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GoVenture Business Learning & Activity Book

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16 Accounting

Business Accounting

Accounting is the process of tracking financial transactions and reporting the results of the transactions.

A financial transaction occurs every time that money or something of value moves in or out of a business. Examples of financial transactions include:

- Making a sale
- Delivering a product to a customer
- Converting raw materials into a finished product
- Buying advertising
- Paying employees
- Receiving loan money
- Making a payment on a loan
- Paying rent
- Buying office supplies
- Collecting taxes
- and more.

Tracking financial transactions is called **bookkeeping**.

Once financial transactions are recorded, financial reports can be generated to display the results of those transactions.

Double-Entry Bookkeeping

Businesses use a system called double-entry bookkeeping to record their financial transactions. This system is believed to have been developed over 600 years ago.

A personal checkbook is an example of a single-entry bookkeeping system. Each time you record a payment or deposit, you write it down once and add or subtract the amount from your bank balance. Each entry will either increase cash or decrease cash.

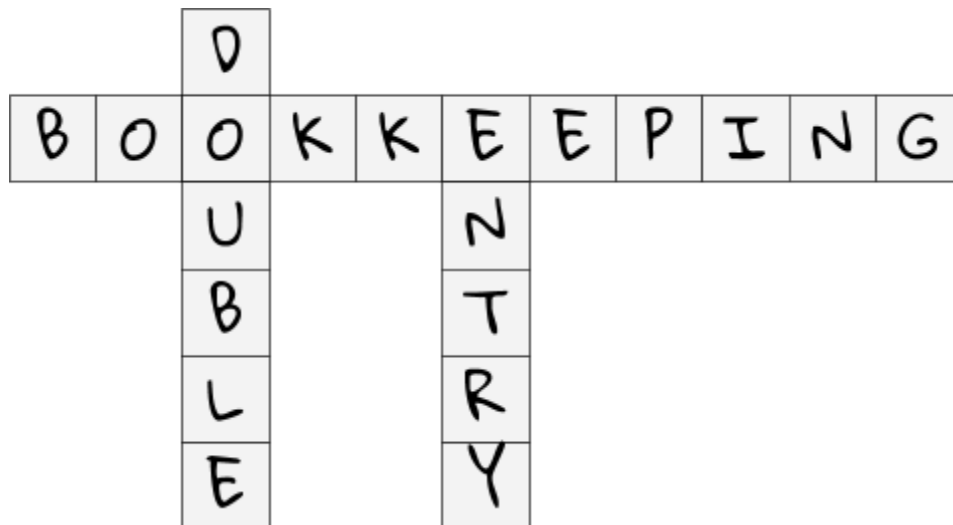
DESCRIPTION	AMOUNT	CASH BALANCE	
		700	
Rent	- 500	200	Easy to make a math mistake
Utilities	- 125	75	
Paycheck	+ 1,000	1,075	

It is easy to make a mistake using single-entry bookkeeping. This could result in the balance of money available to be incorrect.

A business needs a system which will not have this potential for error. And, a business has to categorize all its transactions very carefully. Double-entry bookkeeping solves these challenges.

Double-entry means each item gets entered twice – once to record the impact on cash and once to record the category of the transaction.

By recording the amounts twice (in different subtotals), the system tracks finances more carefully and crosschecks the totals to make sure they are the same. This is similar to how a crossword puzzle requires letters to fit both down and across the puzzle.



Below are three transactions recorded using double-entry bookkeeping. Notice how each transaction has two entries – one to show the effect on Cash and the other to show the effect on a related account.

For example, when a business buys an office chair for \$50, Cash is reduced by the \$50 used to pay for the chair, and Assets are increased by \$50 because the business now owns a chair valued at \$50. The business did not lose \$50. It converted \$50 of value from Cash to an Asset.

DESCRIPTION	CASH ACCOUNT	OTHER ACCOUNT
Buy office chair	- 50	+ 50 Assets
Sell Product	+ 100	+ 100 Revenue
Buy Product to resell	- 75	+ 75 Assets

Double-entry bookkeeping reduces the possibility of error because if an amount is entered incorrectly, it might cause the

accounting to unbalance, which can immediately be seen and corrected.

Traditionally, bookkeeping was done using paper books and pen, but most businesses now use accounting software to save time and provide better reporting.

Accounts

A proper accounting system does more than just track cash in and out of a business – it also tracks how cash is used and how any item of value is moved in an out of the business, or changes value within the business.

The example above used three types of accounts – Cash, Revenue, and Assets. Accounts are a way of categorizing financial transactions in accounting.

There are five major categories (or classes) of accounts commonly used in business accounting:

Assets – Items of value, like cash and product inventory.

Liabilities – Debts that the business owes.

Equity – Money from selling shares (ownership) in the business and holds retained profit.

Revenue – Money received from customers and others.

