

## 5.5: Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate

The study of accounting requires an understanding of precise and sometimes complicated terminology, purposes, principles, concepts, and organizational and legal structures. Typically, your introductory accounting courses will familiarize you with the overall accounting environment, and for those of you who want greater detail, there is an assortment of more advanced accounting courses available.

This chapter concentrates on the four major types of financial statements and their interactions, the major types of business structures, and some of the major terms and concepts used in this course. Coverage here is somewhat basic since these topics are accorded much greater detail in future chapters.

### Types of Business Structure

As you learned in [Role of Accounting in Society](#), virtually every activity that occurs in a business has an associated cost or value. Part of an accountant's role is to quantify these activities, or transactions.

Also, in business—and accounting in particular—it is necessary to distinguish the business entity from the individual owner(s). The personal transactions of the owners, employees, and other parties connected to the business should not be recorded in the organization's records; this accounting principle is called the *business entity concept*. Accountants should record only business transactions in business records.

This separation is also reflected in the legal structure of the business. There are several common types of legal business structures. While the accounting concepts for the various types of businesses are essentially the same regardless of the legal structure, the terminology will change slightly depending on the organization's legal structure, and it is important to understand the differences.

There are three broad categories for the legal structure of an organization: sole proprietorship, partnership, and corporation. A **sole proprietorship** is a legal business structure consisting of a single individual. Benefits of this type of structure include ease of formation, favorable tax treatment, and a high level of control over the business. The risks involved with sole proprietorships include unlimited personal liability and a limited life for the business. Unless the business is sold, the business ends when the owner retires or passes away. In addition, sole proprietorships have a fairly limited ability to raise capital (funding), and often sole proprietors have limited expertise—they are excellent at what they do but may have limited expertise in other important areas of business, such as accounting or marketing.

A **partnership** is a legal business structure consisting of an association of two or more people who contribute money, property, or services to operate as co-owners of a business. Benefits of this type of structure include favorable tax treatment, ease of formation of the business, and better access to capital and expertise. The downsides to a partnership include unlimited personal liability (although there are other legal structures—a limited liability partnership, for example—to help mitigate the risk); limited life of the partnership, similar to sole proprietorships; and increased complexity to form the venture (decision-making authority, profit-sharing arrangement, and other important issues need to be formally articulated in a written partnership agreement).

A **corporation** is a legal business structure involving one or more individuals (owners) who are legally distinct (separate) from the business. A primary benefit of a corporate legal structure is the owners of the organization have limited liability. That is, a corporation is “stand alone,” conducting business as an entity separate from its owners. Under the corporate structure, owners delegate to others (called agents) the responsibility to make day-to-day decisions regarding the operations of the business. Other benefits of the corporate legal structure include relatively easy access to large amounts of capital by obtaining loans or selling ownership (stock), and since the stock is easily sold or transferred to others, the business operates beyond the life of the shareholders. A major disadvantage of a corporate legal structure is double taxation—the business pays income tax and the owners are taxed when distributions (also called dividends) are received.

Table 2.1: Types of Business Structures

	Sole Proprietorship	Partnership	Corporation
Number of Owners	Single individual	Two or more individuals	One or more owners
Ease of Formation	Easier to form	Harder to form	Difficult to form
Ability to Raise Capital	Difficult to raise capital	Harder to raise capital	Easier to raise capital

	Sole Proprietorship	Partnership	Corporation
Liability Risk	Unlimited liability	Unlimited liability	Limited liability
Taxation Consideration	Single taxation	Single taxation	Double taxation

## The Four Financial Statements

Are you a fan of books, movies, or sports? If so, chances are you have heard or said the phrase “spoiler alert.” It is used to forewarn readers, viewers, or fans that the ending of a movie or book or outcome of a game is about to be revealed. Some people prefer knowing the end and skipping all of the details in the middle, while others prefer to fully immerse themselves and then discover the outcome. People often do not know or understand what accountants produce or provide. That is, they are not familiar with the “ending” of the accounting process, but that is the best place to begin the study of accounting.

Accountants create what are known as financial statements. Financial statements are reports that communicate the financial performance and financial position of the organization.

In essence, the overall purpose of financial statements is to evaluate the performance of a company, governmental entity, or not-for-profit entity. This chapter illustrates this through a company, which is considered to be in business to generate a profit. Each financial statement we examine has a unique function, and together they provide information to determine whether a company generated a profit or loss for a given period (such as a month, quarter, or year); the assets, which are resources of the company, and accompanying liabilities, which are obligations of the company, that are used to generate the profit or loss; owner interest in profits or losses; and the cash position of the company at the end of the period.

The four financial statements that perform these functions and the order in which we prepare them are:

1. Income Statement
2. Statement of Owner’s Equity
3. Balance Sheet
4. Statement of Cash Flows.

The order of preparation is important as it relates to the concept of how financial statements are interrelated. Before explaining each in detail, let’s explore the purpose of each financial statement and its main components.

