Financial Statements Video Training

(Handout)

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General Comments that Apply to All Four of the Financial Statements

1. This video training is focused on the financial statements that are distributed to people outside of the company, such as bankers, investors, other lenders, and so on.

2. Our presentation does not cover income tax reporting, which may have different rules for certain transactions.

3. For the financial statements distributed outside of the company, accountants must follow common rules known as generally accepted accounting principles. In the U.S. these are often referred to as GAAP or US GAAP.

4. US GAAP consists of some very complex, detailed rules and also some basic underlying principles. We will focus on the basic underlying principles and concepts such as:
    - cost principle
    - matching principle
    - full disclosure principle
    - consistency
    - objectivity
    - going concern assumption
    - conservatism
    - materiality

5. Our financial statements, that we distribute outside of the company, are prepared under the **accrual method of accounting** and that is different from the cash method.

    Under the accrual method of accounting...

    a. **Revenues and a receivable** will be reported when the goods or services are *delivered* (which is often prior to receiving the money).
    b. **Expenses and liabilities** will be reported *when they occur* (which is likely to be different from the payment date).

6. We will do our best to give you an interesting overview of the financial statements. You must realize that we cannot possibly cover all aspects of the financial statements in a few hours. Therefore, you cannot rely on our short seminar as a substitute for professional accounting advice.

7. Be sure you have printed the handouts that come with this seminar video.

8. We will begin with a discussion of the Balance Sheet.

		Notes
Sample Retailer, Inc.		name of company, enterprise, organization
Balance Sheet		statement of financial position
March 31, 2023		as of a point or moment, midnight of last day of accounting period
ASSETS		resources, owned, purchased or donated; unexpired costs
Current assets		cash and assets that will turn to cash within 1 year of bal sheet date
Cash & cash equivalents	$ 24,500	currency, coins, undeposited checks, checking, purchased < 90 days
Temporary investments	40,000	cert. of deposits maturing in less than 1 year, marketable securities
Accounts receivable - net	38,000	unpaid sales on credit, minus allowance for doubtful accounts
Inventory	350,123	merchandise to be sold, cost or lower, FIFO/LIFO/Avg/specific ID
Prepaid expenses	11,200	costs paid in advance, amount unexpired at balance sheet date
Total current assets	463,823	total liquid assets; total will be compared to total current liabilities
Investments	10,000	first of noncurrent or long-term assets; csv of life ins owned by corp
Property, plant & equipment		fixed assets, plant assets, PP&E; tangible
Land	12,000	land used in business, reported at cost and not depreciated
Land improvements	-	driveways, parking lots, outside lighting; these will be depreciated
Buildings	102,000	cost of building used in business excluding land
Equipment	25,000	cost of equipment used in business
Furniture & fixtures	100,000	cost of furniture & fixtures used in business
Subtotal	239,000	total cost before subtracting accumulated depreciation
Less: Accum depreciation	(187,500)	total depreciation taken to date for assets reported as PP&E
Prop, plant & equip - net	51,500	carrying value or book value of PP&E, does not indicate market value
Intangible assets		not a tangible, physical asset; must have been purchased to be listed
Goodwill	-	cost to purchase another business > value of the tangible assets
Trade names, mailing lists	-	reported if purchased from someone; cost to defend own
Total intangible assets	-	
Other assets	2,000	deferred charges, organization costs
TOTAL ASSETS	**$ 527,323**	this total must be equal to the total of liabilities & stockholders' equity
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities		obligations due within 1 year of the balance sheet date; short-term
Notes payable	$ 10,000	principal portion of loans due within one year of balance sheet date
Accounts payable	119,500	amount owed to suppliers of goods and services
Wages payable	400	amounts owed to employees for work done up to date of bal sheet
Accrued expenses	1,500	owed for interest, repairs, utilities, etc. but not yet recorded
Customer deposits	2,000	advance payments from customers for work to be done
Total current liabilities	133,400	important total that will be compared to total current assets
Long-term liabilities		also known as noncurrent liabilities
Notes payable	40,000	the principal portion of loans not due within one year of bal sheet date
Bonds payable	-	long-term debt with interest every 6 months & principal at maturity
Total long-term liabilities	40,000	
TOTAL LIABILITIES	173,400	total of current liabilities + long term liabilities. Total debt for ratios.
STOCKHOLDERS' EQUITY		
Common stock	50,000	amount received by corp. when new shares of stock were issued
Retained earnings	304,923	cumulative earnings from day 1 minus all dividends to stockholders
Less: Treasury stock	(1,000)	cost to repurchase the corporation's own stock but stock not retired
TOTAL STOCKHOLDERS' EQUITY	353,923	book value of corporation: total assets minus total liabilities. Not mkt
TOTAL LIAB & STKRS' EQUITY	**$ 527,323**	this total must be equal to the total assets

