

AGRICULTURE BUSINESS PLANNING

Chapter 14

Financial Statement

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Lecture Overview

- Financial statement
- Balance sheet
- Income statement
- Cashflow statement

Introduction to this chapter:

The existence of financial information, will help you to understand your business. Thus, in this chapter, you are going to understand the financial statement.

▪ Financial Statement

What are financial statements and who uses them? Some business owners and managers think that financial statements are intended for lending banks, stockholders, or others outside of the company. While this is true, financial statements are also important internal management tools that can and should be used to support all business decisions.

Financial statements for organizations of any size are prepared in a standard manner. Generally Accepted Accounting Principles (GAAP) provide the framework for what information is included and how it is presented. These principles establish guidelines to ensure that the information is reliable and understandable and can be compared to prior periods and outside information.

The key financial statements are the balance sheet, the income statement, and the cashflow statement.

- ✓ The **balance sheet** is a snapshot of the business at a moment in time. It shows the distribution of assets, liabilities, and net worth

- ✓ The **income statement** is a report on operations over a period of time. It shows whether the business is making a profit or losing money
- ✓ The **cash flow statement** shows the liquidity, or cash situation, of the business, based on the cash inflows and outflows. A positive cash flow must be maintained for any business to survive.

▪ **The Balance Sheet**

A company’s financial position-its financial “health”-is shown on the balance sheet, also called **the statement of condition** or **statement of financial position**. The balance sheet is often referred to as a “photograph” of the company because it shows the business’s financial position at a particular moment in time. As the business operates, values shift from one category to another, and the balance sheet changes accordingly.

A balance sheet contains three parts: Assets, Liabilities, and Net Worth (also called Owner’s Equity). It’s called a “balance sheet” because the assets must exactly equal (balance) the liabilities and equity.

BALANCE SHEET		
Assets	=	Liabilities + Net Worth (Equity)

Assets are what a business owns, and they can be tangible (cash, buildings) or intangible (good will). **Current assets** are cash or anything that will be converted into cash within one year, such as marketable securities, accounts receivable, and inventories. **Fixed assets**, also called **long-term assets**, are more permanent items with a useful life of more than one year, such as building and major equipment. Assets are recorded in the accounting systems as **debit balances**.

Liabilities are what a business owes. Liabilities are also divided into current and longer term. **Current liabilities** are those that must be paid within a year or less. Included in current liabilities are accounts payable (inventories, rent, utilities, and so on), accrued wages, and the current portion of longer-term notes payable. **Long-**

term liabilities include items that do not mature within one year, such as bank loans, mortgages, or other longer-term obligations. Liabilities are recorded in the accounting system as **credit balances**.

Net Worth is the difference between the value of the assets and the value of the liabilities. For publicly traded companies, this number is also called **shareholder equity**. If the value of the assets exceeds the value of the liabilities, the business has a positive net worth. If the reverse is true, however, and the value of the assets is less than obligations represented by the liabilities, the business has a negative net worth. A negative net worth can impair the business's ability to borrow funds, open new trade credit with suppliers, or raise new investment capital.

$$\text{Assets} - \text{Liabilities} = \text{Net Worth}$$

Why It's Called "Balance Sheet"

The key word is BALANCE because the total assets will always equal the total liabilities and net worth. Although the asset and liability values change continually, the formula remains constant:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Net Worth}$$

An Example

Let's suppose that a new business was started with the owner's saving of \$100,000. The beginning balance sheet would look like this:

Assets		Liabilities + Net worth	
Current Assets			
Cash	\$ 100,000	Net Worth	\$ 100,000

The owner then decides to stock her store. She purchases \$50,000 of merchandise (inventory), but pays only \$25,000 in cash (this reduces cash by \$ 25,000) and promises to pay the other \$ 25,000 in 30 days. This transaction establishes a new item called **accounts payable**, which is placed under the category of **current liability** because the bill must be paid within one year. The balance sheet would now look like this:

Assets		Liabilities + Net worth	
Current Assets		Current Liabilities	
Cash	\$ 75,000	Account Payable	\$ 25,000
Inventory	<u>\$ 50,000</u>	Net Worth	\$ 100,000
Total Assets	\$ 125,000	Total Liabilities	\$ 125,000
		& Net Worth	

The balance sheet is in balance with the addition of the \$25,000 that is owed to the vendor. Currents assets are the total of cash and inventory – these items can be converted into cash within a year.