## CONTINUING APPLICATION

### Introduction to the Gearhead Outfitters Story

**Gearhead Outfitters**, founded by Ted Herget in 1997 in Jonesboro, Arkansas, is a retail chain that sells outdoor gear for men, women, and children. The company’s inventory includes clothing, footwear for hiking and running, camping gear, backpacks, and accessories, by brands such as **The North Face**, **Birkenstock**, **Wolverine**, **Yeti**, **Altra**, **Mizuno**, and **Patagonia**. Herget fell in love with the outdoor lifestyle while working as a ski instructor in Colorado and wanted to bring that feeling back home to Arkansas. And so, **Gearhead** was born in a small downtown location in Jonesboro. The company has had great success over the years, expanding to numerous locations in Herget’s home state, as well as Louisiana, Oklahoma, and Missouri.

While Herget knew his industry when starting **Gearhead**, like many entrepreneurs he faced regulatory and financial issues that were new to him. Several of these issues were related to accounting and the wealth of decision-making information that accounting systems provide.

For example, measuring revenue and expenses, providing information about cash flow to potential lenders, analyzing whether profit and positive cash flow is sustainable to allow for expansion, and managing inventory levels. Accounting, or the preparation of financial statements (balance sheet, income statement, and statement of cash flows), provides the mechanism for business owners such as Herget to make fundamentally sound business decisions.

## Purpose of Financial Statements

Before exploring the specific financial statements, it is important to know why these are important documents. To understand this, you must first understand who the users of financial statements are. Users of the information found in financial statements are called stakeholders. A **stakeholder** is someone affected by decisions made by a company; this can include groups or individuals affected by the actions or policies of an organization, including include investors, creditors, employees, managers, regulators,

customers, and suppliers. The stakeholder's interest sometimes is not directly related to the entity's financial performance. Examples of stakeholders include lenders, investors/owners, vendors, employees and management, governmental agencies, and the communities in which the businesses operate. Stakeholders are interested in the performance of an organization for various reasons, but the common goal of using the financial statements is to understand the information each contains that is useful for making financial decisions. For example, a banker may be interested in the financial statements to decide whether or not to lend the organization money.

Likewise, small business owners may make decisions based on their familiarity with the business—they know if the business is doing well or not based on their “gut feeling.” By preparing the financial statements, accountants can help owners by providing clarity of the organization's financial performance. It is important to understand that, in the long term, every activity of the business has a financial impact, and financial statements are a way that accountants report the activities of the business. Stakeholders must make many decisions, and the financial statements provide information that is helpful in the decision-making process.

As described in [Role of Accounting in Society](#), the complete set of financial statements acts as an X-ray of a company's financial health. By evaluating all of the financial statements together, someone with financial knowledge can determine the overall health of a company. The accountant can use this information to advise outside (and inside) stakeholders on decisions, and management can use this information as one tool to make strategic short- and long-term decisions.

## ETHICAL CONSIDERATIONS

### Utilitarian View of Accounting Decisions and Stakeholder Well-Being

Utilitarianism is a well-known and influential moral theory commonly used as a framework to evaluate business decisions. Utilitarianism suggests that an ethical action is one whose consequence achieves the greatest good for the greatest number of people. So, if we want to make an ethical decision, we should ask ourselves who is helped and who is harmed by it. Focusing on consequences in this way generally does not require us to take into account the means of achieving that particular end, however. Put simply, the utilitarian view is an ethical theory that the best action of a company is the one that maximizes utility of all stakeholders to the decision. This view assumes that all individuals with an interest in the business are considered within the decision.

Financial statements are used to understand the financial performance of companies and to make long- and short-term decisions. A utilitarian approach considers all stakeholders, and both the long- and short-term effects of a business decision. This allows corporate decision makers to choose business actions with the potential to produce the best outcomes for the majority of all stakeholders, not just shareholders, and therefore maximize stakeholder happiness.

Accounting decisions can change the approach a stakeholder has in relation to a business. If a company focuses on modifying operations and financial reporting to maximize short-term shareholder value, this could indicate the prioritization of certain stakeholder interests above others. When a company pursues only short-term profit for shareholders, it neglects the well-being of other stakeholders. Professional accountants should be aware of the interdependent relationship between all stakeholders and consider whether the results of their decisions are good for the majority of stakeholder interests.

## YOUR TURN

### Business Owners as Decision Makers

Think of a business owner in your family or community. Schedule some time to talk with the business owner, and find out how he or she uses financial information to make decisions.

#### Solution

Business owners will use financial information for many decisions, such as comparing sales from one period to another, determining trends in costs and other expenses, and identifying areas in which to reduce or reallocate expenses. This information will be used to determine, for example, staffing and inventory levels, streamlining of operations, and advertising or other investment decisions.

