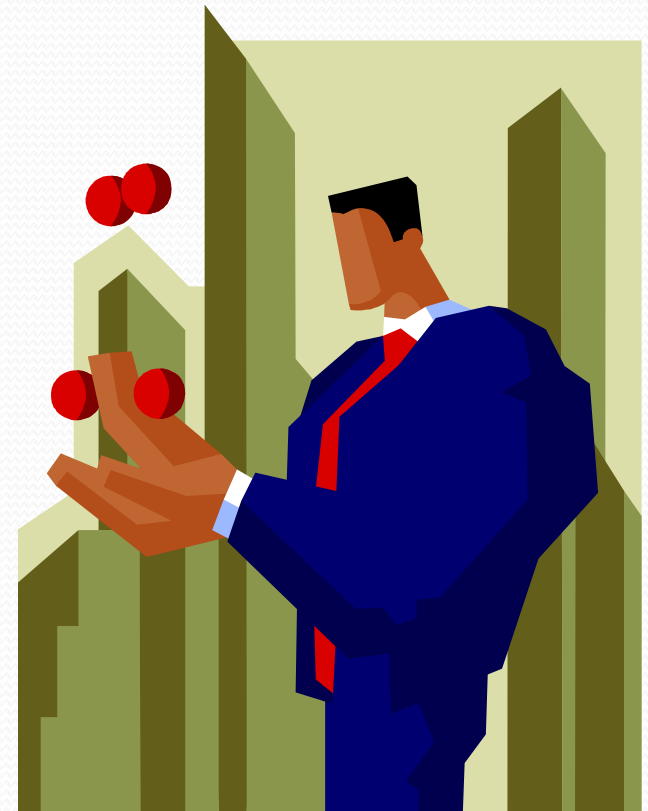


Chapter

2

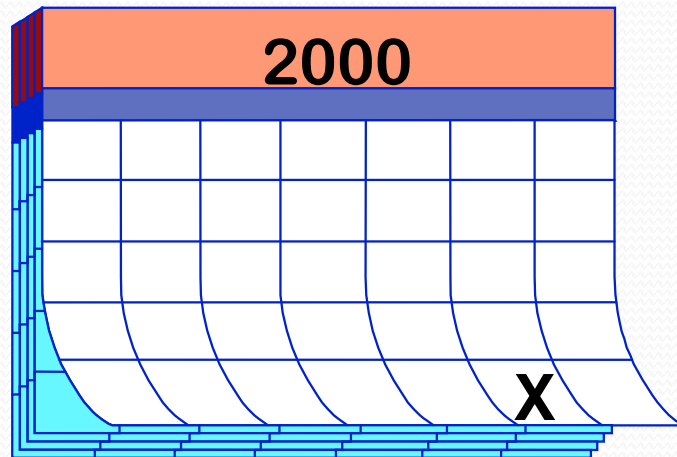
BASIC FINANCIAL STATEMENTS

Presented by:
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Introduction to Financial Statements

Companies prepare interim financial statements and annual financial statements.



