

CHAPTER 1

The Big Three Financial Statements

STARTING WITH A QUICK BACKSTORY

As we launch into the content and concepts presented throughout this book, I would like to begin by referring to a book my father and I coauthored, titled *How to Read a Financial Report* (now in its ninth edition). This book, first written by my father and published by Wiley over 30 years ago, has stood the test of time and represents one of the top “go-to” technical accounting and financial references used by businesses, colleges, and organizations around the world. The book has so much useful information that you will find several overlaps and references to key financial and accounting concepts discussed in this book. However, there are also significant differences between these books that at heart are centered in the following two items:

- First, our book *How to Read a Financial Report* is centered on the premise of an external party (e.g., an investor, lender, etc.) evaluating or analyzing an organization from the outside looking in. That is, all the financial and accounting information produced has been done with the understanding that the audience will be external, independent third parties who are not privy to the organization’s internal operations

and related financial information and data. This represents a critical difference between this book and *How to Read a Financial Report* that will become evident moving through the material. The content of this book has been structured to look at financial and accounting information from the inside out with a heavy emphasis on business management (as opposed to adhering to guidelines, rules, and regulations established by external bodies or organizations such as the SEC).

- Second, *How to Read a Financial Report* is presented from more of a technical/accounting perspective or, for lack of a better term, a bit more black-and-white (as it relates to providing an understanding of accounting and financial concepts and how the big three financial statements are interconnected). This book is based on more of an internal business approach where, while it adheres to general or standard accounting rules and guidelines, its primary purpose is to assist with socializing accounting concepts, financial analyses and reporting strategies, and business planning from an internal operating or strategic perspective. Or, as I told my dad (a retired professor emeritus from the University of Colorado), “That is how you teach it in the classroom, but this is how it is done on the street.”

So, with this said, let’s launch into our first topic on the big three financial statements, as there is no better place to start, making sure you have a clear understanding of the role and importance of the balance sheet, income statement (aka profit-and-loss, or P&L), and statement of cash flows. Large or small, for-profit or non-profit, corporations, LLCs, partnerships, or sole proprietorships, governments, or private businesses, legal or illegal, it doesn’t really matter, as this basic concept is always present. That is, all operating entities need to produce complete, accurate, reliable, and timely financial statements on which to base sound business decision-making.

THE FINANCIAL REPORTING BEDROCK

It should go without saying that business managers, company lenders and investors, regulatory agencies, and countless other parties need to clearly and concisely understand an organization’s financial performance and results in a timely manner. This is common sense, no doubt, but you would be absolutely amazed at how often this basic concept is overlooked or, for lack of a

better term, neglected, by even the senior-most executive management teams. Maybe it is a result of ignorance, not having enough time, or just being lazy, but as we start our discussion on the big three financial statements, it should become abundantly clear just how important all three primary financial statements are and the key role each one plays.

Before we dive into a more detailed analysis of each of the big three financial statements, a quick overview of each financial statement and the related purpose is warranted:

- ***The balance sheet:*** The financial condition of a business is communicated in an accounting report called the *balance sheet*. In its simplest form, the balance sheet reports the assets owned by a business, the liabilities owed by the business (to third parties), and the net ownership equity (assets minus liabilities), all at a point in time.
- ***The income statement (AKA the Profit & Loss or just the P&L):*** The financial performance of a business that reports and measures its profit-or loss-making activities is presented in an accounting report called the *income statement*. In its simplest form, the income statement reports sales, costs of goods sold, operating expenses, other expenses or income, and finally, whether a net profit or loss was generated and covers a period of time (e.g., 12-month period of 1/1/20 through 12/31/20).
- ***The statement of cash flows:*** Finally, the last of the big three financial statements, and often the most important (but least understood), is the *statement of cash flows*. In its simplest form, this financial statement reports a business's sources (i.e., how a business generates cash), uses (i.e., how a company consumes cash), and net change in cash. Similar to the income statement, the statement of cash flows covers a time period which is almost always consistent with the time period reported in the income statement.