### The Income Statement

The first financial statement prepared is the **income statement**, a statement that shows the organization's financial performance *for a given period of time*. Let's illustrate the purpose of an income statement using a real-life example. Assume your friend, Chris, who is a sole proprietor, started a summer landscaping business on August 1, 2020. It is categorized as a service entity. To keep this

example simple, assume that she is using her family's tractor, and we are using the *cash basis* method of accounting to demonstrate Chris's initial operations for her business. The other available basis method that is commonly used in accounting is the *accrual basis* method. She is responsible for paying for fuel and any maintenance costs. She named the business Chris' Landscaping. On August 31, Chris checked the account balance and noticed there is only \$250 in the checking account. This balance is lower than expected because she thought she had been paid by some customers. Chris decides to do some research to determine why the balance in the checking account is lower than expected. Her research shows that she earned a total of \$1,400 from her customers but had to pay \$100 to fix the brakes on her tractor, \$50 for fuel, and also made a \$1,000 payment to the insurance company for business insurance. The reason for the lower-than-expected balance was due to the fact that she spent (\$1,150 for brakes, fuel, and insurance) only slightly less than she earned (\$1,400)—a net increase of \$250. While she would like the checking balance to grow each month, she realizes most of the August expenses were infrequent (brakes and insurance) and the insurance, in particular, was an unusually large expense. She is convinced the checking account balance will likely grow more in September because she will earn money from some new customers; she also anticipates having fewer expenses.

CHRIS' LANDSCAPING Income Statement For the Month Ended August 31, 2020		
Revenue	\$1,400	
Total revenue		\$1,400
Expenses		
Tractor brake repair	100	
Tractor fuel	50	
Business insurance	<u>1,000</u>	
Total expenses		<u>1,150</u>
Net income		<u>\$ 250</u>

The Income Statement can also be visualized by the formula: Revenue – Expenses = Net Income/(Loss).

Let's change this example slightly and assume the \$1,000 payment to the insurance company will be paid in September, rather than in August. In this case, the ending balance in Chris's checking account would be \$1,250, a result of earning \$1,400 and only spending \$100 for the brakes on her car and \$50 for fuel. This stream of cash flows is an example of cash basis accounting because it reflects when payments are received and made, not necessarily the time period that they affect. At the end of this section and in [The Adjustment Process](#) you will address accrual accounting, which does reflect the time period that they affect.

In accounting, this example illustrates an income statement, a financial statement that is used to measure the financial performance of an organization for a particular period of time. We use the simple landscaping account example to discuss the elements of the income statement, which are revenues, expenses, gains, and losses. Together, these determine whether the organization has net income (where revenues and gains are greater than expenses and losses) or net loss (where expenses and losses are greater than revenues and gains). Revenues, expenses, gains, and losses are further defined here.

### Revenue

**Revenue**<sup>1</sup> is the value of goods and services the organization sold or provided to customers for a given period of time. In our current example, Chris's landscaping business, the "revenue" earned for the month of August would be \$1,400. It is the value Chris received in exchange for the services provided to her clients. Likewise, when a business provides goods or services to customers for cash at the time of the service or in the future, the business classifies the amount(s) as revenue. Just as the \$1,400 earned from a business made Chris's checking account balance increase, revenues increase the value of a business. In accounting, revenues are often also called sales or fees earned. Just as earning wages from a business or summer job reflects the number of hours worked for

a given rate of pay or payments from clients for services rendered, revenues (and the other terms) are used to indicate the dollar value of goods and services provided to customers for a given period of time.

## YOUR TURN

### Coffee Shop Products

Think about the coffee shop in your area. Identify items the coffee shop sells that would be classified as revenues. Remember, revenues for the coffee shop are related to its primary purpose: selling coffee and related items. Or, better yet, make a trip to the local coffee shop and get a first-hand experience.

### Solution

Many coffee shops earn revenue through multiple revenue streams, including coffee and other specialty drinks, food items, gift cards, and merchandise.

### Expenses

An **expense**<sup>2</sup> is a cost associated with providing goods or services to customers. In our opening example, the expenses that Chris incurred totaled \$1,150 (consisting of \$100 for brakes, \$50 for fuel, and \$1,000 for insurance). You might think of expenses as the opposite of revenue in that expenses reduce Chris's checking account balance. Likewise, expenses decrease the value of the business and represent the dollar value of costs incurred to provide goods and services to customers for a given period of time.

## YOUR TURN

### Coffee Shop Expenses

While thinking about or visiting the coffee shop in your area, look around (or visualize) and identify items or activities that are the expenses of the coffee shop. Remember, expenses for the coffee shop are related to resources consumed while generating revenue from selling coffee and related items. Do not forget about any expenses that might not be so obvious—as a general rule, every activity in a business has an associated cost.

