

Basic Financial Statements

Chapter 2

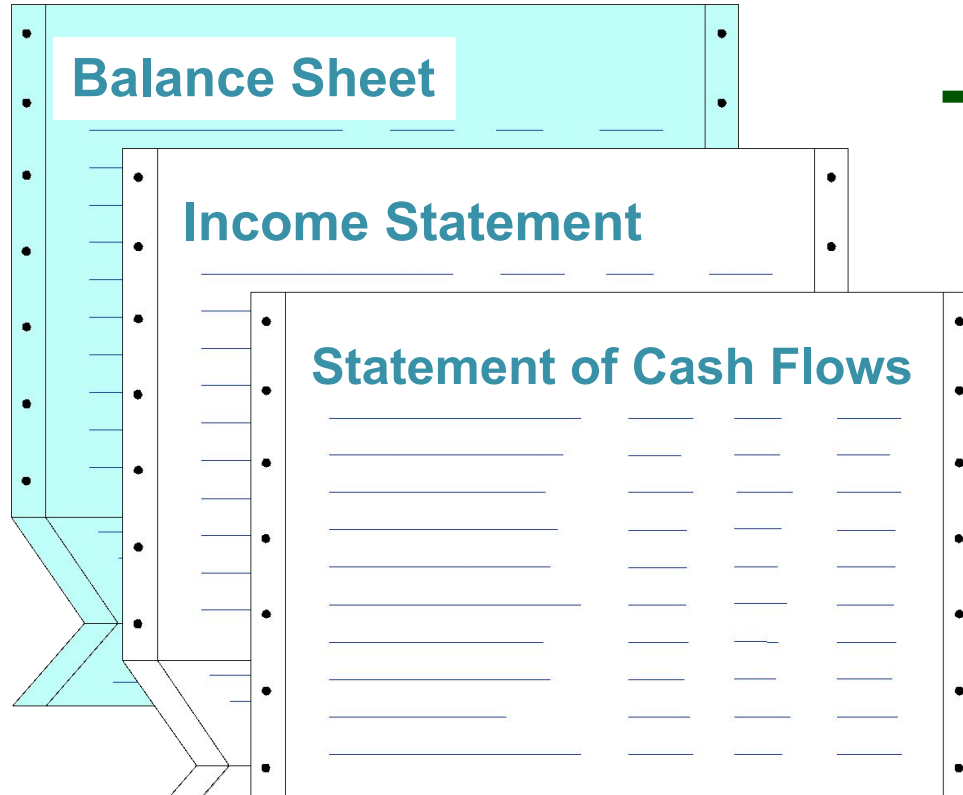


The Concept of the Business Entity



A business entity is separate from the personal affairs of its owner.