See notes to the financial statements.

Balance Sheet

1. The balance sheet allows lenders and others to quickly determine the amount of a company's **working capital**. Working capital is total *current assets* minus total *current liabilities*. In the balance sheet that we just reviewed, the working capital is $330,423 ($463,823 minus $133,400).

2. Related to working capital is the **current ratio**. The computation for the current ratio is total *current assets* divided by total *current liabilities*. Using the amounts from the balance sheet we reviewed, the current ratio is **3.5** ($463,823 divided by $133,400). The ratio is also expressed as **3.5 to 1** or **3.5:1**.

3. The calculations are only as good as the numbers behind them. For instance, if the amount being reported for accounts receivable includes some receivables that are unlikely to be collected, the amount of working capital and the current ratio are overstated (too high). The same holds true for the inventory. If the amount reported for inventory includes the cost of obsolete inventory, the working capital and current ratio are overstated.

4. When looking at the property, plant and equipment, the amounts are the costs of the assets when they were acquired minus the depreciation based on those costs. Today's market value of those assets may be significantly more or less than the amounts reported. The accountants' cost principle and objectivity prevent the accountant from using current values. (A building may have cost $10 million 30 years ago. Today it is fully depreciated with a carrying value of $0. However, the current market value of the building might be $25 million.)

5. The cost principle also prevents a company from listing valuable trademarks, brand names and logos that it did not purchase. The same for a company's excellent management team. This means that hugely successful consumer products' names and logos that were developed by a company over many years may be extremely valuable, but are not listed as assets on the balance sheet.

6. The stockholders' equity reported on the balance sheet is mathematically the total assets minus the total liabilities. If valuable brand names cannot be reported or if some of the assets being reported have lower market values, the stockholders' equity reflects only the reported amounts.

7. Comment for items 4 through 6: Computer savy person starts a website business in her home using her personal computer. Earns $5k, $25k, $100k in first 3 yrs. Withdraws most for living. The balance sheet for the business reports $8k of stockholders' equity at the end of year 3. The business is expected to earn $140k in year 4. The market value of the company at end of year 3 is much greater than the $8k reported in stockholders' equity.

8. The balance sheet shows the company's financial leverage. In other words, how much of the total assets is provided by creditors (debt) and how much is provided by the owners. If a large percentage of the assets' costs came from debt, leverage is being used. In computing leverage and financial ratios, debt is the amount of total liabilities (current plus long-term liabilities). The balance sheet that we reviewed had the following totals:

Assets	=	Liabilities	+	Stockholders' Equity
$527,323	=	$173,400	+	$353,923

These amounts indicate that *debt is 32.9% of the total assets* ($173,400 divided by $527,323). The *debt to equity ratio* compares the liabilities of $173,400 to the stockholders equity of $353,923.

Debt allows a company to control more assets. If the additional assets increase in value, the use of debt/leverage was wise. If assets decrease in value, the use of debt/leverage will cause a loss of the company's equity. Too much debt in relation to equity means more risk and less opportunity to borrow additional money. (Present lenders may have liens on all of the company's assets as collateral for its loans.)

