Bookkeeping
Part 1
Lesson 6

Financial Statements

The objective of this lesson is to inform, introduce, and make you aware of the basic financial statements.
Let's start this lesson by reviewing a few definitions.
Financial Statements are summary accounting reports prepared periodically to inform the owner, creditors, and other interested parties as to the financial condition and operating results of the business. The four basic financial statements or reports are:

Balance Sheet-The financial statement which shows the amount and nature of business assets, liabilities, and owner's equity as of a specific point in time. lt is also known as a Statement Of Financial Position or a Statement Of Financial Condition.

Income Statement-The financial statement that summarizes revenues and expenses for a specific period of time, usually a month or a year. This statement is also called a Profit and Loss Statement or an Operating Statement.

Capital Statement-The financial report that summarizes all the changes in owner's equity that occurred during a specific period.

Statement of Changes in Financial Position-The financial statement that reports the sources and uses of cash or working capital for a specific period of time, normally a year.

The Balance Sheet

A Balance Sheet is simply a picture of a business at a specific point in time, usually the end of the month or year. By analyzing and reviewing this financial statement the current financial health of a business can be determined. The balance sheet is derived from our accounting equation and is a formal representation of our equation
Assets = Liabilities + Owner's Equity.

The categories and format of the Balance Sheet are based on what are called Generally Accepted Accounting Principles (GAAP). These principles are the rules established so that every business prepares their financial statements the same way.

Non-profit Financial Statements are as follows:
- Statement of financial Position
- Statement of Operations see note below
- Statement of changes in Net Assets see note below
- Statement of Cash flows

Note: The Statement of Operations and Statement of changes in Net Assets can be combined into the " Statement of operations and Fund Balances".

Assets
Formal Definition :The properties used in the operation or investment activities of a business.
Informal Definition: All the property a business has (anything with value).
Additional Explanation: The property includes tangible and intangibles. Tangibles you can physical see and touch such as vehicles, equipment and buildings. Intangible is like pieces of paper (sales invoices) representing loans to your customers where they promise to pay you later for your services or product. Examples of assets that many individuals have are cars, houses, boats, furniture, and appliances. Some examples of business type assets are cash, accounts receivable, notes receivable, inventory, land, and equipment.
Assets are listed based on how quickly they can be converted into cash which is called liquidity. In other words, they're ranked. The asset most easily converted into cash is listed first followed by the next easiest and so on. Of course since cash is already cash It's the first asset listed.

Liabilities
Formal Definition: Claims by creditors to the property (assets) of a business until they are paid.
Informal Definition: Other's claims to the business's property. Amounts the business owes to others.
Additional Explanation: Usually one of a business's biggest is to suppliers where they have bought goods and services and charged them. This is similar to us going out and buying a TV and charging it on our credit card. Our credit card bill is a liability. Another good personal example is a home mortgage. Very few people actually own their own home. The bank has a claim against the home which is called a mortgage. This mortgage is another example of a personal liability. Some examples of business liabilities are accounts payable, notes payable, and mortgages payable.
Liabilities are listed in the order of how soon they have to be paid. In other words, the liabilities that need to be paid first are also listed first.

Owner's Equity (Capital)
Formal Definition :The owner's rights to the property (assets) of the business; also called proprietorship and net worth.
Informal Definition: What the business owes the owner. The amount left for the owner assuming all liabilities (amounts owed) have been paid.
Additional Explanation: Owner's Equity represents the owners claim to the property (assets). Most people are familiar with the term equity because it is so often used with lenders wanting to loan individuals money based on their home equity. Home equity can be thought of as the amount of money an owner would receive if he/she sold their house and paid off any mortgage (loan) on the property.

Owner's equity (or net worth or capital) is increased by money or property contributed and any profits earned and decreased by owner withdrawals and losses.
All Balance Sheets contain the same categories of assets, liabilities, and owner's equity.
If you look below at our Balance Sheet for ABC Mowing you can readily see that there are three main sections, assets, liabilities, and owner's equity just like the accounting equation.
The major sections of a balance sheet are the heading, the assets, the liabilities, and the owner's equity. The heading contains the name of the company, the title of the statement, and the date of the statement.

ABC Mowing			
Balance Sheet			
As Of December 31, xxxx			
Assets		**Liabilities**	
Cash	$5,080	Accounts Payable	2,060
Accounts Receivable	1,600	Notes Payable	10,000
Office Supplies	100		
Mowing Equipment	12,500	Total Liabilities	12,060
		Owner's Equity	
		ABC Capital	7,220

Total Assets $19,280 Total Liabilities & Equity $19,280

This layout is called the account form. In this form the major categories are presented side by side.

Another layout sometimes used is called the report form. In this form the major categories are stacked on top of each other. An example of the report form follows.