### Solution

Costs of the coffee shop that might be readily observed would include rent; wages for the employees; and the cost of the coffee, pastries, and other items/merchandise that may be sold. In addition, costs such as utilities, equipment, and cleaning or other supplies might also be readily observable. More obscure costs of the coffee shop would include insurance, regulatory costs such as health department licensing, point-of-sale/credit card costs, advertising, donations, and payroll costs such as workers' compensation, unemployment, and so on.

### Gains

A **gain**<sup>3</sup> can result from selling ancillary business items for more than the items are worth. (Ancillary business items are those that are used to support business operations.) To illustrate the concept of a gain, let's return to our example. However, this example and the accompanying *losses* example are not going to be part of our income statement, balance sheet, or owner's equity statement discussions. The gains and losses examples are only to be used in demonstrating the concepts of gains and losses. Assume that Chris paid \$1,500 for a small piece of property to use for building a storage facility for her company. Further assume that Chris has an opportunity to sell the land for \$2,000. She subsequently found a better storage option and decided to sell the property. After doing so, Chris will have a gain of \$500 (a selling price of \$2,000 and a cost of \$1,500) and will also have \$2,000 to deposit into her checking account, which would increase the balance.

Thinking back to the proceeds (\$1,400) Chris received from her landscaping business, we might ask the question: how are gains similar to and different from revenues? The revenue of \$1,400 that Chris earned from her business and the \$2,000 she received from selling the land are similar in that both increase her checking account balance and make her business more valuable.

A difference, however, is evident if we consider how these funds were earned. Chris earned the \$1,400 because she provided services (her labor) to her clients. Chris's primary objective is to earn revenue by working for her clients. In addition, earning money by selling her land was an infrequent event for Chris, since her primary job was serving as a landscaper. Her primary goal is to earn fees or revenue, not to earn money by selling land. In fact, she cannot consider doing that again because she does not have additional land to sell.

The primary goal of a business is to earn revenue by providing goods and services to customers in exchange for cash at that time or in the future. While selling other items for more than the value of the item does occur in business, these transactions are classified as gains, because these sales are infrequent and not the primary purpose of the business.

### Losses

A **loss**<sup>4</sup> results from selling ancillary business items for less than the items are worth. To illustrate, let's now assume that Chris sells her land that she purchased for \$1,500 at a sales price of \$1,200. In this case she would realize (incur) a loss of \$300 on the sale of the property (\$1,200 sales price minus the \$1,500 cost of purchasing the property) and will also have \$1,200 to deposit into her checking account, which would increase the balance.

You should not be confused by the fact that the checking account balance increased even though this transaction resulted in a financial loss. Chris received \$1,200 that she can deposit into her checking account and use for future expenses. The \$300 loss simply indicates that she received less for the land than she paid for it. These are two aspects of the same transaction that communicate different things, and it is important to understand the differences.

As we saw when comparing gains and revenues, losses are similar to expenses in that both losses and expenses decrease the value of the organization. In addition, just as Chris's primary goal is to earn money from her job rather than selling land, in business, losses refer to infrequent transactions involving ancillary items of the business.

### Net Income (Net Loss)

Net income (net loss) is determined by comparing revenues and expenses. **Net income** is a result of revenues (inflows) being greater than expenses (outflows). A **net loss** occurs when expenses (outflows) are greater than revenues (inflows). In accounting it is common to present net income in the following format:

Net Income	
Revenue (sometimes called Sales or Fees Earned)	
– Expenses	
<hr/>	
Operating Profit (or Net Loss)	

Recall that revenue is the value of goods and services a business provides to its customers and increase the value of the business. Expenses, on the other hand, are the costs of providing the goods and services and decrease the value of the business. When revenues exceed expenses, companies have net income. This means the business has been successful at earning revenues, containing expenses, or a combination of both. If, on the other hand, expenses exceed revenues, companies experience a net loss. This means the business was unsuccessful in earning adequate revenues, sufficiently containing expenses, or a combination of both. While businesses work hard to avoid net loss situations, it is not uncommon for a company to sustain a net loss from time-to-time. It is difficult, however, for businesses to remain viable while experiencing net losses over the long term.

Shown as a formula, the net income (loss) function is:

$$\begin{aligned}\text{Revenues (R)} - \text{Expenses (E)} &= \text{Net Income (when } R > E) \\ \text{Revenues (R)} - \text{Expenses (E)} &= \text{Net Loss (when } E > R)\end{aligned}$$

To be complete, we must also consider the impact of gains and losses. While gains and losses are infrequent in a business, it is not uncommon that a business would present a gain and/or loss in its financial statements. Recall that gains are similar to revenue and losses are similar to expenses. Therefore, the traditional accounting format would be:

## Gains and Losses

Revenue (sometimes called Sales or Fees Earned)  
+ Gains  
– Expenses  
– Losses  
Net Income (or Net Loss)