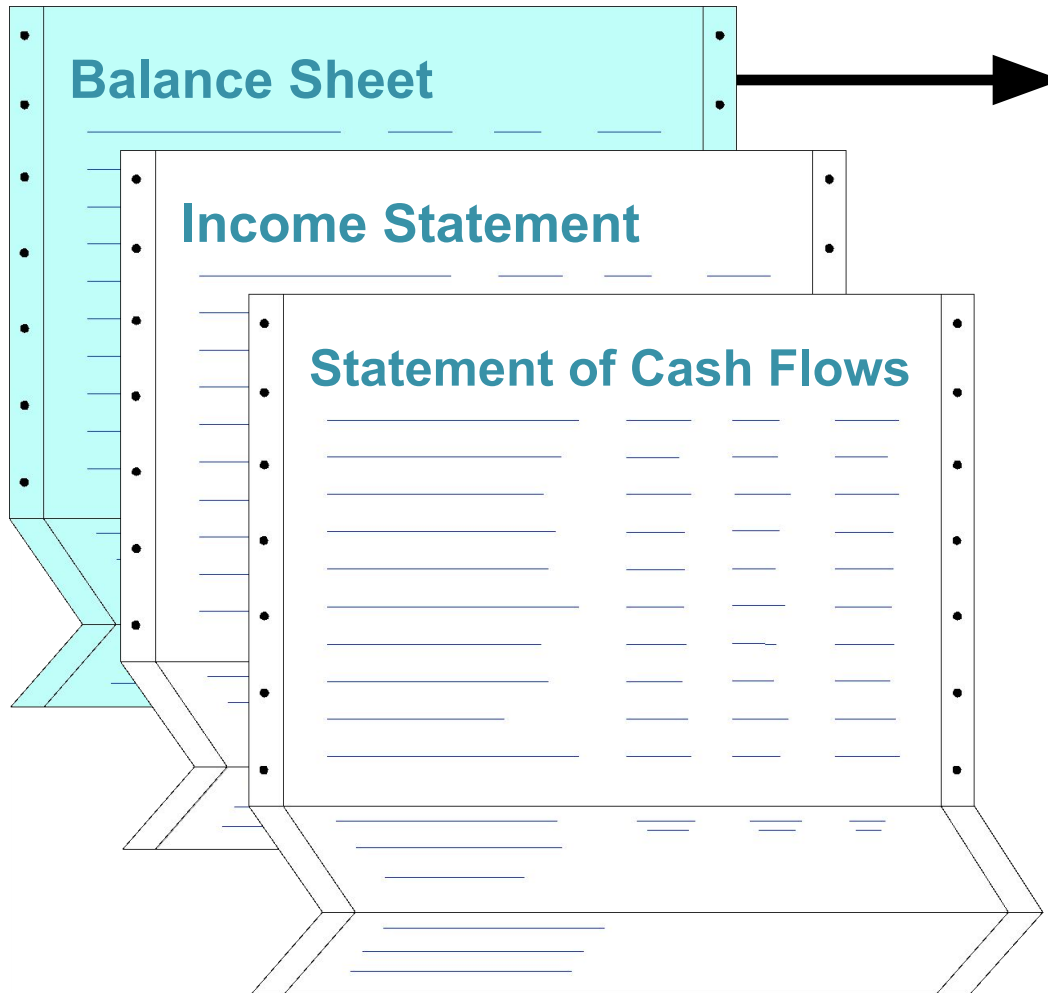
Introduction to Financial Statements



**Three primary
financial
statements.**

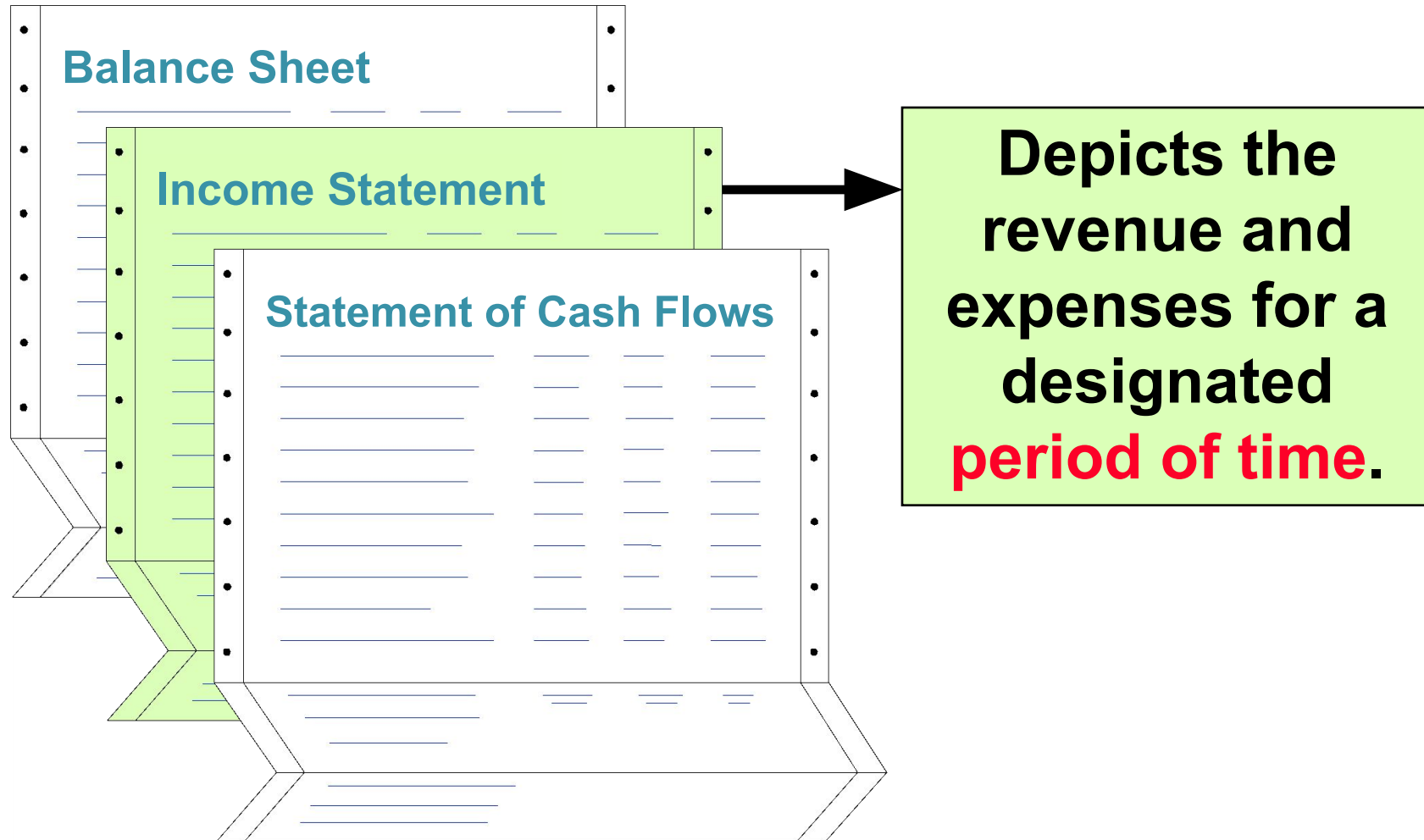
We will use a **corporation to describe these statements.**

