## Basic Financial Statements

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The accounting process
Financial Statements
The Accounting Equation
Chart of Accounts

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What is a financial statement? What does it tell us? Why should we care?
These are good questions and they deserve an answer.

A business is a financial entity separate from its owners. Each business must keep financial records. A number of federal and state laws require this. But even if there were no laws, it would still be a good idea anyway. Businesses provide vital goods and services to those living in the community. They provide jobs for people, and tax dollars that improve our roads, parks and schools. It is in everyone's best interest that our community's businesses be successful.

Business owners take a risk. What if no one wants to buy their goods or services? The owner has spent time and money to start a business, purchased land, buildings and equipment, hired people to work in the business.... all this done with the hope that the business will be successful. And if the business is NOT a success, the owner may have lost his or her life's savings, workers must find jobs, and creditors may go unpaid.

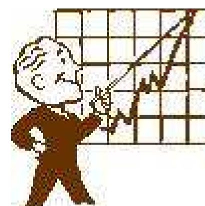
Financial information may not make a business successful, but it helps the owner make sound business decisions. It can also help a bank or creditor evaluate the company for a loan or charge account. And the IRS will be interested in collecting the appropriate amount of income tax. So financial information will serve many purposes.

Financial information comes in many forms, but the most important are the Financial Statements. They summarize relevant financial information in a format that is useful in making important business decisions. If this were not possible, the whole process would be a waste of time. Too much information may be equally useless. Financial statements summarize a large number of Transactions into a small number of significant categories. To be useful, information must be organized.

**Quick Quiz**
The financial statements of a business entity:
A) Include the balance sheet, income statement, and income tax return.
B) Provide information about the profitability and financial position of the company.
C) Are the first step in the accounting process.
D) Are prepared for a fee by the Financial Accounting Standards Board.
Click for answers

Financial statements have generally agreed-upon formats and follow the same rules of disclosure. This puts everyone on the same level playing field, and makes it possible to compare different companies with each other, or to evaluate different year's performance within the same company. There are three main financial statements:

1. Income Statement
2. Balance Sheet
3. Statement of Cash Flows



Each financial statement tells it's own story. Together they form a comprehensive financial picture of the company, the results of its operations, its financial condition, and the sources and uses of its money. Evaluating past performance helps managers identify successful strategies, eliminate wasteful spending and budget appropriately for the future. Armed with this information they will be able to make necessary business decisions in a timely manner.

**The accounting process in a nutshell:**
1) Capture and Record a business transaction,
2) Classify the transaction into appropriate Accounts,
3) Post transactions to their individual Ledger Accounts,
4) Summarize and Report the balances of Ledger Accounts in financial statements.

**There are 5 types of Accounts.**
1) Assets
2) Liabilities
3) Owners' Equity (Stockholders' Equity for a corporation)
4) Revenues
5) Expenses

All the accounts in an accounting system are listed in a **Chart of Accounts**. They are listed in the order shown above. This helps us prepare financial statements, by conveniently organizing accounts in the same order they will be used in the financial statements.

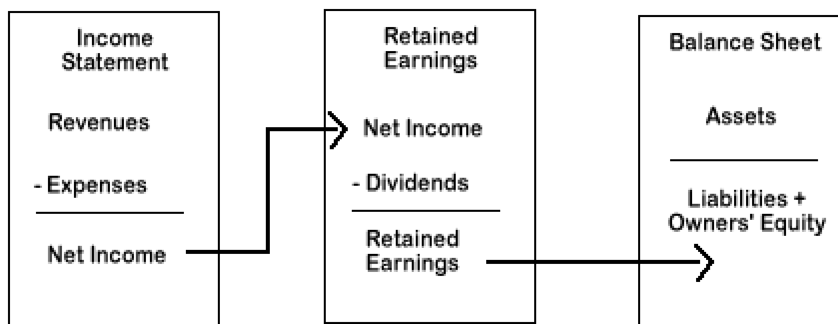
**Financial Statements**
The **Balance Sheet** lists the balances in all **A**sset, **L**iability and **O**wners' Equity accounts.

The **Income Statement** lists the balances in all **R**evenue and **E**xpense accounts.

The Balance Sheet and Income Statement must accompany each other in order to comply with GAAP. Financial statements presented separately do not comply with GAAP. This is necessary so financial statement users get a true and complete financial picture of the company.

All accounts are used in one or the other statement, but not both. All accounts are used once, and only once, in the financial statements. The Balance Sheet shows account balances at a particular date. The Income Statement shows the accumulation in the Revenue and Expense accounts, for a given period of time, generally one year. The Income Statement can be prepared for any span of time, and companies often prepare them monthly or quarterly.

