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Financial Modeling Fundamentals Modules 2 and 3: Accounting and the 3 Financial Statements – Rules for the Financial Statements

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Key Rule #3: The Income Statement

The **Income Statement** lists a company's revenue, expenses, and taxes, with its after-tax profit at the very bottom, over a period (one quarter, one month, or one year).

To appear on the Income Statement, each item must meet the following criteria:

1. **It must correspond to ONLY the period shown on the Income Statement**. If you're paying for an asset that will last for 10-20 years, the initial money spent would not appear on a 1-year Income Statement. But your monthly rent *would* appear.

2. **It must affect the company's taxes.** For example, interest paid on debt is tax-deductible, so it appears on the Income Statement. But repaying debt principal is not tax-deductible, so it does not appear on the Income Statement.

To the right, you can see a screenshot demonstrating common items on the Income Statement.

Income Statement:		
Revenue:	$	700
Cost of Goods Sold (COGS):		70
Gross Profit:		630
Gross Margin %:		*90.0%*
Operating Expenses:		
Sales & Marketing:		165
Research & Development:		75
General & Administrative:		50
Total Operating Expenses:		290
Depreciation:		10
Amortization of Intangible Assets:		10
Stock-Based Compensation:		20
Operating Income (EBIT):		300
Operating Margin:		*42.9%*
Other Income / (Expenses):		20
Interest Income / (Expense):		(20)
Goodwill Impairment:		(50)
PP&E Write-Down:		(10)
Gains / (Losses) on Investment Sales		(15)
Pre-Tax Income (EBT):		225
Income Taxes:		90
Current Portion:		40
Deferred Portion:		50
Net Income (Profit After Taxes):	$	135
Net Income Margin:		*19.3%*

Revenue and Cost of Goods Sold (COGS): Revenue is the value of the products/services that a company sells in the period, and COGS represents the expenses that are linked *directly* to the sale of those products/services.

For example, if each widget you sell costs $10 to order and ship, $10 * # Widgets Sold would show up within COGS.

Operating Expenses: Costs that are not directly linked to individual products sold – employee salaries, rent, marketing, and research and development – show up here.

Depreciation and Amortization (D&A): These items are non-cash expenses related to allocating *capital purchases*, such as spending on factories or equipment or patents or anything else that lasts over 1 year, over time.

These items will be useful for many years, so you have to allocate the initial amount spent over many years rather than showing the entire amount on the Income Statement.

In real life, Depreciation and Amortization are often **embedded** within COGS or Operating Expenses. We show them separately for clarity, but they'll *rarely* be separate in real life.

When D&A is embedded within other line items, you have to look at the **Cash Flow Statement** to get the total number.

Stock-Based Compensation: This represents the cost of paying employees with stock or stock options rather than cash. Companies estimate the value of these awards, and then record their estimates on the Income Statement.

Like D&A, this is almost **never** shown separately in real life; it's almost always embedded within the company's Operating Expenses.

Other Income and Expenses: Items such as Interest Income, Interest Expense, Gains and Losses, Write-Downs, and Impairments show up here.

If a company has any "side activities" that aren't part of its core business, income from those activities will also show up here.

Everything in this section impacts a company's taxes and represents SOMETHING in the current period, but these items are NOT a part of the company's core business of selling products/services.

Some of these items – Gains and Losses, Write-Downs, and Impairments – are **non-cash**, which means they reduce a company's taxes but don't result in a cash payment.

Taxes and Net Income: Net Income represents the company's "bottom line" – how much in after-tax profits it has earned.

As we described above, Income Taxes are split into Current and Deferred. In real life, it is *very* rare to see the actual split on the Income Statement, but we have shown it for clarity.

A few other points on Income Statement revenue, expenses, and taxes:

1. **They do not need to be related to a company's operational activities** – Gains and Losses and Interest Expense all appear, but they are not related to selling products to customers.

2. **They do not need to be cash expenses or cash revenue** – For example, Depreciation and Amortization are both non-cash expenses. Also, companies often record revenue and expenses here before they receive or pay them in cash, which is the whole reason *why* the 3 financial statements exist in the first place.

