Business Growth

Overview of Financial Statements

NLOWE
NEWFOUNDLAND & LABRADOR ORGANIZATION OF WOMEN ENTREPRENEURS

Guidebook:
Overview of Financial Statements

What is a Financial Statement?

A financial statement is a formal document prepared and recognized by business governance, legislation or taxation organizations.

A **financial statement** is not a financial report.

A **financial report** is a document prepared for internal use, and can include elements from various financial statements. For example, a quarterly financial report could include an income statement and balance sheet compiling three months' of data, for use by the management team for internal review and planning.

How is a Financial Statement Prepared?

The creation of financial statements begins with bookkeeping and ends with accounting.

Bookkeeping is the exercise of identifying, categorizing, and recording all the transactions that take place in a business. In general, everything a company does results in a bookkeeping transaction, including things that take place between the business and:

- Customers, who buy products and services sold by the business
- Employees, who are paid wages and provided benefits
- Vendors, who sell services, equipment, and supplies to the business
- Government agencies, who collect taxes from the business
- Sources of equity capital (investors or owners who put money in and take it out of the business)
- Sources of debt capital (banks and lending institutions)

Accounting, on the other hand, is the methodology used to record the transactions and prepare financial statements and reports. Accounting guidelines govern how businesses record transactions. They also dictate the design of the recordkeeping system that a business uses and how reports are prepared, based on the information gathered and put into the system.

Common Financial Terms

Asset: Items of value owned by a business: cash, investments, inventory, equipment, real estate, or intellectual property, for example

Accounts Receivable are payments you are owed by customers who have ordered or purchased your goods and/ or services. Accounts Receivable is an asset account because even though money was not exchanged at the time, the company made a sale and money will come from that sale eventually.

> **Current assets** are generally considered to be anything that will be converted into cash within one year, such as cash, accounts receivable, and inventory. Current assets continually turn over through the company.
>
> **Fixed assets** are more permanent in nature. This includes vehicles, equipment, machinery, land, and buildings. They represent an investment in items that are necessary to carry on its normal operations. Fixed assets can also revolve (to purchase new equipment or update technology, for example) but usually they revolve very slowly.

Liquidity measures how quickly a company can convert its assets into cash. An ample cash balance provides security that the company can meet its obligations. The easier the conversion is, the more liquid the asset. Here is a list of current assets in order from most to least liquid:

- Accounts receivable
- Inventory
- Fixed assets

Liability: A debt owed to a creditor of the business. A creditor could be a supplier, landlord, shareholder, or employee – anyone or any company to which your company owes money.

Current or Short-term liabilities are due and payable usually within a year. Examples include accounts payable, bank overdrafts, payroll for employees, and short-term loans Accounts Payable are payments that your business owes and has yet to pay.

Non-current or Long-term liabilities are due and payable after 12 months or later. Examples include deferred taxes, mortgage payment, and capital leases.

Contingent liabilities are potential bills or payments that may or may not occur, such as product warranties or pending lawsuits. For example, costs are incurred only if a customer requires payout on a warranty or a lawsuit is settled against your company.

Equity: An owner's interest in the business. This can take the form of stocks, securities, shareholder loans or retained earnings.

Revenues/ Income: Proceeds earned from goods or services sold as a normal part of business operations Even though a company's "bottom line" (its net income) gets most of the attention from investors, the "top line" is where the revenue or income process begins.

Gross Revenue/Income refers to the total amount received from a business activity. It can refer to total profit or total sales

Net Revenue/Income or the "bottom line" refers to the amount left over after all applicable deductions have been made from the gross amount. If expenses exceed income, this account caption will read as a net loss. After the payment of preferred dividends, if any, net income becomes part of a company's equity position as retained earnings.

Expenses: Costs incurred by the business for goods and services purchased in the process of generating revenues and running the business

> **Overhead, or operating expenses** refers to expenses that do not directly generate profits but are essential to running your place of business and carrying out your activities that make profit. Examples of overhead include rent, insurance, telephone, internet, and utilities.

Profit Margins: Profit margin is part of a category of profitability ratios calculated as net income divided by revenue, or net profits divided by sales: Profit Margin = Net Income / Net Sales (revenue)

Profit margins are expressed as a percentage and, in effect, measure how much out of every dollar of sales a company actually keeps in earnings. A 20% profit margin, then, means the company has a net income of $0.20 for each dollar of total revenue earned.

Key Financial Reports

The Income Statement

The **income statement** can also be called a profit and loss statement or operating statement. This is a summary of the income and expenses of a business during a certain period: monthly, quarterly, or annually. If the company has more income than expenses for a certain period it has net income (a profit). If the expenses exceed income, the company has a net loss.