Introduction to Financial Statements

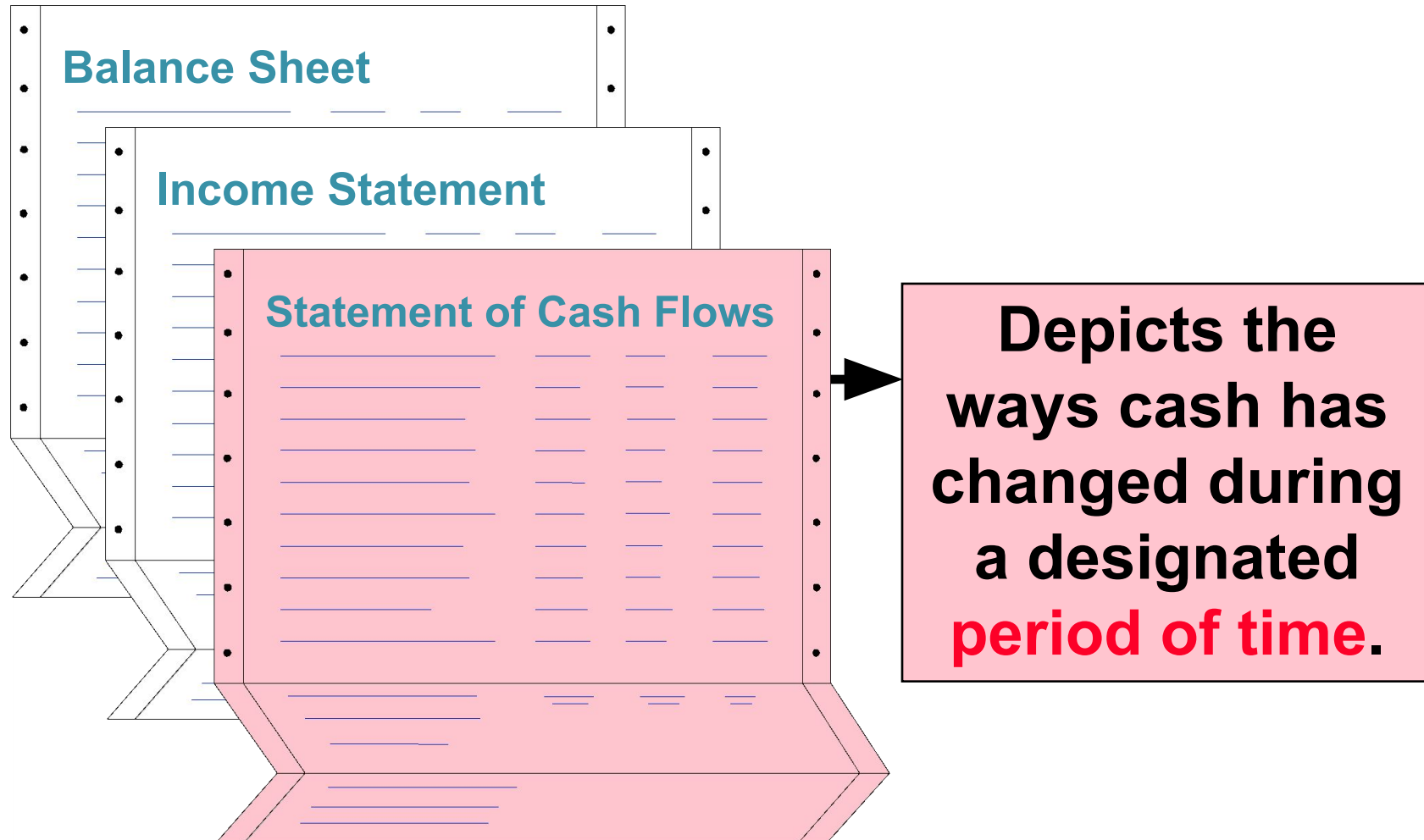


Describes where the enterprise stands **at a specific date.**

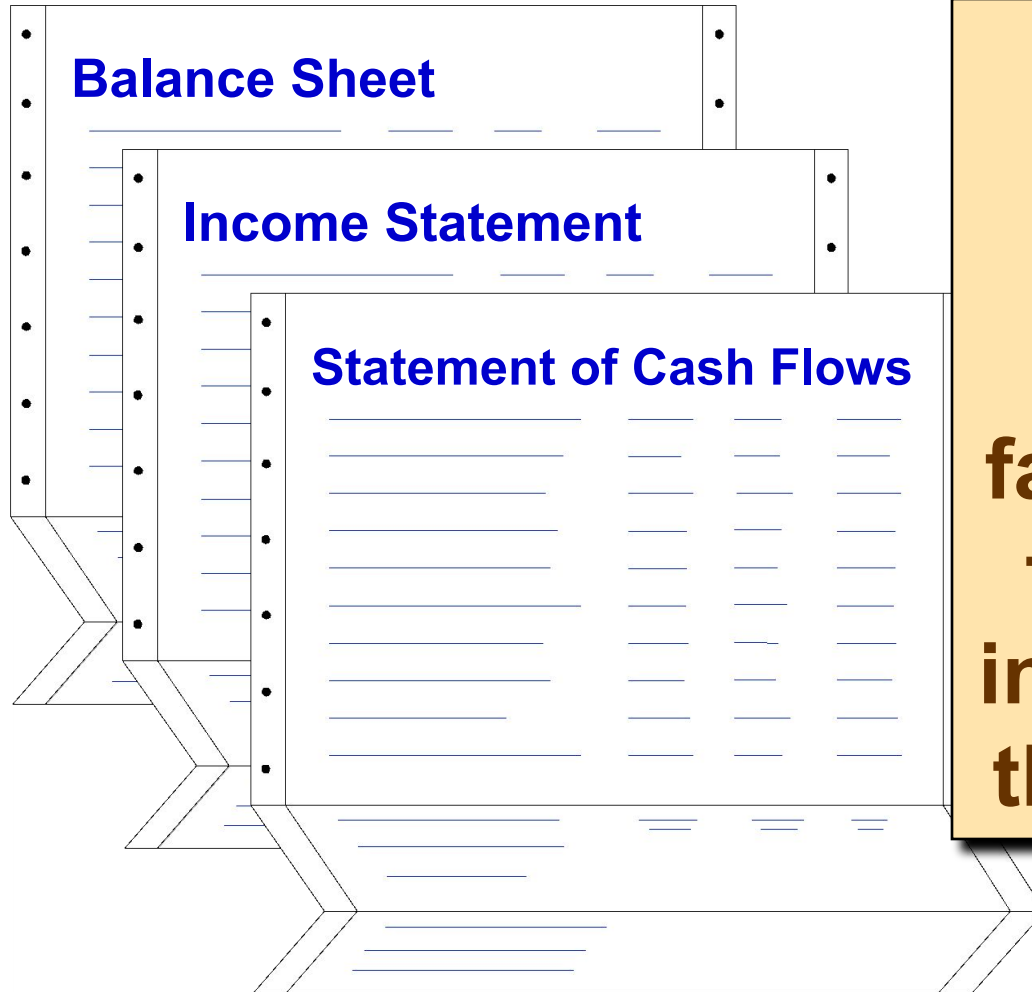
Introduction to Financial Statements



Introduction to Financial Statements



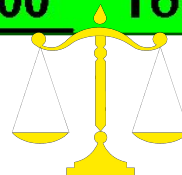
The Need for Adequate Disclosure



Notes to the financial statements often provide facts necessary for the proper interpretation of the statements.

A Starting Point: Statement of Financial Position

Vagabond Travel Agency Balance Sheet December 31, 2009			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,500	Liabilities:	
Notes receivable	10,000	Notes payable	\$ 41,000
Accounts receivable	60,500	Accounts payable	36,000
Supplies	2,000	Salaries payable	3,000
Land	100,000	Total liabilities	\$ 80,000
Building	90,000	Owners' Equity:	
Office equipment	15,000	Capital stock	150,000
		Retained earnings	70,000
Total	\$ 300,000	Total	\$ 300,000



Assets

Vagabond Balanc Decemb	
Assets	
Cash	\$ 22,500
Notes receivable	10,000
Accounts receivable	60,500
Supplies	2,000
Land	100,000
Building	90,000
Office equipment	15,000
Total	\$ 300,000

Assets are economic resources that are owned by the business and are expected to benefit future operations.

Assets

These accounting principles support **cost** as the basis for asset valuation.

Stable-Dollar
Assumption

Cost
Principle

Objectivity
Principle

Going-Concern
Assumption

Liabilities

Liabilities are debts that represent negative future cash flows for the enterprise.

**Vagabond Travel Agency
Balance Sheet
December 31, 2009**

Liabilities & Owners' Equity	
Liabilities:	
Notes payable	\$ 41,000
Accounts payable	36,000
Salaries payable	3,000
Total liabilities	\$ 80,000
Owners' Equity:	
Capital stock	150,000
Retained earnings	70,000
Total	\$ 300,000

Owners' Equity

