

32.5: Financial Statements

Learning Objectives

- Define the accounting equation
- Identify the use and components of the balance sheet
- Identify the use and components of the income statement
- Identify the use and components of the statement of owner's equity
- Identify the use and components of the statement of cash flows

Financial statements are the means by which companies communicate their story. Together these statements represent the profitability and financial strength of a company. The financial statement that reflects a company's profitability is the **income statement**. The **statement of owner's equity**—also called the **statement of retained earnings**—shows the change in retained earnings between the beginning and end of a period (e.g., a month or a year). The **balance sheet** reflects a company's solvency and financial position. The **statement of cash flows** shows the cash inflows and outflows for a company during a period of time.

Financial statements are summative reports in that they report information obtained from the day-to-day bookkeeping activities of financial accountants or bookkeepers. After all of the income and expenses of the business have been recorded, financial accountants prepare financial statements in the following order:

1. Income Statement
2. Statement of Retained Earnings—also called Statement of Owner's Equity
3. The Balance Sheet
4. The Statement of Cash Flows

The following video summarizes the four financial statements required by GAAP.



You can view the [transcript for “Financial Statements – An Introduction”](#) (opens in new window) or the [text alternative for “Financial Statements – An Introduction”](#) (opens in new window).



In order to get a better understanding of financial statements, what they communicate to the users of accounting information, and how the statements are connected, we will use the final balances as of January 31, 20XX for a fictitious delivery-service company, Metro Courier Inc. Just as a financial accountant would do, we will use these figures to prepare the company's financial statements required by GAAP.

Before we start, we need to define three terms and an equation that are used throughout the accounting process.

- **Asset:** An asset is an economic resource. Anything tangible or intangible that can be owned or controlled to produce value and that is held to have positive economic value is considered an asset. Simply stated, assets represent value of ownership that can be converted into cash (although cash itself is also considered an asset). Assets include things like cash, vehicles, buildings, equipment, patents, and debts owed to the company.
- **Liability:** A liability is defined as the future sacrifices of economic benefits that the entity is *obliged* to make to other entities as a result of past transactions or other *past* events, the settlement of which may result in the transfer or use of assets, provision of services, or other yielding of economic benefits in the future. Liabilities include things like loans, monies owed to suppliers or creditors that the business will use assets (i.e., cash) to settle.
- **Equity:** Equity is the difference between the value of the assets and the amount of the liabilities of something owned. Owner's equity consists of the net assets of an entity. Net assets is the difference between the total assets and total liabilities. When the owners are shareholders, the interest can be called shareholders' equity; the accounting remains the same, and it is ownership equity spread out among shareholders.

You can see that these three terms are interconnected, and their interconnection produces an equation that is at the heart of all financial accounting: **The Accounting Equation**. The accounting equation represents the relationship between assets, liabilities, and the owner's equity of a business. It's the foundation for the double-entry accounting system, accepted to be the most reliable and accurate method of recording the financial transactions of a business. The accounting equation must always "balance": The left and right side of the equation must be equal. The accounting equation is as follows:

Assets – Liabilities = Owner's or Shareholders' Equity

Now that you have a better understanding of the language of financial statements, let's look at Metro Courier's financial information and prepare some financial statements.

Balance of Accounts for Metro Courier Inc. as of January 31, 20XX

Item	Item Type	Dollar Amount
Cash	Asset	\$ 66,800
Accounts Receivable	Asset	\$ 5,000
Supplies	Asset	\$ 500
Prepaid rent	Asset	\$ 1,800
Equipment	Asset	\$ 5,500
Truck	Asset	\$ 8,500

Accounts Payable	Liability	\$ 200
Common Stock	Equity	\$ 30,000
Retained Earnings	Equity	\$ 0
Service Revenue	Revenue	\$ 60,000
Salary Expense	Expense	\$ 900
Utilities Expense	Expense	\$ 1,200

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Income Statement

The **income statement**, sometimes called an earnings statement or profit and loss statement, reports the profitability of a business organization for a *stated period of time*. In accounting, we measure profitability for a period, such as a month or year, by comparing the revenues earned with the expenses incurred to produce these revenues. This is the *first* financial statement prepared, as you will need the information from this statement for the remaining statements. The income statement contains the following:

- **Revenues** are the inflows of cash resulting from the sale of products or the rendering of services to customers. We measure revenues by the prices agreed on in the exchanges in which a business delivers goods or renders services.
- **Expenses** are the costs incurred to produce revenues. Expenses are costs of doing business (typically identified as accounts ending in the word “expense”).
- **Revenues – Expenses = Net Income.** Net income is often called the *earnings* of the company. When expenses exceed revenues, the business has a **net loss**.

Metro Courier Inc.		
Income Statement		
Month Ended January 31, 20XX		
Revenue:		
Service Revenue	\$ 60,000	
<i>Total Revenues</i>		\$ 60,000
Expenses:		
Salary Expense	900	
Utility Expense	1, 200	
<i>Total Expenses</i>		2,100
Net Income (\$60,000 – 2,100)		\$ 57,900

The net income from the income statement will be used in the Statement of Equity.

Statement of Retained Earnings (or Owner's Equity)

The **statement of retained earnings**, explains the changes in retained earnings between two balance sheet dates. We start with beginning retained earnings (in our example, the business began in January, so we start with a zero balance) and add any net income (or subtract net loss) from the income statement. Next, we subtract any dividends declared (or any owner withdrawals in a partnership or sole-proprietor) to get the ending balance in retained earnings (or capital for non-corporations)

Metro Courier Inc.

