

# FINANCIAL Statements

## INTRODUCTION

- Financial statements are the primary way to communicate results of operations, financial position, and cash flows to external parties
- Additional information to financial statements includes financial statement notes, supplemental information, and other disclosures
- A full set of financial statements should show:
  - Financial position at the end of the period (balance sheet)
  - Earnings for the period (statement of income)
  - Comprehensive income for the period (statement of comprehensive income)
  - Cash flows for the period (statement of cash flows)

- Investments by and distributions to the owners during the period (statement of changes in equity)
- The Securities and Exchange Commission (SEC) is empowered by Congress to establish the principles for financial reporting
- SEC has delegated this authority to the Financial Accounting Standards Board (FASB)
- FASB establishes generally accepted accounting principles (GAAP)
- GAAP is the acronym for generally accepted accounting principles
- GAAP must be adhered to when a company distributes its financial statements outside of the company (for external parties)

## FINANCIAL STATEMENT PREPARATION

The accounting cycle ends with the preparation of financial statements

- Information from the general ledger is used to prepare the financial statements
- An accountant's worksheet is used to summarize account balances from the general ledger
- Ten-column worksheet with general ledger account titles in the first column followed by ten columns of amounts
- One debit and one credit column for each of the following:
  - Trial Balance:** Contains each account's unadjusted balance
  - Adjustments:** Contains adjusting entries
  - Adjusted Trial Balance:** Contains the combination of the unadjusted balance and adjusting entries
  - Income Statement:** Contains the adjusted balances for the revenue, expense, gain, and loss accounts
  - Balance Sheet:** Contains the adjusted balances for the asset, liability, and owner's equity accounts

- Prepare an **income statement**
  - First financial statement prepared
- Prepare the **statement of retained earnings**
  - Net income or loss has to be calculated before the statement of retained earnings can be prepared
  - The statement of retained earnings shows the amount of profit retained by the company
- Prepare the **balance sheet**
- Prepare the **statement of cash flows**
  - Prepared last as it takes information from previous financial statements

### Statement of Income

- Also called the **income statement**, shows the:
  - Name of the entity (name of company or corporation)
  - Name of the statement (statement of income or income statement)
  - Span of time covered by the report (i.e., for the year ended December 31, 20XX)
- Reveals how much revenue the company earned over a specific time period (usually for a year or some portion of a year)
- Shows the costs and expenses associated with earning that revenue (called the **matching principle**)
- Bottom line of the statement shows the company's net income or losses.
  - Net income or net loss shows how much the company earned or lost over the period
- In the case of a corporation, also shows **Earnings Per Share (EPS)**
  - EPS is how much money shareholders would receive if the company decided to distribute all of the net earnings for the period (in the form of dividends)
- Shows the results of operations
  - Net Income or (Net Loss) = Revenues - Expenses + Gains - Losses
  - Revenues and expenses are the result of the company's major activities
  - Gains and losses are from other activities

- Income or loss from **discontinued operations** and from **extraordinary items** are shown separately from income or loss from continuing operations
  - A discontinued operation is a component of an entity that has been disposed of or is classified on the balance sheet as **held for sale**
  - Discontinued operations and cash flows either are or will be eliminated from the entity's operations
  - An **extraordinary item** is both unusual and infrequent
  - Extraordinary items happen infrequently but have a **major (material) impact** on the current year's operations
  - Items are reported **net of income tax**

### Preparing an Income Statement

- Always start with sales (revenues)
- Deduct **cost of goods sold** (also called **cost of sales**) to arrive at gross profit
- Deduct **operating expenses**
  - Expenses that go toward supporting a company's operations for a given period
  - EX: Salaries of administrative personnel and marketing and selling expenses
- Operating expenses are different from "costs of goods sold" because they cannot be linked directly to the production of the products or services being sold
- Depreciation** is also deducted from gross profit as a part of operating expenses
  - Depreciation is a cost allocation of tangible property over its useful life
  - Takes into account the wear and tear of assets, such as machinery, tools, and furniture, which are used over long periods of time
- Operating expenses are deducted from gross profit to arrive at **operating profit before interest and income tax expenses** (also called "income from operations")
- Add **interest income** and deduct interest expense to arrive at operating profit before income tax
- Deduct **income tax** to arrive at net income or net loss

### Income Statement Examples

#### Single-Step Income Statement

- Provides a grouping for all revenues and gains and another grouping for all expenses and losses
- Named single-step because there is one subtraction to derive net income

<b>Revenues:</b>		
Net sales	\$2,500,000	
Other revenue	500,000	
Gains	50,000	
<b>Total revenues and gains</b>		\$2,750,000
<b>Expenses and losses:</b>		
Cost of goods sold	\$400,000	
Selling and administrative expenses	250,000	
Interest expense	15,000	
Losses	5,000	
Income tax expense	\$20,000	
<b>Total expenses and losses</b>		\$1,290,000
<b>Net income</b>		\$1,460,000
Earnings per common share		\$1.46

- Total Revenues and Gains - Total Expenses and Losses = Net Income (Net Loss)

### Multiple-Step Income Statement

- Operating revenues are shown separately from other revenues and gains
- Operating expenses are shown separately from other expenses and losses
- The matching of operating revenues and gains results in operating income
- Disclosures are enhanced by the use of many subtotals, such as:
  - Gross Profit = Net Sales - Cost of Goods Sold
  - Income from Operating Income = Gross Profit - Total Operating Expenses
  - Income Before Taxes = Income from Operating Income + Other Revenue and Gains - Other Expenses and Losses
  - Net Income = Income Before Taxes - Income Taxes

#### Multiple-step income statement

Company name  
For the year ended December 31, year 1

<b>Revenues:</b>			
Gross sales			\$3,000,000
Less: sales discounts	\$100,000		
Less: sales returns and allowances	200,000		500,000
<b>Net sales</b>			\$2,500,000
<b>Cost of goods sold:</b>			
Beginning inventory		\$200,000	
Purchases	400,000		
Less: purchase returns and allowances	30,000		
Net purchases	\$270,000		
Transportation-in	20,000	\$290,000	
Goods available for sale		490,000	
Less: ending inventory		90,000	
Less: cost of goods sold			400,000
<b>Gross profit</b>			\$2,100,000
<b>Operating Expenses:</b>			
Selling expenses:			
Sales salaries and commissions	\$100,000		
Freight-out	5,000		
Travel	2,000		
Advertising	3,000		
Office supplies	1,500		\$107,500
Administrative expenses:			
Executive salaries	\$100,000		
Professional salaries	30,000		
Wages	5,000		
Depreciation	2,500		
Office supplies	2,500		142,500
<b>Total operating expenses</b>			\$240,000
<b>Income from operations</b>			\$1,858,000
<b>Other revenues and gains:</b>			
Other revenue	\$200,000		
Gains	50,000		250,000
<b>Other expenses and losses:</b>			
Interest expense		\$15,000	
Losses		5,000	20,000
<b>Income before taxes</b>			\$2,093,000
Income taxes			\$20,000
<b>Net income</b>			\$1,400,000
Earnings per common share			\$1.46

# Financial Statements Quick Study Business

**Zhe Xu**



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