Introduction to Financial Statements

Balance Sheet

Income Statement

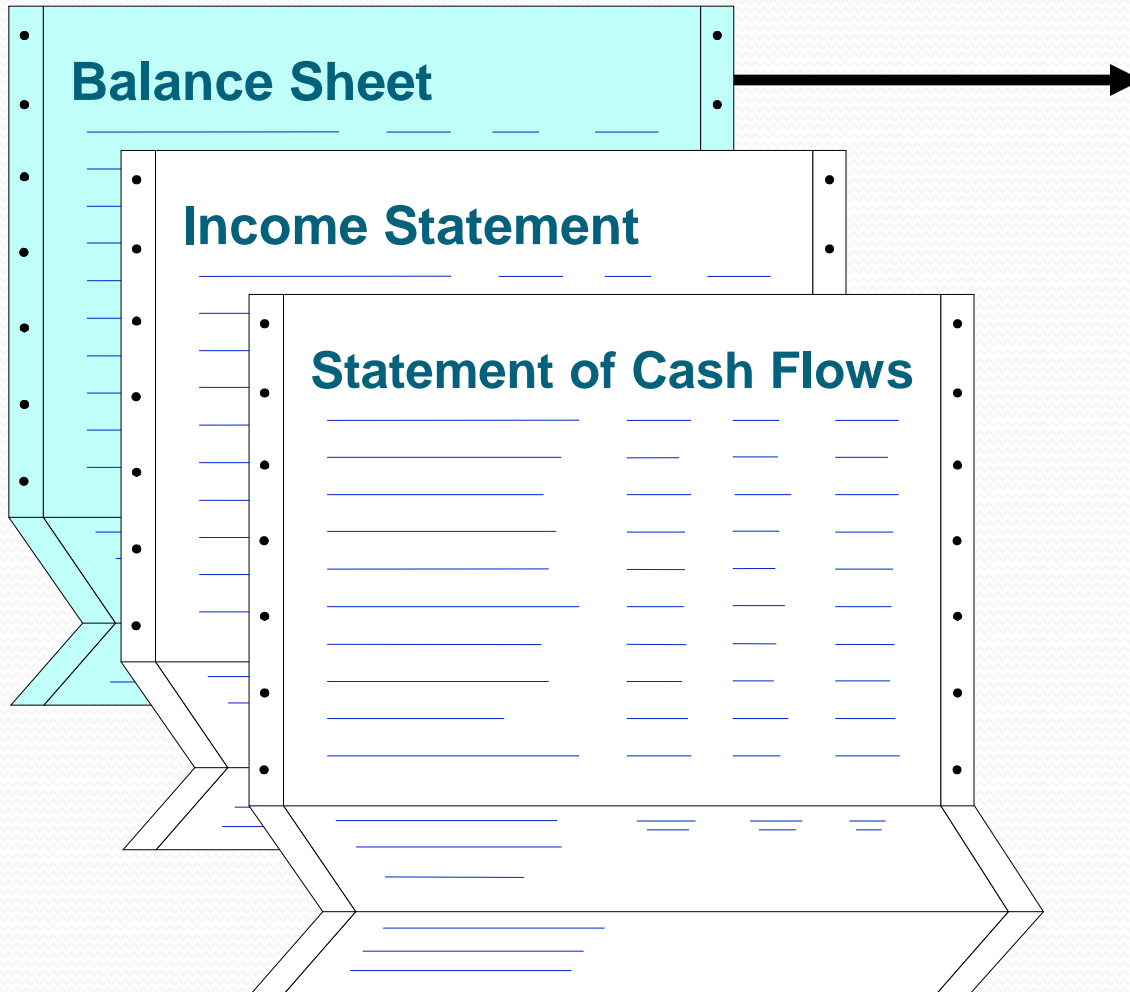
Statement of Cash Flows

Three primary financial statements.

