How Financial Statements Tie Together

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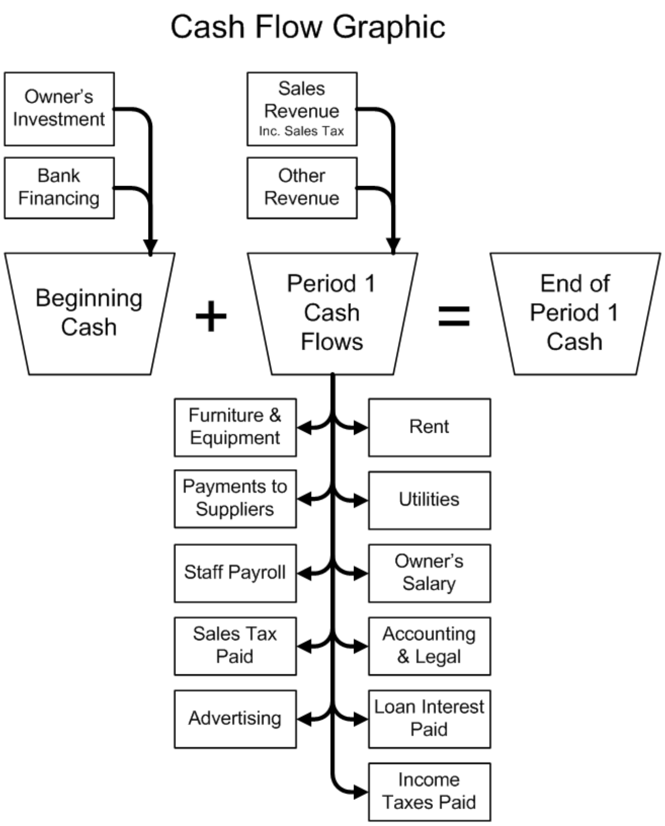
Let's talk about the three primary financial statements for any small business; the Cash Flow Statement, the Profit and Loss Statement, and the Balance Sheet. We will use a business called Bonnie's Beachwear.

Bonnie's Beachwear is a women's retail store located in a busy shopping district across the street from the beach in Miami's trendy South Beach neighborhood. Bonnie's shop specializes in the sale of women's bathing suits, cover-ups and casual beachwear. Bonnie's customers include wealthier residents from the Miami area as well as a significant number of tourists staying at nearby hotels. Bonnie's typical customer is a fashion-conscious woman with a desire to wear the latest designs while at the beach.

What we will do in this article is show how money flows through the Cash Flow Statement and between the Profit and Loss Statement and the Balance Sheet.

Cash Flow Statement

We will start with the Cash Flow Statement. Shown below as the Cash Flow Graphic is a representation of how money flows through the Cash Flow Statement.



This graphical representation shows positive cash flows going into the cash flow bucket and negative cash flows, i.e. expenses coming out the bottom of the bucket.

In the beginning, the cash the business starts with typically comes from either an owner's investment or bank financing. With larger businesses there may be an initial investment by shareholders but let's assume that we are dealing with a business like Bonnie's Beachwear. In the previous chapters on Cash Flow Statement these were referred to as Financing Activity Cash Flows.

The sum of the owner's investment and bank financing is the Beginning Cash bucket.

During the first month of operation Bonnie's Beachwear will have two potential sources of revenue; sales revenue from her beachwear, including the amount that she takes in to pay sales tax at the end of the month, and any other revenue.

Other revenue could be modest items like bounced check fees charged to a customer.

These revenue sources will be the positive cash flows for Bonnie's Beachwear for her first month of operation and for each following month. These positive cash flows will fill the Period 1 Cash Flows bucket.

As you may recall from the spreadsheets Bonnie's Beachwear did not expect to have sales revenue for the first two months of operations.

Although Bonnie's Beachwear will not have positive sales or other revenue in the first couple of months of operations, the business will have expenses. These expenses are shown as negative cash flows out of the Period 1 Cash Flows bucket.

Start-up expense cash flows tend to be particularly heavy in the start-up months. Most of these start-up expenses are asset activity cash flows.