Expenses – Goods and services purchased by the business.

Each category may have subcategories. For example, Assets could have Cash, Furniture, Equipment, Property, and Product Inventory as subcategories.

Debits and Credits

Every time a financial transaction is recorded in accounting, at least two of the categories above must be modified.

Repeating the earlier example, buying an office chair for \$50, Cash is reduced by the \$50 used to pay for the chair, and Assets are increased by \$50 because the business now owns a chair valued at \$50.

DESCRIPTION	CASH ACCOUNT	OTHER ACCOUNT
Buy office chair	- 50	+ 50 Assets

Another way to show the above transaction is to use the accounting terms **debits** and **credits**, as shown here.

ACCOUNT	DEBIT	CREDIT	DESCRIPTION
Cash		50	Buy office chair
Assets	50		Buy office chair

Debit means to *increase* Assets or Expenses and *decrease* Liabilities or Equity or Revenue.

Credit means to *decrease* Assets or Expenses and *increase* Liabilities or Equity or Revenue.

In the example above, the Cash account is credited (decreased) by \$50 and the Assets account is debited (increased) by \$50. The description is the same for both because they form part of the same transaction.

Accounting prefers the terms debits and credits, which are sometimes abbreviated DR and CR. These terms are used to avoid the confusion that could arise with the use of plus, minus, increase, decrease.

	DEBIT	CREDIT
Assets	↑	↓
Liabilities	↓	↑
Equity	↓	↑
Revenue	↓	↑
Expenses	↑	↓

Cash Versus Accrual Accounting

When creating accounting systems for a business, one of the decisions that needs to be made first is whether to use **cash** or **accrual** basis accounting.

The difference between the two methods is the timing of when transactions are recorded in accounting.

With **cash** basis accounting, revenue is recorded when cash is received from customers, and expenses are recorded when cash is paid out.

With **accrual** basis accounting, revenue is recorded when the sale is made, whether or not the cash money is received from customers. Expenses are recorded when they are incurred, whether or not the cash money has been paid out. See examples below.

TRANSACTION	CASH	ACCRUAL
Product sale \$100 on January 1. Customer pays on February 1.	Post \$100 sale on February 1.	Post \$100 sale on January 1. Post again on February 1 when cash is received.
Purchase office chair \$50 on January 1. Pay for chair on February 1.	Post \$50 expense on February 1.	Post \$50 expense on January 1. Post again on February 1 when cash is paid.

Cash basis accounting is simpler but may not give an accurate picture of the company's current financial condition. This is because revenue may be earned on a particular date, but this will not be reflected in the accounting until the cash is received. Similarly, a company may owe a debt that may not appear in the accounting until it is paid.

Accrual basis accounting is the standard practice for most businesses, except for some very small businesses.

Accounts Payable & Receivable

With accrual basis accounting, a business normally uses two accounts to track the purchase and sale of goods when payment is not immediately made:

Accounts Payable is used to record *purchases* of goods and services made by the business for which the business has not yet paid, but expects to pay within one year. It is a liability that is abbreviated as **A/P**.

Accounts Receivable is used to record *sales made* of goods or services by the business for which the business has not yet received payment, but expects to within one year. It is an asset that is abbreviated as **A/R**.

With accrual basis accounting, a product may be sold today but payment may not be received for some time in the future. This means the business is owed money and this debt should appear in accounting as a debt until it is paid, at which point it appears as cash.

For example, when a furniture business sells an office chair for \$50, this is recorded as Revenue at the time the sale is made. But, if the payment is not yet received, it is posted in Accounts Receivable as money that is due to the company and expected to be received in a few days, weeks, or longer – up to one year (based on whatever payment terms are negotiated).

ACCOUNT	DEBIT	CREDIT	DESCRIPTION
Revenue		50	Sold office chair
A/R	50		Sold office chair

Once the customer pays \$50 for the office chair, the furniture company records the payment by moving the \$50 from Accounts Receivable to Cash, as shown below.

ACCOUNT	DEBIT	CREDIT	DESCRIPTION
A/R		50	Sold office chair
Cash	50		Sold office chair

The net result is Revenue +50, Cash +50, A/R 0.

The date on which the office chair was sold is different than the date on which payment was received. This time difference is properly tracked with accrual basis accounting and assures that the \$50 owed to the furniture business is recorded in accounting from the moment the office chair was sold to the moment payment was received.

With cash basis accounting, Accounts Payable and Accounts Receivable are not used because all financial transactions are

posted in accounting when cash is exchanged. So, the time between when a product is purchased or sold and when payment is made or received is not recorded.

Now, consider the above transaction from the customer's point of view, instead of the furniture company. Assuming the Ford company purchases the office chair for use in one of its buildings, the transaction records the purchase of the office chair as an Asset and the money owed for the chair as an Accounts Payable.