9. The notes to the financial statements disclose the company's commitments such as leases, possible losses from lawsuits, accounting practices for inventory and depreciation, and more. Publicly-traded corporations must file a very thorough discussion of the company's operations, risks, etc. in its annual report to the Securities and Exchange Commission (SEC) Form 10-K.

10. Accounting principles require that *comparative* balance sheets be prepared when financial statements are distributed outside of the company. A comparative balance sheet reports amounts for two points in time. Here's an example of a comparative balance sheet:

Comparative Balance Sheet

Example Service Co., Inc.
Balance Sheets
December 31, 2023 and 2022

ASSETS	**Dec 31, 2023**	**Dec 31, 2022**
Current assets		
Cash & cash equivalents	$ 30,000	$ 13,000
Accounts receivable - net	80,500	80,000
Total current assets	110,500	93,000
Property, plant & equipment		
Equipment	250,000	220,000
Furniture & fixtures	100,000	100,000
Subtotal	350,000	320,000
Less: Accum depreciation	(73,000)	(62,000)
Prop, plant & equip - net	277,000	258,000
TOTAL ASSETS	**$ 387,500**	**$ 351,000**
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 119,500	$ 75,000
Accrued expenses	1,500	900
Total current liabilities	121,000	75,900
Long-term liabilities		
Notes payable	40,000	20,000
TOTAL LIABILITIES	161,000	95,900
STOCKHOLDERS' EQUITY		
Common stock	50,000	40,000
Retained earnings	176,500	215,100
TOTAL STOCKHOLDERS' EQUITY	226,500	255,100
TOTAL LIABILITIES & STKRS' EQUITY	**$ 387,500**	**$ 351,000**

See notes to the financial statements.

The comparative balance sheet provides the reader with a frame of reference. In the above example, we can determine that the company's working capital was a negative $10,500 at the end of 2023 (current assets of $110,500 minus current liabilities of $121,000) compared to a positive $17,100 at the end of 2022 ($93,000 minus $75,900).

We also see that the company's equipment increased by $30,000 (see the statement of cash flows to learn if there were additions and some disposals) during 2023. The company also increased its long-term debt by $20,000 and stockholders invested an additional $10,000.

Income Statement: Retailer/Wholesaler (1)

		Notes
Sample Retailer, Inc.		← name of company
Income Statement		← profit & loss, P&L, statement of operations, statement of earnings
For the Three Months Ended March 31, 2023		← any period or interval of time: month, quarter, year, 4 months, 13 weeks, 52/53 weeks
Net sales	$ 1,106,359	← sales of merchandise minus sales returns, discounts, and allowances
Cost of goods sold (see below)	805,077	← cost of merchandise that was sold based on an assumed cost flow (FIFO, LIFO, avg, specific ID)
Gross profit	301,282	← gross margin in $; gross margin or gross profit % = gross profit divided by net sales
Operating expenses		← expenses from the retailer's main activities of buying and selling goods
SG&A expenses excluding depreciation	176,300	← selling, general and administrative expenses: sales & office salaries, store rent, insurance
SG&A depreciation and amortization	10,000	← depreciation of plant assets and amortization of intangible assets
Total operating expenses	186,300	
Operating income	114,982	← income from operations (from main activities)
Nonoperating or other income or (expense)		← transactions that are not part of the company's main operating activities; peripheral activities
Income on investments	1,050	← amount earned on company's investments
Interest expense	(1,800)	← interest incurred on outstanding debt
Loss on disposal of assets	(2,400)	← loss from selling a plant asset for less than the asset's carrying value
Total other income or (expense)	(3,150)	← total from peripheral activities
Income before income tax expense	111,832	← bottom line before income taxes
Income tax expense	25,000	← income taxes that pertain to the items shown on the income statement; different from tax paid
Net income	**$ 86,832**	← bottom line after income taxes
Cost of goods sold		← necessary to properly match the cost of goods sold with the sales during the period
Inventory at beginning of period	$ 320,600	← cost of the inventory of merchandise owned at the beginning of the accounting period
Add: Purchases of merchandise in period	+ 836,000	← cost of the merchandise purchased in the period shown in heading
Less: Purchase returns, discounts, allow	- 3,000	← reduction in cost from suppliers
Add: Freight-in	+ 1,600	← cost paid to get merchandise into inventory when terms are FOB shipping point
Cost of goods available	1,155,200	← result of above amounts
Less: Inventory at end of period	- 350,123	← cost of the goods on hand at end of period based on FIFO, LIFO, avg. & perhaps physical count
Cost of goods sold	$ 805,077	← cost that will be matched against the current period's sales

