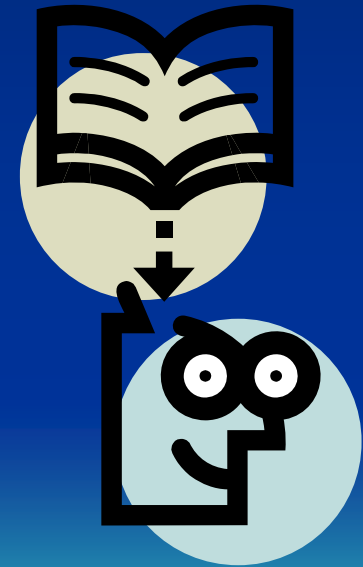


# Understanding Financial Statements



# Elements of Your Financial Statements

A set of financial statements is usually comprised of:

- Balance Sheet – A balance sheet lists the company's Assets, Liabilities and Equity as of a certain point in time.
- Income Statement – An income statement shows the Revenues and Expenses of a company over a particular period of time, usually one year.



# Elements of Your Financial Statements....

- Statement of Retained Earnings – The statement of retained earnings simply shows the profits of the company that remain with the company; the profits that have not been paid out to shareholders (owners).
- Statement of Changes in Financial Position – this statement shows the elements of the change in the company's cash position from one period to the next.
- Notes to financial statements



# Balance Sheet



- As implied by the name, balance sheets must always balance. The formula to maintain the balance is simple;  $\text{Assets} = \text{Liabilities} + \text{Equity}$ . In other words, what the company owns was paid for using funds that were borrowed (liabilities) or invested (equity). The top portion of the balance sheet is the Asset section and the bottom is the Liabilities + Equity section. The balance sheet can be used to determine how “healthy” the company is.
- Assets are items that are owned by the company. They are subdivided into two categories; Current Assets and Fixed Assets. Current assets are those that can be converted to cash easily and will likely be converted to cash within one year. Examples include inventory, cash, accounts receivable and short-term investments. Fixed assets are items that you expect to have for more than one year and are not easily turned to cash. Examples include equipment, buildings and land, and long-term investments.

# Balance Sheet ....

- Liabilities are items that the company owes to others. They are separated into Current Liabilities and Long-term Liabilities. Current liabilities are debts of the company that are expected to be paid in full within one year. Examples include trade payables, short-term debt (like an operating line of credit) and the portion of any long-term loans that will be paid in the coming year. Long-term liabilities are simply the portion of any outstanding loans that will not be repaid in the coming year.
- Equity represents the Book Value of the company. It is made up of Investments that the owners have made in the company and the Retained Earnings of the company. Investments are the shares held by the owners. Retained Earnings are the profits of the company that have not been paid out to the shareholders or owners and have been reinvested in the company.



# Income Statement

- An Income statement shows the profits of the company over a period of time. It will show the Revenue the company has earned, separating the various sources, and the Expenses incurred by the company while generating that revenue. Net income (profits) = Revenue – Expenses.
- Revenue is the income earned by the business by selling its products or services. It may be in the form of cash or credit (accounts receivable). It is often separated into sales, other income and interest income.



# Income Statement....

- Expenses show how the company spent its money. Again, they may be paid in cash or with credit (accounts payable). Well known categories include wages, cost of goods sold, rent, power, office supplies, etc.
- Gross Profit is also usually shown on the income statement of a company that sells a product. Gross profit = Sales (revenue earned from the sale of the company's good and services) – Cost of Goods Sold (the costs of the goods that were sold)



# Cost of Goods Sold (COGS)

- Cost of Goods Sold, as explained above, is an Income Statement expense. It is shown separately from all other expenses so that Gross Profit, and other helpful indicators, can be calculated. Many people confuse purchases of inventories with the cost of goods sold. According to accounting rules, inventory that is purchased and is not sold cannot be included as an expense. It is placed on the balance sheet, as a current asset, under the Inventory heading.
- The calculation of COGS requires a little thought, but once understood, the formula makes complete sense.
- $COGS = \text{Beginning Inventory} + \text{Purchases} - \text{Ending Inventory}$ . Beginning inventory is the inventory that is on hand at the beginning of the year. The number can be found on the past year's balance sheet. Purchases includes all inventory purchases made throughout the year. Ending Inventory is the amount of inventory at the end of the year and can be found on the current year's balance sheet. The calculation will yield this year's COGS.