It should be noted that alternative titles for these financial statements are common. For the balance sheet, alternatives include “statement of financial condition” or “statement of financial position.” An income statement may be titled “statement of operations” or “earnings statement” as well as the profit & loss or, more simply, the P&L. For ease of presentation, we stick with the names *balance sheet* and *income statement* to be consistent throughout the book. The statement of cash flows is almost always called just that (but sometimes referred to as just a cash flow statement).

Finally, as you work your way through the book, please remember these definitions for frequently used terms and concepts:

- **Financial information:** The term *financial information* is used throughout the entire book and in its broadest sense includes basically all types of financial reports, financial statements, data, analyses, evaluations, assessments, and so on. For ease of reference and consistency, we simply use the term *financial information* in an all-encompassing meaning, apart from Chapter 2, where we present a discussion on the role and importance of preparing external financial reports and statements (which represent a selection or fraction of internally generated financial information).
- **Businesses:** As previously noted, all types of businesses, organizations, not-for-profits, government entities, and so on should produce financial statements on a periodic basis. Again, for ease of reference and consistency, when we refer to a *business* throughout the book, it is assumed to include any one of the entities identified.
- **Financial statements:** The term *financial statements*, in the plural, generally refers to a complete set that includes a balance sheet, an income statement, and a statement of cash flows as well as often implying that multiple years of financial statements will be presented. Informally, financial statements are called just “financials.” In almost all cases the financial statements need to be supplemented with additional information, which is presented in *footnotes* and *supporting schedules*. One supporting schedule is very common – the *statement of changes in stockholders’ (owners’) equity*.

THE INCOME STATEMENT, AKA PROFIT AND LOSS (P&L)

First up, we will begin with the income statement, as, for most parties, this is the financial statement that is not only looked to first to quickly assess total sales generated (which is a common measurement of the “size” of a business) and whether a business made any money (i.e., a profit), but, maybe more importantly, is the financial statement that tends to be the most easily understood. Exhibit 1.1 provides an example of a standard externally presented income statement.

The income statement is read in a step-down manner, like walking down a set of stairs. At the top of the staircase, sales revenue is reported first.

EXHIBIT 1.1 Audited Income Statement

QW Example Tech., Inc. Audited Financial Statements For the Fiscal Year Ending 12/31/2020		
Income Statement For the Twelve-Month Period Ending (all numbers in thousands)	FYE 12/31/2019	FYE 12/31/2020
Sales Revenue, Net	\$53,747	\$72,198
Costs of Goods Sold	<u>(\$24,259)</u>	<u>(\$27,541)</u>
Gross Profit	<u>\$29,488</u>	<u>\$44,657</u>
Operating Expenses:		
Selling, Marketing, & Promotional	\$9,406	\$13,357
Corporate General & Administrative	\$7,500	\$9,000
Research, Development, & Design	\$10,749	\$12,996
Depreciation & Amortization Expense	<u>\$1,814</u>	<u>\$2,421</u>
Total Operating Expenses	<u>\$29,469</u>	<u>\$37,774</u>
Operating Income (Loss)	<u>\$19</u>	<u>\$6,883</u>
Other Expenses (Income):		
Other Expenses, Income, & Discontinued Ops	\$250	\$2,000
Interest Expense	<u>\$150</u>	<u>\$400</u>
Total Other Expenses (Income)	<u>\$400</u>	<u>\$2,400</u>
Net Profit (Loss) before Income Taxes	<u>(\$381)</u>	<u>\$4,483</u>
Income Tax Expense (benefit)	<u>(\$133)</u>	<u>\$1,569</u>
Net Profit (Loss)	<u>(\$248)</u>	<u>\$2,914</u>

Sales revenue (AKA the "top line") is always reported first with costs of goods sold then reported to calculate gross profit.

Operating expenses are reported after gross profits and capture general company business expenses.

Finally, after all expenses are reported the company reports its net profit (or loss) often referred to as the "bottom line."

Confidential - Property of QW Example Tech., Inc.

Then, as you proceed down each step, a deduction of one or more expenses is reported. The first step deducts the cost of goods (products) sold from the sales revenue of goods sold, which gives *gross profit* (also called *gross margin* – one of the few places you see the term *profit* in income statements). This measure of profit is called *gross* because many other expenses are not yet deducted.