ABC Mowing		
Balance Sheet		
As Of December 31, xxxx		
Assets		
Cash		$5,080
Accounts Receivable		1,600
Office Supplies		100
Mowing Equipment		12,500
Total Assets		**$19,280**
Liabilities		
Accounts Payable		$2,060
Notes Payable-Bank		10,000
Total Liabilities		$12,060
Owner's Equity		
ABC Capital		$7,220
Total Liabilities & Equity		**$ 19,280**

The Income Statement

The Income Statement is a formal financial statement that summarizes a company's operations (revenues and expenses) for a specific period of time usually a month or year.

A fiscal year is the period used for calculating annual (yearly) financial statements. While a large number of businesses use the calendar year (January-December) as their fiscal year, a business can elect to use any other twelve month period such as June-May as their fiscal year.

The categories and format(s) of the Income Statement also follow the rules known as Generally Accepted Accounting Principles (GAAP) and contains specific revenue and expense categories.

The following types of accounts are used to prepare the Income Statement.

Revenue (Also Called Income)

Formal Definition: The gross increase in owner's equity resulting from the operations and other activities of the business.

Informal Definition: Amounts a business earns by selling services and products. Amounts billed to customers for services and/or products.

Expense (Also Called Cost)

Formal Definition: Decrease in owner’s equity resulting from the cost of goods, fixed assets, and services and supplies consumed in the Operations of a business.

Informal Definition: The costs of doing business. The supplies we used and had to pay for or charge to run our business.

Additional Explanation: Some examples of business expenses are office supplies, salaries & wages, advertising, building rental, and utilities.

Hopefully a business earns a profit called net income (revenues are larger than expenses). If however, expenses are larger than revenues a net loss results.

The major sections of an income statement are the heading, the revenue section, the expense section, and the final calculation of a profit or loss. The heading should contain the name of the company, the title of the statement, and the period covered by the statement.

The Income Statement for ABC Mowing is presented below.

ABC Mowing		
Income Statement		
For The Period Ending December 31, xxxx		
Revenue from operations		$1,205
		Expenses
Advertising Expense	$225	
Mulch Expense	160	
Total Expenses		$385
Net Income		820

Note: An income statement would have many more expense categories than the two types illustrated in our simple example. Some additional expenses that would normally be included are:

- Office Supplies Used
- Telephone
- Building/Office Rent
- Utilities

- Depreciation Expense
- Maintenance and Repairs
- Interest Expense
- Memberships
- Donations
- Bank Fees and Charges
- Salaries & Wages
- Employment Taxes
- Equipment Rental
- Contract Labor
- Professional Fees
- Travel
- Entertainment
- Any other type that your business incurs

The Income Statement or what is sometimes also referred to as a Profit and Loss Statement was prepared for a service type of business. Businesses that are retailers, wholesalers, or manufacturers that sell products have a special section included in their income statement called Cost Of Goods Sold. This section computes the Cost Of The Goods Sold that were either purchased and sold or manufactured and sold. In retailing and wholesaling, computing the cost of goods sold during the accounting period involves beginning and ending inventories. In manufacturing it involves finished-goods inventories, raw materials inventories and goods-in-process inventories.

The Capital Statement

The next financial statement, the capital statement, is prepared to report all the changes in owner's equity that occurred over a period of time usually a month or year. The major sections of the statement are the heading, the owner's capital balance at the beginning of the period, the increases and decreases during the period , and the calculated ending balance. The capital statement serves as the bridge between the income statement and balance sheet. It uses the net income/loss from the income statement in addition to the owners investments and withdrawal to determine the Owner's Capital balance shown on the balance sheet.
Let's illustrate this statement with a simple equation.
Ending Owner's Equity = Beginning Equity + Additional Capital Contributed + Profit or - Loss - Draws
.

ABC Mowing		
Capital Statement		
For The Period Ending December 31, xxxx		
Capital Beginning		$7500
Capital Contributed	0	
Net Income	820	
Less withdrawals		1,100
Decrease in capital		280
Ending Capital		$7.220

If you compare the owner's equity (owners claim to assets) for two year end balance sheets, the difference (increase or decrease) is explained by the Income Statement and Capital Statement Remember, revenues increase equity; capital contributed to the business increases equity; expenses decrease equity; and owners draws decrease equity.

Statement Of Changes in Financial Position

The last financial statement, the statement of changes in financial position, is prepared to report all the changes in cash or working capital that occurred over a period of time usually a month or year.
The working capital form of the statement explains the increase or decrease in working capital for a period. Note: Working capital is the difference between current assets and current liabilities (Working Capital = Current Assets - Current Liabilities).
As you might expect, the cash form of the statement explains the increase or decrease in cash for a period. The statement is often called the Sources and Uses of Cash Statement when cash is used as the basis for preparing the statement.
Since more and more of the accounting regulatory agencies are promoting using cash instead of working capital as the basis for preparing this statement, our example statement will also use cash.
The major sections of the statement are the heading, a section for reporting the increases in cash (resources provided by), a section for reporting the decreases in cash (resources applied to), and a summary of the change in cash (increase/decrease) for the period.
If the business was in Operation in the previous year, the prior year balance sheet along with the current year balance sheet and current year income statement is needed in order to prepare the statement. Additional analysis of some of the accounts may also be needed.
Our example assumes that ABC Mowing's prior year balance sheet is as follows:

ABC Mowing		
Balance Sheet		
As Of December 31, xxxx (Prior Vear)		
Assets		
Cash		$6,400
Accounts Receivable		600
Mowing Equipment		2,500
Total Assets		$9,500
Liabilities		
Accounts Payable		$2,000
Total Liabilities		$2,000
Owner's Equity		
ABC Capital		$7,500
Total Liabilities & Equity		$9,500

Using the above prior year balance sheet along with the current year balance sheet and

income statement we prepared the following Statement Of Changes in Financial Position:
Summary of how to prepare the statement:
• The first step is determining the cash provided or used by operations and begins with the operating income for the period.
• Adjustments are made to the income for revenue or expenses items that did not provide or use cash.
• Additional adjustments are made for all current and noncurrent accounts and are recorded as addition or subtractions depending upon their effect on cash based on their beginning of the year and end of the year balances

ABC Mowing				
Statement Of Changes in Financial Position (Cash)				
As Of December 31, xxxx (Current Year)				
Sources of cash:				
Financing from bank loan			$10,0000	
Total sources $10,000				
Uses of cash:				
Income from Operations	$820			
Add:				
Increase in accounts payable	60	$880		
Deduct:				
Increase in supplies inventory	100			
Increase in accounts receivable	1000	1100		
Cash used by operations			220	
Payment of owner's draws			1,100	
Acquisition of equipment			10,000	
			Total uses	11,320
Decrease in cash				$1,320
Change in cash balance:				
Cash balance, December 31, xxxx (Current Year)				$5,080
Cash balance, December 31, xxxx (Prior Year)				6,400
Decrease in cash				$1,320

Notes To The Financial Statements.
Notes to the financial statements are an integral part of the statements and are required by Generally Accepted Accounting Principles. Notes to financial statements, sometimes referred to as footnotes, are used to provide additional'\-information about a business's financial condition and methods used at arriving at the amounts presented in the financial statements.
These notes contain important information about such things as the accounting methods used for recording and reporting transactions, any pending lawsuits or regulations that may affect the business, and other information that should be disclosed in order to properly analyze and

evaluate the financial condition of the business.
Where Do You Get The Information used to prepare these formal financial statements?
A Trial Balance/Worksheet that we discussed in Lesson 5 is prepared from the General Ledger. The balances listed on this worksheet are listed in the order of the accounting equation. Asset balances are listed first:
followed by Liabilities; and then Owner's Equity, Revenues and Expenses.
Once you have a Trial Balance It's simply a matter of transferring the amounts from the Trial Balance to use to prepare the Balance Sheet, Income Statement, and Capital Financial Statements. Add in the prior year's balance sheet and you have the Information needed for preparing the Statement of Changes in Financial Position (cash).
ABC Mowing's Trial Balance at the end of December

Account	Debit Balances	Credit Balances	Account Type
Asset Accounts			
Cash	5080		Balance Sheet
Accounts Receivable	1600		Balance Sheet
Inventory-Office Supplies	100		Balance Sheet
Mowing Equipment	12500		Balance Sheet
Liability Accounts			
Accounts payable		2060	Balance Sheet
Note Payable Bank		10000	Balance Sheet
			Equity Accounts
Owners		7500	Balance Sheet
Owners Draw	1100		Balance Sheet
Revenue Accounts			
Mowing Revenue		1205	Income Statement
Expense Accounts			
Mulch Expense	160		Income Statement
AjjsinExpense	225		Income Statement
.Totals	20765	20765	

It should be apparent that by having the Information from the General Ledger and the Trial Balance one can readily prepare the Balance Sheet, Income Statement, and Capital financial statements.
The Trial Balance/Worksheet normally contains additional columns for adjusting and closing entries. Briefly, closing entries transfer (dose) the balances in the General Ledger's individual revenue, expense, and drawing account(s) to the owner's capital account at the end of a period (usually year end) which results in the same General Ledger Capital Account ending balance as contained in the Capital Statement. This Ending Capital balance becomes the new Beginning Capital Balance for the new year. All the revenues, expense, and drawing account balances are reset to zero so that their balances will only represent transaction amounts

(increases and decreases to owner's equity) in the new year.
Due to the fact that this is an introductory tutorial, adjusting and closing entry detail illustrations, discussions, and examples are reserved for a more advanced tutorial
Many businesses have their accountant or CPA prepare or review their financial statements. Even if the bookkeeper does not prepare them, they're still a key ingredient in properly analyzing and recording the transactions that are summarized in these statements.
Another plus, good accounting or bookkeeping software will automatically generate these statements.