The asset activity start-up expenses for Bonnie’s Beachwear would be primarily furniture and equipment, e.g. clothing racks, computer equipment, leasehold improvements on the store, signage, etc. There would be similar expenses for a chiropractor’s office which might also have additional medical equipment that the doctor chose to buy rather than lease medical equipment. A manufacturing business like a boutique handbag operation will also have sewing machines and similar equipment.

Payments to suppliers for initial inventory will vary by type of business. Retailers like Bonnie will have a significant up front expense to stock the store. A handbags manufacturing operation will have significant expenses for manufacturing materials. A chiropractor’s office will have comparatively modest payments to suppliers for administrative, therapeutic and diagnostic materials.

All three kinds of businesses will incur some advertising, rent, and utilities expense before positive revenue cash flows begin. All three will likely incur some accounting and legal expenses to set up the company in the first months. Staff payroll for staff member training and payment of loan interest will also being in the first or second month.

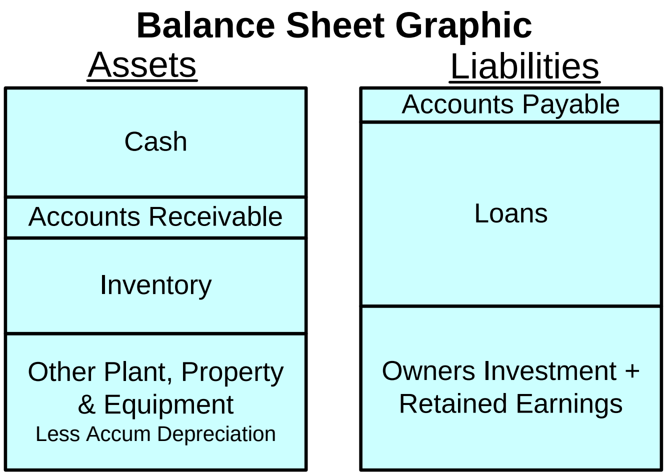
This is why the net cash flow for a business tends to be negative in its first few months of start-up.

Once all the revenues and expenses have been added and subtracted from the start-up cash flows, i.e. owner’s investment and bank financing the result is the End of Period 1 Cash Position bucket.

We began our discussion of business financial statements with this with the Cash Flow Statement because it is in many ways the simplest to envisage. Each month the model has a Beginning Cash Position bucket; revenues will be added and expenses will be subtracted; leaving you with an End of Period Cash Position bucket.

Next we will discuss the interaction between the Balance Sheet and the Profit and Loss Statement.

Balance Sheet



Let's first talk about the Balance Sheet represented in the Balance Sheet Graphic below

The bottom block of the Liabilities side of the Balance Sheet is comprised of the Owner’s Investment and Retained Earnings. These two amounts are called Owner’s Equity.

In the first start-up month there are typically no Retained Earnings because there has been no profit yet.

The second block on the Liabilities side of the Balance Sheet is Loans. These would typically be from a bank or they may be from friends and family members.

The third block on this simple Balance Sheet is Accounts Payable. Accounts Payable is the money that the business owes to its suppliers. For instance, Bonnie would have accounts payable if she purchased inventory from wholesalers and manufacturers under terms that allowed the business 30 days to pay. During these 30 days, Bonnie’s Beachwear will have an accounts payable balance on its Balance Sheet for these purchases.

Let’s go to the Assets side of the Balance Sheet. The bottom block of the Assets side of the Balance Sheet is Other Assets which is primarily Plant, Property and Equipment. At Bonnie's Beachwear this would include the store’s leasehold improvements, furniture, clothing racks, cash registers and computer equipment, etc. The asset activity expense cash flows in the Cash Flow Statement are reflected here in the Balance Sheet.

The next block moving up the Assets side of the Balance Sheet is inventory. Depending on the expected sales volume of Bonnie’s Beachwear this may be a large or small amount and will probably be somewhat limited by the amount of start up cash she has. In retail and manufacturing businesses, like a boutique handbag manufacturing operation, this category can be a large part of the business’s use of cash. Choosing the amount of inventory should follow the Goldilocks philosophy of not too much, not too little, but just the right amount.

