

# Financial Statements

Accounting Simplified



# Financial Statement Components

1. Statement of Financial Position - aka Balance Sheet
2. Statement of Operations - aka Income Statement or Profit & Loss (P & L)
3. Statement of Cash Flows
4. Notes - the intent is to clarify, but most times serve only to confuse

# Accounting Numbers

- The numbers are dollar values.
- Each value is one of only 5 possible kinds of numbers.

# 5 Kinds of Accounting Numbers

1. Assets
2. Liabilities
3. Equities
4. Revenues
5. Expenses

# 1. Assets

These are the things that the entity **OWNS**.

These are the things (both tangible and intangible) that have value.



# Assets (Own)

## Personal Assets

- Cash
- Home
- Car
- Furniture
- Clothes
- Jewelry
- Bicycle, etc.

## Institutional Assets

- Cash
- Accounts Receivable\*
- Inventory
- Prepaid Expenses\*
- Land
- Vehicles
- Equipment
- Buildings, etc.

# 2. Liabilities

These are the moneys that the entity **OWES**.

These are the things that have to be paid in the future.

# Liabilities (Owe)

## Personal Liabilities

- Loans from Friends
- Credit Card Debt
- Phone Bill
- Car Loan
- Mortgage

## Institutional Liabilities

- Accounts Payable\*
- Accrued Liabilities\*
- Unearned Revenue\*
- Operating Loan
- Mortgage
- Long Term Debt\*



# 3. Equities

This is the **difference** between what an entity owns and what they owe.

Total of all assets - Total of all Liabilities = Equity

For Individuals this is usually referred to as **Net Worth**

# Equities (Net Worth) = Assets - Liabilities

## Personal Equity

On F/S this is known as Owners' Equity

The numbers that are used to reflect this equity are called

Owners' Capital

Owners' Drawings or Withdrawals

## Institutional Equities

On F/S this is known as Shareholders' Equity.

The numbers that are used to reflect this equity are called

Common Shares

Retained Earnings

# Stop

So right now we are ready to talk about the first component of a set of Financial Statements:

Statement of Financial Position - SFP

Or

**Balance Sheet**

# Balance Sheet

## - a Statement of Financial Position

- This financial statement, like each of the other statements, has a prescribed format.
- Not only is the layout prescribed but, the contents are also prescribed.
- A Balance Sheet contains, on one page, a list of the Assets (things the entity owns), a list of the Liabilities (moneys the entity owes) and shows the Equity (the difference between what is owned and owed) on a particular date.
- The date is usually the last day of the accounting year.

# Balance Sheet

## - a Statement of Financial Position

A **Balance Sheet contains**, on one page, a list of the **Assets** (things the entity owns), a list of the **Liabilities** (moneys the entity owes) and shows the **Equity** (the difference between what is owned and owed) on a particular date.

Note: We said there were 5 kinds of accounting numbers. Only three of them, **assets, liabilities and equities**, appear on a balance sheet. Revenues and expenses are **not** displayed on a balance sheet.

# Format Requirements

This is a statement of the financial position of the entity on a particular date

## **Assets**

### **Current Assets**

This is a list of those assets which will be used, collected or sold within the next few months and their total value.

### **Long-term Assets**

This is a list of those assets which will be used or collected during many accounting periods and their total value

### **Total Assets**

A total of both the current and long-term assets. \$ xxx,xxx

## **Liabilities**

### **Current Liabilities**

This is a list of those liabilities which will need to be paid within the next few months and their total value.

### **Long-term Liabilities**

This is a list of those liabilities which will not need to be paid until future years and their total value.

### **Total Liabilities and Owner's Equity**

Total of the current and long-term liabilities and the owners'/shareholders' equity \$ xxx,xxx

# Balance Sheet Ratios

## 1. Current Ratio

Do they have enough current assets to pay the current liabilities?

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Rule of Thumb: should be in the range of 1.5 :1 to 2:1

# Balance Sheet Ratios

## 2. Debt to Equity Ratio

Did they use someone else's funds (debt) or their own funds (equity) to pay for their assets?

$$\frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Rule of Thumb: Should be in the range of 50% to 75% debt.



# Let's go back

## There are 5 kinds of accounting numbers

1. Assets
  2. Liabilities
  3. Equities
- We said these three, assets, liabilities and equity and only these three, belong on a balance sheet.
4. Revenues
  5. Expenses
- So, what about these two: revenues and expenses? Where do they belong?

