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Understanding Financial Statements

LEARNING OBJECTIVES

- Identify the key components of financial statements
- Understand and define key financial terms
- Understand the importance of having diversified revenue streams and how to develop them
- Examine financial ratios and understand how they measure the financial well-being of a business
- Understand forecasting and build a simple forecast

The Income Statement

- Shows performance over a specific period of time by listing revenue and subtracting expenses
- Key Components:
 - Revenue: The money earned before expenses are deducted
 - Cost of Goods Sold (COGS): The direct costs tied to production (e.g., materials, direct labor)
 - Gross Profit: The revenue minus the COGS
 - Operating Expenses: Ongoing costs like rent, payroll, and utilities
 - Net Income (Net Profit): The final profit after all expenses are deducted
- Also called a Profit and Loss (P&L) statement

The Income Statement (cont.)

- Diversified revenue streams: Earning money in more than one way (e.g., product sales, services, subscriptions) to create stability and reduce risk
- EBITDA: The earnings before interest, taxes, depreciation, and amortization; used by growth-focused firms to show core operating performance without the effects of financing or taxes

The Balance Sheet

- A financial "snapshot" showing what a business owns and owes at a specific point in time

The Balance Sheet Formula:



The diagram illustrates the balance sheet formula using three magenta circles. The first circle on the left is labeled 'Assets'. To its right is a light pink equals sign. The second circle is labeled 'Liabilities'. To its right is a light pink plus sign. The third circle is labeled 'Equity'.

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

- Assets: Anything of value the business owns
 - Current assets: Assets expected to be converted to cash within a year (cash, inventory, accounts receivable)
 - Fixed assets: Long-term assets used in operations (e.g., equipment, buildings)
 - Liquid assets: A subset of current assets that can quickly be converted to cash with little loss in value

The Balance Sheet (cont.)

- Liabilities: Debts or financial obligations
 - Current liabilities: Those due within one year (accounts payable, wages)
 - Long-term liabilities: Those paid over a period longer than one year (e.g., mortgages, long-term loans)
- Equity (owner's equity): The value belonging to the owner after all liabilities are subtracted from assets

The Statement of Cash Flows

- This shows the movement of money into and out of a business over time.
- Cash vs. profit: A business can be profitable on paper but fail if it lacks available cash to pay bills due to timing issues.
- Three key sections:
 - Cash Flows from Operating Activities: Cash generated/used by core business operations (e.g., customer payments, wages, rent)
 - Cash Flows from Investing Activities: Cash used for buying or selling long-term assets like equipment
 - Cash Flows from Financing Activities: How a business raises money through loans or owner investments and pays it back

Connecting The Financial Statements

- The statements work together: Net Income flows into Equity on the balance sheet, and the Cash Flow statement adjusts Net Income for noncash items.
- Financial Ratios: These are metrics used to evaluate performance and allow for benchmarking across time and industries.
 - Ratio categories:
 - Profitability Ratios: Measure effectiveness in generating profit (e.g., Profit Margin, ROA, ROE)
 - Liquidity Ratios: Measure ability to pay short-term obligations; a ratio above 1 is generally healthy
 - Asset Usage Ratios: Measure efficiency in using assets (e.g., Inventory Turnover)
 - Debt Usage Ratios: Assess risk and ability to repay debt (e.g., Debt-to-Asset ratio; values below 1 are often considered low risk)

Financial Projections

- Forecasting: This is the process of creating "educated estimates" of future outcomes (sales, expenses, profits) based on assumptions and available data.
- Strategic Use: Forecasts help entrepreneurs plan inventory, set pricing, and determine how much funding is required.
- Pro Forma Statements are projected financial reports used to look ahead at future business performance.

CHAPTER SUMMARY

- Financial statements provide the structured framework necessary to evaluate business performance and make informed decisions.
- Income statements measure profit and loss, balance sheets provide a financial snapshot, and cash flow statements track the movement of money.
- Diversified revenue streams reduce risk and increase overall business stability.
- Financial ratios are essential for benchmarking a business's health against industry standards.
- Accurate forecasting allows entrepreneurs to plan for future growth and funding needs effectively.