Vagabond Travel Agency Balance Sheet December 31, 2009			
Owners' equity represents the owners' claims on the assets of the business.	Liabilities & Owners' Equity		
	Liabilities:		
	Notes payable	\$	41,000
	Accounts payable		36,000
	Salaries payable		3,000
	Total liabilities		\$ 80,000
	Owners' Equity:		
Capital stock		150,000	
Retained earnings		70,000	
Total	\$ 300,000	Total	\$ 300,000

The Accounting Equation

Assets = Liabilities + Owners' Equity

\$300,000 = \$80,000 + \$220,000

Cash	\$ 22,500	Liabilities:	
Notes receivable	10,000	Notes payable	\$ 41,000
Accounts receivable	60,500	Accounts payable	36,000
Supplies	2,000	Salaries payable	3,000
Land	100,000	Total liabilities	\$ 80,000
Building	90,000	Owners' Equity	
Office equipment	15,000	Capital stock	150,000
		Retained earnings	70,000
Total	\$ 300,000	Total	\$ 300,000



**Let's analyze
transactions
for JJ's Lawn
Care Service.**

On May 1, Jill Jones and her family invested \$8,000 in JJ's Lawn Care Service and received 800 shares of stock.

**JJ's Lawn Care Service
Balance Sheet
May 1, 2009**

Assets		Owners' Equity	
Cash	\$ 8,000	Capital Stock	\$ 8,000
Total	<u>\$ 8,000</u>	Total	<u>\$ 8,000</u>

On May 2, JJ's purchased a riding lawn mower for \$2,500 cash.

**JJ's Lawn Care Service
Balance Sheet
May 2, 2009**

Assets		Owners' Equity	
Cash	\$ 5,500	Capital Stock	\$ 8,000
Tools & Equipment	2,500		
Total	<u>\$ 8,000</u>	Total	<u>\$ 8,000</u>

On May 8, JJ's purchased a \$15,000 truck. JJ's paid \$2,000 down in cash and issued a note payable for the remaining \$13,000.

**JJ's Lawn Care Service
Balance Sheet
May 8, 2009**

Assets		Liabilities and Owners' Equity	
Cash	\$ 3,500	Liabilities:	
Tools & Equipment	2,500	Notes Payable	\$ 13,000
Truck	15,000	Owners' Equity:	
		Capital Stock	8,000
Total	<u>\$ 21,000</u>	Total	<u>\$ 21,000</u>

On May 11, JJ's purchased some repair parts for \$300 on account.

