Return to: Previous Page

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Course 107

Introduction to Financial Statements

Introduction

Although the words "financial statements" and "accounting" send cold shivers down many people's backs, this is the language of business, a language investors need to know before buying stocks. The beauty is you don't need to be a CPA to understand the basics of the three most fundamental and important financial statements: the income statement, the balance sheet, and the statement of cash flows. All three of these statements are found in a firm's annual report, 10-K, and 10-Q filings.

The financial statements are windows into a company's performance and health. We'll provide a very basic overview of each financial statement in this lesson and go into much greater detail in Lesson 301-303.

The Income Statement

What is it and why do I care?

The income statement tells you how much money a company has brought in (its revenues), how much it has spent (its expenses), and the difference between the two (its profit). The income statement shows a company's revenues and expenses over a specific time frame such as three months or a year. This statement contains the information you'll most often see mentioned in the press or in financial reports--figures such as total revenue, net income, or earnings per share.

The income statement answers the question, "How well is the company's business performing?" Or in simpler terms, "Is it making money?" A firm must be able to bring in more money than it spends or it won't be in business for very long. Firms with low expenses relative to revenues--and thus, high profits relative to revenues--are particularly desirable for investment because a bigger piece of each dollar the company brings in directly benefits you as a shareholder.

Revenues, Expenses, and Profit

Each of the three main elements of the income statement is

described below.

Revenues. The revenue section is typically the simplest part of the income statement. Often, there is just a single number that represents all the money a company brought in during a specific time period, although big companies sometimes break down revenues in ways that provide more information (e.g., segregated by geographic location or business segment). Revenues are also commonly known as sales.

Expenses. Although there are many types of expenses, the two most common are the cost of sales and SG&A (selling, general, and administrative) expenses. Cost of sales, which is also called cost of goods sold, is the expense most directly involved in creating revenue. For example, Gap GPS may pay $10 to make a shirt, which it sells for $15. When it is sold, the cost of sales for that shirt would be $10--what it cost Gap to produce the shirt for sale. Selling, general, and administrative expenses are also commonly known as operating expenses. This category includes most other costs in running a business, including marketing, management salaries, and technology expenses.

Profits. In its simplest form, profit is equal to total revenues minus total expenses. However, there are several commonly used profit subcategories investors should be aware of. Gross profit is calculated as revenues minus cost of sales. It basically shows how much money is left over to pay for operating expenses (and hopefully provide profit to stockholders) after a sale is made. Using our example of the Gap shirt before, the gross profit from the sale of the shirt would have been $5 ($15 sales price - $10 cost of sales = $5 gross profit). Operating profit is equal to revenues minus the cost of sales and SG&A. This number represents the profit a company made from its actual operations, and excludes certain expenses and revenues that may not be related to its central operations. Net income generally represents the company's profit after all expenses, including financial expenses, have been paid. This number is often called the "bottom line" and is generally the figure people refer to when they use the word "profit" or "earnings."

The Balance Sheet

What is it and why do I care?

The balance sheet, also known as the statement of financial condition, basically tells you how much a company owns (its assets), and how much it owes (its liabilities). The difference between what it owns and what it owes is its equity, also commonly called "net

assets," "stockholder's equity," or "net worth."

The balance sheet provides investors with a snapshot of a company's health as of the date provided on the financial statement. Generally, if a company has lots of assets relative to liabilities, it's in good shape. Conversely, just as you would be cautious loaning money to a friend who is burdened with large debts, a company with a large amount of liabilities relative to assets should be scrutinized more carefully.

Assets, Liabilities, and Equity
Each of the three primary elements of the balance sheet is described below.

Assets. There are two main types of assets: current assets and noncurrent assets. Within these two categories, there are numerous subcategories, many of which will be explained in Lesson 302. Current assets are likely to be used up or converted into cash within one business cycle--usually defined as one year. For example, the groceries at your local supermarket would be classified as current assets because apples and bananas should be sold within the next year. Noncurrent assets are defined by our left-brained accountant friends as, you guessed it, anything not classified as a current asset. For example, the refrigerators at your supermarket would be classified as noncurrent assets because it's unlikely they will be "used up" or converted to cash within a year.

Liabilities. Similar to assets, there are two main categories of liabilities: current liabilities and noncurrent liabilities. Current liabilities are obligations the firm must pay within a year. For example, your supermarket may have bought and received $1,000 worth of eggs from a local farm but won't pay for them until next month. Noncurrent liabilities are the flip side of noncurrent assets. These liabilities represent money the company owes one year or more in the future. For example, the grocer may borrow $1 million from a bank for a new store, which it must pay back in five years.

