

Financial Statements

Income Statements

Sometimes referred to as a "statement of operations," "statement of profit and loss," "P & L statement" or "statement of earnings." An income statement is a general purpose financial statement which lists a company's revenues less expenses and the resulting net income or net loss for a period of time. (According to GAAP a public company's earnings per share must also be disclosed in the income statement.)

Definition of Parts of the Income Statement

Sales Revenues- Revenues resulting from a company's product sales to customers. Revenues from the rendering of services to customers may also be referred to as "sales revenues" or "service fee revenues." Sales revenues may also be identified as either cash sales or credit sales based on whether the sales price is paid in cash at the point of sale or the sale is made on account.

Costs of Goods Sold- Cost of goods sold reflects the cost of any products sold to customers. A company's product costs are first accounted for as assets (inventory) until the products are actually sold and become an expense of the business (cost of goods sold). In a merchandising business, a product's cost is its purchase price and any freight or other costs associated with actually obtaining the product from a supplier or vendor. In a manufacturing business, a product's cost includes any direct material, direct labor and manufacturing overhead costs incurred in making the product.

Gross Margin- Also referred to as "gross profit" or a company's overall "markup" or "margin." Gross margin is equal to the amount of a company's net sales revenues less cost of goods sold for a period of time. A company's gross margin does not equal its net income because other operating expenses, other revenues and expenses and income taxes must also be taken into account in the determination of net income.

Operating Expenses- A company's costs incurred as a result of its normal recurring business activities. Operating expenses include the cost of goods sold for manufacturing or merchandising businesses or the cost of providing services for a service business. In addition, operating expenses include any costs incurred in selling the goods or services to customers and any costs incurred in administering or managing the overall business operations (selling and administrative costs). Any interest costs incurred by a company could arguably be classified as an operating expense; however, the costs of financing a business as opposed to operating a business are traditionally reflected as "other expenses." Operating expenses are often reflected as a category in a multi-step formatted income statement and typically include only the selling and administrative expenses of a company. Cost of goods sold, although an operating expense, is excluded from this category because it is reflected separately in a multi-step format to generate a company's gross margin.

Interest Revenue- Also referred to as "interest income." Interest revenue is the amount of interest received plus the amount of any interest receivable as a result of interest earned during the current period on any company loans or other interest bearing investments.

Income Taxes- The cost of both federal and state income taxes paid and/or payable in the future as a result of a corporation's earnings in the current period. Only corporations incur income taxes that would be reflected on a company's income statement. Companies operating as proprietorships or partnerships do not pay income tax; however, their profits are subject to taxes to be paid for personally by the owners. Corporate owners (stockholders) are also taxed personally on company profits to the extent those profits are distributed as dividends. As a result, corporate profits paid as dividends face "double taxation."

Net Income- Net income is equal to a company's total revenues less total expenses over a period of time and is reported through a company's income statement. Net income may also be defined as the amount of any increase in a company's net assets during a period of time due to profitable operations.

EPS (Earnings Per Share)- earnings per share is the amount of a company's net income earned during the year for each share of its common stock outstanding. Disclosure of a company's EPS on its income statement is required under GAAP. The amount is calculated by dividing a company's net income by the number of its shares of common stock outstanding. This calculation can become substantially more complicated with the existence of preferred stock, stock options and other factors covered in more advanced accounting courses. A company's earnings per share is usually different from the amount of its dividends per share due to the fact that companies can and often do choose to retain all or a portion of their earnings for use in the business. A company's EPS is a critical in financial statement analysis and stock valuation. In fact, a company's EPS and financial analysts' projections of future EPS are probably the most significant factors impacting a stock's current fair market value.

ABC Company Income Statement For the year ended December 31, 20X4

	<u>20X4</u>
Sales Revenue	\$185,043
Cost of Goods Sold	<u>111,026</u>
Gross Margin	74,017
Operating Expenses:	
Salaries Expense	49,500
Office Supplies Expense	3,893
Rent Expense	4,150
Utilities Expense	6,345
Misc. Expense	2,336
Insurance Expense	1,055
Postage Expenses	<u>298</u>
Operating Expenses	<u>67,577</u>
Operating Income	6,440
Other Revenues and Expenses	
Rental Revenue	0
Interest Revenue	<u>135</u>
Other Revenue	135
Less: Interest Expense	<u>0</u>
Other Revenue/Expenses	<u>135</u>
Income Before Income Taxes	6,575
Less: Income Taxes	<u>1,644</u>
Net Income (Loss)	<u>\$4,931</u>
Earnings Per Share	<u>\$2.05</u>

Cash Flow Statement

The cash-flow statement shows all sources and uses of a company's money during the accounting period. Sources of cash listed on the statement include revenues, long-term financing, sales of non-current assets, an increase in any current liability account or a decrease in any current asset account. Uses of cash include operating losses, debt repayment, equipment purchases and increases in any current asset account.

Steps to creating a Cash Flow Statement

1. Identify the type of business events that are reported in the three sections of the statement of cash flows: operating, investing, or financing.
2. Record the operating activities.
3. Record the total cash outflows.
4. Record the net cash flow from operating activities.
5. Record the investing activities.
6. Record the net cash flow from investing activities.
7. Record the financing activities.
8. Record the net cash flow from financing activities.
9. Record the net increase or decrease in cash.
10. Record the cash balance from the beginning of the current year.
11. Record the ending cash balance.

3 Parts to a Cash Flow Statement

1. **Operating Activities-** Operating activities are the daily internal activities of a business that either require cash or generate it. They include cash collections from customers; cash paid to suppliers and employees; cash paid for operating expenses, interest and taxes; and cash revenue from interest dividends.
2. **Investing Activities-** includes cash activities related to the acquisition and disposal of assets not directly related to period expenses (purchasing of equipment). Usually cash activity is related to long-term assets.
3. **Financing Activities-** includes cash flow activity related to obtaining and repaying resources of the business. This includes the borrowing and the repaying of most debt, issuing stock, treasury stock transactions, and the payment of cash dividends.

ABC Company Statement of Cash Flows For the year ended December 31, 2005

Cash Flows from Operating Activities			
Cash Receipts from:			
Sales		\$905,000	
Cash Payments for:			
Inventory Purchases	\$(660,000)		
Wages	(108,000)		
Rent	(29,000)		
Interest	(10,000)		
Total Cash Outflows		<u>(807,000)</u>	
Net Cash Flow from Operating Activities			\$98,000
Cash Flows from Investing Activities			
Outflow to Purchase Equipment		<u>(80,000)</u>	
Net Cash Flow from Investing Activities			(80,000)
Cash Flows from Financing Activities			
Inflow from Issuance of Bonds		50,000	
Outflow to Purchase Treasury Stock		(40,000)	
Outflow to Pay Dividends		<u>(20,000)</u>	
Net Cash Flow from Financing Activities			<u>(10,000)</u>
Net Increase in Cash			8,000
Add: Cash Balance, January 1, 2005			<u>20,000</u>
Cash Balance, December 31, 2005			<u>\$28,000</u>

BALANCE SHEETS

What is a *balance sheet* and why is it an important part of a start-up business?

A **balance sheet** is a type of a financial statement. Along with an **income statement** and a **cash flow statement**, a balance sheet is an important tool for you, the entrepreneur, to help you see the assets owned by your business, as well as the liabilities, or what you owe against those assets. It is also an information piece you will need to show bankers and potential investors that what you have is worth investing in. They will use it to calculate key ratios, such as debt to equity and current ratio. Balance sheets are typically prepared at the end of the year, and are particularly important for the first three years of operation.

How do I prepare one?

A balance sheet has two main sections – one showing the assets of the business (what you have going for you) and one showing the liabilities (what debts, etc you have against you) and capital of the business. These two sides must balance.

If your business experience is limited, and financial statements such as these are not familiar to you, it would be smart to find another student or professional, a CPA or an accounting major for example, who understands this process and can easily walk you through the process, or even do it for you. It will save you both time and money, and can help you accelerate the launching of your business idea.

What if you are starting a new business?

If you are starting a new business, you may not have historical data to compile in financial statements. Still, you must estimate how much money you will need, what your expenses will be at different sales levels, and how much money you can expect to make. Financial planning and budgeting are important parts of the business planning process. Making financial projections can even show you whether or not you should start the business. Are the financial risks you are about to take worth the realistic return you can expect?

[Company Name] Balance Sheet For year ended [month] [day], [year]

	YEAR 1
Assets	
Current Assets:	
Cash	\$ _____
Accounts Receivable	_____
Inventory	_____
Supplies	_____
Prepaid Expenses	_____
Fixed Assets	
Real Estate	_____
Equipment	_____
Fixtures and Leasehold Improvements	_____
Vehicles	_____
Other Assets	
License	_____
Goodwill	_____
TOTAL ASSETS	\$ _____
Liabilities & Equity	
Current Liabilities:	
Accounts Payable	_____
Notes Payable (due within 1 year)	_____
Accrued Expenses	_____
Taxes Owed	_____
Long-Term Liabilities	
Notes Payable (due after 1 year)	_____
Bank Loans	_____
TOTAL LIABILITIES	\$ _____
NET WORTH (assets minus liabilities)	\$ _____