**JJ's Lawn Care Service
Balance Sheet
May 11, 2009**

Assets		Liabilities and Owners' Equity	
Cash	\$ 3,500	Liabilities:	
Tools & Equipment	2,800	Notes Payable	\$ 13,000
Truck	15,000	Accounts Payable	300
		Total Liabilities	\$ 13,300
		Owners' Equity:	
		Capital Stock	8,000
Total	<u>\$ 21,300</u>	Total	<u>\$ 21,300</u>

Jill realized she had purchased more repair parts than needed.

On May 18, JJ's was able to sell half of the repair parts to ABC Lawns for \$150, a price equal to JJ's cost. JJ's will receive the cash within 30 days.

**JJ's Lawn Care Service
Balance Sheet
May 18, 2009**

Assets		Liabilities and Owners' Equity	
Cash	\$ 3,500	Liabilities:	
Accounts Receivable	150	Notes Payable	\$ 13,000
Tools & Equipment	2,650	Accounts Payable	300
Truck	15,000	Total Liabilities	\$ 13,300
		Owners' Equity:	
		Capital Stock	8,000
Total	<u>\$ 21,300</u>	Total	<u>\$ 21,300</u>

On May 25, ABC Lawns pays JJ's \$75 as a partial settlement of its accounts receivable.

**JJ's Lawn Care Service
Balance Sheet
May 25, 2009**

Assets		Liabilities and Owners' Equity	
Cash	\$ 3,575	Liabilities:	
Accounts Receivable	75	Notes Payable	\$ 13,000
Tools & Equipment	2,650	Accounts Payable	300
Truck	15,000	Total Liabilities	\$ 13,300
		Owners' Equity:	
		Capital Stock	8,000
Total	<u>\$ 21,300</u>	Total	<u>\$ 21,300</u>

On May 28, JJ's pays \$150 of its accounts payable.

**JJ's Lawn Care Service
Balance Sheet
May 28, 2009**

Assets		Liabilities and Owners' Equity	
Cash	\$ 3,425	Liabilities:	
Accounts Receivable	75	Notes Payable	\$ 13,000
Tools & Equipment	2,650	Accounts Payable	150
Truck	15,000	Total Liabilities	13,150
		Owners' Equity:	
		Capital Stock	8,000
Total	<u>\$ 21,150</u>	Total	<u>\$ 21,150</u>

On May 29, JJ's recorded lawn care services provided during May of \$750. All clients paid cash.

**JJ's Lawn Care Service
Balance Sheet
May 29, 2009**

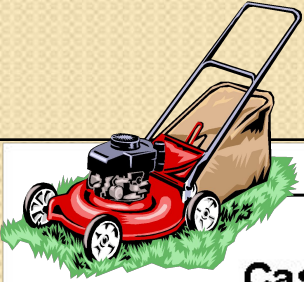
Assets		Liabilities and Owners' Equity	
Cash	\$ 4,175	Liabilities:	
Accounts Receivable	75	Notes Payable	\$ 13,000
Tools & Equipment	2,650	Accounts Payable	150
Truck	15,000	Total Liabilities	13,150
		Owners' Equity:	
		Capital Stock	8,000
		Retained Earnings	750
Total	\$ 21,900	Total	\$ 21,900

On May 31, JJ's purchased gasoline for the lawn mower and the truck for \$50 cash.

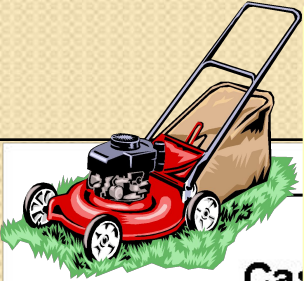
**JJ's Lawn Care Service
Balance Sheet
May 31, 2009**

Assets		Liabilities and Owners' Equity	
Cash	\$ 4,125	Liabilities:	
Accounts Receivable	75	Notes Payable	\$ 13,000
Tools & Equipment	2,650	Accounts Payable	150
Truck	15,000	Total Liabilities	13,150
		Owners' Equity:	
		Capital Stock	8,000
		Retained Earnings	700
Total	\$ 21,850	Total	\$ 21,850

Now, let's review how JJ's transactions affected the accounting equation.



	Assets				=	Liabilities		+	Owners' Equity	
	Cash	Accts. Rec.	Tools & Equip.	Truck	=	Notes Payable	Accts. Pay.	+	Capital Stock	Retained Earnings
May 1	\$8,000								\$8,000	
Balances	\$8,000								\$8,000	
May 2	(2,500)		\$2,500							
Balances	\$5,500		\$2,500						\$8,000	
May 8	(2,000)			\$15,000		\$13,000				
Balances	\$3,500		\$2,500	\$15,000		\$13,000			\$8,000	
May 11			300				\$300			
Balances	\$3,500		\$2,800	\$15,000		\$13,000	\$300		\$8,000	
May 18		\$150	(150)							
Balances	\$3,500	\$150	\$2,650	\$15,000		\$13,000	\$300		\$8,000	
May 25	75	(75)								
Balances	\$3,575	\$75	\$2,650	\$15,000		\$13,000	\$300		\$8,000	
May 28	(150)						(150)			
Balances	\$3,425	\$75	\$2,650	\$15,000		\$13,000	\$150		\$8,000	
May 29	750									750
Balances	\$4,175	\$75	\$2,650	\$15,000		\$13,000	\$150		\$8,000	\$750
May 31	(50)									(50)
Balances	<u>\$4,125</u>	<u>\$75</u>	<u>\$2,650</u>	<u>\$15,000</u>		<u>\$13,000</u>	<u>\$150</u>		<u>\$8,000</u>	<u>\$700</u>



Let's prepare the Income Statement and Statement of Cash Flows for JJ's Lawn Care Service for the month ending May 31, 2009.