Next, a broad category of general business expenses, often referred to as *operating expenses* or *selling, general, and administrative expenses*, are reported in the P&L. In our income statement example (Exhibit 1.1) you see four different operating expenses presented, including selling, marketing, and promotional; corporate general and administrative; followed by research, development, and design; and finally depreciation and amortization expense. When preparing external income statements, there is no set rule as to how many expenses must be presented but generally speaking, you will find that most external income statements attempt to avoid providing too much detail and limit the list to eight or less (unless the business had a very unusual year and elects to provide additional disclosures).

In our example, the reason we have chosen to disclose three specific expense "buckets" separately is for their importance.

- First, in today's hyper-technology-driven economy, investors are keenly focused on just how much a business spends on research, development, and design (an extremely important function). Since our sample company is a technology-based business, this expense bucket makes sense to report separately.
- Second, selling, marketing, and promotional expense is also highlighted to reflect the importance of just how much a business must spend to secure or capture customers and, ultimately, drive sales revenue. Marketing, promotional, and selling expenses often are separated from general and administration expenses, given their significance (from a dollar perspective) and importance in driving sales revenue.
- Third, you will notice that in our income statement example, we have elected to report depreciation and amortization expense (unique non-cash expenses) as a separate line item. The reason for this is that as we move through the book and highlight the importance of understanding the statement of cash flows, it is very convenient to segregate noncash expenses such as depreciation and amortization expense as a separate line item in the income statement. It should be noted that businesses may or may not report depreciation or amortization expense on a separate line in their income statements based on the concept of materiality (discussed in Chapter 5). We have elected to report depreciation and amortization as a unique expense to better help our readers understand its impact on earnings, cash flow, and the balance sheet.

The level of detail for expenses in income statements is flexible and is really dependent on the desires of the company's management team to report what they believe is the right balance of providing too much detail versus not enough. From a financial reporting standards perspective, the guidelines are somewhat loose on this point and left open for different levels of opinions.

Finally, we reach the bottom portion of the income statement where other expenses and income are reported. Interest expense on debt is deducted as well as other non-recurring-type expenses (e.g., in this case, a large loss was incurred for a discontinued operation), which generates earnings before income tax. The last step is to deduct income tax expense, which gives net income, the bottom line in the income statement. Undoubtedly, you have heard the term *bottom line* (but this slang is not used in financial statements), as well as *top line*, which refers to total sales revenue. Other terminology you should be aware of includes being in the "black" (generating a profit) or the "red" (incurring a loss).

Note: Publicly owned businesses are required to report earnings per share (EPS), which basically is annual net income divided by the number of capital stock shares or similar investment units. Privately owned businesses don't have to report EPS, but this figure may be useful to their stockholders.

To conclude our introduction with the income statement, three items should be kept in mind.

First, the income statement presented in Exhibit 1.1 has been structured for external presentation (as opposed to internal business analysis). We dive into the key differences and importance of income statements prepared for external versus internal parties in Chapter 2.

Second, it is important to note that of the big three financial statements, the income statement is the one that tends to be the most easily and often manipulated or subject to misstatement. The reason for this is that many parties tend to focus first (and only) on this financial statement (making it the main attraction), as well as that these same parties are often not nearly as well versed in understanding the balance sheet and statement of cash flows.



Third, you will see multiple references to this all-important advice (throughout the book) which simply states – ***Understand the income statement, trust the balance sheet, but most importantly, rely on the statement of cash flows.*** As you work through the financial statements and this book, the importance of the state of cash flows will become increasingly clear.

THE BALANCE SHEET

The financial statement that is second in line is the balance sheet, which in its simplest form presents the *financial condition* of a business at a point in time (e.g., as of the fiscal year ending 12/31/20). Unlike the income statement, which presents a business's financial performance over a period of time, the balance sheet reports and summarizes a business's assets and liabilities, as well as the ownership interests in the residual of assets in excess of liabilities (referred to as owners' equity).