3. **Sometimes, items may be embedded within other items** – For example, Depreciation is often embedded within COGS or Operating Expenses; other times it is a separate item, either wholly or partially. Stock-Based Compensation is almost always embedded within Operating Expenses.

Here are a few more rules of thumb about what appears on the Income Statement:

- **Always Appears:** Revenue, COGS, Operating Expenses, Depreciation, Amortization, Stock-Based Compensation, Interest Income and Expense, Gains / (Losses), Write-Downs, Impairments, Other Income / (Expenses), Taxes, and Net Income.

- **Never Appears:** Capital Expenditures, Purchasing or Selling Investments or PP&E (Plants, Property & Equipment), Dividends, Issuing or Repaying Debt Principal, Issuing or Repurchasing Shares, and Changes to Balance Sheet Items such as Cash, Debt, Accounts Receivable, or Accounts Payable.

The items on the "Always Appears" list meet the criteria above because:

1. **They affect the company's taxes** (e.g., paying an employee's salary reduces the company's taxable income); and

2. **They correspond to the period shown on the Income Statement** (e.g., monthly rent corresponds only to what you're incurring *in that month*).

The items on the "Never Appears" list fail the criteria above because:

1. **They do not affect the company's taxes** (e.g., Dividends are not tax-deductible, and neither is repaying debt); or

2. **They do not correspond to the period shown on the Income Statement** (e.g., Capital Expenditures refers to purchasing Assets that often last for 10-20 years).

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Key Rule #4: The Balance Sheet

The **Balance Sheet** shows the company's **resources** – its Assets – and how it **paid for** those resources – its Liabilities & Equity – at a specific point in time.

Think about your personal Balance Sheet: maybe you've invested $50K in the stock market, you have $30K in cash in your bank account, and you own a house that's worth $500K.

Those are Assets because they can all be sold for cash, or they'll deliver a cash benefit to you in the future.

How did you pay for the cash, your house, and your investments?

First, you **saved up money** from your job. For example, maybe you've saved $200K, cumulatively, after taxes, over many years.

You also **borrowed money** – the mortgage on your house, which is worth $380K – to pay for some of it.

So your "personal Balance Sheet" might look like this:

Personal Balance Sheet:			
Assets:			
Current Assets:			
Cash:	$	30	<-- Cash in your checking account.
Total Current Assets:		**30**	
Long-Term Assets:			
House:		500	<-- What you paid for that house when you first bought it.
Stock Market Investments:		50	<-- What it sounds like; could also be "short-term."
Total Long-Term Assets:		**550**	
Total Assets:	**$**	**580**	
Liabilities & Equity:			
Current Liabilities:			
Credit Card Debt:	$	-	<-- You're smart and have no credit card debt!
Total Current Liabilities:		**-**	
Long-Term Liabilities:			
Home Mortgage:		380	<-- But you did borrow to buy that house.
Total Long-Term Liabilities:		**380**	
Equity:	**$**	**200**	<-- Saved-up, after-tax earnings from your job.
Total Liabilities & Equity:	**$**	**580**	
BALANCE CHECK:		**OK!**	

These MUST equal each other; if you have $580K in resources, you must have gotten the money from somewhere.

Here are the key Balance Sheet rules:

1. The Balance Sheet shows the company's resources (its Assets) and how it paid for those resources – its Liabilities & Equity – at a specific point in time.

So the Income Statement shows revenue and expenses **from** January 1, 20XX **to** December 31, 20XX, but the Balance Sheet only shows the company's resources **ON** January 1, 20XX or **ON** December 31, 20XX.

2. Assets must always equal Liabilities + Equity – if the Balance Sheet does not balance, it's wrong.

If you want a house – an asset – that costs $1 million, could you use a $380K mortgage and $200K in saved-up income to pay for it?

No! The Balance Sheet would go out of balance!

You'd have to **borrow or save more**.

So you either take out a mortgage for $800K, or you wait and save up an additional $620K.

3. An Asset is something that will result in, directly or indirectly, additional cash in the future, or is something that can be sold for cash.