ACCOUNT	DEBIT	CREDIT	DESCRIPTION
Asset	50		Buy office chair
A/P		50	Buy office chair

Ford has a new asset in its possession worth \$50, but Ford owes the furniture company \$50, which is shown as an Accounts Payable liability. Everything balances with \$50 in value minus \$50 owed for a difference of \$0.

When Ford pays for the office chair, Ford moves \$50 out of Cash for the payment and reduces Accounts Payable by the same amount because it no longer owes the money and therefore has no liability.

ACCOUNT	DEBIT	CREDIT	DESCRIPTION
Cash		50	Buy office chair
A/P	50		Buy office chair

The net result is Assets +50, Cash -50, A/P 0.

Buying and Selling Products

The examples above describe how a product can be purchased and paid for at a later date. The purchase and payment of a product is normally documented using **order forms**, **purchase orders**, and **invoices**.

Order Form

An order form is a document, online form, or online shopping cart provided by a seller to be used by customers to place orders for products.

An order form includes product names, prices, tax information, and payment options. A buyer submits a completed order form to the seller. Payment may be required at the time the order is submitted, or at some designated time in the future.

Examples:

- In a quick-serve restaurant, a customer places their order at a cash register or self-serve kiosk as soon as they enter the business and pays immediately upon ordering. The food is then prepared and delivered to the customer.
- In a full-service restaurant, a customer will first be seated and then a server will take their order and send it to the kitchen. The food is then delivered to the customer. After the customer has finished their meal, payment will be made.
- When purchasing from an online store, a customer will add products to an electronic shopping cart and then checkout by making a payment. The order is transmitted to the seller to fulfill.

Some businesses allow customers to order and receive a product before they have to pay. This happens in the full-service restaurant above. But in that example, the customer is physically inside the business, so there is a high assurance that the customer will pay the amount owing.

What if the customer is not physically present? How does the seller assure that payment will be made after a product is delivered to the customer?

This is accomplished using a **purchase order**.

Purchase Order

A purchase order (PO) is a document used to place an order for goods or services. The buyer prepares and sends a PO to

the seller, indicating the product to be purchased, the price, and payment method. If the seller agrees with the offer in the PO, the seller will provide the product to the buyer.

A PO usually has payment terms where the buyer will receive the product and then have a few days or longer before making payment for the product.

To properly document the delivery of the product and the required payment, the seller will issue an **invoice** to the buyer – more on this below.

A PO is a legally-binding agreement that helps assure that the product requested by the buyer will be delivered by the seller, and that payment will be made by the buyer. While there are no guarantees that everything will go smoothly, this is a common business practice to build trust between parties.

A PO is also a way for a buyer to control who in the organization is authorized to make purchases on behalf of the company. For example, if a company has many employees, normally, only a select few will have the authority to make purchases in the name of the company. By using a valid PO to place an order, an employee is providing the seller with the assurance that they have the authority to act on behalf of the company that is placing the order.

Bill and Invoice

When a customer eats at a full-service restaurant, they place an order for their food. Sometime later, the customer is given a **bill** – a document that lists the goods and services consumed with a total cost that they are expected to pay. The goods and services were delivered and payment is due immediately.

Similarly, a telephone company provides communications services and then issues a bill to the customer for payment.

A bill is also called an **invoice**. The terms are often used to mean the same thing, but for accounting purposes a business that provides a product and expects to be paid will issue an invoice to a customer. The customer that receives the invoice records the invoice as a bill.

Accounts Receivable (seller) records invoices

Accounts Payable (buyer) records bills

Another example to demonstrate the distinction between a bill and an invoice is with a restaurant. The customers who buy from the restaurant are issued bills by the restaurant. The suppliers who provide food and drinks to the restaurant will issue invoices to the restaurant – and the restaurant considers these as bills.

When a business sells a product for which it is not immediately paid, it is common for the business to issue an **invoice** to the customer.

An invoice is a document that includes the following information:

- The word INVOICE prominently displayed.
- Invoice number – unique for every invoice.
- Name, address, and telephone number of the business issuing the invoice.
- Name and address of the customer.
- Date of invoice, which is usually when the product was given or delivered to the customer.
- Name or description of the product sold.
- Quantity of product sold.
- Price of the product, including discounts, taxes, and fees.
- Payments made by the customer, if any.
- Terms describing when the remaining payment is due.

INVOICE

BILL TO

CUSTOMER NAME
345 King Street
Springfield, ON, 92181

INVOICE # 1001
TERMS: NET 30
INVOICE DATE: OCT 1, 2020
DUE DATE: OCT 31, 2020

COMPANY LOGO

COMPANY NAME
123 Main Street
Springfield, ON 92173
555.902.4567

ITEM	QUANTITY	PRICE	AMOUNT
PRODUCT NAME OR DESCRIPTION	2	\$10.00	\$20.00

TAX \$3.00
TOTAL DUE \$23.00

Payment terms are often described as Net 30, Net 60, or other timeframe. *Net* means the remaining balance owing. *30, 60* or other number means the number of the calendar days by which the full payment is due.