# Statement of Retained Earnings....

- As stated above, the statement of retained earnings is a statement that shows the total amount of the earnings retained (not paid out to shareholders in the form of dividends) since the beginning of the company.
- It is important to note that these earnings may not be in the form of cash. They could have been used to purchase any of the other assets that the company owns or to pay down the debt of the company.



# Statement of Retained Earnings

- Retained earnings are calculated with the following formula:  $\text{Previous Retained Earnings} + \text{Current Year's Net Income} - \text{Dividends paid} = \text{Current Retained Earnings}$ .
- Most new companies, if their earnings have been positive, will retain all of their earnings to allow the company to grow. Any earnings taken by owners, in any form, will reduce retained earnings. Because net income is affected by the expenses of the company, additional expenses will also reduce the retained earnings.



# Statement of Changes in Financial Position (SCFP)

- The statement of changes is divided into three main sections; Operations, Financing, Investments. All company transactions affect cash in one way or another and are classed as one of these three types of transactions. The statement breaks down the overall change in cash from the beginning of the year to the end.
- Operations – Any transaction arising from day-to-day operations affects the cash contributed to the overall cash position of the company.
- Financing – Bank loans, payment of dividends, and selling shares all effect the cash position of the company as well. These are all classed as financing activities.
- Investments – Purchases of land, equipment or shares in other companies are classified as investment activities. These too affect the cash position of the company.

# Notes to Financial Statements

- The Notes to the Financial Statements further explain particular items included on the statements and company accounting policies. Topics include depreciation (furniture and equipment), commitments, contingent liability, a breakdown of long-term debt and other such clarifications.
- It is often necessary to thoroughly review the notes to completely understand the financial position of the company.



# Linkages Between the Statements

- Accounting relies on what is called a “Double Entry System” to maintain balance on the balance sheet; Debits and Credits. Every time a transaction occurs within a company at least two separate accounts on the balance sheet are affected.
- The linkages between the statements are very important. The examples below will help clarify exactly how they work. A good knowledge of accounting is needed to learn the debit and credit system so we will not discuss the linkages any further than these examples unless you have specific questions.



# Linkages – Example #1

- Example #1 - if you sell something to a customer for \$150 and they pay with cash, the cash is recorded as an increase to cash on your balance sheet (an asset) and the sale is recorded as revenue on your income statement. The journal entry would look like this:

<b>Debit</b>	<b>Cash \$150</b>
<b>Credit</b>	<b>Sales Revenue \$150</b>

- The sale increases the Net Income since  $\text{Net Income} = \text{Revenue} - \text{Expenses}$ .

Additional Revenue	\$150
Additional Expenses	<u>\$ 0</u>
<b>Net Income</b>	<b>\$150</b>

# Linkages – Example #1....

- The Net Income, according to the formula for Retained Earnings above, affects the retained earnings in the Equity section on the lower half of your balance sheet.

Old Retained earnings \$20,000 (for example) + Net Income (\$150) – Dividends (\$0) = \$20,150

- Thus the increase to cash on the top of the balance sheet is matched by an increase to Retained Earnings on the lower half of the balance sheet.



# Linkages – Example #2

- Example #2 – Your company purchases a truck for \$12,000 with a loan from the Ford Credit
  - It gets recorded as follows:

Debit	Equipment	\$12,000
Credit	Long-term loan	\$12,000
  - The Equipment account is an asset account on the top half of the balance sheet while the Long-term loan is a liability and is recorded on the lower half of the balance sheet. Balance is maintained.



# Linkages – Example #3

- Example #3 – You pay a \$750 power bill you just received.

- It gets recorded as follows:

Debit	Power expense	\$750
Credit	Cash	\$750

- The power expense goes on the income statement as an expense and reduces the net income by \$750, which reduces the retained earnings account on the balance sheet by the same \$750.
- The Cash account, on the top half of the balance sheet, is reduced by \$750 as well so the balance is maintained.

# Questions

- Name two of the statements included in a set of financial statements.
  - Which statement would list the costs of operating your telephones?
  - Which statement would show the current balance of loans a company has outstanding?
  - What is the total of all earnings kept by the company, since it began operating ,called?
  - What are the two categories of assets found on a balance sheet?
  - What is the equation that must be kept in balance at all times?
  - What is subtracted from Sales revenue to calculate the gross profit?
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