar of debt increases the riskiness of the business—both because of the danger just cited, and because high debt results in high interest payments, which must be paid in good times and bad. Many companies have failed when business reversals or recessions reduced their ability to make timely payments on their loans.

When creditors and investors examine corporate balance sheets, they look carefully at the debt-to-equity ratio. They factor the riskiness of the balance sheet into the interest they charge on loans and the return they demand from a company's bonds. Thus, a highly leveraged company may have to pay 14 percent on borrowed funds instead of the 10 to 12 percent paid by a less leveraged competitor. Investors also demand a higher rate of return for their stock investments in highly leveraged companies. They will not accept high risks without an expectation of commensurately large returns.

Where Are the Human Assets?

As people look to financial statements to gain insights about companies, many are questioning the traditional balance sheet's ability to reflect the value of human capital and profit potential. This is particularly true for knowledge-intensive companies, for which the workforce know-how, intellectual property, brand equity, and customer relationships are the real productive assets. Unfortunately, these intangible assets are not found on the balance sheet.

The growing irrelevance of balance sheets to reflect real value prompted Federal Reserve Board chairman Alan Greenspan to complain in January 2000 that accounting failed to track investments in "knowledge assets." Former SEC chairman Arthur Levitt

echoed Greenspan's concern: "As intangible assets grow in size and scope, more and more people are questioning whether the true value—and the drivers of that value—are being reflected in a timely manner in publicly available disclosure." Indeed, a study by Baruch Lev of New York University found that 40 percent of the market valuation of the average company was missing from its balance sheet. For high-tech firms, the figure was more than 50 percent.

The implication of these findings for investors and managers is that they must look beyond the bricks and mortar, the equipment, and even the cash that traditionally constitute balance sheet assets and focus on the undisclosed assets that produce the greatest value for shareholders. In most cases, those assets are the people who create the bonds between the enterprise and its customers, who create innovations that customers are eager to pay for, and who know how to get others to work together productively. The accounting profession is beginning to debate the pros and cons of including these intangible assets in financial statements. Watch for future developments.

The Income Statement

The *income statement* indicates the results of operations over a specified period. Those last two words are important. Unlike the balance sheet, which is a snapshot of the enterprise's position at a point in time, the income statement indicates cumulative business results within a defined time frame. It tells you if the company is making a profit—that is, whether it has positive or negative net income (net earnings). This is why the income statement is often referred to as the *profit-and-loss statement*, or P&L. It shows a company's profitability at the end of a particular time—typically at the end of the month, the quarter, or the company's fiscal year. In addition, the income statement tells you how much money the company spent to make that profit—from which you can determine the company's *profit margin*.

As we did with the balance sheet, we can represent the contents of the income statement with a simple equation:

Revenues – Expenses = Net Income (or Net Loss)

An income statement starts with the company's *revenues*: the amount of money that results from selling products or services to customers. A company may have other revenues as well. In many cases, these are from investments or interest income from its cash holdings.

Various costs and expenses—from the costs of making and storing goods, to depreciation of plant and equipment, to interest expense and taxes—are then deducted from revenues. The bottom line —what's left over—is the *net income*, or net profit or net earnings, for the period of the statement.

Consider the meaning of various line items on the income statement for Amalgamated Hat Rack (table 14-2). The *cost of goods sold* is what it cost Amalgamated to manufacture its hat racks. This figure includes the cost of raw materials, such as lumber, as well as the cost of turning them into finished goods, including direct labor costs. By deducting the cost of goods sold from sales revenue, we get a company's *gross profit*—the roughest estimation of the company's profitability.

The next major category of cost is *operating expenses*. Operating expenses include administrative employee salaries, rents, sales and marketing costs, as well as other costs of business not directly attributed to the cost of manufacturing a product. The lumber for making hat racks would *not* be included here; the cost of the advertising and the salaries of Amalgamated employees would.

Depreciation is counted on the income statement as an expense, even though it involves no out-of-pocket payments. As described earlier, depreciation is a way of estimating the "consumption" of an asset, or the diminishing value of equipment, over time. A computer, for example, loses about a third of its value each year. Thus, the company would not expense the full value of a computer in the first year of its purchase, but as it is actually used over a span of three years. The idea behind depreciation is to recognize the diminished value of certain assets.