Receipt

A receipt is a document that confirms that something of value has been transferred from one person or organization to another.

Most often, receipts are issued by businesses to customers when a payment is made by the customer. A receipt normally includes the amount paid, the name or description of the product or item of value purchased by the customer (transferred), the date of the transaction, and how payment was made.

RECEIPT			
RECEIPT # 1001		COMPANY LOGO	
DATE: OCT 31, 2020		COMPANY NAME 123 Main Street Springfield, ON 92173 555.902.4567	
ITEM	QUANTITY	PRICE	AMOUNT
PRODUCT NAME OR DESCRIPTION	2	\$10.00	\$20.00
			TAX \$3.00
			TOTAL \$23.00
PAID CASH			

Financial Statements

Financial statements report the current and past financial state of the business. Proper accounting makes it easy to generate accurate reports for many aspects of a business.

There are three primary financial statements for a business: **Balance Sheet**, **Income Statement** (sometimes called a Profit and Loss or P&L), and **Cash Flow** statement.

Cash Flow Statement

Shows the timing of money flowing in and out of the business. This report is particularly important in helping make sure the business does not run out of money, unexpectedly.

Income Statement

Shows all of the money flowing in and out of the business to determine if the business is profitable or not.

Balance Sheet

Shows the value of the business by adding up everything the business owns and subtracting everything that the business owes. The actual value of a business is often more complex than the Balance Sheet shows, but the Balance Sheet provides an accurate view of its financial position.

The reports above are described in detail, further in this book.

General Ledger

The **General Ledger (GL)** provides a record of each financial transaction that takes place during the life of an operating company.

Accounting accounts appear in the General Ledger, with each account showing the debits and credits made on the account and the running balance.

A **trial balance** can be generated from the General Ledger that shows the balance of each account. The balance of debits and credits can then be compared to assure they are identical and that the accounting is mathematically correct.

Accounting Standards

Accounting rules may vary based on the different standards used around the world.

Businesses in the USA, Canada, and some other countries use **Generally Accepted Accounting Principles – GAAP**.

The **International Financial Reporting Standards – IFRS** – is another common standard used in many countries.

There are several other less-popular standards.



17 Cash Flow and Budget

Importance of Cash

Running out of money (**cash**) is the most severe problem a business can face. Without money, employees cannot be paid, products cannot be made or shipped, customers cannot be served, and everything eventually comes to a full stop.

Managing cash is of critical importance. Proper planning is needed because the timing of when cash is received by a business and when it has to be paid out is constantly changing. This is particularly challenging when a business is not profitable and has more cash going out than coming in.

Cash Flow

Money flowing in and out of a business is described as **cash flow**:

$$\text{Cash Flow} = \text{Money IN} - \text{Money OUT}$$

Money IN

All sources of incoming cash, such as **revenue** and other **income**.

Money OUT

Everything that requires money to be paid.

MONEY IN	
REVENUE	\$15,000
OTHER INCOME	\$1,000
TOTAL	\$16,000

MONEY OUT	
MANUFACTURING	\$5,000
SALES & MARKETING	\$4,000
WAGES	\$3,000
OPERATIONS	\$2,000
OTHER	\$1,000
TOTAL	\$15,000

CASH FLOW	
MONEY IN	\$16,000
MONEY OUT	\$15,000
MONEY IN – MONEY OUT	\$1,000

Knowing how much money is coming in and going out is important, but equally important is knowing the timing of when money is coming in and going out.

Timing can be difficult to predict because it is not always known exactly when customers will pay bills, or other payments will be made.

Even very successful businesses can run into cash flow problems.

Cash Flow Statement

A **Cash Flow** statement is a report that projects the timing of money in and money out in the immediate future. The report includes a time **period** and **duration**. The period is the segments of time in which the report shows money IN and money OUT – such as weekly, monthly, quarterly, or other time period. The duration is the length of time in the future being projected.

Most often, Cash Flow statements use monthly periods projected 12 months into the future. Review the example in the table below that projects three months forward.

CASH FLOW	JAN	FEB	MAR
MONEY IN	\$16,000	\$14,000	\$15,000
MONEY OUT	\$15,000	\$16,000	\$15,000
MONEY IN – MONEY OUT	\$1,000	– \$2,000	\$0

Complete the table below with additional examples.

CASH FLOW	APR	MAY	JUN
MONEY IN	\$13,000	\$14,000	\$15,000
MONEY OUT	\$12,000	\$12,000	\$17,000
MONEY IN – MONEY OUT	\$ _____	\$ _____	\$ _____

Cash Flow statements include one more important item – a running balance of the cash surplus or deficiency. Review the example in the table below where the Balance for the current month is added to the total Balance of all the previous months.