Shown as a formula, the net income (loss) function, including gains and losses, is:

Revenues (R) + Gains (G) – Expenses (E) – Losses (L) = Net Income [when (R + G) > (E + L)]  
Revenues (R) + Gains (G) – Expenses (E) – Losses (L) = Net Loss [when (E + L) > (R + G)]

When assessing a company's net income, it is important to understand the source of the net income. Businesses strive to attain “high-quality” net income (earnings). High-quality earnings are based on sustainable earnings—also called permanent earnings—while relying less on infrequent earnings—also called temporary earnings. Recall that revenues represent the *ongoing* value of goods and services the business provides (sells) to its customers, while gains are *infrequent* and involve items ancillary to the primary purpose of the business. We should use caution if a business attains a significant portion of its net income as a result of gains, rather than revenues. Likewise, net losses derived as a result of losses should be put into the proper perspective due to the infrequent nature of losses. While net losses are undesirable for any reason, net losses that result from expenses related to ongoing operations, rather than losses that are infrequent, are more concerning for the business.

### Statement of Owner's Equity

Equity is a term that is often confusing but is a concept with which you are probably already familiar. In short, equity is the value of an item that remains after considering what is owed for that item. The following example may help illustrate the concept of equity.

When thinking about the concept of equity, it is often helpful to think about an example many families are familiar with: purchasing a home. Suppose a family purchases a home worth \$200,000. After making a down payment of \$25,000, they secure a bank loan to pay the remaining \$175,000. What is the value of the family's equity in the home? If you answered \$25,000, you are correct. At the time of the purchase, the family owns a home worth \$200,000 (an asset), but they owe \$175,000 (a liability), so the equity or net worth in the home is \$25,000.

The **statement of owner's equity**, which is the second financial statement created by accountants, is a statement that shows how the equity (or value) of the organization has changed over time. Similar to the income statement, the statement of owner's equity is *for a specific period of time, typically one year*. Recall that another way to think about equity is net worth, or value. So, the statement of owner's equity is a financial statement that shows how the net worth, or value, of the business has changed for a given period of time.



## CHRIS' LANDSCAPING

### Statement of Owner's Equity For the Month Ended August 31, 2020

Owner's equity, August 1	\$ 0
+ Net income	250
	<u>250</u>
Owner's equity, August 31	<u><u>\$250</u></u>

The elements of the financial statements shown on the statement of owner's equity include *investments by owners* as well as *distributions to owners*. Investments by owners and distributions to owners are two activities that impact the value of the organization (increase and decrease, respectively). In addition, net income or net loss affects the value of the organization (net income increases the value of the organization, and net loss decreases it). Net income (or net loss) is also shown on the statement of owner's equity; this is an example of how the statements are interrelated. Note that the word *owner's* (singular for a sole owner) changes to *owners'* (plural, for a group of owners) when preparing this statement for an entity with multiple owners versus a sole proprietorship.

In our example, to make it less complicated, we started with the first month of operations for Chris's Landscaping. In the first month of operations, the owner's equity total begins the month of August 2020, at \$0, since there have been no transactions. During the month, the business received revenue of \$1,400 and incurred expenses of \$1,150, for net income of \$250. Since Chris did not contribute any investment or make any withdrawals, other than the \$1,150 for expenses, the ending balance in the owner's equity account on August 31, 2020, would be \$250, the net income earned.

At this stage, it's important to point out that we are working with a sole proprietorship to help simplify the examples. We have addressed the owner's value in the firm as *capital* or *owner's equity*. However, later we switch the structure of the business to a corporation, and instead of owner's equity we begin using stockholder's equity, which includes account titles such as *common stock* and *retained earnings* to represent the owners' interests.

The corporate treatment is more complicated because corporations may have a few owners up to potentially thousands of owners (stockholders). More detail on this issue is provided in [Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses](#).

#### Investments by Owners

Generally, there are two ways by which organizations become more valuable: profitable operations (when revenues exceed expenses) and investments by owners. Organizations often have long-term goals or projects that are very expensive (for example, building a new manufacturing facility or purchasing another company).

While having profitable operations is a viable way to "fund" these goals and projects, organizations often want to undertake these projects in a quicker time frame. Selling ownership is one way to quickly obtain the funding necessary for these goals. **Investments by owners** represent an exchange of cash or other assets for which the investor is given an ownership interest in the organization. This is a mutually beneficial arrangement: the organization gets the funding it needs on a timely basis, and the investor gets an ownership interest in the organization.

When organizations generate funding by selling ownership, the ownership interest usually takes the form of **common stock**, which is the corporation's primary class of stock issued, with each share representing a partial claim to ownership or a share of the company's business. When the organization issues common stock for the first time, it is called an **initial public offering (IPO)**. In



[Corporation Accounting](#), you learn more about the specifics of this type of accounting. Once a company issues (or sells) common stock after an IPO, we describe the company as a **publicly traded company**, which simply means the company's stock can be purchased by the general public on a public exchange like the New York Stock Exchange (NYSE). That is, investors can become owners of the particular company. Companies that issue publicly traded common shares in the United States are regulated by the **Securities and Exchange Commission (SEC)**, a federal regulatory agency that, among other responsibilities, is charged with oversight of financial investments such as common stock.

