Tags: Balance Sheet, Income Statement, Transactions, Financial Accounting

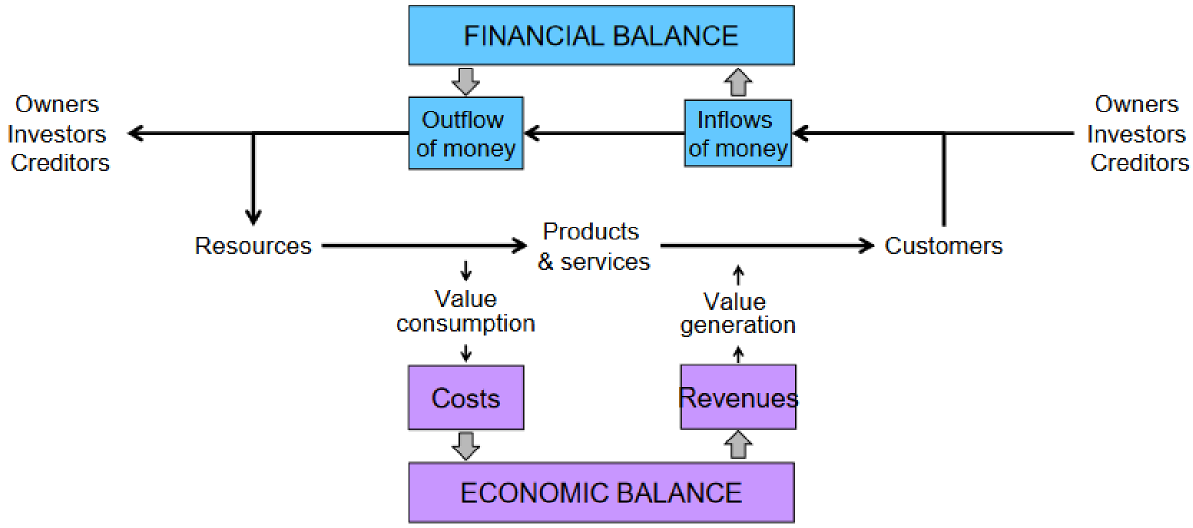
Balance Sheet and Income Statements

Summary

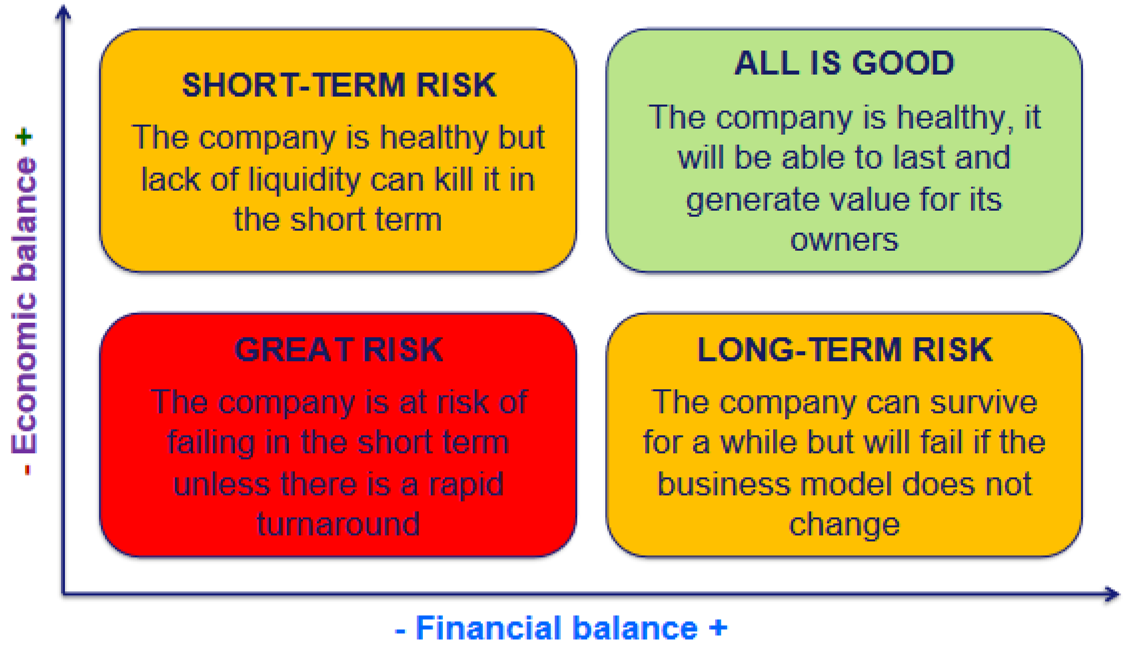
This note covers the fundamental concepts of balance sheets and income statements, their interrelation, and their importance in maintaining a company's financial equilibrium.

Remarks

- A business is an open autonomous system where they make exchanges with other entities via their resources
- A company needs to be in a state of equilibrium, meaning if there is a balance between the financial and economics aspects of it.