CASH FLOW	JAN	FEB	MAR
MONEY IN	\$16,000	\$14,000	\$15,000
MONEY OUT	\$15,000	\$16,000	\$15,000
MONEY IN – MONEY OUT	\$1,000	– \$2,000	\$0
BALANCE Starting Balance = \$0	\$1,000 = \$0 + \$1,000	– \$1,000 = \$1,000 – \$2,000	– \$1,000 = – \$1,000 – \$0

In the example above:

- January Balance equals the Starting Balance of \$0 plus the result of January \$1,000 for an ending Balance of \$1,000.
- February Balance equals the Balance of January \$1,000 plus the result of February – \$2,000 for an ending Balance of – \$1,000.

- March Balance equals the Balance of February – \$1,000 plus the result of March \$0 for an ending Balance of – \$1,000.

Complete the table below.

CASH FLOW	JUL	AUG	SEP
MONEY IN	\$22,000	\$21,000	\$18,000
MONEY OUT	\$20,000	\$20,000	\$20,000
MONEY IN – MONEY OUT	\$2,000	\$1,000	– \$2,000
BALANCE Starting Balance = \$0	\$ _____	\$ _____	\$ _____

In the examples above, the Starting Balance was \$0. This makes it easier to see if future projections will result in a surplus or deficit. Sometimes, a business will use its actual cash balance in the Cash Flow statement as this makes it easier to see if the business risks running low on cash.

Repeat the example above using a Starting Balance of \$2,000.

CASH FLOW	JUL	AUG	SEP
MONEY IN	\$22,000	\$21,000	\$18,000
MONEY OUT	\$20,000	\$20,000	\$20,000
MONEY IN – MONEY OUT	\$2,000	\$1,000	– \$2,000
BALANCE Starting Balance = \$2,000	\$ _____	\$ _____	\$ _____

Budget and Cash

Budget is an amount of money a business has reserved to invest in a project or business function in a given period of time – week, month, quarter, year.

Budget is not money already spent – it is money set aside to be spent. Examples:

- Budget \$10,000 to spend on an advertising campaign in the month of February.
- Budget \$5,000 to conduct a market research survey.
- Budget \$100,000 to develop a mobile app.
- Budget \$20,000 to spend on the purchase of new furniture during the calendar year.

Using budgets serves three purposes:

1. Knowing how much money could be spent on individual activities within the company helps the business manage cash flow and the overall cash available in the business. In basic terms, it helps the company avoid running out of money, or spending more money than desired.
2. Budgets help guide the people who will be spending the money on the project or business function for which they are responsible. By having a specific budget, the scope of the effort can be scaled so that the desired goal is achievable with the money available.
3. Helps the business measure and compare results, which helps with future decision making.

Budget should not be confused with cash. Cash is the amount of money a business has available, often in bank accounts and short-term liquid investments.

Budget is taken from cash, but is usually only a small portion of the cash available in the business. Cash is needed to operate a business and a good amount of cash needs to always be available to provide working capital for the business. This is why the budget is only a small portion of cash.

CASH	\$100,000
BUDGET	\$20,000
BUDGET AS % OF CASH	20%

The board of directors and management of a company determine how much cash is allocated to individual budgets. A company may have many budgets for different activities that the business must undertake.

Over and Under Spending

Once a budget amount is set aside for a specific activity, should the entire budget be spent on that activity? The best answer is that as much of the budget should be spent as is necessary to achieve the desired goals.

Achieving a specific goal may require the full budget or only a portion of it.

Spending more money in certain business functions can increase the opportunity to make more profit, but it can also risk losing the business more money.

For example, investing more money to produce more products provides a business with more products to sell and thereby the opportunity to generate more revenue. But, if the business does not sell all of the extra products produced, the business may end up losing money.

Similarly, spending more money on sales and marketing could help generate more sales. But, if the business strategy does not work, then all of that extra money spent on sales and marketing will be lost.

MONEY INVESTED	\$20,000	\$20,000	\$20,000
SALES REVENUE	\$25,000	\$18,000	\$8,000
PROFIT (LOSS)	\$5,000	-\$2,000	-\$12,000

Complete the table below with additional examples.

MONEY INVESTED	\$50,000	\$30,000	\$18,000
SALES REVENUE	\$52,000	\$45,000	\$8,000
PROFIT (LOSS)	\$ _____	\$ _____	\$ _____

In business, spending money always offers you both opportunity and risk.



18 Income Statement

Financial Statements

There are two primary financial statements for a business: **Balance Sheet** and the **Income Statement** (sometimes called a Profit and Loss or P&L).

The **Income Statement** shows all of the money flowing in and out of the business to determine if the business is profitable or not.