Statement of Retained Earnings	
Month Ended January 31, 20XX	
Beginning Retained Earnings, Jan 1	\$ 0
Net income from month (from income statement)	57,900
Total increase	\$ 57,900
Dividends (or withdrawals for non-corporations)	– \$0
Ending Retained Earnings, January 31	\$ 57,900

The ending balance we calculated for retained earnings (or capital) is reported on the balance sheet.

Balance Sheet

The **balance sheet** lists the company's assets, liabilities, and equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. Notice how the heading of the balance sheet differs from the headings on the income statement and statement of retained earnings. A balance sheet is like a photograph; it captures the financial position of a company at a particular *moment* in time. The other two statements are for a *period* of time. As you learn about the assets, liabilities, and stockholders' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

Metro Courier Inc.	
Balance Sheet	
January 31, 20XX	
Assets	
Cash	\$ 66,800
Accounts Receivable	5,000
Supplies	500
Prepaid Rent	1,800
Equipment	5,500
Truck	8,500
Total Assets	\$ 88,100
Liabilities	
Accounts Payable	\$ 200
Total Liabilities	\$200
Equity	
Common Stock	\$ 30,000
Retained Earnings	57,900
Total Equity	\$ 87,900
Total Liabilities + Equity	\$ 88,100

You can see the accounting equation in action here on the balance sheet. The accounting equation is Assets – Liabilities = Owner's Equity. For Metro Courier Inc., this is \$88,100 – \$200 = \$87,900.

? Practice Questions

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Statement of Cash Flows

The main purpose of the statement of cash flows is to report on the cash receipts and cash disbursements of an entity during an accounting period. Broadly defined, cash includes both cash and cash equivalents, such as short-term investments in Treasury bills, commercial paper, and money market funds. Another purpose of this statement is to report on the entity's investing and financing activities for the period. The statement of cash flows reports the effects on cash during a period of a company's operating, investing, and financing activities. Firms show the effects of significant investing and financing activities that do not affect cash in a schedule separate from the statement of cash flows.



You can view the [transcript for “Cash Flow Introduction” \(opens in new window\)](#) or [text alternative for “Cash Flow Introduction” \(opens in new window\)](#).

The **statement of cash flows** summarizes the effects on cash of the operating, investing, and financing activities of a company during an accounting period; it reports on past management decisions on such matters as issuance of capital stock or the sale of long-term bonds. This information is available only in bits and pieces from the other financial statements. Since cash flows are vital to a company's financial health, the statement of cash flows provides useful information to management, investors, creditors, and other interested parties.

The statement of cash flows presents the effects on cash of all significant operating, investing, and financing activities. By reviewing the statement, management can see the effects of its past major policy decisions in quantitative form. The statement may show a flow of cash from operating activities large enough to finance all projected capital needs internally rather than having to incur long-term debt or issue additional stock. Alternatively, if the company has been experiencing cash shortages, management can use the statement to determine why such shortages are occurring. Using the statement of cash flows, management may also recommend to the board of directors a reduction in dividends to conserve cash.

The statement of cash flows classifies cash receipts and disbursements as operating, investing, and financing cash flows. Both inflows and outflows are included within each category.

Operating activities generally include the cash effects (inflows and outflows) of transactions and other events that enter into the determination of net income. Cash inflows from operating activities affect items that appear on the income statement and include: (1) cash receipts from sales of goods or services; (2) interest received from making loans; (3) dividends received from investments in equity securities; (4) cash received from the sale of trading securities; and (5) other cash receipts that do not arise from transactions defined as investing or financing activities, such as amounts received to settle lawsuits, proceeds of certain insurance settlements, and cash refunds from suppliers.

Cash outflows for operating activities affect items that appear on the income statement and include payments: (1) to acquire inventory; (2) to other suppliers and employees for other goods or services; (3) to lenders and other creditors for interest; (4) for purchases of trading securities; and (5) all other cash payments that do not arise from transactions defined as investing or financing activities, such as taxes and payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

Investing activities generally include transactions involving the acquisition or disposal of noncurrent assets. Thus, cash inflows from investing activities include cash received from: (1) the sale of property, plant, and equipment; (2) the sale of available-for-sale and held-to-maturity securities; and (3) the collection of long-term loans made to others. Cash outflows for investing activities include cash paid: (1) to purchase property, plant, and equipment; (2) to purchase available-for-sale and held-to-maturity securities; and (3) to make long-term loans to others.

Financing activities generally include the cash effects (inflows and outflows) of transactions and other events involving creditors and owners. Cash inflows from financing activities include cash received from issuing capital stock and bonds, mortgages, and notes, and from other short- or long-term borrowing. Cash outflows for financing activities include payments of cash dividends or other distributions to owners (including cash paid to purchase treasury stock) and repayments of amounts borrowed. Payment of interest is not included because interest expense appears on the income statement and is, therefore, included in operating activities. Cash payments to settle accounts payable, wages payable, and income taxes payable are not financing activities. These payments are included in the operating activities section.

Information about all material investing and financing activities of an enterprise that do not result in cash receipts or disbursements during the period appear in a separate schedule, rather than in the statement of cash flows. The disclosure may be in narrative form. For instance, if a company issued a mortgage note to acquire land and buildings.

? Practice Question

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