Key Financial Reports

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Discuss various types of financial reports, including income statements, balance sheets, cash flow statements, and statements of retained earnings
- ✓ Explain single-entry and double-entry bookkeeping
- ✓ Differentiate between debits and credits

The Key Reports

The Income Statement

The first key financial statement we will review is the **income statement**, also known as a profit and loss statement or operating statement. This is a summary of the income and expenses of a business during a certain period: monthly, quarterly, or annually. If the company has more income than expenses for a certain period it has net income (a profit). If the expenses exceed income, the company has a net loss.

Income can be broken into two broad categories: **service income** and **sales income**. The difference between the two lies in the need to consider inventory costs. Service income is derived from performing a service while sales income is derived from selling a product of some type. In general, service companies have staff that perform a service for a customer, while sales companies have product that they sell.

With service income, the profit can be determined simply by deducting expenses associated with performing the service. With sales income, however, you must consider the cost of creating the product (raw materials, labor, overhead, etc.). This inventory cost is referred to as the **cost of goods sold**.

The income statement equation typically looks like this:

$$Revenue - Expenses = Net\ Income\ or\ Loss$$

- **Revenue** is what the business earned from the sale of goods and services during this period.
- **Expenses** are bills (phone and Internet bill, insurance, payroll, advertising, etc.) incurred during this period.
- **Net income or loss** is the net financial result of the business efforts during that period. It must be added to the Equity portion of the balance sheet, which we will discuss in a moment.

Some examples of the types of accounts that influence net income and are reported on the income statement usually include:

- Revenue
- Advertising expenses
- Repair expenses
- Utilities expenses
- Wage expenses

Sample Income Statement

Acme Widgets Inc. **Income Statement** **For the Month Ended February 28, 2020**		
REVENUE		
Widget Sales		$20,000
Widget Installation		$1,500
Interest Income		$500
Total Revenue		**$22,000**
EXPENSES		
Rent	$4,500	
Utilities	$1,200	
Advertising	$8,000	
Wages	$5,000	
Total Expenses		**18,700**
NET INCOME (LOSS)		**$3,300**

The Balance Sheet

The purpose of a balance sheet is to show what a company owns and owes as of a specific date. Income statements are prepared "for the period ending" and balance sheets are prepared "as at" a certain date.

The balance sheet summarizes what the business owns and compares it to what the business owes. It does so in a standard format to make it easy to see what kind of financial shape the business is in. If a

business has more assets than liabilities, that's a good sign. On the other hand, if a company has more liabilities than assets, it might be a sign of trouble.

Balance Sheet Equation

The balance sheet reflects the most basic financial equation:

$$Assets - Liabilities = Equity$$

- **Assets** are anything that the business owns. Some examples: cash, office equipment, vehicles, tools, real estate, buildings, and land. **Bills that are prepaid** (such as monthly insurance premiums) are also considered an asset, as are **accounts receivable** (money that others owe to you).
- **Liabilities** are anything the business owes to others, including banks and suppliers. Money which a company owes as a result of its ongoing trading are generally called **accounts payable**.
- **Equity** is often a measure of what the business is worth. It is the combination of profits and money invested in or withdrawn from the company by its owners.

This is what people refer to as balancing the books: ensuring that this equation is always in balance. Accounts typically reported on the balance sheet include:

- Accounts receivable (money owed to the company but not collected)
- Cash
- Equipment
- Accounts, and notes payable
- Prepaid items
- Unearned revenue
- Vehicles, land, and buildings, and their accumulated, individual depreciation (decrease in value)

The term **consolidated balance sheet** refers to the "consolidation," or adding together, of individual balance sheets of various related companies into one balance sheet, which shows the financial position of the entire group of companies.

Current vs. Fixed Assets

On a balance sheet, the assets of a business are generally broken down into two groups: current assets and fixed assets.

Current assets are generally considered to be anything that will be converted into cash within one year, such as cash, accounts receivable, and inventory. Current assets continually turn over through the company.

Fixed assets are more permanent in nature. This includes vehicles, equipment, machinery, land, and buildings. They represent an investment in items that are necessary to carry on its normal operations. Fixed assets can also revolve (to purchase new equipment or update technology, for example) but usually they revolve very slowly.