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

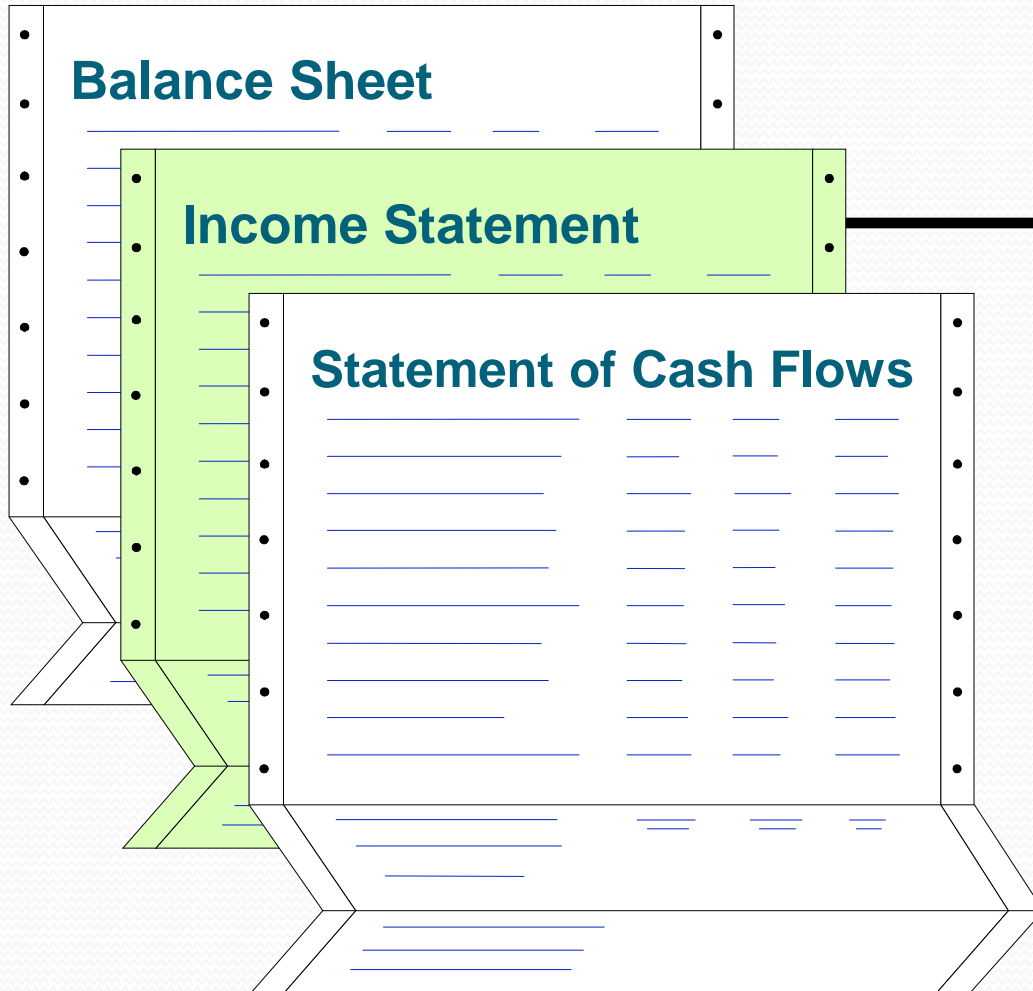


Introduction to Financial Statements