The next block moving up the Assets side of the Balance Sheet is Accounts Receivable. Accounts Receivable is the money that customers owe the business. For instance, a handbag manufacturing operation will sell its handbags to retailers but will likely need to provide terms like 60 days net.

That means that the retailers who buy the handbags have up to 60 days to pay for any merchandise shipped to them. During these 60 days, the money owed by customers to a boutique handbag manufacturing operation is an account receivable of the business. In retail businesses like Bonnie's Beachwear the amount of Accounts Receivable is relatively small.

In a service business, particularly in the medical field like a chiropractor's office, Accounts Receivable can become quite large reflecting the extraordinarily long reimbursement schedule of medical insurance companies. Accounts Receivable can also turn into unpaid accounts typically referred to as losses. If not controlled, Accounts Receivable can cause a significant cash crunch.

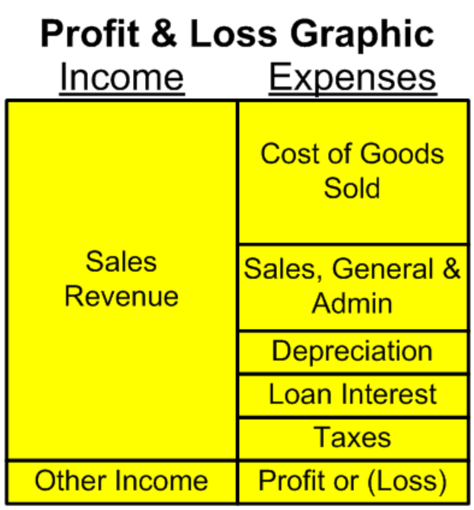
The fourth block moving up the assets side of the Balance Sheet is cash. Cash includes the cash the business has on hand in the cash drawer, in the safe, or in one of the bank or credit union accounts of the business. The cash balance at the end of the month on the Balance Sheet should be the same as the cash at end of month on the Cash Flow Statement.

Remember that the Balance Sheet must always balance. The model (and real life) uses the Owner's Equity block as the "plug" in the model. That means that, if the Balance Sheet doesn't initially balance, and all the other numbers are all input and correct, that an adjustment will be made to Owner's Equity.

If there are more Assets than Liabilities, the Owner's Equity will be increased. If there are fewer Assets than Liabilities, the Owner's Equity will be reduced; even if that means that the Owner's Equity has to become a negative number. Of course that would mean there is a serious problem with the business that must be corrected. It means that if the business owner liquidated the business there would not be enough money to pay off the business's loans and accounts payable.

Profit & Loss Statement

Now let's discuss the Income side of the Profit & Loss Statement represented in the Profit & Loss Graphic below.



From the top of the Income side of the P&L Statement, the first block is sales revenue. This is usually the largest part of the income side of the P&L Statement.

Below the Sales Revenue block is Other Income which is likely to be modest in a small business. These together are the Total Income for that time period; month, quarter or year.

On the Expense side of the P&L Statement Cost of Goods Sold (COGS) is the top block. This is typically the largest part of the expenses for retail and manufacturing businesses.

In the case of Bonnie's Beachwear this would be the cost of the beachwear that she purchases from suppliers and wholesalers. In the case of a small handbag manufacturing business it would be the cost of leather, hardware and other materials to make the handbags.

In a service business like a chiropractor's office this would be called Cost of Services (COS) and would also typically be the largest part of expenses on the P&L Statement.

The next block down is Sales, General, & Administrative expenses which would include payroll expenses for the sales staff and regular monthly expenses such as rent and utility bills. One of the challenges of a service business like a chiropractor's office is accurately breaking out the staff time between the Cost of Services and Sales, General, & Administrative expenses.

Next is Depreciation which was discussed extensively in the chapters on the P&L Statement. This is the depreciation of fixed assets like furniture fixtures and equipment that were purchased for the business.

The next block is Loan Interest, which are the interest payments made to the bank or credit union on the loan that was taken out to provide start-up cash for the business.