# 4. Revenues

These are the moneys that the entity has **earned**.

Revenues are always gross. Expenses are only subtracted to calculate Net Income or Net Profit.

Note: It is **not** necessary for moneys to be paid to be considered revenues.



# Revenue (Earned)

## Personal Revenues

- LAPP - pension
- OAS - old age security
- CPP - pension payments from the Federal
  - government
- Investment income - dividends, interest
- Salary


## Institutional Revenues

- Sales revenue - from the sale of goods
- Consulting revenue - from the provision of
  - services
- Contract Revenue
- Donations

# 5. Expenses

These are the costs that the entity has **incurred** to earn the revenue that is reported.

Note: It is **not** necessary for costs to be paid they simply have to have happened to be considered expenses.



# Expenses (Incurred)

## Personal Expenses

- Gas & oil change for my car
- Groceries
- Interest expense on mortgage
- Hair cuts & dyes
- Nails
- Cleaning lady
- Phone costs
- Utilities Expense
- Insurance expense

## Institutional Expenses

- Vehicle maintenance
- Phone costs
- Salaries expense
- Travel expenses
- Utilities expense
- Miscellaneous office expenses
- Insurance expense
- Interest on loans
- Income tax expense

# Stop

So right now we are ready to talk about the second component of a set of Financial Statements:

Statement of Operations

**Income Statement**

Statement of Profit Or Loss - P & L

# Income Statement

## - a Statement of Profit or Loss - P & L

- This financial statement, like each of the other statements, has a prescribed format.
- Not only is the layout prescribed but, the contents are also prescribed.
- An **Income Statement** contains, on one page, a list of the different types of gross **Revenues** (earned), a list of the **Expenses** (incurred) to earn those revenues and it shows Net Income or Net Loss (the difference between total revenues and total expenses) for a particular period of time.
- The period of time is usually a year or a quarter (three months).

# Income Statement

An **Income Statement contains**, on one page, a list of the **Revenues** (moneys the entity has earned), a list of the **Expenses** (costs incurred to earn the revenue) and it shows the **Net Profit** (the difference between what is earned and the costs incurred) for a particular period of time.

Note: We said there were 5 kinds of accounting numbers. Only two of them, **revenues and expenses**, appear on a balance sheet. Assets, liabilities and equities are **not** displayed on an income statement.



# Coreen Dolan

## Statement of Operations

### For the Year ended December 31, 2017

#### Revenues

Pension income	\$ 27,600
Investment Income	<u>2,400</u>

#### Total Revenue

30,000

#### Expenses

Insurance Expense	800
Personal Expenses	22,000
Tax Expense	<u>2,500</u>

#### Total Expenses

25,300

#### Net Income

\$ 4,700

# Income Statement Ratios

## 1. Profit Margin

Out of each dollar of revenue what proportion ends up on the bottom line - net Income?

$$\frac{\text{Net Income}}{\text{Total Gross Revenue}}$$

Rule of Thumb: should be in the range of 5% to 10%

# Income Statement Ratios

## 2. Return on Long-term Assets

Out of every dollar invested in long-term assets (machinery and equipment) what percentage gets returned as net income?

$$\frac{\text{Net Income}}{\text{Total long-term Assets}}$$

Rule of Thumb: should be in the range of 10% to 20%

# Income Statement Ratios

## 3. Return on Equity

Out of every dollar in equity (net worth) what percentage gets returned as net income?

$$\frac{\text{Net Income}}{\text{Total Shareholders' Equity}}$$

Rule of Thumb: should be in the range of 10% to 20%

# Cash vs Accrual Accounting

A commonly held **misconception** about Net income is that it represents the cash that an entity has had flow into it.

Net income is composed of revenues that **may or may not** have been collected and expenses that **may or may not** have been paid.

Not all revenue is collected when earned. Revenue can be earned and collected in cash at two different points in time.

Not all expenses are paid when they are incurred. Expenses can be incurred and paid in cash at two different points in time.

# Cash vs Accrual Accounting

- The whole idea of recording and recognizing revenues and expenses when they are **earned** or when they are **incurred** is called **accrual** accounting.
- Most financial statements, that is, Balance Sheets and Income Statements, are prepared on an accrual basis.
- Because of accrual accounting a third financial statement is prepared. It is called a statement of cash flows.

