

Financial Statement Fundamentals – *‘Show Me the Money!’*

By Michael W. Blitstein, CPA

Many of us remember Cuba Gooding Jr.’s immortal line from the movie “Jerry Maguire,” “Show me the money!” Well, that’s what financial statements do. They show you where your practice’s money comes from, where it goes, and where it is now.

There are three main financial statements: (1) balance sheets, (2) income statements, and (3) cash flow statements. Balance sheets show what your practice owns and what it owes at a fixed point in time. Income statements indicate how much money a practice made and spent over a period of time. Cash flow statements reflect the exchange of money between your practice and the outside world also over a period of time. Let’s look at each of the three financial statements in more detail.

Balance Sheets

A balance sheet provides detailed information about your practice’s assets, liabilities, and owner’s equity. This formula summarizes what a balance sheet reflects: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.

Assets are items that a practice owns that have value. This typically means they can either be sold or used by the practice to provide services. Assets include cash as well as physical property such as equipment, furniture, and leasehold improvements. It also includes things that can’t be touched but nevertheless exist and have value, such as goodwill.

Assets are generally listed based on how quickly they will be converted into cash. Current assets are things a practice expects to convert to cash within one year. Noncurrent assets are things a practice does not expect to convert to cash within one year or that would take longer than one year to sell. Noncurrent assets include fixed assets. Fixed assets are those assets used to operate the business but are not available for sale, such as equipment, furniture, and leasehold improvements.

Liabilities are amounts of money that a practice owes to others. This can include all kinds of obligations, like money borrowed from a bank and payroll taxes owed to the government. Liabilities are generally listed based on their due dates. Liabilities are said to be either current or long term. Current liabilities are obligations a practice expects to pay off within one year. Long-term liabilities are obligations due more than one year from the balance sheet date.

Owner’s equity is sometimes called capital, retained earnings, or net worth. It’s the money that would be left if a practice sold all of its assets and paid off all of its liabilities. This leftover money belongs to the owner(s) of the practice. Owner’s equity is the amount owners invested in the practice’s stock or capital plus or minus the practice’s earnings or losses since inception. Sometimes practices distribute earnings instead of retaining them. These distributions reduce owner’s equity.

A balance sheet shows a snapshot of a practice’s assets, liabilities, and owners’ equity as of the date of the balance sheet. It does not show the flows into and out of the accounts during the period.

Income Statements

An income statement is a report that indicates how much revenue a practice earned over a specific time period. An income statement also shows the costs and expenses associated with earning that revenue. The literal “bottom line” of the statement shows the practice’s net income or loss. This tells you how much the practice earned or lost over the period.

To understand how income statements are set up, think of them as a set of stairs. You start at the top with the total amount of revenue during the accounting period. Then you go down, one step at a time. At each step, you make a deduction for certain costs or other operating expenses associated with earning the revenue. At the bottom of the stairs, after deducting all of the expenses, you learn how much the practice actually earned or lost during the accounting period.

At the top of the income statement is the total amount of money brought in from sales of services. This top line is

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often referred to as net revenues. It's called "net" because any refunds or discounts have been deducted.

Moving down the stairs from the net revenue line, the next line typically reflects direct costs. This number tells you the amount of money the practice spent to produce the net revenues during the accounting period.

The next line subtracts the direct costs from the net revenues to arrive at a subtotal called gross profit. It's considered "gross" because there are certain expenses that haven't been deducted from it yet.

The next section deals with operating expenses. These are expenses that go toward supporting a practice's operations for a given period – for example, salaries, rent, advertising, insurance, etc. Operating expenses are different from direct costs, because operating expenses cannot be linked directly to the production of the services provided.

Depreciation is also deducted from gross profit. Depreciation takes into account the wear and tear on some assets, such as equipment, furniture, and leasehold improvements, which are used over the long term. Practices spread the cost of these assets over the periods they are used.

After all operating expenses are deducted from gross profit, you arrive at an operating profit before interest and income tax expenses. This is often called "net income from operations."

Next, practices must account for interest income and expense. Interest income is the money practices make from keeping their cash in interest-bearing savings accounts, money market funds, and the like. On the other hand, interest expense is the money practices pay in interest for money they borrow.

Then you arrive at the bottom line: net income or loss. This tells you how much the practice actually earned or lost during the accounting period.

Cash Flow Statements

Cash flow statements report a practice's inflows and outflows of cash. This is important because a practice needs to have sufficient cash on hand to pay its expenses and handle cash flow issues. While an income statement can tell you whether a practice made a profit, a cash flow statement can tell you whether the practice generated cash.

A cash flow statement shows changes over time rather than absolute dollar amounts at a point in time, like a balance sheet. The bottom line of the cash flow statement shows the net increase or decrease in cash for the period. Generally, cash flow statements are divided into three main parts. Each part reviews the cash flow from one of three types of activi-

ties: (1) operating activities, (2) investing activities, and (3) financing activities.

The first part of a cash flow statement analyzes a practice's cash flow from net income or losses. For most practices, this section of the cash flow statement reconciles the net income to the actual cash the company received from or used in its operating activities. To do this, it adjusts net income for any non-cash items, such as depreciation, and adjusts for any cash that was used or provided by other operating assets and liabilities.

The second part of a cash flow statement shows the cash flow from all investing activities, which generally include purchases or disposition of long-term assets, such as property and equipment. If a practice buys new equipment, the cash flow statement would reflect this activity as a cash outflow from investing activities because it used cash. If the practice decided to dispose of equipment, the proceeds would show up as a cash inflow from investing activities because it provided cash.

The third part of a cash flow statement shows the cash flow from all financing activities. Typical sources of cash flow include cash provided from borrowing from banks. Likewise, paying back a bank loan would show up as a use of cash flow.

Bringing It All Together

Although this article discusses each financial statement separately, keep in mind that they are all related. The changes in assets and liabilities that you see on the balance sheet are also reflected in the revenues and expenses that you see on the income statement, which result in the practice's net income. Cash flows provide more information about cash assets listed on a balance sheet and are related, but not equivalent, to net income shown on the income statement. No one financial statement tells the complete story. But combined, they provide very powerful information for practice owners. And information is the best tool when it comes to managing your practice wisely. **tND**