May 1	\$8,000						\$8,000
Balances	\$8,000						\$8,000
May 2	(2,500)	\$2					
Balances	\$5,500	\$2					\$8,000
May 8	(2,000)						
Balances	\$3,500	\$2					\$8,000
May 11							
Balances	\$3,500	\$2					\$8,000
May 18		\$ 150	(150)				
Balances	\$3,500	\$ 150	\$2,650	\$15,000	\$13,000	\$ 300	\$8,000
May 25	75	(75)					
Balances	\$3,575	\$ 75	\$2,650	\$15,000	\$13,000	\$ 300	\$8,000
May 28	(150)					(150)	
Balances	\$3,425	\$ 75	\$2,650				\$8,000
May 29	750						
Balances	\$4,175	\$ 75	\$2,650				\$8,000
May 31	(50)						
Balances	\$4,125	\$ 75	\$2,650				\$8,000

These transactions impact the Statement of Cash Flows.

These transactions impact the Income Statement.

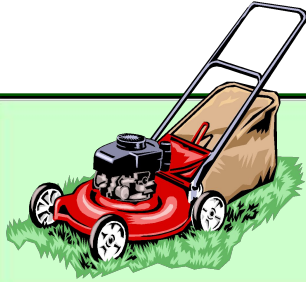
	750
\$	750
	(50)
\$	700



JJ's Lawn Care Service Income Statement For the Month Ended May 31, 2009

Sales Revenue	\$	750
Operating Expense:		
Gasoline Expense		50
Net Income	\$	700

Investments by and payments to the owners are **not** included on the Income Statement.



JJ's Lawn Care Service
Statement of Cash Flows
For the Month Ended May 31, 2009

Cash flows from operating activities:

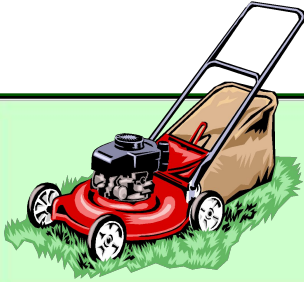
Cash received from revenue transactions	\$	750	
Cash paid for expenses		(50)	
Net cash provided by operating activities			\$ 700

Cash flows from investing activities:

Purchase of lawn mower	\$	(2,500)	
Purchase of truck		(2,000)	
Collection for sale of repair parts		75	
Payment for repair parts		(150)	
Net cash used by investing activities			(4,575)

Cash flows from financing activities:

Investment by owners			8,000
Increase in cash for month	\$		4,125
Cash balance, May 1, 2009			-
Cash balance, May 31, 2009	\$		4,125



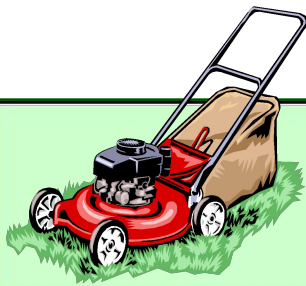
JJ's Lawn Care Service
Statement of Cash Flows
For the Month Ended May 31, 2009

Cash flows from operating activities:

Cash received from revenue transactions	\$	750	
Cash paid for expenses		(50)	
Net cash provided by operating activities			\$ 700

Operating activities include the cash effects of revenue and expense transactions.

Net cash used by investing activities		(4,575)	
Cash flows from financing activities:			
Investment by owners		8,000	
Increase in cash for month	\$	4,125	
Cash balance, May 1, 2009		-	
Cash balance, May 31, 2009	\$	4,125	



**JJ's Lawn Care Service
Statement of Cash Flows
For the Month Ended May 31, 2009**

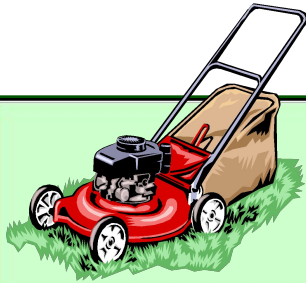
Cash flows from operating activities:

Cash received from revenue transactions	\$	750	
Cash paid for expenses		<u>(50)</u>	
Net cash provided by operating activities			\$ 700

Cash flows from investing activities:

Purchase of lawn mower	\$	(2,500)	
Purchase of truck		(2,000)	
Collection for sale of repair parts		75	
Payment for repair parts		<u>(150)</u>	
Net cash used by investing activities			(4,575)

Investing activities include the cash effects of purchasing and selling assets.



**JJ's Lawn Care Service
Statement of Cash Flows
For the Month Ended May 31, 2009**

Cash flows from operating activities:

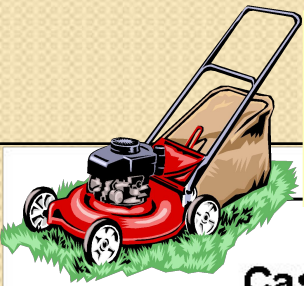
Cash received from revenue transactions	\$	750	
Cash paid for expenses		<u>(50)</u>	
Net cash provided by operating activities	\$		700

Cash flows from investing activities:

Financing activities include the cash effects of transactions with the owners and creditors.

Cash flows from financing activities:

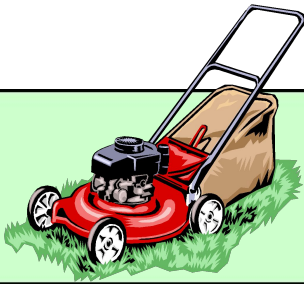
Investment by owners		<u>8,000</u>
Increase in cash for month	\$	4,125
Cash balance, May 1, 2009		<u>-</u>
Cash balance, May 31, 2009	\$	<u><u>4,125</u></u>



Now, let's prepare the Balance Sheet for JJ's Lawn Care Service for May 31, 2009.