See notes to the financial statements.

Selling, General and Administrative Expenses (SG&A) (1a)

Sample Retailer, Inc.
Schedule of Selling, General and Administrative (SG&A) Expenses
For the Three Months Ended March 31, 2023

Selling, general and administrative (SG&A) expenses	
Officers' salaries	$ 60,000
Sales and marketing salaries	28,000
Accounting and IT salaries	28,000
Other office salaries and wages	10,000
Delivery wages	-
Other SG&A salaries and wages	-
Payroll taxes and fringe benefits	14,432
Selling and marketing supplies	2,700
Administrative and general supplies	1,500
Rent and property taxes for office	6,000
Electricity, gas, water for office	9,500
Telephone, cell phones, internet	2,200
Repairs & maintenance of office building	893
Repairs & maintenance of office equipment	1,200
Insurance	1,400
Postage and shipping costs	600
Travel and entertainment	3,900
Advertising	2,400
Commissions	-
Other sales & marketing	-
Professional fees: accounting, tax, attorney	2,500
Warranty expense	-
Bad debts expense	-
Miscellaneous expenses	1,075
SG&A expenses before depreciation	**176,300**
Depreciation on office building	4,000
Depreciation on office equipment	6,000
Depreciation on SG&A vehicles & other	-
SG&A depreciation expense	**10,000**
Total selling, general & admin expenses	**$ 186,300**

See notes to the financial statements.

Income Statement Formats (2)

Here are two formats for an income statement (with the headings omitted) that can be used on the income statements distributed outside of a company:

Multiple-step income statement

Net sales	$ 1,106,359
Cost of goods sold	805,077
Gross profit	301,282
Operating expenses	
SG&A expenses excluding depreciation	176,300
SG&A depreciation and amortization	10,000
Total operating expenses	186,300
Operating income	114,982
Nonoperating or other income or (expense)	
Income on investments	1,050
Interest expense	(1,800)
Loss on disposal of assets	(2,400)
Total other income or (expense)	(3,150)
Income before income tax expense	111,832
Income tax expense	25,000
Net income	**$ 86,832**

See notes to the financial statements.

Single-step income statement

Revenues and gains	
Net sales	$ 1,106,359
Income on investments	1,050
Total revenues and gains	1,107,409
Expenses and losses	
Cost of goods sold	805,077
SG&A expenses	186,300
Interest expense	1,800
Loss on disposal of assets	2,400
Total expenses and losses	995,577
Income before income tax expense	111,832
Income tax expense	25,000
Net income	**$ 86,832**

See notes to the financial statements.

Multiple subtractions to get to income before tax.
Also displays the amount of gross profit, operating income, and nonoperating income.

One subtraction to get to income before tax.

Comparative Income Statement (3)

Corporations whose stock is traded on a U.S. stock exchange are required to issue comparative income statements showing the current period's results plus the amounts from each of the previous two years.

Below we are presenting a comparative income statement with only one of the previous years. We also added percentages to the right of the amounts (these are not required, but are something that is helpful for business owners to see). The percentages are the result of dividing all of the dollar amounts in each column by the net sales dollars listed on the first line of the respective column.