## CONCEPTS IN PRACTICE

### Roku Goes Public

On September 1, 2017, **Roku, Inc.** filed a Form S-1 with the Securities and Exchange Commission (SEC).<sup>5</sup> In this form, **Roku** disclosed its intention to become a publicly traded company, meaning its stock will trade (sell) on public stock exchanges, allowing individual and institutional investors an opportunity to own a portion (shares) of the company. The Form S-1 included detailed financial and nonfinancial information about the company. The information from **Roku** also included the purpose of the offering as well as the intended uses of the funds. Here is a portion of the disclosure: “The principal purposes of this offering are to increase our capitalization and financial flexibility and create a public market for our Class A common stock. We intend to use the net proceeds we receive from this offering primarily for general corporate purposes, including working capital . . . research and development, business development, sales and marketing activities and capital expenditures.”<sup>6</sup>

On September 28, 2017, **Roku** “went public” and exceeded expectations. Prior to the IPO, **Roku** estimated it would sell between \$12 and \$14 per share, raising over \$117 million for the company. The closing price per share on September 28 was \$23.50, nearly doubling initial expectations for the share value.<sup>7</sup>

### Distributions to Owners

There are basically two ways in which organizations become less valuable in terms of owners' equity: from unprofitable operations (when expenses or losses exceed revenues or gains) and by distributions to owners. Owners (investors) of an organization want to see their investment appreciate (gain) in value. Over time, owners of common stock can see the value of the stock increase in value—the share price increases—due to the success of the organization. Organizations may also make **distributions to owners**, which are periodic rewards issued to the owners in the form of cash or other assets. Distributions to owners represent some of the value (equity) of the organization.

For investors who hold common stock in the organization, these periodic payments or distributions to owners are called **dividends**. For sole proprietorships, distributions to owners are withdrawals or drawings. From the organization's perspective, dividends represent a portion of the net worth (equity) of the organization that is returned to owners as a reward for their investment. While issuing dividends does, in fact, reduce the organization's assets, some argue that paying dividends increases the organization's long-term value by making the stock more desirable. (Note that this topic falls under the category of “dividend policy” and there is a significant stream of research addressing this.)

### Balance Sheet

Once the statement of owner's equity is completed, accountants typically complete the **balance sheet**, a statement that lists what the organization owns (*assets*), what it owes (*liabilities*), and what it is worth (*equity*) on a *specific date*. Notice the change in timing of the report. The income statement and statement of owner's equity report the financial performance and equity change for a period of time. The balance sheet, however, lists the financial position at the close of business on a specific date. (Refer to [Figure 2.2](#) for the balance sheet as of August 31, 2020, for Chris' Landscaping.)

CHRIS' LANDSCAPING Balance Sheet August 31, 2020	
<b>Assets</b>	
Cash	\$250
<b>Liabilities</b>	
None	0
<b>Owner's Equity</b>	
Owner's Equity	\$250

Figure 2.2 “Balance Sheet for Chris’ Landscaping.” (attribution: Copyright, Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

### Assets

If you recall our previous example involving Chris and her newly established landscaping business, you are probably already familiar with the term **asset**<sup>8</sup>—these are resources used to generate revenue. In Chris’s business, to keep the example relatively simple, the business ended the month with one asset, cash, assuming that the insurance was for one month’s coverage.

However, as organizations become more complex, they often have dozens or more types of assets. An asset can be categorized as a **short-term asset** or current asset (which is typically used up, sold, or converted to cash in one year or less) or as a **long-term asset** or noncurrent asset (which is not expected to be converted into cash or used up within one year). Long-term assets are often used in the production of products and services.

Examples of short-term assets that businesses own include cash, accounts receivable, and inventory, while examples of long-term assets include land, machinery, office furniture, buildings, and vehicles. Several of the chapters that you will study are dedicated to an in-depth coverage of the special characteristics of selected assets. Examples include [Merchandising Transactions](#), which are typically short term, and [Long-Term Assets](#), which are typically long term.

An asset can also be categorized as a tangible asset or an intangible asset. **Tangible assets** have a physical nature, such as trucks or many inventory items, while **intangible assets** have value but often lack a physical existence or corpus, such as insurance policies or trademarks.

### Liabilities

You are also probably already familiar with the term **liability**<sup>9</sup>—these are amounts owed to others (called creditors). A liability can also be categorized as a **short-term liability** (or current liability) or a **long-term liability** (or noncurrent liability), similar to the treatment accorded assets. Short-term liabilities are typically expected to be paid within one year or less, while long-term liabilities are typically expected to be due for payment more than one year past the current balance sheet date.