The **Balance Sheet** shows the value of the business by adding up everything the business owns and subtracting everything that the business owes. The actual value of a business is often more complex than the Balance Sheet shows, but the Balance Sheet provides an accurate view of its financial position.

Revenue and Expenses

To understand the **Income Statement**, you must first understand some key definitions.

Revenue or Income

This is money earned by selling a product or service. You receive this money directly from end consumers, resellers, or distributors.

Cost of Goods Sold (COGS)

The cost to produce the products you have sold are recorded as COGS. For clarity, COGS is only for

products that have been sold, not for products that are in inventory and not yet sold.

Expenses

This is money paid out to sell your products and operate the business. It can include employee wages, sales and marketing expenses, interest on loans, and more.

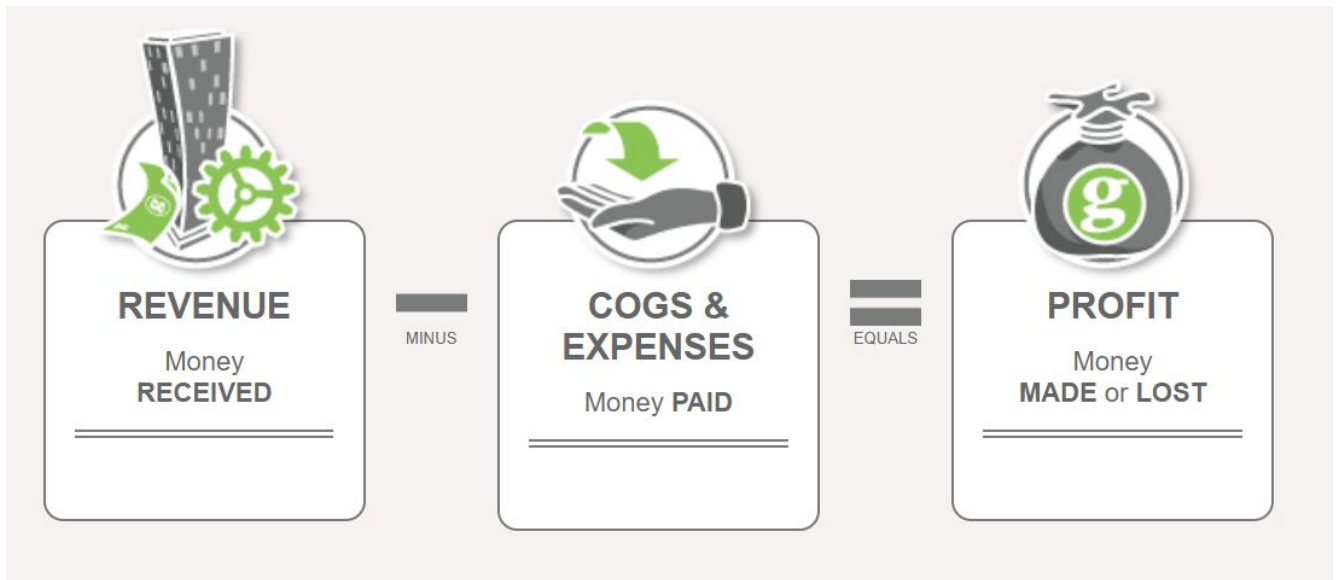
Profit

This is the money generated from your business activity that exceeds the costs of the business. If revenue minus COGS minus expenses is positive, it means you have generated a profit. If it is negative, you have losses. Profit is also called earnings.

The Income Statement adds up all the revenue, COGS, and expenses and applies this formula:

$$\text{Revenue} - \text{COGS} - \text{Expenses} = \text{Profit}$$

If the formula above results in a positive number, then the business has generated a profit. If the number is negative, then the business has suffered losses. Here is the Income Statement formula visually:



Here is an example that applies the Income Statement formula:

$$\text{Revenue} - \text{COGS} - \text{Expenses} = \text{Profit}$$

REVENUE \$5,000	Product Sales \$5,000
COGS & EXPENSES \$3,000	COGS \$1,000 Expenses \$2,000
PROFIT \$2,000	

The business above has generated a profit of \$2,000.

Complete the table below with additional examples.

REVENUE	Product Sales \$8,000	Product Sales \$6,000 Sale of Services \$2,000
COGS & EXPENSES	COGS \$2,500 Expenses \$1,000	COGS \$3,000 Expenses \$6,000
PROFIT	\$ _____	\$ _____

If profit is negative, the company has suffered a loss. Losses in accounting are sometimes shown with negative numbers or numbers in parenthesis, like this:

– \$100 or (\$100)

Both of the above mean negative \$100 or a loss of \$100.

Net Profit and Gross Profit

The Income Statement often shows two different profit numbers: Gross profit and net profit.

