

5. The Core Financial Statements

Your future will undoubtedly be marked by numerous decisions about investing money in the capital stock of some corporation. Another option that will present itself is to lend money to a company, either directly, or by buying that company's debt instruments known as "bonds." Stocks and bonds are two of the most prevalent financial instruments of the modern global economy. The financial press and television devote seemingly endless coverage to headline events pertaining to large public corporations. Public companies are those with securities that are readily available for purchase/sale through organized stock markets. Many more companies are private, meaning their stock and debt is in the hands of a narrow group of investors and banks. If you are contemplating an investment in a public or private entity, there is certain information you will logically seek to guide your decision process. What types of information will you desire? What do you want to know about the companies in which you are considering an investment? If you were to prepare a list of questions for the company's management, what subjects would be included? Whether this challenge is posed to a sophisticated investor or to a new business student, the listing almost always includes the same basic components.

What are the corporate assets? Where does the company operate? What are the key products? How much income is being generated? Does the company pay dividends? What is the corporate policy on ethics and environmental responsibility?

Many such topics are noted within the illustrated "thought cloud." Some of these topics are financial in nature (noted in blue). Other topics are of more general interest and cannot be communicated in strict mathematical terms (noted in red),



Financial accounting seeks to directly report information for the topics noted in blue. Additional supplemental disclosures frequently provide insight about subjects such as those noted in red. But, you would also need to gain additional information by reviewing corporate web sites (many have separate sections devoted to their investors), filings with the securities regulators, financial journals and magazines, and other such sources. Most companies will have annual meetings for shareholders and host web casts every three months (quarterly). These events are very valuable in allowing investors and creditors to make informed decisions about the company, as well as providing a forum for direct questioning of management. You might even call a company and seek "special insight"

about emerging trends and developments. Be aware, however, that the company will likely not be able to respond in a meaningful way. Securities laws have very strict rules and penalties that are meant to limit selective or unique disclosures to any one investor or group (in the United States: Regulation Full Disclosure/Reg. FD). It is amusing, but rarely helpful, to review “message boards” where people anonymously post their opinions about a company.

5.1 Financial Statements

Financial accounting information is conveyed through a standardized set of reports. You have already been introduced to the balance sheet. The other fundamental financial statements are the income statement, statement of retained earnings, and statement of cash flows. There are many rules that govern the form and content of each financial statement. At the same time, those rules are not so rigid as to preclude variations in the exact structure or layout. For instance, the earlier illustration for Edelweiss was first presented as a “horizontal” layout of the balance sheet. The subsequent Edelweiss examples were representative of “vertical” balance sheet arrangements. Each approach, and others, is equally acceptable.

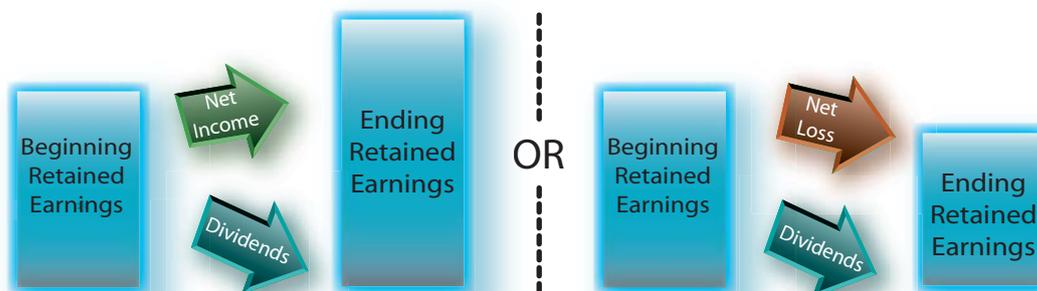
5.2 Income Statement

A summary of an entity’s results of operation for a specified period of time is revealed in the income statement, as it provides information about revenues generated and expenses incurred. The difference between the revenues and expenses is identified as the net income or net loss. The income statement can be prepared using a single-step or a multiple-step approach, and might be further modified to include a number of special disclosures relating to unique items. These topics will be amplified in a number of subsequent chapters. For now, take careful note that the income statement relates to activities of a specified time period (e.g., year, quarter, month), as is clearly noted in its title:

QUARTZ CORPORATION Income Statement For the Year Ending December 31, 20X9		
Revenues		
Services to customers	\$750,000	
Interest revenue	<u>15,000</u>	
Total revenues		\$765,000
Expenses		
Salaries	\$235,000	
Rent	115,000	
Other operating expenses	<u>300,000</u>	
Total expenses		<u>650,000</u>
Net income		<u><u>\$115,000</u></u>

5.3 The Statement of Retained Earnings

The example balance sheets for Edelweiss revealed how retained earnings increased and decreased in response to events that impacted income. You also know that retained earnings are reduced by dividends paid to shareholders.



The statement of retained earnings provides a succinct reporting of these changes in retained earnings from one period to the next. In essence, the statement is nothing more than a reconciliation or “bird’s-eye view” of the bridge between the retained earnings amounts appearing on two successive balance sheets.

QUARTZ CORPORATION Statement of Retained Earnings For the Year Ending December 31, 20X9	
Retained earnings - January 1, 20X9	\$400,000
Plus: Net income	<u>115,000</u>
	\$515,000
Less: Dividends	<u>35,000</u>
Retained earnings - December 31, 20X9	<u>\$480,000</u>

If you examine very many sets of financial statements, you will soon discover that many companies provide an expanded statement of stockholders’ equity in lieu of the required statement of retained earnings. The statement of stockholders’ equity portrays not only the changes in retained earnings, but also changes in other equity accounts such as capital stock. The expanded statement of stockholders’ equity is presented in a subsequent chapter.

5.4 Balance Sheet

The balance sheet focuses on the accounting equation by revealing the economic resources owned by an entity and the claims against those resources (liabilities and owners' equity). The balance sheet is prepared as of a specific date, whereas the income statement and statement of retained earnings cover a period of time. Accordingly, it is sometimes said that balance sheets portray financial position (or condition) while other statements reflect results of operations. Quartz's balance sheet is as follows:

QUARTZ CORPORATION Balance Sheet December 31, 20X9		
Assets		
Cash		\$192,000
Accounts receivable		248,000
Land		450,000
Other assets		<u>10,000</u>
Total assets		<u>\$900,000</u>
Liabilities		
Salaries payable	\$ 34,000	
Accounts payable	<u>166,000</u>	
Total liabilities		\$200,000
Stockholders' equity		
Capital stock	\$220,000	
Retained earnings	<u>480,000</u>	
Total stockholders' equity		<u>700,000</u>
Total liabilities and equity		<u>\$900,000</u>

5.5 Statement of Cash Flows

The statement of cash flows details the enterprise's cash flows. This operating statement reveals how cash is generated and expended during a specific period of time. It consists of three unique sections that isolate the cash inflows and outflows attributable to (a) operating activities, (b) investing activities, and (c) financing activities. Notice that the cash provided by operations is not the same thing as net income found in the income statement. This result occurs because some items hit income and cash flows in different periods. For instance, remember how Edelweiss (from the earlier illustration) generated income from a service provided on account. That transaction increased income without a similar effect on cash. These differences tend to even out over time.

QUARTZ CORPORATION Statement of Cash Flows For the Year Ending December 31, 20X9	
Operating activities	
Cash received from customers	\$ 720,000
Cash received for interest	15,000
Cash paid for salaries	(240,000)
Cash paid for rent	(115,000)
Cash paid for other items	<u>(300,000)</u>
Cash provided by operating activities	\$ 80,000
Investing activities	
Purchase of land	(250,000)
Financing activities	
Payment of dividends	<u>(35,000)</u>
Decrease in cash	\$(205,000)
Cash, January 1	<u>397,000</u>
Cash, December 31	<u>\$ 192,000</u>

Suffice it to say that the underpinnings of the statement cash flows require a fairly complete knowledge of basic accounting. Do not be concerned if you feel like you lack a complete comprehension at this juncture. A future chapter is devoted to the statement.