You typically split Assets into "Current" or "Short-Term" (anything that lasts for less than 1 year) and "Non-Current" or "Long-Term" (anything that lasts for more than 1 year).

4. A Liability is something that will result in, directly or indirectly, less cash in the future.

Again, you typically split these into "Current" or "Short-Term" and then "Non-Current" or "Long-Term."

Liabilities are usually related to **external parties** – lenders, suppliers, or the government.

5. An "Equity" line item is a funding source, like a Liability, but it will not result in less cash in the future.

Like Liabilities, the items in the "Equity" category are also funding sources.

Unlike Liabilities, the Equity line items *don't* necessarily result in less cash in the future.

They also tend to relate more to the company's *internal operations* and how it's saving money over time, whereas Liabilities relate more to *external parties* such as lenders.

Below, you'll see a typical Balance Sheet, along with explanations of how each item meets the definition of an Asset, a Liability, or an Equity line item:

Balance Sheet:			How Does This Item Satisfy the Definitions of Assets, Liabilities, and Equity?
Assets:	**Start of Period**	**End of Period**	
Current Assets:			**Assets - Generate cash or can be sold for cash.**
Cash:	$ 300	$ 610	
Short-Term Investments:	-	-	Earn interest - more cash - or can be sold for cash.
Accounts Receivable:	-	50	Will get more cash from customers eventually.
Inventory:	-	30	Will turn into products and sell for cash.
Prepaid Expenses:	-	30	Will reduce taxes in the future, saving us cash.
Total Current Assets:	**300**	**720**	
Long-Term Assets:			
Property, Plant & Equipment:	-	30	Can be used to manufacture goods, producing cash.
Goodwill:	100	50	Possible future synergies will produce more cash.
Other Intangible Assets:	50	40	Customer relationships, brand, etc. result in more sales.
Long-Term Investments:	-	100	Earn interest - more cash - or can be sold for cash.
Total Long-Term Assets:	**150**	**220**	
Total Assets:	**$ 450**	**$ 940**	
Liabilities & Equity:			**Liabilities - Will cost the company cash.**
Current Liabilities:			
Accounts Payable:	$ -	$ 15	Recorded the expense, but must pay **CASH** in the future!
Accrued Expenses:	-	10	Recorded the expense, but must pay **CASH** in the future!
Deferred Revenue:	-	15	Must pay expenses and taxes on this revenue in the futur
Total Current Liabilities:	**-**	**40**	
Long-Term Liabilities:			
Debt:	-	240	Must pay interest and repay debt principal.
Deferred Tax Liability:	-	50	Must pay higher cash taxes in the future.
Total Long-Term Liabilities:	**-**	**290**	
Equity:			**Equity - Funding, but no cash cost.**
Common Stock & Additional Paid-In Capit	50	170	Stock issued to others to fund the business.
Retained Earnings:	400	485	"Saved up, after-tax earnings" - add NI, subtract Dividends
Treasury Stock:	-	(50)	Always record repurchases as a negative.
Accumulated Other Comprehensive Incor	-	5	FX rate effects, unrealized gains/losses, misc. items.
Total Equity:	**$ 450**	**$ 610**	
Total Liabilities & Equity:	**$ 450**	**$ 940**	
BALANCE CHECK:	**OK!**	**OK!**	

Definitions of Key Assets:

- **Cash:** Just like cash in your bank account.
- **Short-Term Investments:** Anything that generates some interest income and is less liquid than cash – a money-market account, for example.

- **Accounts Receivable:** The company has recorded this as revenue on its Income Statement but hasn't received it in cash yet. It's like an "IOU" from a customer. And it will turn into cash when the customer pays.

- **Inventory:** The physical parts and supplies that the company needs to manufacture and sell products.

- **Prepaid Expense:** The company has paid these expenses in cash but hasn't recorded them as expenses on the Income Statement yet because they haven't been incurred.

The most common Long-Term Assets include:

- **Property, Plant & Equipment (PP&E):** Factories, buildings, land, and equipment that will be useful for more than a year and contribute to the company's core business.

