FINANCIAL MANAGEMENT 101:
Get a Grip on Your Business Numbers

Angie Mohr, CA, CMA
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In this chapter, you will learn –

- The basic attributes of the balance sheet, income statement, and cash flow statement
- How the three statements interconnect
- The difference between net income and cash flow

Before we can examine how to interpret your financial information and make valid management decisions based on that information, you need to understand the three basic financial statements of the business and how they work. If, after reading this chapter, you feel that you need to brush up on bookkeeping topics, please refer to Bookkeepers’ Boot Camp, the first book in the Self-Counsel Press Numbers 101 for Small Business series. There you will learn the basics of double-entry bookkeeping and how to prepare your financial statements.
The three basic financial statements for any small business are the —

- balance sheet,
- income statement (sometimes called the profit and loss statement or P&L), and
- cash flow statement (sometimes called the statement of changes in financial position).

We will look at each of these in turn.

The Balance Sheet

The balance sheet is a freeze-frame picture of the assets a business owns and the liabilities (debts) a business owes at a particular time. Sample 1 shows a typical balance sheet.

For example, if a business prepared a balance sheet as of December 31, it would show some or all of the following assets:

- Cash in the bank
- Accounts receivable (i.e., amounts to be received from customers)
- Inventory
- Capital assets (e.g., equipment)

And the following liabilities (debts):

- Suppliers that will be paid in the future
- Bank loans and mortgages
- Wages payable to employees

The liabilities are split on the balance sheet between current (those that will be paid within one year) and long term.

The balance sheet also shows the owner’s equity. This is the sum of —

- retained earnings (i.e., all the historical profits a business has made that have been left in the business),
- capital stock (i.e., the stock that has been purchased by shareholders in a corporation), and
- contributed capital (i.e., any capital funds that have been invested by the owners of the business).
In other words, the owner’s equity is the net worth of the business. Another way of valuing net worth is to subtract what the business owes (liabilities) from what the business owns (assets).

\[
\text{Assets} - \text{Liabilities} = \text{Owner's equity}
\]

or

\[
\text{Assets} = \text{Liabilities} + \text{Owner's equity}
\]

One final note to keep in mind about the balance sheet is its valuation. In most countries, accounting rules (called Generally Accepted Accounting Principles or GAAP) require that the balance

<table>
<thead>
<tr>
<th>SAMPLE 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>TYPICAL BALANCE SHEET</td>
</tr>
</tbody>
</table>

Balance sheet as at December 31, 200-

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>4,250</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>6,975</td>
</tr>
<tr>
<td>Inventory</td>
<td>1,200</td>
</tr>
<tr>
<td>Capital assets</td>
<td>9,325</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>21,750</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td></td>
</tr>
<tr>
<td>Line of credit payable</td>
<td>3,250</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>1,350</td>
</tr>
<tr>
<td>Long term</td>
<td></td>
</tr>
<tr>
<td>Equipment loan</td>
<td>8,750</td>
</tr>
<tr>
<td>Mortgage on building</td>
<td>2,575</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>15,925</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>2,295</td>
</tr>
<tr>
<td>Capital stock</td>
<td>100</td>
</tr>
<tr>
<td>Contributed capital</td>
<td>3,430</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td><strong>5,825</strong></td>
</tr>
</tbody>
</table>

| **Total liabilities and equity** | **21,750** |

*Note that total assets should equal the total liabilities and equity*
sheet be valued at historical cost. That means, for example, that if your business bought the building in which it resides in 1982 for $100,000 and it’s now worth $295,000, it will still be recorded in the balance sheet at its historical cost of $100,000 (minus depreciation). For this reason, a balance sheet does not always give a business owner the true picture of the value of a business. We will discuss valuation principles in later chapters.

The Income Statement

The income statement shows the revenue and expense activities of the business for a period of time — be it a day, week, month, or year. See Sample 2 for an example of an income statement.