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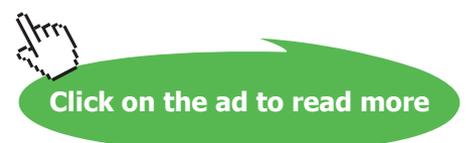
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Sources: Keuzegids Master ranking 2013; Elsevier 'Beste Studies' ranking 2012; Financial Times Global Masters in Management ranking 2012

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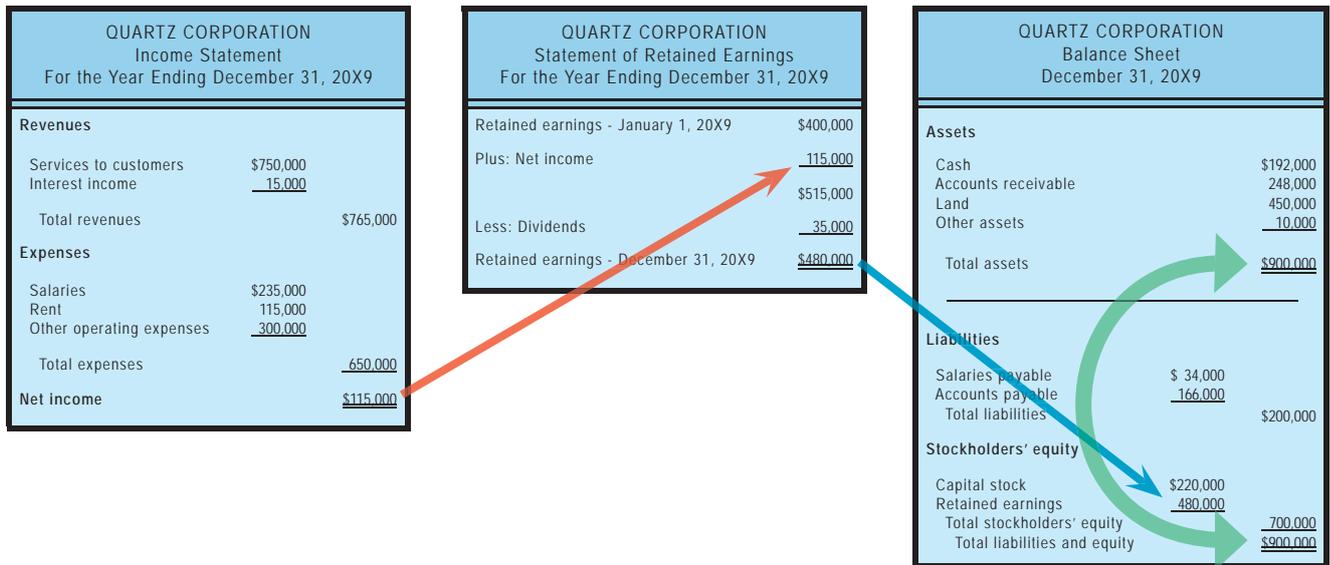
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5.6 Articulation

It is important for you to take note of the fact that the income statement, statement of retained earnings, and balance sheet articulate. This means they mesh together in a self-balancing fashion. The income for the period ties into to the statement of retained earnings, and the ending retained earnings ties into the balance sheet. This final tie-in causes the balance sheet to balance. These relationships are illustrated in the following diagram.



5.7 Unlocking the Mystery of Articulation

It seems almost magical that the final tie-in of retained earnings will exactly cause the balance sheet to balance. This is reflective of the brilliance of Pacioli's model, and is indicative of why it has survived for centuries.