	Cash	Accts. Rec.	Tools & Equip.	Truck	=	Notes Payable	Accts. Pay.	Capital Stock	Retained Earnings
May 1	\$8,000							\$8,000	
Balances	\$8,000							\$8,000	
May 2	(2,500)		\$2,500						
Balances	\$5,500		\$2,500					\$8,000	
May 8	(2,000)			\$15,000		\$13,000			
Balances	\$3,500		\$2,500	\$15,000		\$13,000		\$8,000	
May 11			300				\$300		
Balances	\$3,500		\$2,800	\$15,000		\$13,000	\$300	\$8,000	
May 18		\$150	(150)						
Balances	\$3,500	\$150	\$					\$8,000	
May 25	75	(75)							
Balances	\$3,575	\$75	\$					\$8,000	
May 28	(150)								
Balances	\$3,425	\$75	\$					\$8,000	
May 29	750								750
Balances	\$4,175	\$75	\$2,650	\$15,000		\$13,000	\$150	\$8,000	\$750
May 31	(50)								(50)
Balances	\$4,125	\$75	\$2,650	\$15,000		\$13,000	\$150	\$8,000	\$700

These balances will appear on the Balance Sheet.



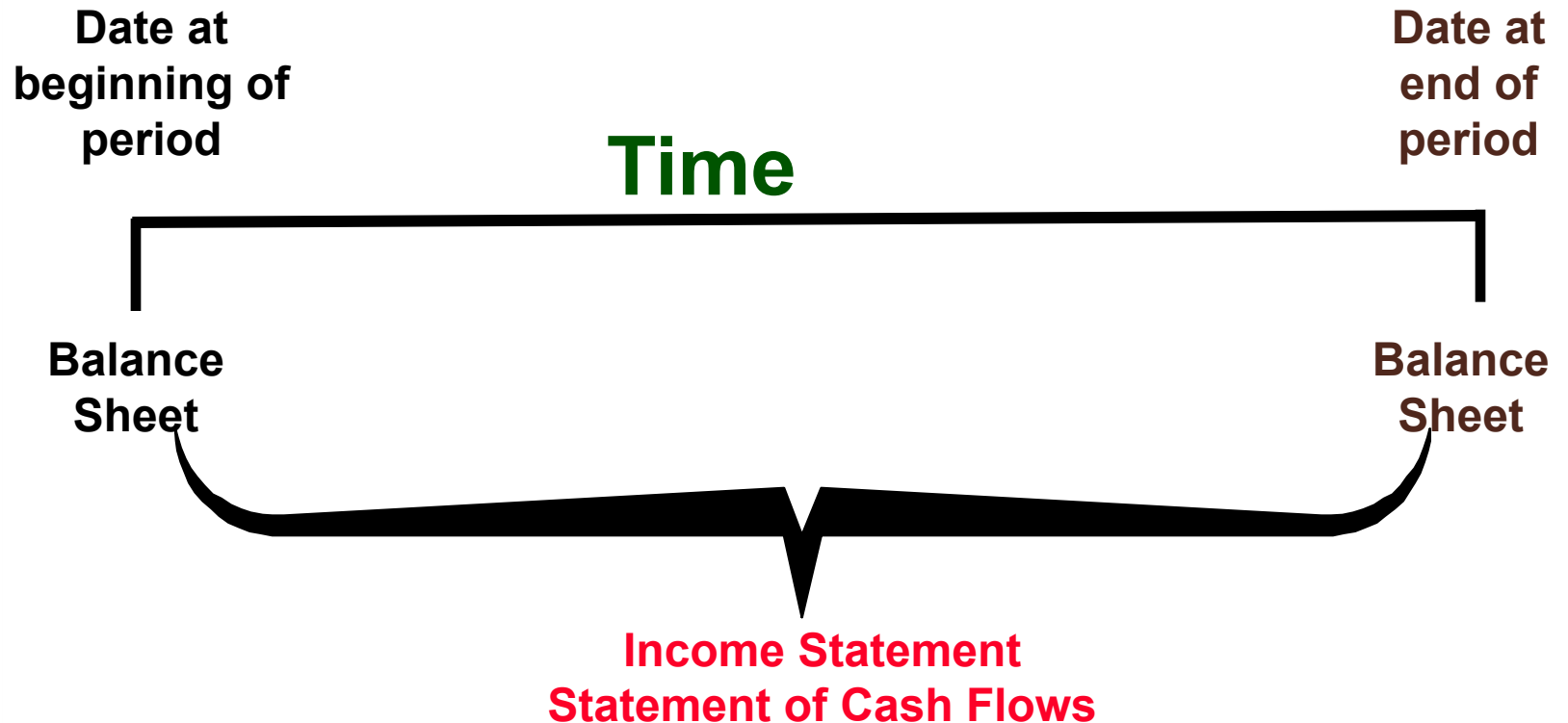
**JJ's Lawn Care Service
Balance Sheet
May 31, 2009**

Assets		Liabilities	
Cash	\$ 4,125	Notes payable	\$ 13,000
Accounts receivable	75	Accounts payable	150
Tools & equipment	2,650	Owners' Equity	
Truck	15,000	Capital stock	8,000
		Retained earnings	700
Total assets	\$ 21,850	Total liabilities & equity	\$ 21,850