Equity. Equity represents the part of the company that is owned by shareholders; thus, it's commonly referred to as shareholder's equity. As described above, equity is equal to total assets minus total liabilities. Although there are several categories within equity, the two biggest are paid-in capital and retained earnings. Paid-in capital is the amount of money shareholders paid for their shares when the stock was first offered to the public. It basically represents how much money the firm received when it sold its shares. Retained earnings represent the total profits the company has earned since it began, minus whatever has been paid to

shareholders as dividends. Since this is a cumulative number, if a company has lost money over time, retained earnings can be negative and would be renamed "accumulated deficit."

The Statement of Cash Flows

What is it and why do I care?
The statement of cash flows tells you how much cash went into and out of a company during a specific time frame such as a quarter or a year. You may wonder why there's a need for such a statement because it sounds very similar to the income statement, which shows how much revenue came in and how many expenses went out.

The difference lies in a complex concept called accrual accounting. Accrual accounting requires companies to record revenues and expenses when transactions occur, not when cash is exchanged. While that explanation seems simple enough, it's a big mess in practice, and the statement of cash flows helps investors sort it out.

The statement of cash flows is very important to investors because it shows how much actual cash a company has generated. The income statement, on the other hand, often includes noncash revenues or expenses, which the statement of cash flows excludes.

One of the most important traits you should seek in a potential investment is the firm's ability to generate cash. Many companies have shown profits on the income statement but stumbled later because of insufficient cash flows. A good look at the statement of cash flows for those companies may have warned investors that rocky times were ahead.

The Three Elements of the Statement of Cash Flows
Because companies can generate and use cash in several different ways, the statement of cash flows is separated into three sections: cash flows from operating activities, from investing activities, and from financing activities.

The cash flows from operating activities section shows how much cash the company generated from its core business, as opposed to peripheral activities such as investing or borrowing. Investors should look closely at how much cash a firm generates from its operating activities because it paints the best picture of how well the business is producing cash that will ultimately benefit shareholders.

The cash flows from investing activities section shows the amount

of cash firms spent on investments. Investments are usually classified as either capital expenditures--money spent on items such as new equipment or anything else needed to keep the business running--or monetary investments such as the purchase or sale of money market funds.

The cash flows from financing activities section includes any activities involved in transactions with the company's owners or debtors. For example, cash proceeds from new debt, or dividends paid to investors would be found in this section.

Free cash flow is a term you will become very familiar with over the course of these workbooks. In simple terms, it represents the amount of excess cash a company generated, which can be used to enrich shareholders or invest in new opportunities for the business without hurting the existing operations; thus, it's considered "free." Although there are many methods of determining free cash flow, the most common method is taking the net cash flows provided by operating activities and subtacting capital expenditures (as found in the "cash flows from investing activities" section).

Cash from Operations - Capital Expenditures = Free Cash Flow

The Bottom Line

Phew!!! You made it through an entire lesson about financial statements. While we're the first to acknowledge that there are far more exciting aspects about investing in stocks than learning about accounting and financial statements, it's essential for investors to know the language of business. We also recommend you sharpen your newfound language skills by taking a good look at the more-detailed discussion on financial statements in Lessons 301-303.

Quiz 107

There is only one correct answer to each question.

1 On the income statement, profits tell you:

a. The difference between how much a company owns and how much it owes.
b. The difference between how much a company brought in and how much it spent during a given period.
c. The difference between how much a company owns and how much it spend during a given period.

2 Which of the following is not part of the statement of cash flows?

a. Cash flows from operating activities.
b. Cash flows from financing activities.
c. Cash flows from expense activities.

3 A company with lots of assets relative to liabilities on its balance sheet:

a. Is in danger of going bankrupt.
b. Has very little equity.
c. Is healthier than a company with lots of liabilities.

4 Current assets are:

a. Assets likely to be used up or converted into cash within the next year.
b. Assets likely to be used up or converted into cash within the next three years.
c. Assets a company does not own yet.

5 What is a major difference between the income statement and the statement of cash flows?

a. The statement of cash flows refers to a single point in time, rather than a period of time like a quarter or a year.
b. The statement of cash flows excludes noncash revenues and expenses.
c. The statement of cash flows provides a breakdown of revenues, expenses, and profits.

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Return to: Previous Page