Net Profit is as described above, using the P&L formula:

$$\text{Revenue} - \text{COGS} - \text{Expenses} = \text{Net Profit}$$

Gross Profit uses this formula:

$$\text{Revenue} - \text{COGS} = \text{Gross Profit}$$

Gross profit is the revenue generated from product sales minus the cost of good sold (COGS). Unlike net profit, gross profit does not account for other expenses, like sales and marketing, operations costs, interest paid, and more. See the example below.

REVENUE \$5,000
 COGS \$1,000
 \$4,000 = GROSS PROFIT

EXPENSES \$3,000
 \$1,000 = NET PROFIT

Net profit generally means the final, bottom line, profit. This is also called **earnings**.

Complete the table below with additional examples.

REVENUE	\$8,000	\$6,000
COGS	\$2,500	\$3,000
GROSS PROFIT	\$ _____	\$ _____
EXPENSES	\$2,000	\$4,000
NET PROFIT	\$ _____	\$ _____

COGS and COS

Cost of goods sold (COGS) is normally used to refer to physical products (goods).

When selling services, the term **cost of sales** (COS) is often used instead.

Cost of revenue is also a common term, and could apply to both goods and services.

COGS normally includes all costs associated with producing a product. This includes raw materials, parts, assembly, and the transportation costs to bring everything together. Human labor costs needed to make the product are also included in COGS.

Costs that are not *directly* associated with making a product are not included in COGS. This includes sales and marketing, financing costs, employee wages that are not involved in the making of the product, and more. These are all considered Expenses not COGS. And, COGS only includes the costs of products that are already sold, not the cost of products that remain in inventory.

The concepts above also apply to services and cost of services.

Other Income

Sometimes, a business will generate money (revenue or income) in ways that are not part of its primary business. This money is normally classified as **other income**.

For example, a company that makes and sells widgets as its primary business may also earn income from interest on the money it has in the bank. The company may also receive a government grant (a grant is a financial incentive that does not have to be repaid).

This new money that is not derived from the primary business is classified as Other Income, and appears on the Income Statement as shown below.

Revenue – COGS – Expenses + Other Income = Net Profit

REVENUE \$5,000	Widget Sales \$5,000
COGS & EXPENSES \$3,000	COGS \$1,000 Expenses \$2,000
OTHER INCOME \$1,500	Bank Interest \$1,000 Grant \$500
NET PROFIT \$3,500	

Complete the table below with additional examples.

REVENUE	Widget Sales \$7,000	Widget Sales \$6,000
COGS & EXPENSES	COGS \$3,000 Expenses \$2,000	COGS \$5,000 Expenses \$3,000
OTHER INCOME	Bank Interest \$750 Grant \$750	Bank Interest \$1,000 Grant \$1,000
NET PROFIT	\$ _____	\$ _____

Period

When generating an Income Statement, you have to choose two dates: The starting (From) date and the ending (To) date. The data that will be displayed will include all transactions between and including the dates you select.

Retained Earnings

An important term that appears in financial statements is **retained earnings**.

Earnings is another word for net profit.

“Retained” means held or kept.

Retained earnings is net profit that remain in the company — as opposed to profit or earnings that are paid out to company shareholders.

Some companies will pay out a portion of net profits to the company owners (the shareholders). This payout is called a **dividend**.

When a dividend is paid, the net profits held (retained) in the company are reduced. This means the retained earnings are reduced.

Retained earnings are a running total of all the profits accumulated in a business. The Income Statement shows both the net profits of the current time period, and the cumulative net profits (retained earnings) from the entire history of the company.

The table below shows how retained earnings is a running total of the profits from past years and the current year.

	YEAR 1	YEAR 2	YEAR 3
NET PROFIT	\$1,000	\$2,000	\$1,500
RETAINED EARNINGS	\$1,000	\$3,000 = \$1000 + \$2,000	\$4,500 = \$3,000 + \$1,500

The table below shows how dividends paid out will reduce retained earnings.

	YEAR 1	YEAR 2	YEAR 3
NET PROFITS	\$1,000	\$2,000	\$1,500
DIVIDENDS	\$0	\$500	\$1,000
RETAINED EARNINGS	\$1,000	\$2,500 = \$1000 + \$2,000 - \$500	\$3,000 = \$2,500 + \$1,500 - \$1,000

Complete the table below with additional examples.

	YEAR 1	YEAR 2	YEAR 3
NET PROFITS	\$2,000	\$4,000	\$3,000
DIVIDENDS	\$0	\$1,000	\$2,000
RETAINED EARNINGS	\$ _____	\$ _____	\$ _____

Relationship to Balance Sheet

The Income Statement and the Balance Sheet are connected through one number: retained earnings.

The Balance Sheet shows the current value of the business. Value includes the total net profit accumulated by the business, minus dividends paid out to shareholders — what is known as retained earnings.