EXHIBIT 1.2 Audited Balance Sheet

QW Example Tech., Inc. Audited Financial Statements For the Fiscal Year Ending 12/31/2020		
Balance Sheet Period Ending (all numbers in thousands)	FYE 12/31/2019	FYE 12/31/2020
Assets (all numbers in thousands)		
Current Assets:		
Cash & Equivalents	\$1,704	\$9,411
Accounts Receivable, Net	\$6,718	\$9,025
Inventory, LCM	\$4,331	\$1,841
Prepaid Expenses	<u>\$300</u>	<u>\$325</u>
Total Current Assets	<u>\$13,053</u>	<u>\$20,602</u>
Long-Term Operating & Other Assets:		
Property, Plant, Equipment, & Machinery	\$9,200	\$9,950
Accumulated Depreciation	<u>(\$3,264)</u>	<u>(\$4,686)</u>
Net Property, Plant, & Equipment	<u>\$5,936</u>	<u>\$5,264</u>
Other Assets:		
Intangible Assets & Goodwill, Net	\$1,000	\$12,500
Other Assets	<u>\$100</u>	<u>\$125</u>
Total Long-Term Operating & Other Assets	<u>\$7,036</u>	<u>\$17,889</u>
Total Assets	<u>\$20,089</u>	<u>\$38,491</u>
<i>Confidential - Property of QW Example Tech., Inc.</i>		
Liabilities		
Current Liabilities:		
Accounts Payable	\$1,701	\$1,995
Accrued Liabilities & Other	\$632	\$1,373
Current Portion of Debt	\$1,000	\$2,000
Other Current Liabilities & Deferred Revenue	<u>\$2,625</u>	<u>\$4,594</u>
Total Current Liabilities	<u>\$5,958</u>	<u>\$9,962</u>
Long-term Liabilities:		
Notes Payable & Other Long-Term Debt	<u>\$2,500</u>	<u>\$6,625</u>
Total Liabilities	<u>\$8,458</u>	<u>\$16,587</u>
Stockholders' Equity		
Capital Stock - Common	\$10,000	\$10,000
Capital Stock - Preferred	\$0	\$8,000
Retained Earnings	<u>\$1,631</u>	<u>\$3,905</u>
Total Stockholders' Equity	<u>\$11,631</u>	<u>\$21,905</u>
Total Liabilities & Stockholders' Equity	<u>\$20,089</u>	<u>\$38,491</u>
<i>Confidential - Property of QW Example Tech., Inc.</i>		

Cash & equivalents listed first followed by trade receivables (highly liquid). Notice the decrease in inventory from the prior year.

Capital assets are presented which include equipment, machinery, etc.

Finally, other assets are presented. Large increase in intangible assets relates to goodwill acquired from a company acquisition.

Trade payables & accrued liabilities listed first followed by current portion of debt. Notice large increase in deferred revenue.

Long-term liabilities presented next. Notice increase from 2019.

Finally, capital stock is listed by primary class followed by retained earnings. This company raised \$8 million of capital with preferred stock in 2020.

The balance sheet shown in Exhibit 1.2 follows the standardized format regarding the classification and ordering of assets, liabilities, and ownership interests in the business. It should be noted that financial institutions, public utilities, railroads, and other specialized businesses use somewhat

different balance sheet layouts but for the purpose of this book, we will use the standard format presented in Exhibit 1.2 for our overview. This format is generally used by technology companies, manufacturers, distributors, professional service companies, and retailers, as well as the large majority of other business types.

The assets, liabilities, and owners' equity reported in the balance sheet follow generally accepted conventions, which we briefly summarize here. According to long-standing rules, balance sheet accounts are subdivided into the following classes, or basic groups, in the following order of presentation:

Left Side (or Top Section)	Right Side (or Bottom Section)
Current assets	Current liabilities
Long-term operating assets	Long-term liabilities
Other assets	Owners' equity

Balance sheets are often presented in a horizontal format, with *assets* presented or listed on the left side, *liabilities* on the upper half of the right side, and *net owners' equity* on the lower half of the right side below the liabilities, to emphasize that the owners or equity holders in a business (the stockholders of a business corporation) have a secondary and lower-order claim on the assets – after its liabilities are satisfied. Balance sheets can also be presented in a vertical format with assets listed at the top or first, liabilities listed in the middle or second, and net owners' equity presented at the bottom or third. For ease of presentation, we used the vertical format in Exhibit 1.2.

Roughly speaking, a balance sheet lists assets in their order of “nearness to cash.” Cash is listed first at the top of the assets stack. Next, receivables that will be collected in the short run are listed, and so on down the line. In later chapters, we say much more about the cash characteristics of different assets. In like manner, liabilities are presented in the sequence of their “nearness to payment.” We discuss this point as we go along in later chapters.