TABLE 14-2

Amalgamated Hat Rack Income Statement for the Fiscal Year Ending December 31, 2002

Retail Sales	$2,200,000
Corporate Sales	$1,000,000
Total Sales Revenue	$3,200,000
Less: Cost of Goods Sold	$1,600,000
Gross Profit	$1,600,000
Less: Operating Expenses	$800,000
Depreciation Expense	$42,500
Earnings Before Interest and Taxes	$757,500
Less: Interest Expense	$110,000
Earnings Before Income Tax	$647,500
Less: Income Tax	$300,000
Net Income	$347,500

Source: HMM Finance.

By subtracting operating expenses and depreciation from the gross profit, we get *operating earnings*. These earnings are often called earnings before interest and taxes, or EBIT.

We're now down to the last reductions in the path that revenues follow on their way to the bottom line. Interest expense is the interest charged on loans a company has taken out. Income tax, tax levied by the government on corporate income, is the final charge.

What revenues are left are referred to as net income, or earnings. If net income is positive—as it is in the case of Amalgamated—we have a profit, what the for-profit company lives for.

Making Sense of the Income Statement

As with the balance sheet, our analysis of a company's income statement is greatly aided when presented in a multiperiod format. This allows us to spot trends and turnarounds. Most annual reports make multiperiod data available, often going back five or more years. Amalgamated's income statement in multiperiod form is depicted in table 14-3.

TABLE 14-3

Amalgamated Hat Rack Multiperiod Income Statement

	For the Period Ending December 31			
	2002	**2001**	**2000**	**1999**
Retail Sales	$2,200,000	$2,000,000	$1,720,000	$1,500,000
Corporate Sales	$1,000,000	$1,000,000	$1,100,000	$1,200,000
Total Sales Revenue	$3,200,000	$3,000,000	$2,820,000	$2,700,000
Less: Cost of Goods Sold	$1,600,000	$1,550,000	$1,400,000	$1,300,000
Gross Profit	$1,600,000	$1,450,000	$1,420,000	$1,400,000
Less: Operating Expenses	$800,000	$810,000	$812,000	$805,000
Depreciation Expense	$42,500	$44,500	$45,500	$42,500
Earnings Before Interest and Taxes	$757,500	$595,500	$562,500	$552,500
Less: Interest Expense	$110,000	$110,000	$150,000	$150,000
Earnings Before Income Tax	$647,500	$485,500	$412,500	$402,500
Less: Income Tax	$300,000	$194,200	$165,000	$161,000
Net Income	$347,500	$291,300	$247,500	$241,500

In this multiyear format, we observe that Amalgamated's annual retail sales have grown steadily, while its corporate sales have stagnated and even declined slightly. Operating expenses have stayed about the same, however, even as total sales have expanded. That's a good sign that management is holding the line on the cost of doing business. The company's interest expense has also declined, perhaps because it has paid off one of its loans. The bottom line, net income, has shown healthy growth.

The Cash Flow Statement

The *cash flow statement*, the last of the three essential financial statements, is the least used and understood. This statement details the reasons why the amount of cash (and cash equivalents) changed during the accounting period. More specifically, it reflects all changes in cash as affected by operating activities, investments, and financing activities. Like the bank statement you receive for your checking account, the cash flow statement tells how much cash was on hand at the beginning of the period, and how much was on hand at the end. It then describes how the company acquired and spent cash in a particular period. The uses of cash are recorded as negative figures, and sources of cash are recorded as positive figures.

If you're a manager in a large corporation, changes in the company's cash flow won't typically have an impact on your day-to-day functioning. Nevertheless, it's a good idea to stay up-to-date with your company's cash flow projections, because they may come into play when you prepare your budget for the upcoming year. For example, if cash is tight, you will probably want to be conservative in your spending. Alternatively, if the company is flush with cash, you may have opportunities to make new investments. If you're a manager in a small company or its owner, you're probably keenly aware of your cash flow situation and feel its impact almost every day.

The cash flow statement is useful because it indicates whether your company is turning accounts receivable into cash—and that ability is ultimately what will keep your company solvent. *Solvency* is the ability to pay bills as they come due.

As we did with the other statements, we can conceptualize the cash flow statement in terms of a simple equation:

> Cash Flow from Profit + Other Sources of Cash − Uses of Cash = Change in Cash

Again using the Amalgamated Hat Rack example, we see that in its year 2002 cash flow statement, the company generated a positive cash flow of $377,900 (table 14-4). The statement shows that cash flows from operations ($283,900), plus those from investing activities ($92,000), and from financing ($2,000) produced $377,900 in additional cash.