Liquidity measures how quickly a company can convert its assets into cash. An ample cash balance provides security that the company can meet its obligations. The easier the conversion is, the more liquid the asset. Here is a list of current assets in order from most to least liquid:

- Accounts receivable
- Inventory
- Fixed assets

Sample Balance Sheet

Acme Widgets Inc. **Balance Sheet** **As at February 28, 2020**			
Assets		**Equity**	
Cash	$2,500	Owner's Capital	$5,000
Accounts Receivable	7,500	Retained Earnings (Cumulative Net Income)	3,300
Computer Equipment	1,000	Less Withdrawals and Dividends	(300)
Supplies (Inventory)	1,500		
Total Assets	**$12,500**	**Total Equity**	**$8,000**
Liabilities			
Accounts Payable	$500		
Notes Payable	4,000		
Total Liabilities	**$4,500**		

Remember:

$$Assets - Liabilities \; = Equity$$

$$12500 - 4{,}500 = 8{,}000$$

The Cash Flow Statement

What is the Cash Flow Statement?

The cash flow statement shows the flow of cash for an accounting period. This statement links the cash accounting method and the accrual accounting method: it analyzes what transactions impacted cash and what transactions were accruals.

The cash flow statement is usually divided into three sections.

Operating

- Cash flow for day-to-day operations
- Examples: Customer revenue, tax payments, interest, supplies purchased

Investing

- Cash flow generated from or consumed by assets
- Examples: Sale of a vehicle or purchase of a building

Financing

- Cash flow in from selling stocks or bonds, or borrowing
- Cash flow out from purchasing stock back, paying out dividends, and repaying borrowed money

Sample Cash Flow Statement

Acme Widgets Inc. Statement of Cash Flows For the Month Ended February 28, 2020	
Cash Flows from Operating Activities	
Net Income	$3,300
Add back non-cash amortization	NA
Subtotal	**$3,300**
Net Changes in Non-Cash Working Capital	
Accounts Receivable	($7,500)
Supplies (Inventory)	(1,500)
Accounts Payable	500
Total cash provided by (used by) operating activities	**($5,200)**

Cash Flows from Investing Activities	
Cash used to purchase computer equipment	($1,000)
Total cash provided by (used by) investing activities	**($1,000)**
Cash Flows from Financing Activities	
Cash received from the issuance of shares	$5,000
Cash received from the issuance of notes payable	4,000
Cash paid via dividends	(300)
Total cash provided by (used by) financing activities	**$8,700**
INCREASE (DECREASE) IN CASH DURING THE PERIOD	**$2,500**
CASH BALANCE BEGINNING OF PERIOD	**0**
CASH BALANCE END OF PERIOD	**$2,500**

Statement of Retained Earnings

What is the Statement of Retained Earnings?

This statement shows how much of the company's profits were kept inside the company, and not paid out in dividends.

Sample Statement of Retained Earnings

Statement of Retained Earnings for Acme Widgets Inc. As At February 28, 2020	
Opening retained earnings	0
Add net income for the period	$3,300
Total Retained Earnings	**$3,300**
Minus dividends paid	(300)
Retained earnings	**$3,000**

Keeping Score

Understanding the Chart of Accounts

Unless you are starting a business from scratch, you won't need to worry about setting up a chart of accounts. However, you may need a new account, in which case you should understand where it fits in. It is also vital that you understand the hierarchy of accounts in order to understand how transactions flow through the business.

First, let's review the two key equations that we looked at before lunch.

The **income statement equation** is:

$$Revenue - Expenses = Net\ Income\ or\ Loss$$

The **balance sheet equation** is:

$$Assets - Liabilities\ = Equity$$

Every accounting transaction involves parts of these equations. Below is a list of some common accounts in the chart of accounts and where they would fit into the equations.

Assets

- Cash
- Vehicles
- Accounts receivable (money that others owe to you)
- Equipment and tools
- Buildings and land

Liabilities

- Accounts payable (debts that you owe, due within one year from today)
- Notes payable (debts that you owe, due beyond one year from today, except for mortgages)
- Mortgages payable

Equity

- Capital (money the owner has put into the business)
- Withdrawals (money the owner takes out of the business)
- Dividends (money paid to shareholders and owners)

Revenue

- Money the business has earned for goods or services

Expenses

- Advertising
- Insurance
- Interest

- Payroll
- Rent
- Supplies
- Utilities
- Anything that is spent to keep the business running

Single vs. Double Entry Accounting

There are two main methods of accounting: single and double entry.

Single Entry Accounting

In general, each accounting entry has two parts: a debit and a credit. With single entry accounting it is possible to create a transaction that has only a debit or a credit (only one side). This method is usually used for very small businesses that use cash-based accounting and entries are recorded when money moves in or out. Single entry accounting is not popular.

A checkbook is a good example of a single entry accounting system. You make entries in your checkbook as you make deposits and write checks.

Check #	Date	Description	Payment		Deposit		Balance	
							5000	00
101	01/01/20	Rent	1000	00			4000	00
N/A	01/05/20	Deposit from Smith Plumbing			675	21	3324	79

In single entry accounting, items are not simply noted in the checkbook but are actually entered into the accounting records. The risk with single entry accounting is that the second side of the entry is not ultimately made and the balance sheet does not balance.