- If an equilibrium between the Economic and Financial Balance is reached then we have a prosperous situation



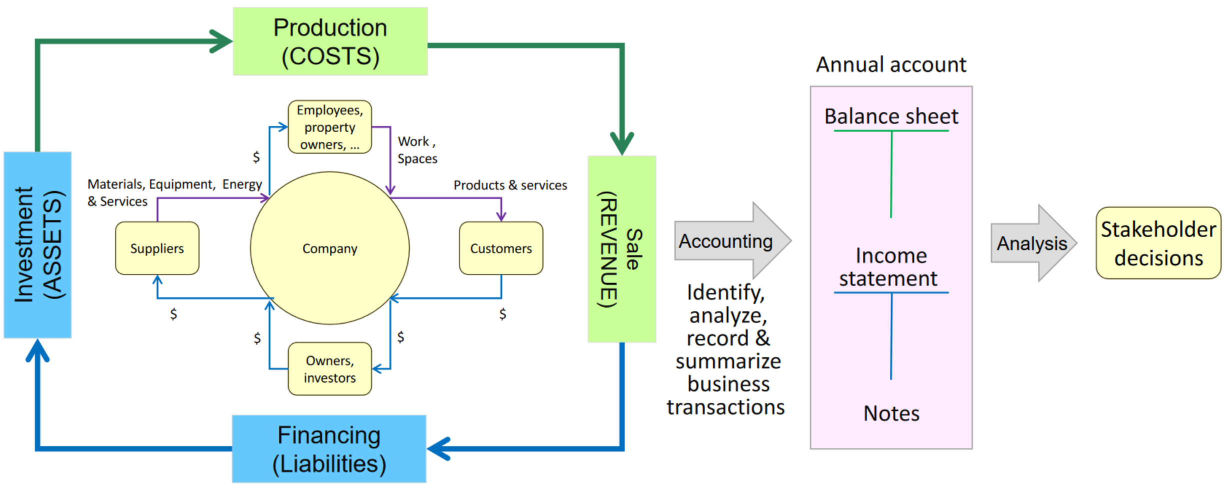
Definitions and Important Concepts

- Any loan has an inhered cost via interest, which regardless of the company situation needs to be paid
- Long term loans and equity compose the cash
- Assets is what the company has to its disposal while liabilities is what they need to give back.
- Rent is not a liability just because it is not of our own property, this would have been the case if the property was of our own. In this case we would have put a new entry in the assets and have either the entry of the long term loan increase accordingly or introduce a new one called Mortgage.
- Because of amortization both the property assets and the mortgage decrease over time but not in the same manner because of the inhered time difference and other reasons (such as interest payments and rate of depreciation based on the asset).
- Any asset can be reconstructed in the following method: We have an opening balance and we increase its amount if it is a credit to the entry meaning we increase the value or amount of that asset, while we decrease it if it is depreciated. Same thing but in the inverse order happens for the liabilities.
- Costs are the sum of what we have consumed to make and generate the revenue.
- Not all costs are made of cash, some are made of credit such as amortizations (or depreciations)
- Solvency: is the ability of a company to meet its long-term debts and financial obligations. The quickest way to assess a company's solvency is by checking its shareholders' equity on the balance sheet, which is the sum of a company's assets minus liabilities.

- Liquidity: refers to the efficiency or ease with which an asset or security can be converted into ready cash without affecting its market price. The most liquid asset of all is cash itself. Consequently, the availability of cash to make such conversions is the biggest influence on whether a market can move efficiently.

Revised Definitions and Concepts

- Balance Sheet: A financial statement that reports a company's assets, liabilities, and shareholders' equity at a specific point in time.
- Income Statement: A financial statement that shows a company's revenues, expenses, and profits over a period of time.



- Assets: Resources owned by a company that have economic value.
- Liabilities: Financial obligations or debts owed by a company to others.
- Equity: The residual interest in the assets after deducting liabilities.
- Revenue: Income generated from normal business operations.
- Costs: Expenses incurred in the process of generating revenue.

Key Accounting Principles

- Economic and Financial Balance: A company needs to maintain a balance between its **Economic Activitys** and financial resources to achieve prosperity.
- Liquidity Order: Assets in the balance sheet are typically listed in order of decreasing liquidity.
- Liability Order: Liabilities are placed in increasing order of payment timeframe.
- Accrual Basis: Transactions are recorded when they occur, not necessarily when cash changes hands.

The more liquid an asset is, the easier and more efficient it is to turn it back into cash. Less liquid assets take more time and may have a higher cost.

Formulas and Calculations

- Basic Accounting Equation: Assets = Liabilities + Equity
- Net Income: Revenue - Expenses
- Cash Flow from Operations: Net Income + Non-cash Expenses - Increases in Current Assets + Increases in Current Liabilities

Example Problems

① Calculating Depreciation: A company purchases equipment for $50,000 with a 5-year useful life and no salvage value. Annual Depreciation = $50,000 / 5 years = $10,000 per year

② Impact on Balance Sheet: Equipment (Asset) decreases by $10,000 each year Retained Earnings (Equity) decreases by $10,000 each year (via the income statement)

Financial Statements Impact

- Balance Sheet: Reflects the financial position at a specific point in time.
- Income Statement: Shows financial performance over a period.
- Both statements are interconnected: Net income from the Income Statement affects Retained Earnings on the Balance Sheet.

References

- Lecture notes, Date: Financial Statements Overview
- Course material: **PrinciplesOfAccounting_02_Theory.pdf**