- **Goodwill:** The cumulative premiums that the company has paid over other companies' Shareholders' Equity when acquiring them.

- **Other Intangible Assets**: The cumulative values of patents, trademarks, and intellectual property from acquired companies. Unlike Goodwill, this balance amortizes over time because these items have fixed useful lives.

- **Long-Term Investments:** These also generate interest or investment income, but are less liquid and longer-lasting than Cash or Short-Term Investments.

Definitions of Key Liabilities:

- **Short-Term Debt or "Revolver":** Borrowing that incurs interest expense and that is owed back in less than a year. It's sort of like a credit card because it represents short-term borrowing.

- **Accounts Payable:** The company has recorded these as expenses on the Income Statement, but hasn't yet paid them in cash – it's used for one-time items with specific invoices, such as legal services.

- **Accrued Expenses:** The company has recorded these as expenses on the Income Statement, but hasn't yet paid them in cash – it's used for recurring monthly items without invoices, such as employee wages, utilities, and rent.

- **Deferred Revenue:** The company has collected cash in advance from customers for products/services that it has not yet delivered. It will recognize Deferred Revenue as real revenue over time as it delivers the products/services.

The most common Long-Term Liabilities include:

- **Deferred Tax Liability:** This represents a **timing difference** in taxes. For some reason, the company paid less in taxes than what it owed in some earlier period, and it must make up the difference by paying more to the government in the future.

- **Long-Term Debt:** Similar to a mortgage, a car loan, or a student loan: debt that must be repaid in over a year's time.

Definitions of Key Equity Line Items:

- **Common Stock & Additional Paid-In Capital (APIC**): This item represents the market value of shares **at the time the company issued those shares**. When a company goes public, the total dollar value of shares issued shows up here. This does **NOT** change even if the share price changes afterward. Non-U.S.-based companies call these items "Share Capital" and "Share Premium."

- **Retained Earnings:** This item represents the company's saved-up, after-tax profits, minus any dividends it has issued. This item is like the $200K you saved up, after taxes, in the "personal Balance Sheet" example above.

- **Treasury Stock:** This item represents the cumulative value of shares the company has repurchased from shareholders. Just like Common Stock & APIC, the values here are based on the share prices **at the time the company repurchased the shares**. This value does **NOT** change even if the company's share price changes afterward.

- **Accumulated Other Comprehensive Income (AOCI):** This is a section for "miscellaneous saved-up income" – items like the effect of foreign currency exchange rate changes go here, as well as "unrealized" gains and losses on certain types of securities.

A few extra notes on this section:

With Common Stock & APIC, let's say a company issues 100 million shares. The par value of each share is $1.00, and the market value of each share is $10.00.

Common Stock would increase by 100 million * $1.00, or $100 million.

APIC would increase by 100 million * ($10.00 – $1.00), or $900 million.

If the company's share price now goes from $10.00 to $25.00 or $100.00 or $1.00, COMMON STOCK AND APIC DO NOT CHANGE.

We almost always combine these items into a single line item – Common Stock & APIC – to streamline models.

With Treasury Stock, let's say the company repurchases $500 million in shares at a price of $50.00 per share.

You'd record that as a negative $500 million on the Cash Flow Statement and *reduce* Treasury Stock by $500 million, **making it even more negative**.

If the share price then goes from $50.00 to $100.00 or $1.00, **Treasury Stock does not change**.

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Key Rule #5: Cash Flow Statement

The **Cash Flow Statement**, like the Income Statement, tracks **changes over a period** (one year, quarter, month, etc.).

It exists for 2 main reasons:

1) **You may have recorded non-cash revenue, expenses, or taxes on the Income Statement**. If you did, then you need to make an adjustment on the Cash Flow Statement to reflect this.

   Remember, these cash/non-cash differences are the whole reason *why* the 3 financial statements exist in the first place!

2) **There may be additional cash inflows and outflows that have NOT appeared on the Income Statement**. For example, Capital Expenditures and Dividends both impact a company's cash balance, but neither one appears on the Income Statement.