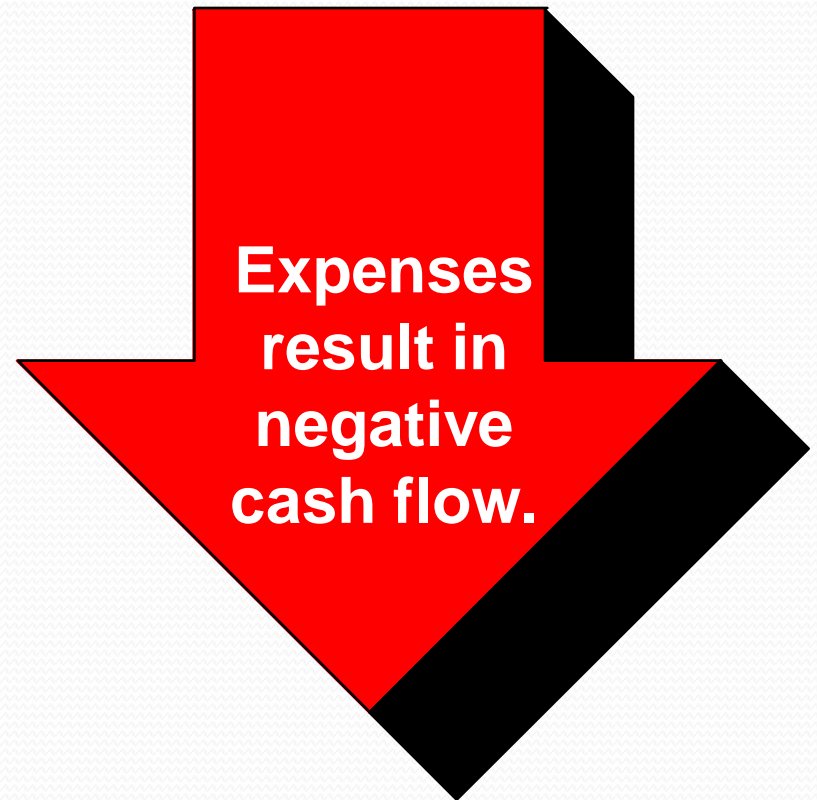
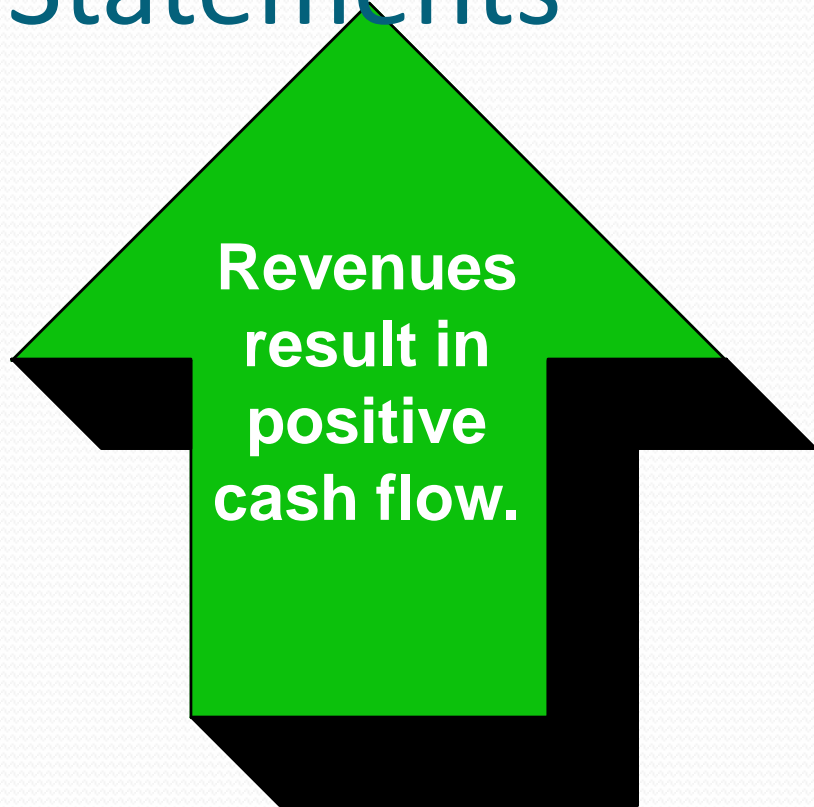
Describes where the enterprise stands **at a specific date.**

