

How to Read and Understand the 4 Financial Statements

Financial statements are the "report cards" of a business. To get the full picture, you must understand how these four documents work individually and how they link together.

1. The Balance Sheet (The Snapshot)

Purpose: Shows what a company **owns** and **owes** at a specific point in time.

The Formula:

$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$

- **Assets:** Resources the company owns (Cash, Inventory, Property, Patents).
- **Liabilities:** Debts the company owes (Bank loans, Accounts payable, Taxes).
- **Shareholders' Equity:** The "book value" of the company. It is what's left for the owners if all assets were sold and all debts paid.

What to look for: - **Liquidity:** Does the company have enough cash and "current assets" to pay off its "current liabilities" (debts due within a year)?

- **Debt Levels:** Is the company heavily burdened by long-term debt compared to its equity?

2. The Income Statement (The Movie)

Purpose: Shows the company's **profitability** over a period of time (e.g., a quarter or a year). It is often called the "Profit and Loss" (P&L) statement.

The Structure:

1. **Revenue (The Top Line):** Total money brought in from sales.
2. **Cost of Goods Sold (COGS):** Direct costs of producing the products sold.
3. **Gross Profit:** Revenue minus COGS.
4. **Operating Expenses:** Costs of running the business (Rent, Salaries, Marketing).
5. **Net Income (The Bottom Line):** The final profit after *all* expenses, interest, and taxes are paid.

What to look for:

- **Margins:** Is Gross Profit high enough to cover operating costs?
- **Trend:** Is Net Income growing over time, or are expenses eating up all the revenue?

3. The Cash Flow Statement (The Reality Check)

Purpose: Tracks the actual **movement of cash** in and out. Because of "accrual accounting," a

company can show a profit on the Income Statement but actually be running out of physical cash.

The Three Sections:

- **Operating Activities:** Cash generated from the core business. (This should ideally be positive).
- **Investing Activities:** Cash spent on long-term assets (buying equipment) or received from selling them.
- **Financing Activities:** Cash from issuing stock, taking out loans, or paying dividends to shareholders.

What to look for:

- **Cash vs. Profit:** If Net Income is high but Operating Cash Flow is negative, the company might be struggling to collect money from customers.

4. Statement of Shareholders' Equity (The Bridge)

Purpose: Details the changes in the owners' stake in the company over a period.

Key Components:

- **Common Stock:** Value received from selling shares.
- **Retained Earnings:** The portion of Net Income that was *not* paid out as dividends but kept to reinvest in the business.
- **Dividends:** Cash returned to shareholders.

What to look for:

- **Reinvestment:** Is the company keeping its profits to grow (high retained earnings), or is it paying most of it out to shareholders?

How They Connect (The "Flow")

Understanding the relationship between these statements is the key to advanced analysis:

1. **Income Statement** flows into the **Equity Statement:** The **Net Income** from the Income Statement flows into the **Retained Earnings** section of the Equity Statement.
2. **Equity Statement** flows into the **Balance Sheet:** The ending balance of **Shareholders' Equity** moves to the Equity section of the Balance Sheet.
3. **Cash Flow** flows into the **Balance Sheet:** The "Net Change in Cash" at the bottom of the Cash Flow Statement must match the change in the **Cash** line item on the Balance Sheet between two periods.

Summary Table

Statement	Primary Question	Focus
Balance Sheet	What is the company's value today?	Financial Position
Income Statement	Did the company make a profit?	Operational Performance
Cash Flow	Where did the money come from/go?	Liquidity
Equity Statement	How did owner value change?	Ownership Interest