Common short-term liabilities or amounts owed by businesses include amounts owed for items purchased on credit (also called *accounts payable*), taxes, wages, and other business costs that will be paid in the future. Long-term liabilities can include such liabilities as long-term notes payable, mortgages payable, or bonds payable.

### Equity

In the Statement of Owner’s Equity discussion, you learned that **equity** (or net assets) refers to book value or net worth. In our example, Chris’s Landscaping, we determined that Chris had \$250 worth of equity in her company at the end of the first month (see [Figure 2.2](#)).

At any point in time it is important for stakeholders to know the financial position of a business. Stated differently, it is important for employees, managers, and other interested parties to understand what a business owns, owes, and is worth at any given point. This provides stakeholders with valuable financial information to make decisions related to the business.

## Statement of Cash Flows

The fourth and final financial statement prepared is the **statement of cash flows**, which is a statement that lists the cash inflows and cash outflows for the business *for a period of time*. At first glance, this may seem like a redundant financial statement. We know the income statement also reports the inflows and outflows for the business for a period of time. In addition, the statement of owner's equity and the balance sheet help to show the other activities, such as investments by and distributions to owners that are not included in the income statement. To understand why the statement of cash flows is necessary, we must first understand the two bases of accounting used to prepare the financial statements. The changes in cash within this statement are often referred to as sources and uses of cash. A source of cash lets one see where cash is coming from. For example, is cash being generated from sales to customers, or is the cash a result of an advance in a large loan. Use of cash looks at what cash is being used for. Is cash being used to make an interest payment on a loan, or is cash being used to purchase a large piece of machinery that will expand business capacity? The two bases of accounting are the cash basis and the accrual basis, briefly introduced in [Describe the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate](#).

Under **cash basis accounting**, transactions (i.e., a sale or a purchase) are not recorded in the financial statements until there is an exchange of cash. This type of accounting is permitted for nonprofit entities and small businesses that elect to use this type of accounting. Under **accrual basis accounting**, transactions are generally recorded in the financial statement when the transactions occur, and not when paid, although in some situations the two events could happen on the same day.

An example of the two methods (cash versus accrual accounting) would probably help clarify their differences. Assume that a mechanic performs a tune-up on a client's car on May 29, and the customer picks up her car and pays the mechanic \$100 on June 2. If the mechanic were using the cash method, the revenue would be recognized on June 2, the date of payment, and any expenses would be recognized when paid.

If the accrual method were used, the mechanic would recognize the revenue and any related expenses on May 29, the day the work was completed. The accrual method will be the basis for your studies here (except for our coverage of the cash flow statement in [Statement of Cash Flows](#)). The accrual method is also discussed in greater detail in [Explain the Steps within the Accounting Cycle through the Unadjusted Trial Balance](#).

While the cash basis of accounting is suited well and is more efficient for small businesses and certain types of businesses, such as farming, and those without inventory, like lawyers and doctors, the accrual basis of accounting is theoretically preferable to the cash basis of accounting. Accrual accounting is advantageous because it distinguishes between the timing of the transactions (when goods and services are provided) and when the cash involved in the transactions is exchanged (which can be a significant amount of time after the initial transaction). This allows accountants to provide, in a timely manner, relevant and complete information to stakeholders. [The Adjustment Process](#) explores several common techniques involved in accrual accounting.

Two brief examples may help illustrate the difference between cash accounting and accrual accounting. Assume that a business sells \$200 worth of merchandise. In some businesses, there are two ways the customers pay: cash and credit (also referred to as "on account"). Cash sales include checks and credit cards and are paid at the time of the sale. Credit sales (not to be confused with credit card sales) allow the customer to take the merchandise but pay within a specified period of time, usually up to forty-five days.

A cash sale would be recorded in the financial statements under *both* the cash basis and accrual basis of accounting. It makes sense because the customer received the merchandise and paid the business at the same time. It is considered two events that occur simultaneously (exchange of merchandise for cash).

Similar to the previous example for the mechanic, a credit sale, however, would be treated differently under each of these types of accounting. Under the cash basis of accounting, a credit sale would not be recorded in the financial statements until the cash is received, under terms stipulated by the seller. For example, assume on April 1 a landscaping business provides \$500 worth of services to one of its customers. The sale is made on account, with the payment due forty-five days later. Under the cash basis of accounting, the revenue would not be recorded until May 16, when the cash was received. Under the accrual basis of accounting, this sale would be recorded in the financial statements at the time the services were provided, April 1. The reason the sale would be recorded is, under accrual accounting, the business reports that it provided \$500 worth of services to its customer. The fact the customers will pay later is viewed as a separate transaction under accrual accounting ([Figure 2.3](#)).