Here's what a typical Cash Flow Statement looks like, along with a summary of each section:

Cash Flow from Operations (CFO) – Starts with Net Income at the top, adjusts for non-cash items, and then factors in how *operational* Balance Sheet items change in that period.

Rough Proxy: Corresponds to Current Assets and Current Liabilities… but that's not exactly true, since cash, investments, and debt do **NOT** show up here, whereas some longer-term items such as Deferred Revenue do.

So it's **better** to think of this section as: "Net Income, non-cash adjustments, and operational Balance Sheet items."

Cash Flow from Investing (CFI) – Anything related to the company's investments, acquisitions, and PP&E shows up here.

Purchases are negative because they use up cash, and sales are positive because they result in more cash.

Rough Proxy: Corresponds to Long-Term Assets… but that's not exactly true since investments within Current Assets can also show up here.

Cash Flow from Financing (CFF) – Items related to debt, dividends, and issuing or repurchasing shares show up here.

Rough Proxy: Corresponds to Long-Term Liabilities and Equity… but this is also not exactly true!

For example, items like Deferred Tax Liabilities are impacted by adjustments in the CFO section.

Cash Flow Statement:		
Cash Flow from Operating Activities:		
Net Income:	$	135
Depreciation:		10
Amortization of Intangible Assets:		10
Stock-Based Compensation:		20
Goodwill Impairment:		50
PP&E Write-Down:		10
Deferred Income Taxes:		50
(Gains) / Losses on Investment Sales		15
Change in Operating Assets & Liabilities:		
Change in Accounts Receivable:		(50)
Change in Inventory:		(30)
Change in Prepaid Expenses:		(30)
Change in Accounts Payable:		15
Change in Accrued Expenses:		10
Change in Deferred Revenue:		15
Cash Flow from Operations:	**$**	**230**
Cash Flow from Investing Activities:		
Capital Expenditures (CapEx):	$	(50)
Purchases of Short-Term Investment		(100)
Purchases of Long-Term Investment		(100)
Proceeds from ST Investment Sales:		85
Cash Flow from Investing:	**$**	**(165)**
Cash Flow from Financing Activities:		
Debt Raised:	$	300
Debt Principal Repayment:		(60)
Equity Issuance:		100
Dividends Issued:		(50)
Share Repurchases:		(50)
Cash Flow from Financing:	**$**	**240**
FX Rate Effects:		5
Net Change in Cash:	**$**	**310**
Beginning Cash Balance:	**$**	**300**
Ending Cash Balance:	**$**	**610**

Meanwhile, Common Stock & APIC, for example, is impacted not just by the equity issuances shown here, but also by Stock-Based Compensation in the CFO section.

These rough proxies are useful for figuring out where *most* items go, but remember that there are always exceptions and that companies' financial statements vary **TREMENDOUSLY**.

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Key Rule #6: How to Link the Financial Statements

We cover this topic in more detail in the sections on how to **project the financial statements**, but it's helpful to understand these links for interview questions as well.

So we'll lay out the principles and then explain the step-by-step process.

Principle #1: Each item on the Balance Sheet must have a corresponding line item on the Cash Flow Statement, and vice versa.

The change in each item on the Balance Sheet must be reflected **once and only once** on the Cash Flow Statement.

When an Asset goes up, cash flow goes down, and when a Liability goes up, cash flow goes up, and vice versa.

Think about what it means when an Asset like Inventory "goes up": **it means the company spent cash to acquire more Inventory.**

And then think about what it means when a Liability like Accounts Payable "goes up": **it means the company has delayed cash payment, resulting in more cash.**

Principle #2: The CFO section of the Cash Flow Statement is derived from the Income Statement and operational items on the Balance Sheet, and the CFI and CFF sections are projected directly on the CFS and then flow into the Balance Sheet.

So you don't "project" items like the Change in Accounts Receivable directly on the Cash Flow Statement. Instead, these items are based on how the company's Balance Sheet has changed over time.

Principle #3: When you're linking in items from the Cash Flow Statement to the Balance Sheet, SUBTRACT when you're on the Assets side and ADD when you're on the Liabilities & Equity side.

