

Topic 3: Financial Statement Preparation

Overview of Financial Statements

Financial statements are formal records that communicate the financial activities and position of a business. The three primary financial statements are the Balance Sheet, Income Statement, and Statement of Cash Flows. Each statement serves a distinct purpose and provides different insights into the company's financial health. All three statements are interconnected and derived from the same underlying accounting data recorded in the Balance Sheet Equation.

The Balance Sheet

Purpose and Structure

The Balance Sheet, also called the Statement of Financial Position, reports the financial position of a business at a specific point in time. It presents a snapshot of what the company owns (assets), what it owes (liabilities), and the owners' residual interest (stockholders' equity) as of a particular date. The balance sheet follows the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.

Preparing the Balance Sheet from BSE

To prepare the balance sheet from your BSE table, use the ending balances of the permanent accounts (asset, liability, and equity accounts). List assets in order of liquidity (how quickly they can be converted to cash): current assets first (cash, accounts receivable, prepaid expenses), then non-current assets (equipment, buildings, less accumulated depreciation). Liabilities are listed by when they are due: current liabilities first (accounts payable, salaries payable), then long-term liabilities. Stockholders' equity section includes common stock and retained earnings.

The ending balance of retained earnings on the balance sheet equals: $\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends}$. This calculation connects the balance sheet to the income statement.

The Income Statement

Purpose and Structure

The Income Statement, also called the Statement of Operations or Profit and Loss Statement, reports the financial performance of a business over a period of time (for the month ended, for the year ended, etc.). It shows how revenues and gains compare to expenses and losses during the period, ultimately revealing whether the company generated a profit (net income) or incurred a loss (net loss). The basic structure is: $\text{Revenues} - \text{Expenses} = \text{Net Income}$.

Preparing the Income Statement from BSE

To prepare the income statement from your BSE table, use only the temporary accounts (revenue and expense accounts), not the permanent balance sheet accounts. List all revenues first (service revenue, interest revenue, etc.), then list all expenses (salaries expense, rent expense, utilities expense, depreciation expense, etc.). Calculate net income by subtracting total expenses from total revenues. If expenses exceed revenues, the result is a net loss.

The income statement uses the accrual basis of accounting, meaning revenues are recognized when earned (not when cash is received) and expenses are recognized when incurred (not when cash is paid). This is why net income often differs from cash flow.

Relationship Between Statements

The Articulation of Financial Statements

Financial statements are interconnected through a process called articulation. The net income from the income statement flows into the statement of retained earnings, which then flows into the balance sheet. Specifically: Net Income (from Income Statement) increases Retained Earnings, and Dividends decrease Retained Earnings. The ending Retained Earnings balance appears on the Balance Sheet as part of Stockholders' Equity.

This connection ensures consistency across statements and provides a complete picture of the company's financial situation. Changes in balance sheet accounts from the beginning to end of period explain cash flows and other financial activities during the period.

Key Preparation Principles

- 1. Use proper headings:** Each statement should have three lines of heading: (1) Company name, (2) Statement title, (3) Date or period covered. The balance sheet is dated "As of [date]" while the income statement is dated "For the period ended [date]."
- 2. Classify accounts properly:** Ensure revenues and expenses appear on the income statement, while assets, liabilities, and equity appear on the balance sheet. Never mix temporary and permanent accounts on the same statement.
- 3. Check mathematical accuracy:** Total assets must equal total liabilities plus stockholders' equity on the balance sheet. Revenues minus expenses must equal net income on the income statement.
- 4. Use appropriate formatting:** Dollar signs appear at the top of columns and for final totals. Underline subtotals with a single line and final totals with a double line. Indent subcategories appropriately.

Common Preparation Errors

Including dividends on the income statement (they are not expenses), failing to update retained earnings for net income and dividends, using beginning balances instead of ending balances for the balance sheet, mixing up the date formats for different statements, and forgetting to include all accounts from the BSE table in the appropriate statement.