Each separate asset, liability, and stockholders' equity reported in a balance sheet is called an *account*. Every account has a name (title) and a dollar amount, which is called its *balance*. For instance, from Exhibit 1.2, at the end of the most recent year ending 12/31/20 the inventory account had a balance of \$1.841 million. It should be noted that the inventory account is most likely made up of multiple sub-accounts, including raw material, work-in-process, finished goods, and other inventory accounts, which for external reporting purposes are consolidated to reflect just one value in inventory.

This generally holds for most other balances (presented in the balance sheet); also, in almost all cases, the dollar figure represents a summation of multiple individual accounts (that are summed together given their similarities in purpose).

A balance sheet is prepared at the close of business on the last day of the income statement period. For example, if the income statement is for the year ending December 31, 2020, the balance sheet is prepared at midnight December 31, 2020. The amounts reported in the balance sheet are the balances of the accounts at that precise moment in time. The financial condition of the business is frozen for one split second. A business should be careful to make a precise and accurate cutoff to separate transactions between the period just ended and the next period.

A balance sheet does not report the flows of activities in the company's assets, liabilities, and shareowners' equity accounts during the period. Only the ending balances at the moment the balance sheet is prepared are reported for the accounts. For example, the company reports an ending cash balance of \$9.441 million at the end of its most recent year (see again Exhibit 1.2). Can you tell the total cash inflows and outflows for the year? No, not from the balance sheet; you can't even get a clue from the balance sheet alone, as when understanding the flow of cash over a period of time, this represents the purpose of the statement of cash flows.

Some part of the total assets of a business comes not from liabilities but from its owners investing capital in the business and from retaining some or all of the profit the business earns that is not distributed to its owners. In this example the business is organized legally as a corporation. Its *stockholders' equity* accounts in the balance sheet reveal the sources of the company's total assets in excess of its total liabilities. Notice in Exhibit 1.2 the three stockholders' (owners') equity sources, which are called *capital stock – common*, *capital stock – preferred*, and *retained earnings*. The reason we have separated different forms of capital stock between common and preferred is extremely important to understand and will be covered in more depth in Chapter 17 in our discussion on sources of capital.

When owners (stockholders of a business corporation) invest capital in the business, the capital stock account is increased. Net income earned by a business less the amount distributed to owners increases the retained earnings account. The nature of retained earnings can be confusing; therefore, we explain this account in depth at the appropriate places in the book. Just a quick word of advice here: Retained earnings is *not*—we repeat, is *not*—an asset. Get such a notion out of your head.



A final word or two with the balance sheet. First, when reviewing the balance sheet, keep these thoughts in your head: Are your assets lying to you? and Are your liabilities telling you the truth? For example, in our balance sheet presented in Exhibit 1.2, the value in inventory as of the fiscal year-end 12/31/19 is stated at \$4.331 million, yet this decreases to \$1.841 million as of the fiscal year-end 12/31/20 (a substantial drop). The value of inventory was in fact written down in 2020 (as you will discover later in this book), but it begs the question, did management “massage” the inventory value to be a bit higher as of the fiscal year end 12/31/19 to protect net income?

Second, it is recommended that you become familiar with the term *balance sheet dressing*. No, this is not some special type of side dish served with your seasonal Thanksgiving Day turkey but rather represents the efforts by company executives to manage certain transactions as of the end of a period to present the performance of a business in the best light possible. When we dive into various company performance ratios and analyses covered in Chapters 8 and 9, this will become more apparent.

THE STATEMENT OF CASH FLOWS

Finally, we reach the third and final financial statement of the big three, which I like to think of in terms of the Disney movie *Cinderella*. If you recall, the two attention-starved stepsisters (i.e., the balance sheet and income statement) demand all the attention and relegate Cinderella to performing demeaning tasks. However, as the story moves forward, Cinderella blossoms into the most beautiful sister of all as her true, deep, and rich value comes to light. You might think of the statement of cash flows in this same light as, once you truly understand its importance and meaning, you will find that it really shines an amazing light on the operating performance of a business.