Here are a few examples:

- **PP&E** – **Subtract** both Depreciation and CapEx when you link them to the PP&E on the Balance Sheet.
- **Debt** – **Add** both debt issuances and repayments when you link them to Debt.
- **Investments** – **Subtract** Gains and Losses, purchases, and proceeds from sales.

Here's a diagram for the process of linking the statements:

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Income Statement:		
Revenue:	$	700
Cost of Goods Sold (COGS):		70
Gross Profit:		630
Gross Margin %:		*90.0%*
Operating Expenses:		
Sales & Marketing:		165
Research & Development:		75
General & Administrative:		50
Total Operating Expenses:		290
Depreciation:		10
Amortization of Intangible Assets:		10
Stock-Based Compensation:		20
Operating Income (EBIT):		300
Operating Margin:		*42.9%*
Other Income / (Expenses):		20
Interest Income / (Expense):		(20)
Goodwill Impairment:		(50)
PP&E Write-Down:		(10)
Gains / (Losses) on Investment Sales		(15)
Pre-Tax Income (EBT):		225
Income Taxes:		90
Current Portion:		40
Deferred Portion:		50
Net Income (Profit After Taxes):	$	135
Net Income Margin:		*19.3%*

Cash Flow Statement:		
Cash Flow from Operating Activities:		
Net Income:	$	135
Depreciation:		10
Amortization of Intangible Assets:		10
Stock-Based Compensation:		20
Goodwill Impairment:		50
PP&E Write-Down:		10
Deferred Income Taxes:		50
(Gains) / Losses on Investment Sales		15
Change in Operating Assets & Liabilities:		
Change in Accounts Receivable:		(50)
Change in Inventory:		(30)
Change in Prepaid Expenses:		(30)
Change in Accounts Payable:		15
Change in Accrued Expenses:		10
Change in Deferred Revenue:		15
Cash Flow from Operations:	$	230
Cash Flow from Investing Activities:		
Capital Expenditures (CapEx):	$	(50)
Purchases of Short-Term Investment		(100)
Purchases of Long-Term Investment		(100)
Proceeds from ST Investment Sales:		85
Cash Flow from Investing:	$	(165)
Cash Flow from Financing Activities:		
Debt Raised:	$	300
Debt Principal Repayment:		(60)
Equity Issuance:		100
Dividends Issued:		(50)
Share Repurchases:		(50)
Cash Flow from Financing:	$	240
FX Rate Effects:		5
Net Change in Cash:	$	310

Adjust for non-cash items from the Income Statement here.

These items all come from how the Balance Sheet has changed.

Project these items independently on the Cash Flow Statement.

Balance Sheet:	Start of Period		End of Period	
Assets:				
Current Assets:				
Cash:	$	300	$	610
Short-Term Investments:		-		-
Accounts Receivable:		-		50
Inventory:		-		30
Prepaid Expenses:		-		30
Total Current Assets:		300		720
Long-Term Assets:				
Property, Plant & Equipment:		-		30
Goodwill:		100		50
Other Intangible Assets:		50		40
Long-Term Investments:		-		100
Total Long-Term Assets:		150		220
Total Assets:	$	450	$	940
Liabilities & Equity:				
Current Liabilities:				
Accounts Payable:	$	-	$	15
Accrued Expenses:		-		10
Deferred Revenue:		-		15
Total Current Liabilities:		-		40
Long-Term Liabilities:				
Debt:		-		240
Deferred Tax Liability:		-		50
Total Long-Term Liabilities:		-		290
Equity:				
Common Stock & APIC:		50		170
Retained Earnings:		400		485
Treasury Stock:		-		(50)
Accumulated Other Compr. Income:		-		5
Total Equity:	$	450	$	610

Cash comes from the bottom of the CFS; ST Investments from CFI.

These are projected independently on the BS.

These all flow in from the Cash Flow Statement.

These are projected independently on the Balance Sheet.

These flow in from the CFS.

These mostly flow in from the CFS; Net Income flows into Retained Earnings.