It is common for companies to prepare a Statement of Retained Earnings or a Statement of Owners' Equity, but one of these statement is not required by GAAP. These statements provide a link between the Income Statement and the Balance Sheet. They also reconcile the Owners' Equity or Retained Earnings account from the start to the end of the year.




The **Statement of Cash Flows** is the third financial statement required by GAAP, for full disclosure. The Cash Flow statement shows the inflows and outflows of Cash over a period of time, usually one year. The time period will coincide with the Income Statement. In fact, account balances are not used in the Cash Flow statement. The accounts are analyzed to determine the Sources (inflows) and Uses (outflows) of cash over a period of time.

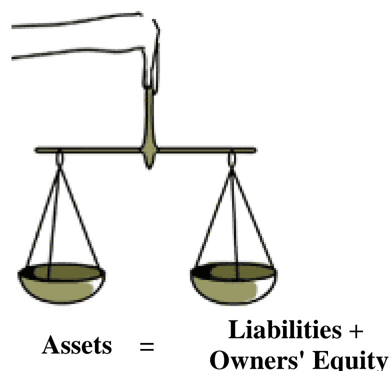
**There are 3 types of cash flow (CF):**
1) Operating - CF generated by normal business operations
2) Investing - CF from buying/selling assets: buildings, real estate, investment portfolios, equipment.
3) Financing - CF from investors or long-term creditors

The SEC (Securities and Exchange Commission) requires companies to follow GAAP in their financial statements. That doesn't mean companies do what they are supposed to do. Enron executives had millions of reasons ($$) to falsify financial information for their own personal gain. Auditors are independent CPAs hired by companies to determine whether the rules of GAAP and full disclosure are being followed in their financial statements. In the case of Enron and Arthur Andersen, auditors sometimes fail to find problems that exist, and in some cases might have also failed in their responsibilities as accounting professionals.

**The Accounting Equation**
You may have heard someone say "the books are in balance" when referring to a company's accounting records. This refers to the use of the double-entry system of accounting, which uses equal entries in two or more accounts to record each business transaction. Because the dollar amounts are equal we say the transaction is "in balance." You can think of it like an old two pan balance scale, which measures things in dollars, instead of pounds.

Double-entry accounting follows one simple rule, called the **accounting equation**. It is a simple algebraic equation, expressed as an equality. $E = MC^2$ OOPS! That's not it.

The Accounting Equation really is:



**Assets** = **Liabilities + Owners' Equity**

another way to think about it
**everything we own = who provided the financing**

Remember in Chapter 1, I told you that each transaction describes both an **object** and form of **financing**. In the accounting equation, Assets are the objects, and are on the Left side of the equation. Financing activities are on the Right side of the equation. Liabilities represent borrowings and credit arrangements. Owners' Equity represents investments by owners, residual net worth and retained earnings from ongoing business operations.

The accounting equation uses "simple math" and involves only addition and subtraction. In fact, almost all the math you will do in this course is simple math. We will occasionally use multiplication and division, but **all changes to accounts will be addition or subtraction**.

Think for a moment about a new company. It's accounting system consists of a new, "fresh" set of books, no entries have ever been made, all accounts have a zero balance.

| Assets | = | Liabilities | + | Owners' Equity |
|---|---|---|---|---|
| **$0** | = | **$0** | + | **$0** |

The books are in balance!!

If each, and every, transaction is a entered as a "balanced" entry, the books will stay in balance.

**There are three general types of transactions and entries.**
1) Routine, daily operating events - represents over 99% of all transactions.
2) Occasional events involving major assets, liabilities and owners' equity transactions.
3) Adjusting and Closing entries - made to prepare statements and close the books at the end of the year.

**Here are some examples** of common type 2 transactions. Before and after each one, the books must be in balance. In Chapter 3 we will see how these are actually entered into the books, in the form of journal entries.

Owner deposits $100 in the company checking account.

| Assets | = | Liabilities | + | Owners' Equity |
|---|---|---|---|---|
| **$100** | = | **$0** | + | **$100** |

Cash is an Asset, on the Left side. Owners' Equity is on the Right side.
The amounts are equal

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A $1000 computer is purchased on credit.

| Assets | = | Liabilities | + | Owners' Equity |
|---|---|---|---|---|
| **$1000** | = | **$1000** | + | **$0** |

Computer is an Asset, on the Left side.
A Charge account is a Liability and is on the Right side.