Okay, so this might be a bit of an overreach, but this analogy drives home a critical concept associated with the big three financial statements. That is, the income statement and, to a lesser extent, the balance sheet, tend to get most of the attention from financial experts, as in today’s “time is of the essence” business mindset, the questions that generally first come to mind are: (a) What are top line sales (and how much did they grow)?, (b) What’s the company’s bottom-line profit?, and (c) How financially strong is the company? All

good questions, but none of these addresses the most important question of all – can the business generate enough cash to support ongoing operations? This, in a nutshell, represents the essence of the statement of cash flows.

Earlier in this chapter you were introduced to the two hardcore financial statements that are included in the financial report of a business – Exhibit 1.1 (income statement) and Exhibit 1.2 (balance sheet). These two provide a comprehensive summary of the financial performance and financial condition of the business. This is not the end of the story, however. Financial reporting standards require that a *statement of cash flows* also be presented for the same time period as the income statement.

This third financial statement, as its title implies, focuses on the cash flows of the period. The cash flow statement is not “better” than the income statement and/or balance sheet. Rather, it discloses additional critical information that supplements the income statement and balance sheet.

EXHIBIT 1.3 Audited Statement of Cash Flows

QW Example Tech., Inc. Audited Financial Statements For the Fiscal Year Ending 12/31/2020		
Statement of Cash Flows For the Twelve-Month Period Ending (all numbers in thousands)		
	FYE 12/31/2019	FYE 12/31/2020
Net Profit (Loss)	(\$248)	\$2,914
Operating Activities, Cash provided (used):		
Depreciation & Amortization	\$1,814	\$2,421
Decrease (increase) in trade receivables	(\$746)	(\$2,307)
Decrease (increase) in inventory	\$482	\$2,490
Decrease (increase) in other current assets	(\$50)	(\$25)
Increase (decrease) in trade payables	\$158	\$294
Increase (decrease) in accrued liabilities	\$68	\$174
Increase (decrease) in other liabilities	\$1,520	\$2,536
Net Cash Flow from Operating Activities	<u>\$2,998</u>	<u>\$8,497</u>
Investing Activities, Cash provided (used):		
Capital Expenditures	(\$2,000)	(\$750)
Investments in Other Assets	\$0	(\$12,525)
Net Cash Flow from Investing Activities	<u>(\$2,000)</u>	<u>(\$13,275)</u>
Financing Activities, Cash provided (used):		
Dividends or Distributions Paid	\$0	(\$640)
Sale (repurchase) of Equity	\$0	\$8,000
Proceeds from Issuance of Debt	\$0	\$8,000
Repayments of Long-term Debt	(\$1,000)	(\$3,000)
Other Financing Activities	\$250	\$0
Net Cash Flow from Financing Activities	<u>(\$750)</u>	<u>\$12,360</u>
Other Cash Flow Adjustments - Asset Impairment	<u>\$0</u>	<u>\$125</u>
Net Increase (decrease) in Cash & Equivalents	<u>\$247</u>	<u>\$7,707</u>
Beginning Cash & Equivalents Balance	<u>\$1,457</u>	<u>\$1,704</u>
Ending Cash & Equivalents Balance	<u>\$1,704</u>	<u>\$9,411</u>

Statement of cash flows begins with information from the income statement including net profit or loss & depr./amort expense.

Net cash flow from operating activities presents a company's ability to generate or consume cash from internal operations.

Net cash flow from investing activities is presented next. Note the significant investment made in other assets (a business acquisition).

Net cash flow from financing activities is presented last. The company raised money from both debt and equity sources.

Ending cash balance agrees to the balance sheet (a proper check).

Confidential - Property of QW Example Tech., Inc.

Exhibit 1.3 presents the statement of cash flows for our business example. Similar to the income statement, the statement of cash flows reads like going down a flight of stairs, from the top down, and has three primary parts, or layers: cash flows from *operating* activities, cash flows from *investing* activities, and cash flows from *financing* activities.