LANDSCAPE Statement of Cash Flows For Month Ended <b>May 31, 2021</b>		LANDSCAPE Statement of Cash Flows For Month Ended <b>April 30, 2021</b>	
Cash Flow from Operations		Cash Flow from Operations	
Net Earnings	\$500	Net Earnings	\$500

Figure 2.3 Credit versus Cash. On the left is a credit sale recorded under the cash basis of accounting. On the right the same credit sale is recorded under the accrual basis of accounting. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Let's now explore the difference between the cash basis and accrual basis of accounting using an expense. Assume a business purchases \$160 worth of printing supplies from a supplier (vendor). Similar to a sale, a purchase of merchandise can be paid for at the time of sale using cash (also a check or credit card) or at a later date (on account). A purchase paid with cash at the time of the sale would be recorded in the financial statements under *both* cash basis and accrual basis of accounting. It makes sense because the business received the printing supplies from the supplier and paid the supplier at the same time. It is considered two events that occur simultaneously (exchange of merchandise for cash).

If the purchase was made on account (also called a *credit purchase*), however, the transaction would be recorded differently under each of these types of accounting. Under the cash basis of accounting, the \$160 purchase on account would not be recorded in the financial statements until the cash is paid, as stipulated by the seller's terms. For example, if the printing supplies were received on July 17 and the payment terms were fifteen days, no transaction would be recorded until August 1, when the goods were paid for. Under the accrual basis of accounting, this purchase would be recorded in the financial statements at the time the business received the printing supplies from the supplier (July 17). The reason the purchase would be recorded is that the business reports that it bought \$160 worth of printing supplies from its vendors. The fact the business will pay later is viewed as a separate issue under accrual accounting. [Table 2.2](#) summarizes these examples under the different bases of accounting.

#### Transactions by Cash Basis versus Accrual Basis of Accounting

Transaction	Under Cash Basis Accounting	Under Accrual Basis Accounting
\$200 sale for cash	Recorded in financial statements at time of sale	Recorded in financial statements at time of sale
\$200 sale on account	<i>Not</i> recorded in financial statements until cash is received	Recorded in financial statements at time of sale
\$160 purchase for cash	Recorded in financial statements at time of purchase	Recorded in financial statements at time of purchase
\$160 purchase on account	<i>Not</i> recorded in financial statements until cash is paid	Recorded in financial statements at time of purchase

**Table 2.2** Businesses often sell items for cash as well as on account, where payment terms are extended for a period of time (for example, thirty to forty-five days). Likewise, businesses often purchase items from suppliers (also called vendors) for cash or, more likely, on account. Under the cash basis of accounting, these transactions would not be recorded until the cash is exchanged. In contrast, under accrual accounting the transactions are recorded when the transaction occurs, regardless of when the cash is received or paid.

Knowing the difference between the cash basis and accrual basis of accounting is necessary to understand the need for the statement of cash flows. Stakeholders need to know the financial *performance* (as measured by the income statement—that is, net income or net loss) and financial *position* (as measured by the balance sheet—that is, assets, liabilities, and owners' equity) of the business. This information is provided in the income statement, statement of owner's equity, and balance sheet. However, since these financial statements are prepared using accrual accounting, stakeholders do not have a clear picture of the business's cash activities. The statement of cash flows solves this inadequacy by specifically focusing on the cash inflows and cash outflows.

#### Footnotes

- 1 In a subsequent section of this chapter, you will learn that the accounting profession is governed by the Financial Accounting Standards Board (or FASB), a professional body that issues guidelines/pronouncements for the accounting profession. A set of theoretical pronouncements issued by FASB is called Statement of Financial Accounting Concepts (SFAC). In SFAC No. 6,

FASB defines revenues as “inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations” (SFAC No. 6, p. 23).

- [2](#) Expenses are formally defined by the FASB as “outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations” (SFAC No. 6, p. 23).
- [3](#) FASB notes that gains represent an increase in organizational value from activities that are “*incidental or peripheral*” (SFAC No. 6, p. 24) to the primary purpose of the business.
- [4](#) FASB notes losses represent a decrease in organizational value from activities that are “*incidental or peripheral*” (SFAC No. 6, p. 24) to the primary purpose of the business.
- [5](#) Roku, Inc. “Form S-1 Filing with the Securities and Exchange Commission.” September 1, 2017.  
<https://www.sec.gov/Archives/edgar/d...d403225ds1.htm>
- [6](#) Roku, Inc. “Form S-1 Filing with the Securities and Exchange Commission.” September 1, 2017.  
<https://www.sec.gov/Archives/edgar/d...d403225ds1.htm>
- [7](#) Roku, Inc. Data. finance.yahoo.com/quote/ROKU/history?p=ROKU
- [8](#) The FASB defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events” (SFAC No. 6, p. 12).
- [9](#) The FASB defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events” (SFAC No. 6, p. 13).

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