The cash flow statement doesn't measure the same thing as the income statement. If there is no cash transaction, then it cannot be reflected on a cash flow statement. Notice, however, that net income at the top of the cash flow statement is the same as the bottom line of the income statement—it's the company's profit. Through a series of adjustments, the cash flow statement translates this net income into a cash basis.

The statement's format reflects the three categories of activities that affect cash. Cash can be increased or decreased because of (1) operations, (2) the acquisition or sale of assets, that is, investments, or (3) changes in debt or stock or other financing activities. Let's consider each in turn, starting with operations:

- Accounts receivable and finished-goods inventory represent items the company has produced, but for which it hasn't received payment. Prepaid expenses represent items the company has paid for but has not consumed. These items are all subtracted from cash flow.
- Accounts payable and accrued expenses represent items the company has already received or used, but for which it hasn't yet paid. Consequently, these items add to cash flow.

Now, consider investments. Investment activities include the following:

- Gains realized from the sale of plant, property, and equipment—in other words, gains realized from converting investments into cash.

TABLE 14-4

Amalgamated Hat Rack Cash Flow Statement, 2002

Net Income	$347,500
Operating Assets and Liabilities	
Accounts receivable	$(75,600)
Finished-goods inventory	$(125,000)
Prepaid expenses	$(37,000)
Accounts payable	$83,000
Accrued expenses	$25,000
Income tax payable	$(23,000)
Depreciation expense	$89,000
Total changes in operating assets and liabilities	$(63,600)
Cash flow from operations	$283,900
Investing Activities	
Sale of property, plant, and equipment	$267,000
Capital expenditures	$(175,000)
Cash flow from investing activities	$92,000
Financing Activities	
Short-term debt increase	$27,000
Long-term borrowing	$112,000
Capital stock	$50,000
Cash dividends to stockholders	$(187,000)
Cash flow from financing activities	$2,000
Increase in cash during year	$377,900

Source: HMM Finance.

Cash Flow Versus Profit

Many people think of profits as cash flow. Don't make this mistake. For a particular period, profit may or may not contribute positively to cash flow. For example, if this year's profit derives from a huge sale made in November, the sale may be booked as revenues in the fiscal period—thus adding to profit. But if payment for that sale is not received until the next accounting period, it goes on the books as an account receivable, which reduces cash flow.

- Cash that the company uses to invest in financial instruments and plant, property, and equipment (such investments in plant, property, and equipment are often shown as capital expenditures).

The cash flow statement shows that Amalgamated has sold a building for $267,000 and made capital expenditures of $175,000, for a net addition to cash flow of $92,000.

Finally, we come to cash flow changes from financing activities. Amalgamated has raised money by increasing its short-term debt, by borrowing in the capital markets, and by issuing capital stock, thereby increasing its available cash flow. The dividends that Amalgamated pays, however ($187,000) must be paid out of cash flow and thus represent a decrease in cash flow.

Where to Find It

As mentioned earlier, all firms that trade their shares in U.S. public financial markets are required by the Securities and Exchange Commission to prepare and distribute their financial statements in an annual report to shareholders. Most annual reports go beyond the basic disclosure requirement of the SEC, providing discussion of the year's operations and the future outlook. Most public companies also issue quarterly reports.

If you are looking for even more material on your company—or on one of your competitors—obtain a copy of the company's form 10-K, which must be filed with the SEC. The 10-K often contains abundant and revealing information about a company's strategy, its view of the market and its customers, its products, its important risks and business challenges, and so forth. You can obtain 10-K reports and annual and quarterly reports directly from a company's investor relations department, or online at http://www.sec.gov/edgar/searchedgar/formpick.htm.

Summing Up

- The balance sheet shows a company's financial position at a specific point in time. That is, it gives a snapshot of the company's financial situation—its assets, equity, and liabilities—on a given day.
- The income statement shows the bottom line: It indicates how much profit or loss was generated over a period—a month, a quarter, or a year.
- The cash flow statement tells where the company's cash came from and where it went—in other words, the flow of cash in, through, and out of the company.
- In a nutshell, the income statement tells you whether your company is making a profit. The balance sheet tells you how efficiently a company is utilizing its assets and managing its liabilities in pursuit of profits. The cash flow statement tells you how cash has been increased or decreased through operations, the acquisition or sale of assets, and financing activities.

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