An income statement is used to track revenues and expenses so that you can determine the operating performance of your business over a period of time. Small business owners use these statements to find out what areas of their business are over budget or under budget. Specific items that are causing unexpected expenditures can be pinpointed, such as phone, fax, mail, or supply expenses. Compare your expenses from year to year, or month to month to ensure that you have control of your expenses.

Income can be broken into two broad categories: **service income** and **sales income.** The difference between the two lies in the need to consider inventory costs. Service income is derived from performing a service while sales income is derived from selling a product. In general, service companies have staff that perform a service for a customer, while sales companies have product that they sell.

With service income, the profit can be determined simply by deducting expenses associated with performing the service. With sales income, however, you must consider the cost of creating the product (raw materials, labor, overhead, etc.). This inventory cost is referred to as the **cost of goods sold.**

The income statement equation typically looks like this:

Revenue - Expenses = Net Income or Loss

Some examples of the types of accounts that influence net income and are reported on the income statement include:

- Revenue
- Advertising expenses
- Repair expenses
- Utilities expenses
- Wage expenses

Sample Income Statement

INCOME STATEMENT: All Seasons Adventure Inc. for the year 2020	
REVENUE	**$100,000**
Cost of Goods Sold (COGS)	$35,000
Gross Profit	$65,000
Expenses	
Salaries and Benefits	$30,000
Rent and Overhead	$10,000
Depreciation/Amortization	$20,000
Total Expenses	**$60,000**
Earnings Before Tax	**$5,000**
Taxes	$1,500
Net Earnings	**$3,500**

Balance Sheet

The purpose of a balance sheet is to show what a company owns and owes as of a specific date. Income statements are prepared “for the period ending” and balance sheets are prepared “as at” a certain date.

The balance sheet summarizes what the business owns and compares it to what the business owes. It does so in a standard format to make it easy to see what kind of financial shape the business is in. If a business has more assets than liabilities, that’s a good sign. On the other hand, if a company has more liabilities than assets, it might be a sign of trouble.

The balance sheet equation typically looks like this:

Assets - Liabilities = Equity

This is what people refer to as “balancing the books:” ensuring that this equation is always in balance.

Accounts typically reported on the balance sheet include:

- Accounts receivable (money owed to the company but not collected)
- Cash
- Equipment
- Accounts and notes payable
- Prepaid items
- Unearned revenue
- Vehicles, land, and buildings, and their accumulated, individual depreciation (decrease in value)

Sample Balance Sheet

Name of Business: All Seasons Adventure Inc.

as at (date): December 31, 2020

ASSETS	
Cash	$15,000
Inventory	$10,000
Property/Equipment	$160,000
Accounts Receivable	$3,000
TOTAL ASSETS	**$188,000**
LIABILITIES	
Bank loans.	$30,000
Accounts payable	$5,000
TOTAL LIABILITIES.	**$35,000**
OWNER EQUITY	
Capital contributions/investment	$150,000
Retained earnings	$3,500
Total Owner Equity	**$153,000**

TOTAL LIABILITIES AND OWNER'S EQUITY **$188,000**

Cash Flow Statement

This shows the flow of cash for an accounting period – how much cash is going in and how much cash is going out.

A cash flow statement serves two important functions:

To track how money is raised and spent, disclosing how a company raised money and how it spent those funds during a given period.

To measure ability to cover expenses. Generally speaking, if a company is consistently bringing in more cash than it spends the company is considered to be of good value.

The cash flow statement is usually divided into three sections.

Operating

- Cash flow for day-to-day operations
- Examples: Customer revenue, tax payments, interest, supplies purchased

Investing

- Cash flow generated from or consumed by assets
- Examples: Sale of a vehicle or purchase of a building

Financing

- Cash flow in from selling stocks or bonds or borrowing
- Cash flow out from purchasing stock back, paying out dividends, and repaying borrowed money

Sample Cash Flow Statement

All Seasons Adventure Inc.
Reporting Period: January 1 - December 31, 2020

OPERATING		
Net Earnings (from income statement)	$3,500	
Plus: Depreciation/Amortization (fr. income stmt)	$20,000	
Minus: Use of Working Capital	<$5,000>	
Net cash flow from operations		**$18,500**
INVESTMENT		
Sale/Proceeds of purchases	$10,000	
Interest, other income	$3,000	
Net cash flow from investing		**$13,000**
FINANCING		
Issuance (repayment) of debt		
Issuance (repayment) of equity (capital contributions/investment from balance sheet)	$150,000	
Net cash flow from financing activities		**$150,000**
NET INCREASE (DECREASE) IN CASH FLOW (Cash from Income Statement)		**$15,000**
Cash at Start of Reporting Period		
Cash at Close of Reporting Period (This becomes Cash at Start of the reporting period for 2021 statements)		**$15,000**

Sources:

Templates and Business Guides
https://www.bdc.ca/en/articles-tools/entrepreneur-toolkit/templates-business-guides

Basic Business Management:
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Small Business Training for Entrepreneurs Series

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