Week 5 DQ 2 How to Read Financial Statements

If you don't have a business or accounting background but you found yourself running or interested in running your own company you're going to need to learn at least the basics. The first thing, or three things rather, that you should teach yourself are the basic financial statements, the balance sheet, income statement, and statement of cash flows. These three statements are vitally important because they paint the financial picture of your company and help you to evaluate past performance and plan for the future. So here are the basics to financial statements in less than five minutes.

The first financial statement that you need to know about is the balance sheet. The balance sheet shows the company's assets, liabilities, and shareholders equity as of a specific date. Its assets are split into current assets, which includes liquid assets such as cash and accounts receivable, and property, plant, and equipment which are less liquid assets such as land, buildings, and obviously equipment.

Liabilities are also split into current liabilities and long-term liabilities. Current liabilities are those due within the next year while long-term liabilities are those due in over a year. So, for example, if you have a mortgage the portion of the mortgage that's due within the next 12 months would be counted under current liabilities and the rest of that mortgage would be counted under long-term liabilities.

The total assets, and total liabilities plus shareholders equity (together) must equal each other so if you create a balance sheet and these two numbers don't match you've made a mistake somewhere and need to go back and check your work.

The second financial statement that you'll need to learn is the income statement. Also known as the profit and loss statement, the income statement shows the company's profit or loss over a specified period of time and it shows revenues and expenses split into operating and non-operating income. Operating income starts with sales and cost of goods sold to give the gross profit margin. It then deducts operating expenses split into selling expenses and general and administrative expenses. Selling expenses are those expenses directly related to sales and would include things like advertising and sales commissions for your salespeople. Administrative expenses include the cost of running the business that are not directly related to sales, such as office supplies and utilities. The gross profit less you're operating expenses gives you your operating income. Then you add or subtract the non-operating income such as interest to get your net income.

The final financial statement that you'll need to learn is the statement of cash flows. The statement of cash flows is vitally important as many small businesses failed not because of profitability issues but because of cash flow issues. The statement of cash flows shows the company's inflow and outflow of cash over a specified period of time. The cash flow statement is broken into cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. For cash flows from operating activities you start with the net income and then you adjust for non-cash revenue and expenses such as depreciation, accounts receivable, and accounts payable. For cash flows from investing activities you include things like the sale of a factory building or equipment. Finally, cash flow from financing activities will include things like the sales or purchases of stock or a distribution of dividends. This gives your net increase in cash. Add that to the cash you had at the beginning of the period and you know how much cash you have on hand available now.

Now you should understand the basics of these three financial statements to better understand how your company is performing so that you can strategize for future growth.

I hope you found this tutorial helpful.