Sample Retailer, Inc.
Income Statement
For the Three Months Ended March 31, 2023 and 2022

	2023	%	2022	%
Net sales	$ 1,106,359	100.0%	$ 910,000	100.0%
Cost of goods sold	805,077	72.8%	670,000	73.6%
Gross profit	301,282	27.2%	240,000	26.4%
Operating expenses				
SG&A expenses excluding depreciation	176,300	15.9%	170,000	18.7%
SG&A depreciation and amortization	10,000	0.9%	10,000	1.1%
Total operating expenses	186,300	16.8%	180,000	19.8%
Operating income	114,982	10.4%	60,000	6.6%
Nonoperating or other income or (expense)				
Income on investments	1,050	0.1%	4,100	0.4%
Interest expense	(1,800)	-0.2%	(2,200)	-0.2%
Loss on disposal of assets	(2,400)	-0.2%	-	0.0%
Total other income or (expense)	(3,150)	-0.3%	1,900	0.2%
Income before income tax expense	111,832	10.1%	61,900	6.8%
Income tax expense	25,000	2.3%	16,000	1.8%
Net income	$ 86,832	7.8%	$ 45,900	5.0%

More About the Income Statement

1. The income statement reports on a company's profitability during the period shown in its heading.

2. The accrual method of accounting is best for reporting the revenues earned during the period and for reporting the expenses that match the revenues or were incurred during the period.

3. The gross margins (gross profit divided by net sales) and net income as percent of sales are closely monitored by financial analysts, and should be monitored by owners and managers.

4. Your banker might have the percentages for the companies in your industry.

5. Net income for manufacturers and merchandisers is affected by the cost flow assumption they elected (FIFO, LIFO, etc.) during periods when costs are changing due to inflation or other factors.

6. Depreciation expense is based on the plant assets' original costs, not their replacement costs. A company with older equipment may have very little depreciation as the original cost was relatively low and the equipment has been fully depreciated.

7. The depreciation expense reported on the financial statements will likely be different from the depreciation reported on the income tax return.

8. The notes to the financial statements are an important part of the income statement.

Relationship of Balance Sheet and Income Statement

1. The balance sheet and income statement are linked. Notice below how revenues resulting from a credit sale will increase Retained Earnings (an account within stockholders' equity) and will increase the asset account Accounts Receivable.

Example Corporation

Balance Sheet

January 1, 2024

ASSETS	
Cash & cash equivalents	$ 10,000
LIABILITIES & STOCKHOLDERS' EQUITY	
STOCKHOLDERS' EQUITY	
Common stock	$ 10,000
Retained earnings	-
TOTAL STOCKHOLDERS' EQUITY	$ 10,000

On January 2, a service is provided on credit →

Example Corporation

Income Statement

For the Day, January 2, 2024

Revenues	$	50
Expenses		-
Net income	$	50

Example Corporation

Balance Sheet

January 2, 2024

ASSETS	
Cash & cash equivalents	$ 10,000
Accounts receivable	50
Total assets	$ 10,050
LIABILITIES & STOCKHOLDERS' EQUITY	
STOCKHOLDERS' EQUITY	
Common stock	$ 10,000
Retained earnings	50
TOTAL STOCKHOLDERS' EQUITY	$ 10,050

2. Because of double-entry, both the accounting equation (Assets = Liabilities + Stockholders' Equity) and the balance sheet will remain in balance. The transaction was recorded with a debit of $50 to Accounts Receivable and a credit of $50 to Revenues. Revenues cause stockholders' equity to increase even though the credit of $50 went to the account Revenues. (Revenues is a temporary account which means its balance will be transferred to Retained Earnings after the income statement for the accounting year has been prepared.)

