The ABC's of Financial Statements

By: Jim Turner, CPA, CVA, President

What are financial statements you might ask. Perhaps you have heard the terms P&L and balance sheet before, but you wonder what they are and what they tell us about a business. Let me provide you with a few analogies to provide some insight about these two parts of the financial statements.

The Profit and Loss

First, the profit & loss "P&L" is analogous to how much money an employee is paid by their employer (income) minus all the expenses incurred maintaining their household. If the wages earned are greater than the expenses, then they have a surplus [this would be synonymous with net income for a business]. In the same way if you review a P&L for a business, it depicts all income earned and all expenses incurred. If the income earned exceed expenses, then the business has a net income. If income is less than total expenses the business has a net loss.

In the simple example below Clark Kent earns wages of $5,000 for the month. In the same month he incurs expenses of $4,000 for food, utilities, clothing, and interest expense on a bank loan for his home. Clark ended the period with a surplus of $1,000.

Clark Kent	
Personal Profit & Loss	
Income	
Wages	$5,000
Total Income	$5,000
EXPENSES	
Food	$500
Household expenses	$1,000
Interest	$1,500
Utilities	$1,000
Total Expenses	$4,000
Net Income	$1,000

The Balance Sheet

While the P&L depicts cash coming in (income) and going out (expenses) the balance sheet reflects the assets, liabilities, and equity of the business as of a specific date. It is analogous to tallying up all of assets that you own. You might have cash in the bank, own the car you drive, and own the house where you live. These are all examples of assets that would be depicted on your personal balance sheet. On the other hand, you might owe the bank money for your car and home. These two loans are liabilities. If the value of your assets exceeds the value of your liabilities, then you have equity. In the example below the Clark Kent owns $280,000 worth of assets and has a balance due to Metropolis City Bank in the amount of $220,000 for borrowed funds to purchase the assets. The net of the assets $280,000 minus the liabilities of $220,000 is equity of $60,000.

Clark Kent	
Personal Balance Sheet	
ASSETS	
Cash	$5,000
Car	$25,000
Home	$250,000
Total Assts	$280,000
LIABILTIIES AND EQUITY	
Bank Loan Car	$20,000
Home Loan	$200,000
Total Liabilities	$220,000
Equity	$60,000
Total Liabilties and Equity	$280,000

The Statement of Cash Flows

The statement of cash flows is another part of the financial statements. Although arguably not as well-known as the P&L and balance sheet, the statement of cash flows is an important source of financial information. It depicts an entities' overall change in cash. Recall in our P&L example Clark Kent had net income of $1,000. But if you look closely, you will discover there is no provision for the principal portion of the mortgage payment. Because the payment reduces the principal balance of a debt it is not an expense but rather a reduction in a liability. Since the P&L only records income and expense it stands to reason the payment will not show up on the P&L. Instead this outlay of cash is depicted on the statement of cash flows "SoCF". The starting point for the SCF is the net income of $1,000. Cash expenditures to purchase assets like real estate are depicted on the statement of cash flows as well. The example SoCF below depicts the cash flows for Clark Kent during the period. As you can see the $500 in principal payments is an investing activity and reduced cash flow by -$500. To calculate the cash flow for the period; start with cash flow from operations of $1,000 and subtract the ($500) decrease in cash flow from investing. Thus, the net cash flow for the period was an increase of $500.

Clark Kent	
Personal Statement of Cash Flows	
OPERATING ACTIVITIES	
Net Income	$1,000
Net cash provided by operations	$1,000
INVESTING ACTIVITIES	
Principal Payment Home	($500)
Net cash provided by investing activities	($500)
NET CASH INCREASE FOR THE PERIOD	$500
Cash at the beginning of period	$4,500
CASH AT END OF PERIOD	$5,000

Highlights

A business uses these three parts of the financial statements to display its performance. It allows the owner and other interested parties to track the score of the business. If the business has net income it is winning the game of business. If it has a net loss it is losing. The balance sheet is a snapshot of the assets, liabilities, and equity that are owned or owed by the business and how much worth the owner has as of a particular day. The statement of cash flows shows how the cash from net income has been utilized and it depicts the amount of cash that was used to buy assets or pay down debt. The statement of cash flows details where every dollar of cash was used and whether cash flow increased or decreased during the period. If properly understood the insight provided by the financial statements can help you run a business, buy a business, grow a business, or sell a business.