



How to Read a Financial Statement

An Online Continuing Education Course for Engineers

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Table of Contents

<u>Section</u>	<u>Page</u>
Introduction	3
I. Financial Reporting	4
II. Balance Statements	8
III. Income Statements	21
IV. Statement of Cash Flows	27
V. Statement of Retained Earnings	32
VI. Ratios	33
VII. Financial Analysis	40
Conclusions	42

Introduction

This course explains how to read and interpret the financial statements of a business enterprise. It is not an accounting course and it is written by a non-accountant for non-accountants. The purpose of the financial statements of a company is to provide information on the profitability and economic well-being of the organization. Accounting and the corresponding financial statements are the “language of business” and allow business owners, investors, bankers, and others to understand how the business is doing.

Everyday hundreds of financial transactions take place in the normal course of business and without some mechanism to compile and organize the transactions they would just be a mind-numbing jumble of data. To bring order to this chaos, accountants developed standard reporting guidelines for business data. The guidelines allow us to summarize a large number of transactions into groupings of similar transactions.

The standard reporting format includes three primary reports: The Balance Sheet, the Income Statement, and a Statement of Cash Flows. Sometimes other reports are included such as a Statement of Retained Earnings. To insure consistency, the reports must comply with guidelines known as Generally Accepted Accounting Principles (GAAP). GAAP is a set of accounting and financial reporting standards administered by the Financial Accounting Standards Board (FASB). More information about FASB can be found at www.FASB.org.

In this course we will analyze each of the three basic financial statements in detail, as well as other statements and key indicators of the financial well-being of the company. The first section is an overview of the financial statements, followed by detailed explanations of the Balance Sheet, Income Statement, Statement of Cash Flows, and Statement of Retained Earnings.

I. Financial Reporting

One of the advantages of standard reporting formats is that the financial results of a company can be evaluated on a comparable basis with other companies, since they are all using the same basic reporting format.



The process of compiling financial data includes,

- Recording a business transaction
- Classifying the transaction
- “Posting” a transaction to the appropriate Ledger account
- Summarizing the Ledger accounts

Posting is an accounting term that means to transfer the accounting entries from a journal into a ledger book in the order in which they were generated. *Ledger* is an accounting term that is used to describe a book of accounts in which data from transactions recorded in journals are posted and thereby classified and summarized.

Business transactions fall into five main accounts on the balance sheet and the income statement. They are,

- Assets
- Liabilities
- Shareholders Equity
- Revenues
- Expenses

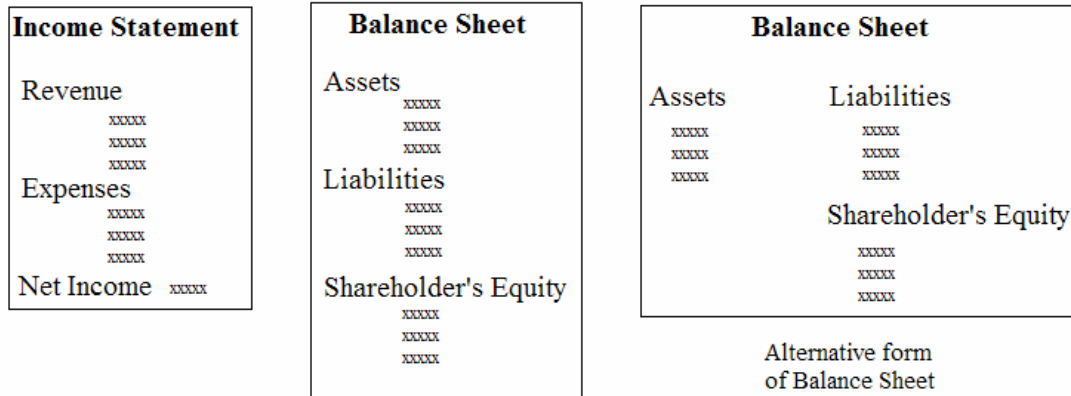
In addition to these five main accounts, accountants develop a *Chart of Accounts* for their particular business. For instance, in the Asset account, the accountant will likely include accounts for cash, accounts receivable, and pre-paid expenses among others. For the expense accounts, the accountant may include in the Chart of Accounts, rent expense, depreciation, payroll expenses, etc. The Chart of Accounts for this course will be shown momentarily.

The accounts: Assets, Liabilities, Shareholders Equity, Revenues, and Expenses are the main categories in the Balance Sheet and the Income Statement. Sub-accounts in these categories are listed in the Chart of Accounts. The Balance Sheet will list all balances in the Asset, Liability, and Shareholder’s Equity accounts. The Income Statement will list the balances in the Revenue and Expense accounts. A Balance Sheet must always be accompanied by an Income Statement to get a true financial picture of the business.

On the Balance Sheet, Assets are always listed first, followed by Liabilities, and then Shareholder’s Equity. In Some financial statements, the Balance Sheet is organized with the Assets on the left side of the page and the Liabilities and Shareholder’s Equity on the right side of the page. Another form is to show the Assets followed by the Liabilities and Shareholder’s Equity all in one column. Either approach is acceptable. Income

Statement reports the Revenues first followed by the Expenses in a columnar form. The following graphic shows the typical formats for the Income Statement and the Balance Sheet.

Income Statement and Balance Sheet Formats



One important distinction between the Balance Sheet and the Income Statement are the reporting periods. The Balance Sheet reports the Assets, Liabilities, and Shareholder's Equity as of a particular date, such as December 31, 2006. The Income Statement reports Revenues and Expenses for a given span of time, such as for the month of December, 2006, or for the year 2006.

While discussing the Balance Sheet, we need to mention the different forms for the Shareholder's Equity. *Shareholder's Equity* is the portion of the company that is owned by the shareholders. For a sole proprietor or partnership this account may be called Owner's Equity or Partner's Capital. In this course, we will use the term Shareholder's Equity.

For the purposes of this course, we will use the financial statements of a fictitious company known as the Retail Sales Corporation, or RSC. The company sells retail products such as refrigerators, washing machines, dryers, and other appliances and is a publicly traded company. The Chart of Accounts for RSC is shown below.

Retail Sales Corporation Chart of Accounts	
Balance Sheet	Income Statement
Asset Accounts	Revenue Accounts
Cash	Sales
Accounts Receivable	Less allowance for returns
Reserve for Doubtful Accounts	Cost of Goods Sold
Inventory	Expense Accounts
Prepaid Expenses	Salaries & Wages
Other Current Assets	Advertising
Long Term Investments	Utilities
Land	Rents
Buildings, Equipment, and Fixtures	Administration
Accumulated Depreciation	Depreciation
Liability Accounts	Dividends & Interest Income
Accounts Payable	Interest Expense
Notes Payable	Other Income
Accrued Expenses	Taxes
Taxes Payable	
Interest Payable	
Current	
Long T	
Other L	
Sharehold	
Common	
Additional	
Retained	

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GAAP also requires a Balance Sheet and Income Statement to be prepared. The Statement of Cash Flows is also required. Since financial statements are often difficult to really understand, for instance, the income statement may show a profit, but the company is selling its assets, for example, 30-90 days, if at all. This can help the business owner to understand where his cash is coming from and where it is going. The cash flow statement can also be misleading though. If the business decides to sell a major subsidiary, it may generate a great deal of cash, but the cash is temporary and will not be

Balance Sheet and Income Statement. The purpose of the company's financial statements is to provide information to investors and creditors. It may be difficult to understand. For example, a company may have a great deal of cash due to great sales, but it may be collecting for another