Introduction to Financial Statements



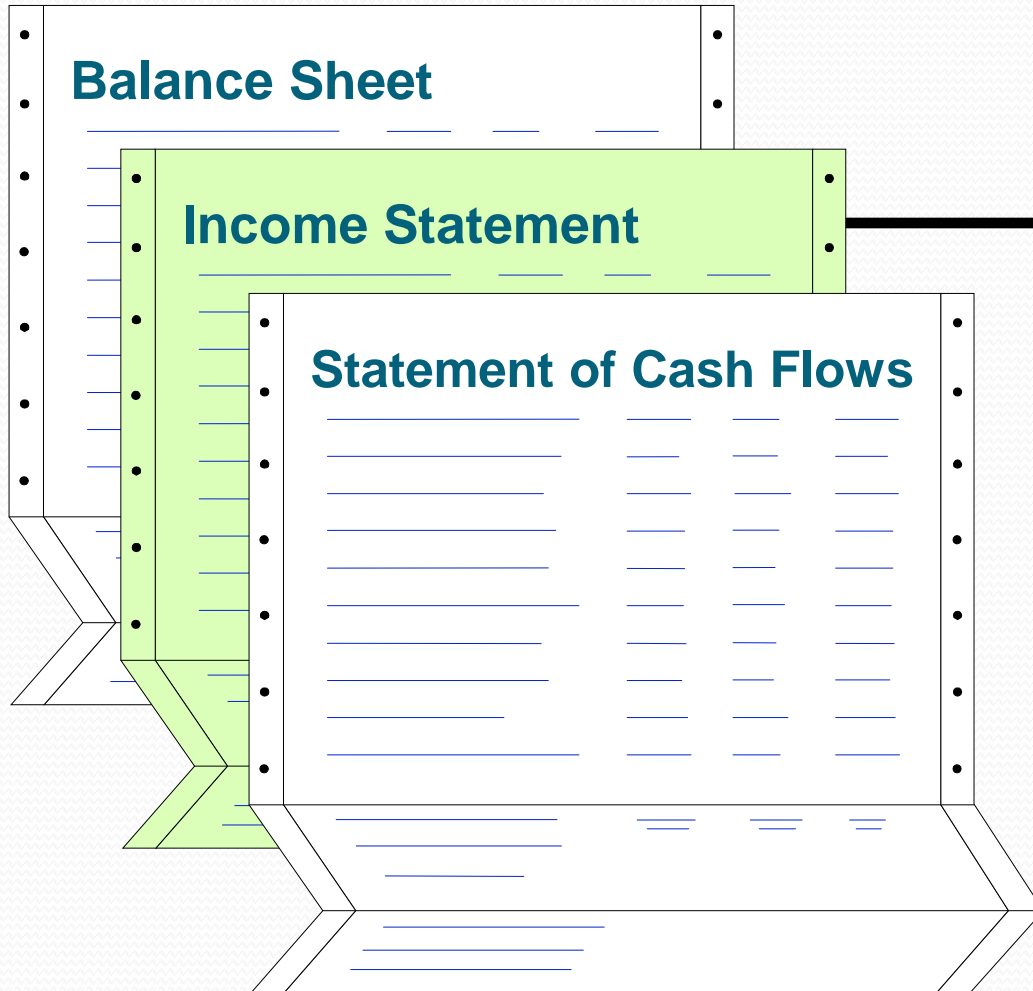
Depicts the revenue and expenses for a designated period of time.

