Chapter 2
Financial Statements, Taxes, and Cash Flow

Chapter Outline

- The Balance Sheet
- The Income Statement
- Taxes
- Cash Flow

The Balance Sheet

- The balance sheet is a snapshot of the firm's assets and liabilities at a given point in time
- Assets are listed in order of liquidity
  - Ease of conversion to cash
  - Without significant loss of value
- Balance Sheet Identity
  - Assets = Liabilities + Stockholders' Equity

Market vs. Book Value

- The balance sheet provides the book value of the assets, liabilities, and equity.
- Market value is the price at which the assets, liabilities or equity can actually be bought or sold.
- Market value and book value are often very different. Why?
- Which is more important to the decision-making process?

Income Statement

- The income statement is more like a video of the firm's operations for a specified period of time.
- You generally report revenues first and then deduct any expenses for the period
- Matching principle – GAAP say to show revenue when it accrues and match the expenses required to generate the revenue

Taxes

- The one thing we can rely on with taxes is that they are always changing
- Marginal vs. average tax rates
  - Marginal – the percentage paid on the next dollar earned
  - Average – the tax bill / taxable income
### The Concept of Cash Flow

- Cash flow is one of the most important pieces of information that a financial manager can derive from financial statements.
- The statement of cash flows does not provide us with the same information that we are looking at here.
- We will look at how cash is generated from utilizing assets and how it is paid to those that finance the purchase of the assets.

### Cash Flow From Assets

- Cash Flow From Assets (CFFA) = Cash Flow to Creditors + Cash Flow to Stockholders
- Cash Flow From Assets = Operating Cash Flow – Net Capital Spending – Changes in NWC