And here's the step-by-step process:

1) Project the entire Income Statement first and link in Net Income at the top of the CFS.

Link Net Income from the Income Statement in as the top line of the Cash Flow Statement.

2) Adjust for Non-Cash Items on the Income Statement.

For example, you'd make positive adjustments for Depreciation & Amortization, Stock-Based Compensation, Impairments, and Write-Downs because they're all non-cash expenses.

Items like Gains and Losses and Deferred Taxes might have either positive or negative signs.

3) Project the items in CFI and CFF separately.

You have to forecast the company's CapEx and investing activities, and what it plans to do with equity and debt issuances, share repurchases, and so on.

FX Rate Effects, if they exist, also fall into the "separate and independent" category.

4) Sum up all the sections to calculate the Net Change in Cash.

Add up CFO, CFI, CFF, and FX Rate Effects to calculate the Net Change in Cash at the bottom.

5) Link Net Income and the Net Change in Cash to the Balance Sheet.

Cash at the bottom of the Cash Flow Statement flows into Cash on the Balance Sheet, and Net Income at the top of the CFS flows into Retained Earnings.

6) Link each Non-Cash Adjustment to the appropriate line item.

For example, link Depreciation to PP&E and the Amortization of Intangibles to Other Intangible Assets.

On the **ASSETS side**, you **subtract** links, and on the **LIABILITIES & EQUITY side**, you **add** links.

7) Link each CFI and CFF item to the appropriate line item on the Balance Sheet.

You link many CFI items to Long-Term Assets, and you link many CFF items to Long-Term Liabilities and Equity.

For example, you link CapEx under CFI to PP&E and you link Share Repurchases under CFF to Treasury Stock.

On the **ASSETS side**, you **subtract** links, and on the **LIABILITIES & EQUITY side**, you **add** links.

8) Check that the Balance Sheet balances.

If it does not, review the line items on the BS and CFS and check that they satisfy all the principles above.

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Key Rule #7: U.S. GAAP vs. IFRS and Different Financial Statements

So far, we have assumed that any company's financial statements are similar to those of U.S.-based companies.

However, there are many different accounting systems worldwide, and not all companies present their financial statements in the same way.

The core concepts are the same. Companies in all countries and industries create the Income Statement, Balance Sheet, and Cash Flow Statement to record their activities.

And the financial statements exist for the same basic reason: there's a difference between Net Income and Cash Generated.

The *names* of the statements may differ: For example, the Income Statement might be called the "Consolidated Statement of Earnings" or the "Profit & Loss Statement," and the Balance Sheet might be called the "Statement of Financial Position."

However, the MAIN difference, by far, is that companies outside the U.S. tend to use the DIRECT METHOD to create the Cash Flow Statement rather than the INDIRECT METHOD.

With the Direct Method, companies record the *actual cash received from customers* and *cash paid out*.

So the Cash Flow Statement does **NOT** start with Net Income and then make adjustments for other items.

Instead, it might start with "Cash Received" or "Cash Paid" and then list other items such as Interest and Taxes separately.

Here's an example of a Cash Flow Statement for a non-U.S.-based company:

Cash Flow Statement:		
Cash Flow from Operating Activities:		
Cash Generated from Operations:	£	788
Ordinary Dividends Paid:		(85)
Special Dividends Paid:		-
Net Interest and Financing Charges:		(22)
Taxes Paid:		(65)
Cash Flow from Operations:	**£**	**616**
Cash Flow from Investing Activities:		
Purchase of PP&E:	-£	400
Proceeds from Sale of PP&E:		1
Purchases of Intangible Assets:		(21)
Redemption of Loan Notes:		4
Cash Flow from Investing:	**-£**	**416**
Cash Flow from Financing Activities:		
Net Proceeds from Share Capital:	£	1
Share Repurchases:		(26)
Repayment of Bank Loans:		(273)
Repayment of Finance Leases:		(10)
Aircraft Sale and Leaseback Proceed		316
Net Decrease in Money Market Dep		41
Change in Restricted Cash:		148
Cash Flow from Financing:	**£**	**197**
FX Rate Effects:		(29)
Net Change in Cash:	**£**	**368**
Beginning Cash Balance:	**£**	**645**
Ending Cash Balance:	**£**	**1,013**

This statement is quite problematic for several reasons.