Cash flows from *operating activities* refers to revenue and expenses (as well as gains and losses) during the period that culminate in the bottom-line net income or loss for the period. In short, “operating” refers to the profit-(or loss-)making activities of the business and, as you can see, represents the first amount reported in the statement of cash flows (at the top of the statement). After this, companies generally report noncash expenses such as depreciation and amortization expense, along with reporting changes in the company’s current assets and current liabilities realized during the reporting period. Once all this activity is reported, net cash flow from operating activities is reported, which in our example, amounts to a positive \$8.497 million for the fiscal year ending 12/31/20.

Now this next statement may sound counterintuitive, but it is especially important to understand. That is, when a company’s asset value increases over a period of time, this represents a use of cash (i.e., cash is consumed and decreases during the period). Likewise, when a company’s asset value decreases over a period of time, this represents a source of cash (e.g., inventory is sold, the value is reduced, and it is turned into cash when the customer pays). On the liability side of life, a liability increasing in value over a period of time represents a source of cash (the opposite of the asset relationship), and a liability decreasing in value over a period of time represents a use of cash (e.g., vendor obligations due are paid, consuming cash).



As you work through the book, these concepts will become clearer and emphasize a critical concept in business financial management. That is, in order to improve liquidity and cash flows, businesses need to make sure they don’t overinvest in assets (that consume excess cash) while at the same time utilize appropriate credit sources from vendors, third parties, future customers (e.g., receiving deposits), and so on to, for lack of a better term, leverage their liabilities to improve cash flows. Translation – what this really means is that smart business operators know exactly how far they can push vendors, suppliers, lenders, and so on to provide extra or extended terms to retain added cash inside a company to support ongoing operations.

Next up in the statement of cash flows is the section referred to as cash provided or (used) in *investing* activities. This section generally reports how a company spends or invests large amounts of cash/capital in long-term investments such as equipment or machinery additions, investments in intangible assets such as software development, and so forth (i.e., what long-term investments are being made by the company). In our sample company, one item that should clearly catch your eye is the \$12.525 million investment made in other assets in the fiscal year ending 12/31/20. As we will discover later in the book, this investment was part of a large acquisition the company made of another business to drive future growth.

The final section in the statement of cash flows presents cash provided or used in the *financing* activities of the business. This section is designed to clearly disclose how a company finances its business operations from sources of cash other than operating cash flows (previously discussed). The information reported in this section relates to both how a company secures cash/capital (debt or equity) from external parties and how cash/capital is deployed as a return to the external parties. For example, in our sample company, you will notice that \$8 million of new debt was secured in the fiscal year ending 12/31/20 while at the same time \$3 million of old debt was repaid during the same period. You may ask what these transactions relate to, so I'll go ahead and give you a hint. The company raised new debt of \$8 million (along with selling equity, raising another \$8 million) to fund a large acquisition of approximately \$12.5 million and as part of its new debt facility, the company was required to pay off an existing loan (thus the repayment or use of \$3 million for debt).

At the very end of the statement of cash flows, a simple summary is provided that calculates the net increase or decrease in cash and adds this to the beginning cash balance, which then presents the final ending cash balance.

As we close our discussion on the statement of cash flows, it's worth visiting (and remembering) two critical concepts:

- First, you will notice that in our sample company, a net profit of \$2.914 million was generated, compared to a net increase in cash of \$7.707 million being realized during the year. So, if you've ever asked how the net increase in cash during a given period can be greater than the profit generated, the answer lies in the statement of cash flows. Rarely will you find a situation where the net profit generated equates to exactly the same amount of net cash increase during the same period as cash inflows from sales revenue are almost always higher or

lower than the actual sales revenue recorded during the period, and actual cash outflows for expenses are typically higher or lower than the amounts of expenses recorded for the period.

- Second, we would direct you toward our previous thoughts on understanding the income statement, trusting the balance sheet, and, most importantly, relying on the statement of cash flows. In effect, the statement of cash flows acts as the glue that ties or connects all the financial statements together. It starts by reporting net profit or loss and depreciation and amortization expense (both from the income statement). Then, it captures all the changes in a company's assets and liabilities to produce a net increase or decrease in cash, which, when added to the beginning cash balance, results in an ending cash balance (which ties to or should agree with the cash balance reported on the balance sheet). In effect, the statement of cash flows acts in the capacity of a self-regulating series of checks and balances to help parties better understand a company's economic model and ability to generate reliable positive cash flows (the ultimate purpose of a business).