Statement of Cash Flows (regular corporation, indirect method)

Sample Retailer, Inc.
Statement of Cash Flows
For the Three Months Ended March 31, 2023

		Notes
Cash flows from operating activities		
Net income	$ 86,832	← from income statement
Add back: Depreciation & amortization	10,000	← from income statement; noncash expense
Add back: Loss on disposal of fixed assets	2,400	← from income statement; proceeds in investing
Deduct: Gain on disposal of fixed assets	-	← from income statement; proceeds in investing
Add for *decreases* in current assets:		
Accounts receivable	3,000	← change in balance sheet amounts
Inventory	-	← change in balance sheet amounts
Other current assets (other than cash)	-	← change in balance sheet amounts
Deduct for *increases* in current assets:		
Accounts receivable	-	← change in balance sheet amounts
Inventory	(29,523)	← change in balance sheet amounts
Other current assets (other than cash)	(4,200)	← change in balance sheet amounts
Add for *increases* in current liabilities:		
Accounts payable	8,900	← change in balance sheet amounts
Other current liabilities	-	← change in balance sheet amounts
Deduct for *decreases* in current liabilities:		
Accounts payable	-	← change in balance sheet amounts
Other current liabilities	(650)	← change in balance sheet amounts
Net cash provided by operating activities	**76,759**	← often compared to net earnings
Cash flows from investing activities		
Add: Proceeds from sale of long-term assets	3,100	← amount received
Deduct: Capital expenditures	(70,000)	← used in calculation of free cash flow
Deduct: Purchase of other long-term assets	-	
Net cash used in investing activities	**(66,900)**	
Cash flows from financing activities		
Deduct: Cash dividends	(15,000)	
Add: Issuance of stock	-	
Add: Issuance of long-term debt	-	
Deduct: Repayment of long-term debt	-	
Net cash used in financing activities	**(15,000)**	
Net change in cash and cash equivalents	**(5,141)**	← Operating + Investing + Financing
Cash and cash equivalents at beginning of period	29,641	
Cash and cash equivalents at end of period	$ 24,500	

See notes to the financial statements.

Statement of Cash Flows (2)

1. The statement of cash flows is often referred to as SCF or as the cash flow statement.

2. The statement of cash flows shows how a company's cash and cash equivalents have changed during the accounting period.

3. Many small business owners have asked me, *"If I made all that money that my income statement shows, how come I don't have any money in the bank?"* The statement of cash flows will help answer that question.

4. The statement of cash flows is also used by some financial analysts to judge the quality of earnings. Specifically they compare the corporation's earnings to the *cash flows from operating activities*. If the cash flows are less than the earnings, the analyst is concerned.

5. Financial analysts also use the SCF to determine the amount of *free cash flow*. The calculation of free cash flow is:

	Cash flows from operating activities	$
minus:	Capital expenditures needed to maintain operations	-
equals:	Free cash flow	$

   Some people also subtract the dividends to stockholders.

6. The SCF is a bit difficult to prepare. However, it is not difficult to read. Therefore, you should become familiar with this important financial statement. Remember it took lots of information from the balance sheet, income statement, and elsewhere to present a meaningful analysis of how a company's cash has changed during the accounting period.

Statement of Changes in Owner's Equity

Sample Retailer Company*

Statement of Changes in Owner's Equity

For the Four Months Ended April 30, 2023

Balance of owner's equity at December 31, 2022	$	80,000
Add: Investments by owner		-
Deduct: Withdrawals by owner		30,000
Subtotal		50,000
Add: Net income (subtract net loss) during current period		45,000
Balance of owner's equity at April 30, 2023	**$**	**95,000**

**A sole proprietorship*

To learn about a corporation's Statement of Changes in Stockholders' Equity and its Statement of Comprehensive Income see any publicly-traded corporation's Form 10-K, which is usually available on the corporation's website under Investor Relations.

Other Comprehensive Income (OCI)

Examples of other comprehensive income (or loss) include foreign currency translation adjustments, certain pension liability adjustments, and the income tax expense which pertains to the other comprehensive income.

Additional Comments

The financial statements report the past transactions. There is no assurance that the past will hold true for the current year and future years.

If a corporation's stock is publicly-traded, you can learn much about its operations and industry by reading its Annual Report to the Securities and Exchange Commission (SEC) Form 10-K. Be sure to read the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations.