



## Financial Statements

Businesses report information in the form of financial statements issued on a periodic basis. GAAP (Generally Accepted Accounting Principles) requires the following four financial statements

- **Balance Sheet** - statement of financial position at a given point in time.
- **Income Statement** - revenues minus expenses for a given time period ending at a specified date.
- **Statement of Owner's Equity** - also known as Statement of Retained Earnings or Equity Statement.
- **Statement of Cash Flows** - summarizes sources and uses of cash; indicates whether enough cash is available to carry on routine operations.

### **Balance Sheet**

The balance sheet is based on the following fundamental accounting model:

$$\mathbf{Assets = Liabilities + Equity}$$

Assets can be classed as either current assets or fixed assets. Current assets are assets that quickly and easily can be converted into cash, sometimes at a discount to the purchase price. Current assets include cash, accounts receivable, marketable securities, notes receivable, inventory, and prepaid assets such as prepaid insurance. Fixed assets include land, buildings, and equipment. Such assets are recorded at historical cost, which often is much lower than the market value.

Liabilities represent the portion of a firm's assets that are owed to creditors. Liabilities can be classed as short-term liabilities (current) and long-term (non-current) liabilities. Current liabilities include accounts payable, notes payable, interest payable, wages payable, and taxes payable. Long-term liabilities include mortgages payable and bonds payable. The portion of a mortgage long-term bond that is due within the next 12 months is classed as a current liability, and usually is referred to as the current portion of long-term debt. The creditors of a business are the primary claimants, getting paid before the owners should the business cease to exist.

Equity is referred to as owner's equity in a sole proprietorship or a partnership, and stockholders' equity or shareholders' equity in a corporation. The equity owners of a business are residual claimants, having a right to what remains only after the creditors have been paid. For a sole proprietorship or a partnership, the equity would be listed as the owner or owners' names followed by the word "capital".

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**For example:**

**Sole Proprietorship:** Samnang, Capital

**Partnership:** Deth, Capital  
Lim Soksophay, Capital

In the case of a corporation, equity would be listed as common stock, preferred stock, and retained earnings.

The balance sheet reports the resources of the entity. It is useful when evaluating the ability of the company to meet its long-term obligations. Comparative balance sheets are the most useful; for example, for the years ending December 31, 2000 and December 31, 2001.

### **Income Statement**

The income statement presents the results of the entity's operations during a period of time, such as one year. The simplest equation to describe income is:

$$\text{Net Income} = \text{Revenue} - \text{Expenses}$$

Revenue refers to inflows from the delivery or manufacture of a product or from the rendering of a service. Expenses are outflows incurred to produce revenue.

Income from operations can be separated from other forms of income. In this case, the income can be described by:

$$\text{Net Income} = \text{Revenue} - \text{Expenses} +/- \text{Gains or Losses}$$

where gains refer to items such as capital gains, and losses refer to capital losses, losses from natural disasters, etc.

### **Statement of Owners' Equity** (Statement of Retained Earnings)

The equity statement explains the changes in retained earnings. Retained earnings appear on the balance sheet and most commonly are influenced by income and dividends. The Statement of Retained Earnings therefore uses information from the Income Statement and provides information to the Balance Sheet.

The following equation describes the equity statement for a sole proprietorship:

$$\text{Ending Equity} = \text{Beginning Equity} + \text{Investments} - \text{Withdrawals} + \text{Income}$$

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For a corporation, substitute "Dividends Paid" for "Withdrawals". The stockholders' equity in a corporation is calculated as follows:

$$\begin{aligned} & \text{Common Stock (recorded at par value)} \\ + & \text{Premium on Common Stock (issue price minus par value)} \\ + & \text{Preferred Stock (recorded at par value)} \\ + & \text{Premium on Preferred Stock (issue price minus par value)} \\ + & \text{Retained Earnings} \\ \hline = & \text{ **Stockholders' Equity** } \end{aligned}$$

Note that the premium on the issuance of stock is based on the price at which the corporation actually sold the stock on the market. Afterwards, market trading does not affect this part of the equity calculation. Stockholders' equity does not change when the stock price changes!

### **Cash Flow Statement**

The nature of accrual accounting is such that a company may be profitable but nonetheless experience a shortfall in cash. The statement of cash flows is useful in evaluating a company's ability to pay its bills. For a given period, the cash flow statement provides the following information:

- Sources of cash
- Uses of cash
- Change in cash balance

The cash flow statement represents an analysis of all of the transactions of the business, reporting where the firm obtained its cash and what it did with it. It breaks the sources and uses of cash into the following categories:

- Operating activities
- Investing activities
- Financing activities

The information used to construct the cash flow statement comes from the beginning and ending balance sheets for the period and from the income statement for the period.

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