# Stop

So right now we are ready to talk about the third component of a set of Financial Statements:

**Statement of Cash Flows**

# Statement of Cash flows

- No new accounting numbers are used to prepare this statement
- This statement tries to explain the **difference in the cash** from the beginning of a period of time to the cash held at the end of a period of time.
- It answers three big questions:
  - How much cash did an entity start with?
  - How much cash did they have at the end?
  - How and why did it change?



# Statement of Cash flows

Cash flows in and out of an entity for three basic reasons:

1. Cash goes in and out because that's a part of normal **operations**. An entity buys things cash goes out. We sell things cash comes in.
2. Cash also goes in and out as the entity manages its **investments**. They buy new equipment and retire old machinery and equipment.
3. Finally, cash goes in and out as the entity gets loans, pays off old loans and pays dividends to its owners's or shareholders'. These are **financing** activities.

# Statement of Cash flows

Cash flows in and out of an entity for three basic reasons:

1. **Operating** Activities - normal day to day operations
2. **Investing** activities - buying and selling the assets they use to earn revenue
3. **Financing** Activities - getting and repaying loans and issuing dividends

# Statement of Cash Flows

- This financial statement, like each of the other statements, has a prescribed format.
- Not only is the layout prescribed but, the contents are also prescribed.
- A Statement of cash flows contains, on one page, a list of the cash that has flowed in and out of the entity for **operating, investing** and **financing** activities during a specific time period.
- It also shows the total of all of the cash that has come in and out for the period, adds or subtracts that from the cash held at the beginning to obtain the balance of cash at the end of the period.
- The period of time is usually one year or one quarter.

# Format of a Statement of Cash Flows

## Cash flows from Operating Activities:

Cash from sales	\$	xxxx	
Cash used in purchasing		<u>(xxx)</u>	

<b>Net cash provided by operations</b>			xxx
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## Cash flows from Investing Activities:

Cash from sales old old equipment		xx	
Cash used to buy new machinery		<u>(xxxxx)</u>	

<b>Net cash used by investing</b>			(xxxx)
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## Cash flows from Financing Activities:

Cash from new loans		xxxx	
Dividends paid to Shareholders'		<u>(xxx)</u>	

<b>Net cash provided by financing</b>			<u>xxx</u>
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<b>Increase (decrease) in cash during the year</b>			xx
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Cash balance at the beginning of the year			<u>xxx</u>
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<b>Cash balance at the end of the year</b>	\$	<u>xxx</u>	
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**Review**

# Financial Statement Components

1. Statement of Financial Position - aka Balance Sheet
2. Statement of Operations - aka Income Statement or Profit & Loss (P & L)
3. Statement of Cash Flows
4. Notes to accompany the financial statements

# 5 Kinds of Accounting Numbers

1. Assets
2. Liabilities
3. Equities
4. Revenues
5. Expenses

# Statement of Financial Position

Balance Sheet

1. Assets (own)
2. Liabilities (owe)
3. Equity (difference) - Net worth



# Coreen Dolan

## Statement of Financial Position

### December 31, 2017

#### **Assets**

##### Current Assets

Cash	\$5,000
Receivable from Lynn	<u>100</u>
Total Current Assets	5,100

##### Long-term Assets

House	250,000
Car	27,000
Bike	<u>600</u>
Total Long-term Assets	<u>277,600</u>
Total Assets	<u>\$282,700</u>

#### **Liabilities**

##### Current Liabilities

Credit Card	\$1,000
Phone Bill	<u>100</u>
Total Current Liabilities	1,100

Long- term Mortgage	<u>100,000</u>
Total Liabilities	101,100
<b>Owner's Equity</b>	<u>181,600</u>

Total Liabilities and Owner's Equity	<u>\$282,700</u>
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# Statement of Operations

P & L

4. Revenues (gross)
5. Expenses (incurred)

# Coreen Dolan

## Statement of Operations

### For the Year ended December 31, 2017

#### Revenues

Pension income	\$ 27,600
Investment Income	<u>2,400</u>
<b>Total Revenue</b>	<u>30,000</u>

#### Expenses

Insurance Expense	800
Personal Expenses	22,000
Tax Expense	<u>2,500</u>
<b>Total Expenses</b>	<u>25,300</u>
<b>Net Income</b>	<u>\$ 4,700</u>

# Statement of Cash Flows

1. Operations - day to day
2. Investments - changes in assets
3. Financing - changes in loans & equity

**Questions?**