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The owner transfers a parcel of land to the company, and signs a contract for a building to be constructed. The land is worth $10,000 and the building will cost $90,000. The building will be paid for with a bank loan.

| Assets | = | Liabilities | + | Owners' Equity |
|---|---|---|---|---|

**$100,000 = $90,000 + $10,000**

Land and Building are Assets, on the Left side. Bank loan is a Liability and is on the Right side. This is a compound entry, and involves more than two accounts.

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Balance Sheet accounts can increase or decrease, so you will be adding to or subtracting from their balance after each transaction.

The accounting equation can be expressed in 3 ways:

1. Assets = Liabilities + Owners' Equity
2. Liabilities = Assets - Owners' Equity
3. Owners' Equity = Assets - Liabilities

It is common to abbreviate the accounting equation as **A=L+OE.** Using the numbers from the balance sheet above we get the following equations:

1. 33,000 = 14,000 + 19,000 [A=L+OE]
2. 14,000 = 33,000 - 19,000 [L=A-OE]
3. 19,00 = 33,000 - 14,000 [OE=A-L]

If you know any two of the amounts you can calculate the third.

**Quick Quiz** Try solving these equations for practice.

| | Assets | = | Liabilities | + | Owners' Equity |
|---|---|---|---|---|---|
| 1 | ? | = | 27,000 | + | 36,000 |
| 2 | 426,600 | = | ? | + | 168,400 |
| 3 | 1,537,618 | = | 692,327 | + | ? |

Click for answers

Try making up several examples on your own for practice.

We can see the Accounting Equation reflected in the layout of the Balance Sheet, as shown below. Notice that Total Assets equals the sum of Total Liabilities and Total Owners' Equity, shown in **bold** below.

**ABC Company**
**Balance Sheet**
**December 31, 2002**

| **Assets** | | |
|---|---|---|
| Cash | $ 10,000 | |
| Accounts Receivable | 6,000 | |
| Inventory | 17,000 | |
| **Total Assets** | **$ 33,000** | <- |
| | | \| |
| **Liabilities & Owners' Equity** | | \| |
| Accounts Payable | $ 6,000 | E |
| Notes Payable | 8,000 | Q |
| Total Liabilities | 14,000 | U |
| | | A |
| Common Stock, $1 par | 10,000 | L |
| Retained Earnings | 9,000 | \| |

| | | |
|---|---|---|
| Total Owners' Equity | 19,000 | \| |
| **Total Liabilities & Owners' Equity** | **$ 33,000** | **<-** |

**Accounts and the Chart of Accounts**

An **Account** is a record used to summarize increases and decreases in a particular asset or liability, revenue or expense, or in owner's equity. Accounts usually have very simple and generic titles such as Cash, Accounts Payable, Sales, and Inventory. These are simple and descriptive terms under which many different transactions can be recorded.

Accounts are organized in a **Chart of Accounts** . This is a simple list of account titles presented in the following order: Assets, Liabilities, Owners' Equity, Revenue, Expenses. Organizing accounts in the correct order makes it much easier to prepare financial statements and enter transactions.

When doing homework problems students should read carefully and look for a Chart of Accounts, or for references to specific accounts, that should be used in that problem. If you don't find these, you should review the examples in the textbook chapter material for the correct accounts to use.

Here is a sample Chart of Accounts, showing accounts in the correct order. **Account group dividers are usually omitted in actual practice**. They are shown here for illustrative purposes, so the student can see how the Chart of Accounts is organized, and how it relates to the financial statements.

**ABC Company, Inc.**
**Chart of Accounts**

| Balance Sheet Accounts | Income Statement Accounts |
|---|---|
| ---- Asset Accounts ---- | ---- Revenue Accounts ---- |
| Cash | Sales Revenue |
| Accounts Receivable | Sales Returns & Allowances |
| Prepaid Expenses | Sales Discounts |
| Supplies | Interest Income |
| Inventory | ---- Expense Accounts ---- |
| Land | Advertising Expense |
| Buildings | Bank Fees |
| Vehicles & Equipment | Depreciation Expense |
| Accumulated Depreciation | Payroll Expense |
| Other Assets | Payroll Tax Expense |
| ---- Liability Accounts ---- | Rent Expense |
| Accounts Payable | Income Tax Expense |
| Notes Payable - Current | Telephone Expense |
| Notes Payable - Long Term | Utilities Expense |
| ---- Stockholders' Equity Accounts ---- | |
| Common Stock | |
| Retained Earnings | |

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