

## Accounting Financial Statements

In accounting, it is important to be able to compose and interpret financial statements. Being able to do this will allow investors, accountants, and lenders to determine the financial health of a company. This handout will explain how to prepare each financial statement, including the income statement, statement of retained earnings, balance sheet, and statement of cash flows.

### Important Terms

You can click each term to navigate to specific sections of this handout.

[Income statement](#): This is the first financial statement prepared. The income statement is prepared to look at a company's revenues and expenses over a certain period, such as a month, a quarter, or a year. When expenses are subtracted from revenues, the result is net income.

[Statement of retained earnings](#): This is the second financial statement prepared. This statement shows how much of a company's earnings were kept within the company and not paid out via dividends (the earnings distributed to a company's shareholders).

[Balance sheet](#): This is the third financial statement prepared. The balance sheet shows a company's financial position at any point in time, rather than over a period. To prepare a company's balance sheet, all that is needed is the company's assets, liabilities, and equity.

[Statement of cash flows](#): This is the last financial statement prepared. The statement of cash flows lists the cash inflows and outflows for a company over a period, such as a month, a quarter, or a year.

### Income Statement

When doing income statements, it is important to account for all types of revenues and expenses. For example, common types of revenue accounts include sales, commissions, fees earned, interest revenue, and service revenue. Common types of expense accounts include depreciation expense, salary expense, rent expense, utilities expense, income tax expense, and interest expense. The reason the income statement is prepared first is because the final product is net income, which is needed for the statement of retained earnings.

**Example:**

ABC Company had a total revenue of \$55,000 during the fiscal year, ending on December 31st. Of the company's total revenue, \$50,000 was from service revenue, \$4,000 was from sales, and \$1,000 was from fees earned. Also, ABC Company had \$28,000 in total expenses. Of the expenses, \$10,000 came from paying employee salaries, \$8,000 came from rent expenses, and \$5,000 came from interest expenses. Furthermore, ABC Company had \$3,000 of income tax expenses, \$1,000 in depreciation expenses, \$1,000 of utility expenses. A class assignment may require students to complete an income statement that would look like the following table.

Income Statement	ABC Company		For Fiscal Year Ended December 31
<b>Revenues</b>			
	Service revenue	<b>\$50,000</b>	
	Sales	<b>4,000</b>	
	Fees earned	<b>1,000</b>	
	Total revenues		<b>\$55,000</b>
<b>Expenses</b>			
	Salary expense	<b>\$10,000</b>	
	Rent expense	<b>8,000</b>	
	Interest expense	<b>5,000</b>	
	Income tax expense	<b>3,000</b>	
	Depreciation expense	<b>1,000</b>	
	Utilities expense	<b>1,000</b>	
	Total expenses		<b>\$28,000</b>
<b>Net income</b>			<b>\$27,000</b>

It should be noted that the net income of \$27,000 was calculated by subtracting the total expenses of \$28,000 from the total revenues of \$55,000. ABC Company's net income will be used to prepare the next financial statement, which is the statement of retained earnings.

## Statement of Retained Earnings

The reason this is the second statement to prepare is because the retained earnings are needed to prepare the equity section of the balance sheet. The first item needed to determine a company's retained earnings for a period is to record the retained earnings from the beginning of the period. Next, add the company's net income from the income statement to the amount of retained earnings at the beginning of the period. Finally, subtract how much money was paid in dividends to the company's shareholders.

### Example:

The following table shows ABC Company's retained earnings as of the end of the fiscal year on December 31st. It should be noted that ABC Company started the year with \$12,000 in retained earnings. They also had a net income of \$27,000 for year, which was calculated by preparing the income statement. Lastly, they paid out \$4,000 in dividends to company shareholders during the fiscal year. A class assignment may require students to complete a statement of retained earnings for ABC Company that would look like the following table.

Statement of Retained Earnings	ABC Company	For Fiscal Year Ended December 31st
	Retained earnings (January 1st)	<b>\$12,000</b>
Add	Net income	<b>27,000</b>
		<b>\$39,000</b>
Subtract	Dividends	<b>4,000</b>
	Retained earnings (December 31st)	<b>\$35,000</b>

In this example, ABC Company started the fiscal year with \$12,000. After adding \$27,000 to that amount, the running total is \$39,000. Next, \$4,000 is subtracted from that to account for dividend payments. Therefore, ABC Company ends the year with \$35,000 in retained earnings. The \$35,000 in retained earnings will be needed to prepare the equity section of the next financial statement, the balance sheet.

## Balance Sheet

The balance sheet is prepared using the accounting equation formula. Therefore, it should be set up as  $\text{assets} = \text{liabilities} + \text{equity}$ . The company's asset accounts should be recorded on the left side of the page, while its liabilities and equity accounts should be recorded on the right side of the page. Assets are any tangible item of value that a company owns. Common examples of assets are cash, accounts receivable, land, equipment, and inventory. Liabilities are debts the company owes to other entities, such as lenders, sellers, and other companies. Common examples of liabilities are accounts payable, wages payable, notes payable, and taxes payable. The difference between a company's assets and liabilities is the company's equity. Within the equity section of the balance sheet, the company's retained earnings and common stock are listed. The reason the balance sheet is the third statement prepared is because the cash account balance in assets is needed for the statement of cash flows. The following table shows ABC Company's balance sheet on December 31st.

### Example:

On December 31st, ABC Company had \$75,000 in total assets. Of their assets, they had \$50,000 in cash, \$20,000 in inventory, and \$5,000 in accounts receivable. ABC Company also had \$27,000 in total liabilities. Of their liabilities, they had \$15,000 in wages payable, \$6,000 in accounts payable, \$3,000 in taxes payable, and \$3,000 in notes payable. In addition, ABC Company had \$48,000 in equity. Of their equity, they had \$13,000 in common stock and \$35,000 in retained earnings. A class assignment may require students to complete a balance sheet for ABC Company that would look like the following table.

Balance Sheet	ABC Company		December 31st
<b>Assets</b>		<b>Liabilities</b>	
Cash	<b>\$50,000</b>	Wages payable	<b>\$15,000</b>
Inventory	<b>20,000</b>	Accounts payable	<b>6,000</b>
Accounts receivable	<b>5,000</b>	Taxes payable	<b>3,000</b>
		Notes payable	<b>3,000</b>
		Total liabilities	<b>\$27,000</b>
		<b>Equity</b>	
		Common stock	<b>\$13,000</b>
		Retained earnings	<b>35,000</b>
		Total equity	<b>\$48,000</b>
Total assets	<b>\$75,000</b>	Total liabilities and equity	<b>\$75,000</b>

In the example above, it should be noted that the value of the total assets equals the value of the total liabilities and equity combined, which is \$75,000 for each. Also, remember that the retained earnings from the previous statement were used to prepare the equity section of the balance sheet. To prepare the next statement, which is the statement of cash flows, the cash account balance in the assets section will be needed. Therefore, the \$50,000 in cash will be used to prepare the statement of cash flows.

### **Statement of Cash Flows**

The statement of cash flows is divided into three sections. The first section is the cash flows from operating activities. Examples of operating activity accounts include wages, salaries, interest payments, interest income, cash receipts from customers, and cash paid to vendors. The second section is the cash flows from investing activities. For example, investing cash flows could be the buying and selling of an asset, such as equipment. The third section is the cash flows from financing activities. Examples of financing cash flows would be dividends paid to shareholders, cash investments by investors, bond issuances, and repayment of loans. The sum of net cash flows from all three activities should equal the cash balance in the cash account from the balance sheet. Additionally, there are two different methods to prepare the statement of cash flows: the direct method and the indirect method.

The following example shows ABC Company's statement of cash flows for the fiscal year that ended on December 31st. ABC Company uses the direct method in the following example. It should be noted that account balances in parentheses indicate a negative balance for that account.

#### **Example:**

At the beginning of the fiscal year, ABC Company had \$0 in cash. During the year, they increased that amount by \$50,000, to end with \$50,000. ABC Company accumulated a net total of \$52,000 from operating activities. Even though they received \$70,000 cash from customer receipts, they paid \$10,000 to vendors and \$8,000 for rent. ABC Company had a negative balance of \$18,000 for investing activities during the year. Of that \$18,000, \$12,000 went toward purchasing vehicles, \$4,000 went toward purchasing computer equipment, and \$2,000 went toward purchasing furniture. For financing activities, ABC Company accumulated a net total of \$16,000. Even though they received \$26,000 in investments from investors, they still paid \$6,000 towards their bank loan, and \$4,000 via dividends toward their shareholders. A class assignment may require students to complete a statement of cash flows for ABC Company that would look like the table on the following page.

ABC Company	Statement of Cash Flows	Fiscal Year Ended on December 31st	
<b>Cash flows from operating Activities</b>			
	Cash receipts from customers	<b>\$70,000</b>	
	Cash paid to vendors	<b>(10,000)</b>	
	Cash paid for rent	<b>(8,000)</b>	
	Net cash from operating activities		\$52,000
<b>Cash flows from investing activities</b>			
	Cash paid for vehicles	<b>\$(12,000)</b>	
	Cash paid for computer equipment	<b>(4,000)</b>	
	Cash paid for furniture	<b>(2,000)</b>	
	Net cash from investing activities		\$(18,000)
<b>Cash flows from financing activities</b>			
	Cash investments from investors	<b>\$26,000</b>	
	Cash paid towards bank loan	<b>(6,000)</b>	
	Cash paid in the form of dividends to shareholders	<b>(4,000)</b>	
	Net cash from financing activities		\$16,000
<b>Net increase in cash</b>			\$50,000
<b>Cash balance, January 1st</b>			\$0
<b>Cash balance, December 31st</b>			\$50,000

It should be noted that the ending cash balance equals the cash balance on the balance sheet, which is \$50,000. The \$50,000 was calculated by adding the net cash from operating, investing, and financing activities. It should also be noted that ABC Company started the fiscal year with \$0 in cash and increased that amount to \$50,000 cash by the end of the year.

For more accounting resources, visit the Helpful Handouts webpage on Germanna's Academic Center for Excellence website at <https://www.germannna.edu/academic-center-for-excellence/helpful-handouts/#accounting>.

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