First off, it's almost impossible to link this to the Balance Sheet since items like AR and AP are not shown.

Second, "Cash Generated from Operations" doesn't match any item on the Income Statement.

Third, Dividends are listed in Cash Flow from Operating Activities, but they are financing-related.

Finally, Interest and Taxes should be on the Income Statement. If a non-cash adjustment is required, the adjustment can be shown on the CFS.

The Cash Flow from Investing and Financing sections are mostly OK, so we don't need to adjust much there.

When you encounter this type of Cash Flow Statement, you need to find a reconciliation between "Cash Generated from Operations" and Net Income or Operating Income, and then change around the Cash Flow Statement.

Here's an example for this company:

Reconciliation of Operating Profit to Cash Generated from Operations:		
Operating Profit:	£	497
Adjustments for Non-Cash Items:		
Depreciation:		102
Loss on Disposal of PP&E:		-
Amortization of Intangible Assets:		10
Stock-Based Compensation:		18
Changes in Working Capital and Other Operational Items:		
Change in Accounts Receivable:		74
Change in Accounts Payable:		64
Change in Provisions:		29
Change in Other Non-Current Assets:		8
Change in Derivative Financial Instruments:		-
Change in Deferred Revenue:		(14)
Cash Generated from Operations:	**£**	**788**

The company is still doing things a bit differently because these items are based on adjustments to *Operating Income*, not Net Income, but it's good enough.

They're giving us the non-cash adjustments and changes in operational Balance Sheet items, which is all we need.

At this point, we would take this information and change the company's Cash Flow Statement so that it looks something like this:

Cash Flow Statement:		
Cash Flow from Operating Activities:		
Net Income:	£	398
Adjustments for Non-Cash Items:		
Depreciation:		102
Loss on Disposal of PP&E:		-
Amortization of Intangible Assets:		10
Stock-Based Compensation:		18
Deferred Income Taxes:		15
Additional Cash Interest Paid:		(3)
Changes in Working Capital and Other Operational Items:		
Change in Accounts Receivable:		74
Change in Accounts Payable:		64
Change in Provisions:		29
Change in Other Non-Current Assets		8
Change in Derivative Financial Instru		-
Change in Deferred Revenue:		(14)
Cash Generated from Operations:	**£**	**701**
Cash Flow from Investing Activities:		
Purchase of PP&E:	-£	400
Proceeds from Sale of PP&E:		1
Purchases of Intangible Assets:		(21)
Redemption of Loan Notes:		4
Cash Flow from Investing:	**-£**	**416**
Cash Flow from Financing Activities:		
Net Proceeds from Share Capital:	£	1
Share Repurchases:		(26)
Dividends:		(85)
Repayment of Bank Loans:		(273)
Repayment of Finance Leases:		(10)
Aircraft Sale and Leaseback Proceed		316
Change in Money Market Deposits:		41
Change in Restricted Cash:		148
Cash Flow from Financing:	**£**	**112**
FX Rate Effects:		(29)
Net Change in Cash:	**£**	**368**
Beginning Cash Balance:	**£**	**645**
Ending Cash Balance:	**£**	**1,013**

This version of the Cash Flow Statement is much easier to work with because it **starts with Net Income.**

Then, it makes the standard non-cash adjustments, including a few items related to Deferred Taxes and Interest (some interest can be non-cash as well).

Then it shows the changes in the operational Balance Sheet items, like Accounts Receivable and Accounts Payable.

We didn't change much in the Investing Activities and Financing Activities sections, but we did move the Dividends down to Cash Flow from Financing instead.

We *always* prefer to make these adjustments when we work with companies that use the Direct Method on their Cash Flow Statements.

All the interview questions and remaining sections of this guide will assume this treatment as well.

This Cash Flow Statement setup makes it much easier to walk through interview questions, and bankers also expect you to use this setup when you explain these questions.

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