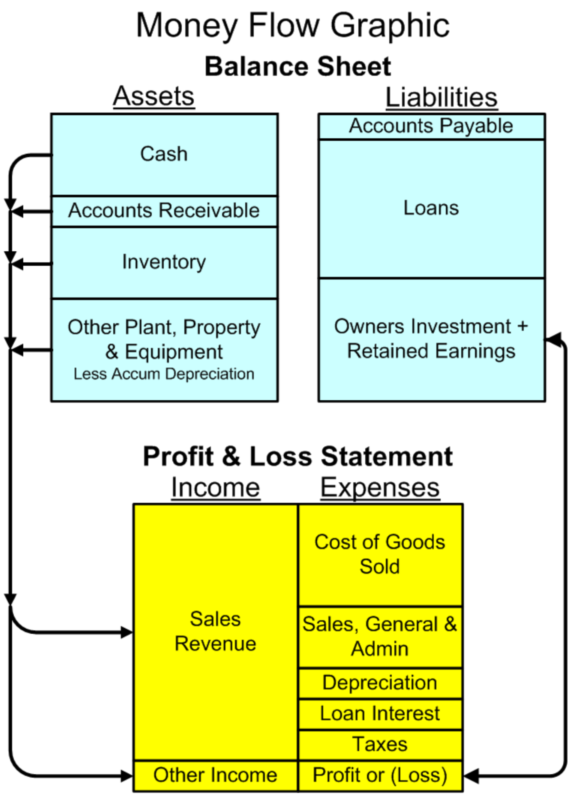
The next block is Taxes. These would include both income taxes and sales taxes paid by the business.

In the last block of the expenses side of the P&L Statement is the Profit or (Loss) that the business experiences in that particular month, quarter or year. If the business had more income in the month that it had expenses it made a profit; if it had more expenses than income it suffered a loss. Losses are negative numbers and are shown with the accounting convention of parenthesis around the number.

Remember that the P&L Statement must always balance. The model (and real life) uses the Profit or (Loss) block as the "plug" in the model. That means that, if the P&L Statement doesn't initially balance, and all the other numbers are all input and correct, that an adjustment will be made to Profit or (Loss).

How Money Flows Between the Balance Sheet and P&L Statement

Now let's put the Balance Sheet and P&L Statement together and see how money flows between them. The Money Flow Graphic below is a graphical representation of how money flows between the Balance Sheet and P&L Statement.



All businesses use their assets to generate income. That is represented by the arrows flowing from all four blocks in the Assets side of the Balance Sheet to the Income side of the P&L Statement.

In the case of Bonnie's Beachwear the store, represented by Plant, Property and Equipment, and the Inventory that is sold by Bonnie and her staff to their customers, generates Sales Revenue.

Other income could be generated by charging customers bounced check fees or other forms of these or interest earned on the Cash held in the bank or credit union.

As the total Income represented in the Profit & Loss Statement is earned and accumulated during the month, it will simultaneously be largely consumed by the category shown on the expense side of the P&L Statement.

If the income is greater than the expenses (certainly hoped for in business), the business will show a profit. If the expenses exceed the income for the month, the business will suffer a loss.

The double arrowhead line that runs from the P&L Statements profit or loss block to the Owner's Investment and Retained Earnings block illustrates this two-way flow of money.

If there is a profit by the end of the month, that profit flows to, and adds to the Retained Earnings block on the Liability side of the Balance Sheet. If there is a loss, funds from Owner's Investment and Retained Earnings block are drawn upon to ensure that all expenses can be covered.

Remember that the Balance Sheet must always balance.

So what happens to the Assets side of the Balance Sheet when there is a change in Retained Earnings? The most likely answer is that the money goes to cash. Alternatively, investments may have been made in inventory or other assets including equipment during the month. Those changes would be reflected in those blocks on the Assets side of the Balance Sheet.

This flow of money between the Balance Sheet and the Profit & Loss Statement is a representation of a living business. The size of the blocks will be different for different kinds of businesses but the paradigms and mechanics of the financial statements will carry through to all businesses. The more the business owner uses his or her financial statements the more he or she will develop an intuitive understanding of how the business is operating.

In the website www.financewithoutfear.com there are spreadsheet models available to enhance the business owner and student's understanding of how to make money in the business. The models will allow the business owner to test their assumptions about the business and see the effects of different results on the business.