Introduction to Financial Statements



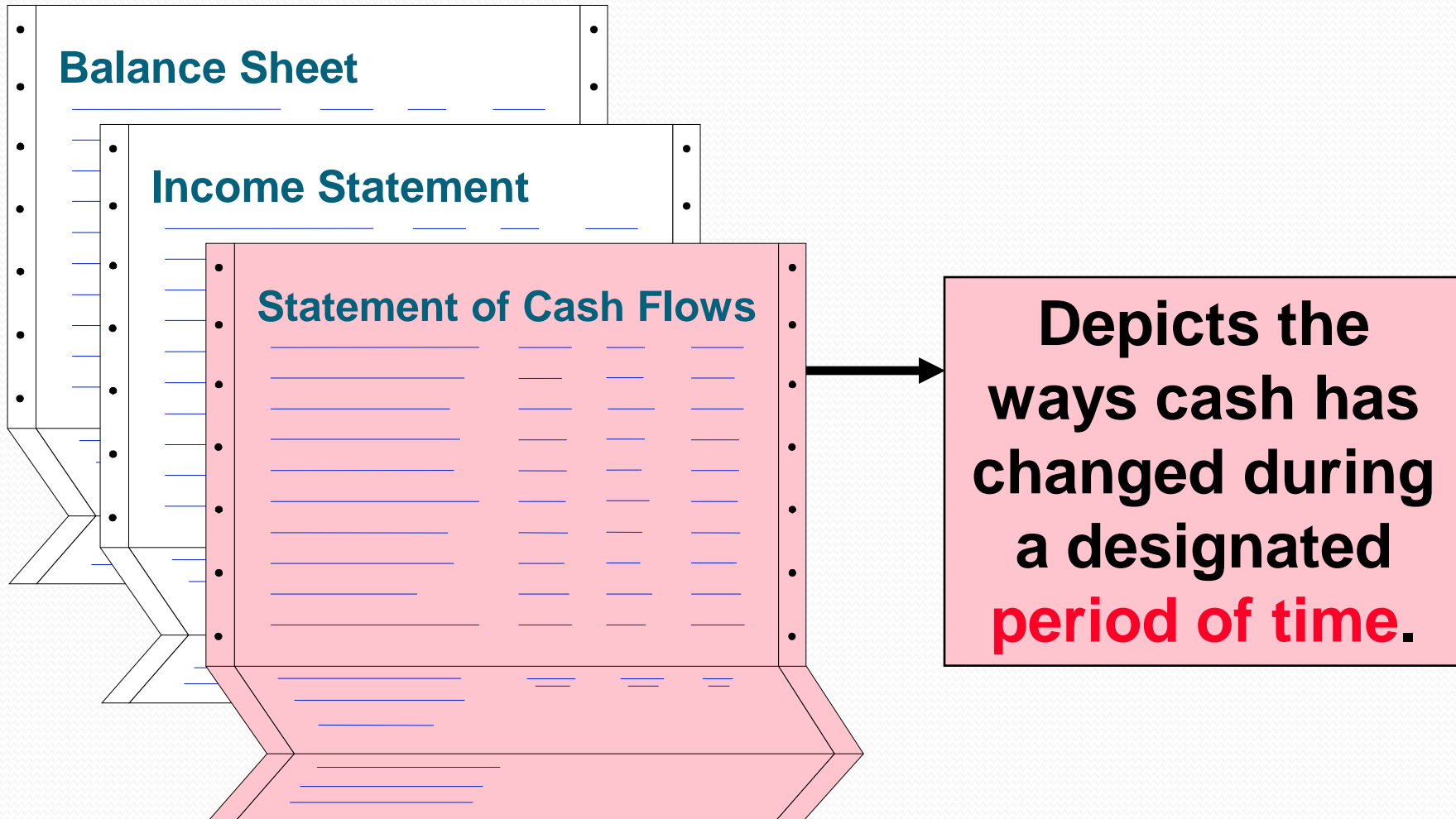
Either in the past, present, or future.

Introduction to Financial Statements



Net income (or net loss) is simply the difference between revenues and expenses.

Introduction to Financial Statements



The Concept of the Business Entity

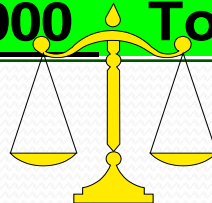


A business entity is separate from the personal affairs of its owner.

A Starting Point: Statement of Financial Position

Vagabond Travel Agency Balance Sheet December 31, 2002

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 Travel Agency
Balance Sheet
December 31, 2002**

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 provide positive future cash flows.

Assets

Cost Principle

**Stable-Dollar
Assumption**

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

**Going-Concern
Assumption**

**Objectivity
Principle**

Liabilities

**Vagabond Travel Agency
Balance Sheet
December 31, 2002**

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

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**

Owners' Equity

Vagabond Travel Agency
Balance Sheet
December 31, 2002

Owners' equity represents the owner's claim to 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

Owners' Equity

Changes in Owners' Equity



•Owners' Investments

•Business Earnings



•Payments to Owners

•Business Losses

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
some
transactions for
JJ's Lawn Care
Service.**

On May 1, 2003, 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, 2003**

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, 2003**

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, 2003**

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, 2003**

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, 2003**

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, 2003**

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, 2003**

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 in cash.

**JJ's Lawn Care Service
Balance Sheet
May 29, 2003**

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, 2003**

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, 2003.