Now let's suppose the owner buys a building for \$100,000. She puts \$25,000 down and obtains a \$75,000 mortgage for the remainder. The balance sheet would now look like this:

Balance Sheet			
Current Assets		Current Liabilities	
Cash	\$ 50,000	Account Payable	\$ 25,000
Inventory	<u>\$ 50,000</u>		
Total Current Assets	\$ 100,000	Total Current Liabilities	\$ 25,000
		Liabilities	
Fixed Assets		Long-Term Debt	
Building	<u>\$ 100,000</u>	Mortgage	\$ 75,000
Total fixed assets	\$ 100,000	Total long-term debt	<u>\$ 25,000</u>
		Total Liabilities	\$ 100,000
		Net Worth	<u>\$ 100,000</u>
Total assets	\$ 200,000	Total liabilities & Net worth	\$ 200,000

Two new accounts have been added:

- ✓ Fixed assets: These include property, plants, equipment

- ✓ Long term debt: the mortgage will be paid over a period of more than one year, so this debt is not entered into current liabilities.

▪ **The Income Statement**

The income statement, also called the **profit and loss statement, P & L, or statement of operation**, shows the performance of a business over a period of time- typically a month, a quarter, a semi-annual period, or a year. Most organizations must recap their operational activities at least annually for tax reporting. Many organizations do so much more frequently, and use this financial information as an important element in their business decision making.

The basic formula for determining performance is:

$$\text{Revenues} - \text{Expenses} = \text{Income}$$

Revenues represent the company's income in some form- for example, from sales or service fees. Expenses are any cost that company incurs in supporting operations. Expenses are divided into two categories: variable and fixed.

- ✓ Variable costs vary according to the sales activity of the company, and they are usually listed in the "cost of goods sold" section of the income statement. If there are no sales, the variables costs will be zero.
- ✓ Fixed cost occurs despite sales levels and they include such things as rent and insurance. If there are no sales, these costs will still occur.

The income statement always begins with revenues from sales. Here is an example:

Income Statement	
Sales	\$ 25,000

The next item on the income statement is cost of goods sold. The cost of goods sold is normally the total of the manufacturing cost or purchase price of the goods, the freight cost from the supplier, royalties, and other costs associated with having the goods available to sell.

The cost of goods sold is subtracted from sales to show the gross profit. The gross profit, also called the gross margin or simply margin is the amount left over before operating expenses and taxes are deducted.

Income Statement	
Sales	\$ 25,000
Cost of goods sold	\$ 20,000
Gross profit	\$ 5,000

The next entries on an income statement are the expenses connected with running the business. These are usually referred to as operating expenses or overhead. Operating expenses can be both cash and accrued. When they are subtracted from gross profit, the result is operating income.

Sometimes business have sources of income that are not part of the principal business, such as interest income from a bank account. This is considered other income. And is listed separately, after operating income. Income taxes are normally listed separately on the income statement. The words income, profit and earnings are often used synonymously on income statements.

In the following example, expenses totalling \$ 226,200 are identified. The income statement's heading identifies the company and the period of time that the statement covers, in this case, a year.

Sample income statement:

XYZ CORP		
January 1 – December 31, 20xx		
Annual Income Statement		
Sales		\$ 700,000
Cost of goods sold		<u>\$ 400,000</u>
Gross profit		\$ 300,000
Expenses:		
Salaries *	\$ 140,000	
Freight	7,000	
Bad debt	4,000	
Utilities	7,000	
Depreciation	14,000	
Insurance	7,000	
Taxes (local)	8,000	
Advertising	13,000	
Interest	22,000	
Miscellaneous	4,200	
Total expenses		\$ 226,200
Other income		\$
Income taxes		5,400
Net income		\$ 72,900

* For the purpose of this chapter, distributions to owners are considered part of salary expenses

▪ The Cash Flow Statement

The cash flow statement deals only with cash activity- cash taken in and cash paid out. It helps identify periods when borrowing should be considered. It allows owners and managers to make arrangements before cash is actually needed, and it is critical when you are working with outside agencies to help finance a negative cash flow.

Sample cash flow statement:

	Forecast annual budget	Forecast January	February
Cash in (Sources)			
Beginning Cash Balance	\$ 0	\$ 0	\$ 39,000
Cash sales	15,000	0	0
Interest received	50	0	0
Contribution from owners	60,000	60,000	0
Loans/Borrowed money	<u>5,000</u>	<u>0</u>	<u>0</u>
Total receipts	\$ 80,050	\$ 60,000	\$ 0
Cash out (Uses)			
Inventory	\$ 7000	\$ 0	\$ 0
Operating expenses	15,000	1,000	1,200
Furniture and fixtures	20,000	5,000	4,500
Equipment	35,000	15,000	6,500
Income taxes	1,000	0	0
Distributions to owners	<u>0</u>	<u>0</u>	<u>0</u>
Total Disbursements	\$ 78,000	\$ 21,000	\$ 12,200
Ending cash balance	\$ 2,050	\$ 39,000	\$ 26,800

Reference

This chapter is adopted from e-book

Gill, James., Chatton, Moira. 2009. Understanding Financial Statements. Master the Tools that Help You Succeed. 3rd Edition. A Crisp Fifty-Minute Series Book. USA. AXZO PRESS.