Assets = Liabilities + Owners' Equity

\$21,850 = \$13,150 + \$8,700

Relationships Among Financial Statements



Financial Statement Articulation

JJ's Lawn Care Service

Statement of Cash Flows

For the Month Ended May 31, 2009

Cash flows from operating activities:

Cash received from revenue transactions	\$	750	
Cash paid for expenses		(50)	
Net cash provided by operating activities	\$		700

Cash flows from investing activities:

Purchase of lawn mower	\$	(2,500)	
Purchase of truck		(2,000)	
Collection for sale of repair parts		75	
Payment for repair parts		(150)	
Net cash used by investing activities			(4,575)

Cash flows from financing activities:

Investment by owners			8,000
Increase in cash for month	\$	4,125	
Cash balance, May 1, 2009			-
Cash balance, May 31, 2009	\$	4,125	

JJ's Lawn Care Service

Income Statement

For the Month Ended May 31, 2009

Sales Revenue	\$	750
Operating Expense:		
Gasoline Expense		50
Net income	\$	700

JJ's Lawn Care Service

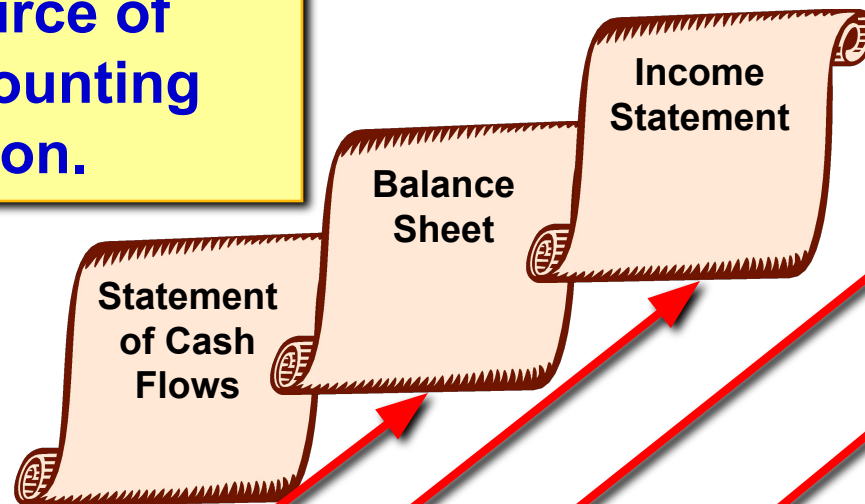
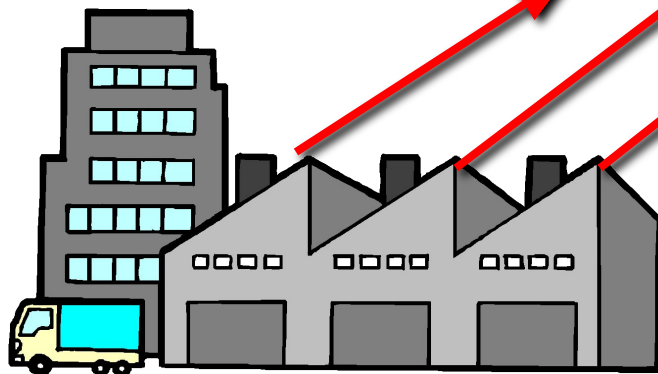
Balance Sheet

May 31, 2009

Assets		Liabilities	
Cash	\$ 4,125	Notes payable	\$ 13,000
Accounts receivable	75	Accounts payable	150
Tools & equipment	2,650	Owners' Equity	
Truck	15,000	Capital stock	8,000
		Retained earnings	700
Total assets	\$ 21,850	Total liabilities & equity	\$ 21,850

Financial Reporting and Financial Statements

Financial statements are just one source of financial accounting information.



Other Information:

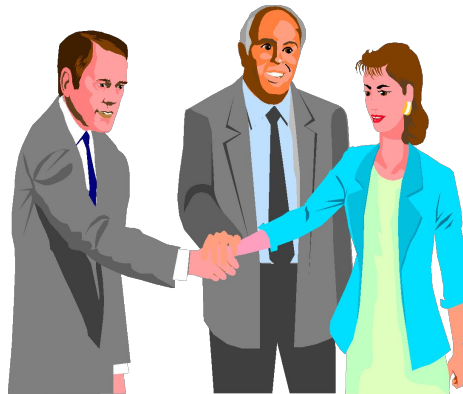
- Industry
- Competitors
- National economy

Forms of Business Organization

**Sole
Proprietorships**



Partnerships



Corporations



Reporting Ownership Equity in the Statement of Financial Position

Sole Proprietorships

Owner's equity:

Jill Jones, capital	\$	8,000
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Partnerships

Partners' equity

Jill Jones, capital	\$	4,000	
Bill Jones, capital		<u>4,000</u>	
Total partners' equity	\$		8,000

Corporations

Owners' equity

Capital stock	\$	7,000	
Retained earnings		<u>1,000</u>	
Total stockholders' equity	\$		8,000

The Use of Financial Statements by External Parties



Creditors



Investors

**Two concerns:
Liquidity
Profitability**

Management's Interest in Financial Statements

Creditors are more likely to extend credit if financial statements show a strong statement of financial position—that is, relatively little debt and large amounts of liquid assets.



Window dressing occurs when management takes measures to make the company appear as strong as possible in its financial statements.

End of Chapter 2