May 1	\$8,000						\$8,000
Balances	\$8,000						\$8,000
May 2	(2,500)	\$2					\$8,000
Balances	\$5,500	\$2					\$8,000
May 8	(2,000)						\$8,000
Balances	\$3,500	\$2					\$8,000
May 11							\$8,000
Balances	\$3,500	\$2					\$8,000
May 18		\$150	(150)				\$8,000
Balances	\$3,500	\$150	\$2,650	\$15,000	\$13,000	\$300	\$8,000
May 25	75	(75)					\$8,000
Balances	\$3,575	\$75	\$2,650	\$15,000	\$13,000	\$300	\$8,000
May 28	(150)					(150)	\$8,000
Balances	\$3,425	\$75	\$2,650	\$15,000	\$13,000	\$150	\$8,000
May 29	750						\$8,000
Balances	\$4,175	\$75	\$2,650	\$15,000	\$13,000	\$300	\$8,000
May 31	(50)						\$8,000
Balances	\$4,125	\$75	\$2,650	\$15,000	\$13,000	\$150	\$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, 2003

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, 2003

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, 2003		-
Cash balance, May 31, 2003		\$ 4,125



**JJ's Lawn Care Service
Statement of Cash Flows
For the Month Ended May 31, 2003**

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

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	<u>\$ 4,125</u>
Cash balance, May 1, 2003	-
Cash balance, May 31, 2003	<u><u>\$ 4,125</u></u>



JJ's Lawn Care Service
Statement of Cash Flows
For the Month Ended May 31, 2003

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)

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, 2003**

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	8,000	
Increase in cash for month		<u>\$ 4,125</u>
Cash balance, May 1, 2003		-
Cash balance, May 31, 2003		<u><u>\$ 4,125</u></u>

Relationships Among Financial Statements

**Beginning
of period**

**End of
period**

Time

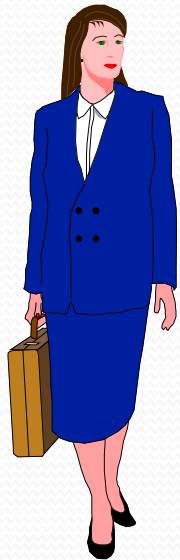
**Balance
Sheet**

**Balance
Sheet**

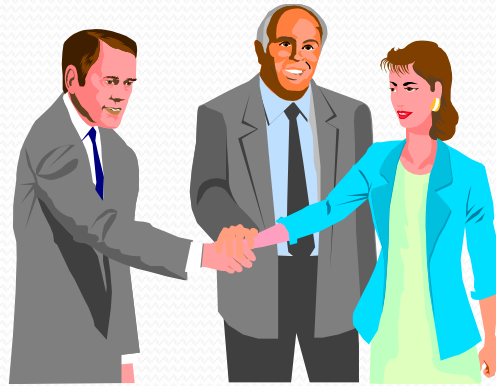
Income Statement
Statement of Cash Flows

Forms of Business Organizations

**Sole
Proprietorship**



Partnership



Corporation



Reporting Ownership Equity in the Balance Sheet

**Sole
Proprietorship**

Owner's equity:

Jill Jones, capital	\$	8,000
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Partnership

Partners' equity

Jill Jones, capital	\$	4,000
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Bill Jones, capital	4,000
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Total partners' equity	\$	8,000
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Corporation

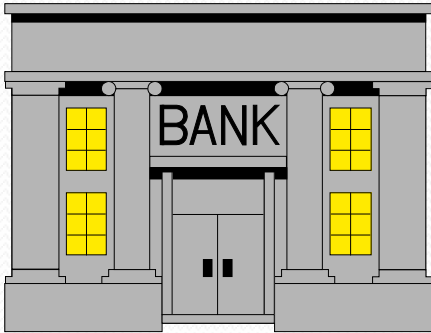
Owners' equity

Capital stock	\$	7,000
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Retained earnings	1,000
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Total stockholders' equity	\$	8,000
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The Use of Financial Statements by Outsiders



Creditors



Investors

Two concerns:

Solvency

Profitability

The Need for Adequate Disclosure

Balance Sheet

A diagram showing three overlapping financial statement templates. The top one is the Balance Sheet, the middle one is the Income Statement, and the bottom one is the Statement of Cash Flows. Each template has a header, a title, and several horizontal lines representing rows of data. The templates are arranged in a 3D perspective, with the bottom one being the largest and most prominent.

Income Statement

Statement of Cash Flows

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

Reference

Williams et al. 2011. *Financial and Managerial Accounting: The Basis for Business Decision 16 ed.* New York: McGraw-Hill.