Double Entry Accounting

This is the method used by most businesses and preferred by accountants. With this method, every valid entry or transaction must involve two (or more) accounts. (In fact, most accounting software packages will not allow you to post a single entry transaction!) Both sides – the debit and the credit – of the transaction must balance and this ensures that all financial statements balance.

For example, let's say that the business buys a $2,000 computer on credit. The company's assets go up by $2,000 (the debit) but the liabilities also go up by $2,000 (the credit). As this is paid, assets (cash) decrease as payments are made and the liability goes down by the same amount.

Some notes about recordkeeping:

- Dollar signs are typically not used in journals or ledgers, but should be placed in financial reports and statements (even if it is on the first line only).
- Commas (to show thousands of dollars) are not required in journals or ledgers but should be placed in financial reports and statements for clarity.
- Dashes or blank spaces can be used to indicate zeroes.

Self-Test

Classify each of the accounts listed below.

	Assets	Liabilities	Equity	Revenue	Expenses
Wages paid during the month					
Maintenance garage					
Long-term investments					
Fees for servicing widgets					
Short term loan					
Owner's salary					
Accounts receivable					
Office supplies					
Money from widget sales					
Accounts payable					

A Review of Financial Terms

Term	Definition
	Total of the money owed by the company to suppliers or vendors.
	Money due to the company from customers that have not been paid.
	Expenses that have been incurred but are not due to be paid.

Term	Definition
	Revenue that has been earned but is not yet due to be paid. (Typically this is because it has not been invoiced.) Example: You are working on a six-month project and the bill will not be sent until the project is complete. In the accrual accounting system, you will need to create an adjusting entry for each of the first five months to show earnings.
	A journal entry that moves the difference between revenue and expenses from the income statement to the owner's equity.
	Total price paid for the products being sold by the business, including shipping costs.
	The decrease in value of a fixed asset over its life. This expense is spread out over its future life. It is considered a source of cash because it can reduce your tax bill.
	What the shareholders or company owner has left after all liabilities have been paid.
	Profit before expenses, interest, taxes, and other charges have been deducted.
	The sum of finished products, work in progress, and raw materials on hand.
	The company's debts.
	Profit after expenses, interest, taxes, and other charges have been deducted.
	An asset that you have paid for but not used. For example, businesses often pay insurance up-front at the beginning of the year. The expense is incurred all at once and then the asset is redeemed over the course of the year.
	The profits of a business that are not paid to shareholders or the owner. They are retained by the business, reinvested in the company, and therefore accumulate.

Understanding Debits and Credits

Understanding Debits and Credits

Debits and credits can be difficult to understand. The layperson often thinks of a debit strictly as a subtraction. For example, when you pay your rent or put gas in your car, money is taken out of your account, or **debited**. If they overcharge you by accident, money is put back into your account, or **credited**.

In accounting, debits and credits can both be positive or negative amounts and could be either an increase to a balance or a decrease. For example, assets have debit balances, so if you debit an asset, you are increasing its balance. Conversely, liabilities are credit balances. This means that if you credit a liability, you are increasing it. The chart on the next page outlines how credits and debits apply to the major categories of accounts.

Remember our balance sheet equation:

$$Assets - Liabilities\ = Equity$$

In a healthy company, equity should be a credit balance. Consider the following:

$$Debits - Credits = Credit$$

$$\$1{,}000 - \$500 = \$500$$

Unless you're going to be an accountant (in which case you'll need far more training than this course) that's about all you need to know.

Here is a summary of account categories and whether they are a debit or credit.

Account Category	Debit	Credit
Assets (normal balance)	X	
Assets transactions (increase asset balance)	X	
Assets transactions (decrease asset balance)		X
Liabilities (normal balance)		X
Liabilities transactions (increase liability balance)		X
Liabilities transactions (decrease liability balance)	X	
Capital		X

Withdrawals	X	
Revenue		X
Expenses	X	

Working with Debits and Credits

Complete the chart below. Remember, a transaction can fall into one of these categories:

- Assets (transactions or normal balance)
- Liabilities (transactions or normal balance)
- Capital
- Withdrawals
- Revenue
- Expenses

Item	Account Category	Debit	Credit
Wages paid during the month	Expenses		
Purchase a maintenance garage	Assets (transaction)		
Purchase long-term investments	Assets (transaction)		
Fees for servicing widgets	Revenue		
Short term loan increase	Liabilities (transaction)		
Owner's salary	Equity (withdrawals)		
Increase in accounts receivable	Assets (transaction)		
Office supplies	Expenses		
Money from widget sales	Revenue		
Accounts payable decrease	Liabilities (transaction)		
End of the month assets balance	Assets (normal balance)		