**SAMPLE 2**

**INCOME STATEMENT**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$50,000</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$15,000</td>
</tr>
<tr>
<td>Rent</td>
<td>$9,570</td>
</tr>
<tr>
<td>Wages</td>
<td>$6,250</td>
</tr>
<tr>
<td>Office supplies</td>
<td>$1,290</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>$32,110</strong></td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td><strong>$17,890</strong></td>
</tr>
</tbody>
</table>

The first section of the income statement shows the business’s revenues. This is the amount of sales it has made in the period, regardless of whether or not the money has been collected. For example, if your business sold $50,000 worth of product or services, but you weren’t going to collect the money until 90 days after the period end, you would still show the $50,000 as revenue (and you would have $50,000 in Accounts receivable on the balance sheet).

The next section of the income statement shows the business’s total expenses for that period, again, regardless of whether or not they have been paid.

The number at the bottom of the income statement is the net profit for the period, calculated by subtracting the total expenses from the revenue.
The Cash Flow Statement

The cash flow statement is the most misunderstood statement in your financial statement package. Its purpose is to show a summary of the sources and uses of a business’s cash during a particular period. It answers the critical question, “Where did my cash go?” See Sample 3 for an example of a cash flow statement.

**SAMPLE 3**

**CASH FLOW STATEMENT**

<table>
<thead>
<tr>
<th>Small Company Inc.</th>
<th>Cash flow statement</th>
<th>Year ended 31 December 200-</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$68,812</td>
<td></td>
</tr>
<tr>
<td>Add back: Depreciation*</td>
<td>9,340</td>
<td></td>
</tr>
<tr>
<td><strong>Cash from operating activities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in Accounts receivable</td>
<td>(5,268)</td>
<td></td>
</tr>
<tr>
<td>Increase in Inventory</td>
<td>(4,750)</td>
<td></td>
</tr>
<tr>
<td>Decrease in Accounts payable</td>
<td>(26,745)</td>
<td></td>
</tr>
<tr>
<td>Increase in Government remittances</td>
<td>463</td>
<td></td>
</tr>
<tr>
<td>Increase in Income taxes</td>
<td>77</td>
<td></td>
</tr>
<tr>
<td>Increase in Due to shareholder</td>
<td>5,130</td>
<td></td>
</tr>
<tr>
<td>Decrease in Mortgage payable</td>
<td>(13,913)</td>
<td></td>
</tr>
<tr>
<td><strong>(45,006)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash from investing activities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of capital assets</td>
<td>(1,475)</td>
<td></td>
</tr>
<tr>
<td><strong>(1,475)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash from financing activities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>(40,707)</td>
<td></td>
</tr>
<tr>
<td><strong>(40,707)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total decrease in cash</td>
<td>(9,036)</td>
<td></td>
</tr>
<tr>
<td>Opening cash balance**</td>
<td>10,295</td>
<td></td>
</tr>
<tr>
<td>Closing cash balance</td>
<td>$1,259</td>
<td></td>
</tr>
</tbody>
</table>

* For more information on depreciation, read Bookkeepers’ Boot Camp.

** The opening cash balance is the ending cash balance from the previous year.
The cash flow statement can take many formats but the most common one breaks the statement into three sections:

- **Cash from operating activities.** This could include the collection of receivables, payment of payables, and purchase of inventory.

- **Cash from investing activities.** This could include the purchase or disposal of equipment.

- **Cash from financing activities.** This could include borrowing new money from lenders, repaying debt to lenders, new capital investments from the owners, and cash distributions to owners.

The sums of all three sections of the cash flow statement plus the net income minus non-cash expenses are combined to show the net increase or decrease in cash for the period. For example, if you started your year with $5,000 in the business’s bank account and now there was $2,700, the cash flow statement would summarize all the inflows and outflows that make up the net decrease in cash of $2,300.

**CHAPTER SUMMARY**

- The three major financial statements for a business are the balance sheet, income statement, and cash flow statement.

- The balance sheet represents a snapshot in time of what a business owns and owes, usually recorded at historical cost.

- The income statement represents a business’s operating activity for the period leading up to the related balance sheet.

- The cash flow statement answers the question, “Where did the money go?” It shows cash inflows and outflows from all activities for the period leading up to the related balance sheet.