BALANCE SHEET	P&L
ASSETS	REVENUE
LIABILITIES	COGS & EXPENSES
EQUITY	RETAINED EARNINGS

In the table above, retained earnings from the Income Statement is added to equity on the Balance Sheet.

Sample Income Statement

Below is a sample Income Statement.

	P1	Total All-Time
Revenue	96,096	96,096
Cost of Goods Sold	13,728	13,728
Other Income	0.00	0.00
SubTotal	82,368	82,368
Operating Expenses		
General and Administrative	10,000	10,000
Human Resources		
Research & Development	10,000	10,000
Production	5,000	5,000
Sales & Marketing	4,000	4,000
Operations	3,000	3,000
Management	7,000	7,000
Benefits and Programs	0.00	0.00
Hiring Costs	0.00	0.00
Severance Costs	0.00	0.00
Training Costs	0.00	0.00
Turnover Costs	0.00	0.00
Expired Units	0.00	0.00
Loan Interest Payments	0.00	0.00
Sales & Marketing		
Advertising - Brand - North FL	5,000	5,000
Advertising - Brand - South FL	0.00	0.00
Advertising - Brand - East FL	0.00	0.00
Advertising - Price Discount - North FL	0.00	0.00
Advertising - Price Discount - South FL	0.00	0.00
Advertising - Price Discount - East FL	0.00	0.00
Sales Promotion - North FL	5,000	5,000
Sales Promotion - South FL	0.00	0.00
Sales Promotion - East FL	0.00	0.00
Research & Development		
Taste	5,000	5,000
Health	0.00	0.00
Change costs to update processes/equipment	0.00	0.00
Change costs to upgrade product inventory	0.00	0.00
Other		
Expansion to other territories	0.00	0.00
Market Research Reports	0.00	0.00
Miscellaneous Expenses	0.00	0.00
Legal	0.00	0.00
SubTotal	54,000	54,000
Net Profit (Loss)	28,368	28,368



19 Balance Sheet

Financial Statements

There are two primary financial statements for a business: **Balance Sheet** and the **Income Statement** (sometimes called a Profit and Loss or P&L).

The **Income Statement** shows all of the money flowing in and out of the business to determine if the business is profitable or not.

The **Balance Sheet** shows the value of the business by adding up everything the business owns and subtracting everything that the business owes. The actual value of a business is often more complex than the Balance Sheet shows, but the Balance Sheet provides an accurate view of its financial position.

Assets and Liabilities

To understand a Balance Sheet, you must first understand some key definitions.

Asset

This is something that a business owns. This could be cash, furniture, property, buildings, computer software, and more.

Liability

This is something that a business owes. This could be money owed to employees, vendors, the government, or loans owed to banks and others.

The Balance Sheet adds up all the assets and the liabilities and then applies this simple formula:

Assets - Liabilities

If the business owns more value in assets than it owes in liabilities, then it has positive **equity**. Equity is the value held in the business and is the third component of the Balance Sheet formula, as shown here:



Here is an example that applies the Balance Sheet formula:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

ASSETS \$5,000	Cash \$4,000 Furniture \$600 Computer \$400
LIABILITIES \$3,000	Bank Loan \$2,000 Credit Card \$1,000
EQUITY \$2,000	

One way to read the above is to say that if the business is shut down and everything in it sold (“liquidated”) and the liabilities paid off to \$0, there would be \$2,000 left over. This is how much value currently exists in the business.

Complete the table below with additional examples.

ASSETS	Cash \$8,000 Furniture \$700 Computer \$400	Cash \$12,000 Unpaid Sales \$1,000 Land \$10,000
LIABILITIES	Bank Loan \$2,500 Credit Card \$900	Bank Loan \$9,500 Owed to Suppliers \$6,000
EQUITY	\$ _____	\$ _____

Business Value

Intangible Assets

The concept of business value is somewhat simplified in the examples above, as a business may also have **intangible assets** which contribute to its value.

Intangible assets may include patents, trademarks, customer contracts, goodwill, and more. Intangible means something that is not physical and cannot be touched. Furniture and computers are tangible assets — they have physical form.

Assigning value to intangible assets can be subjective, but generally equates to the value of what the intangible asset could be sold for if it had to be sold. This means that there has to be a reasonable expectation that a buyer can be found that is willing and able to purchase the intangible asset at the price set. However, sometimes intangible assets are valued differently based on generally-accepted accounting principles.

This is an advanced topic beyond the scope of this document, but is noted here to help frame the Balance Sheet.

See the table below and complete the second example. Notice that intangible assets (patents and customer contracts) have been added to the Balance Sheet.

BALANCE SHEET		
ASSETS	Cash \$8,000 Furniture \$1,000 Patents \$2,000	Cash \$12,000 Land \$10,000 Customer Contracts \$2,000
LIABILITIES	Bank Loan \$7,000	Bank Loan \$12,000
EQUITY	\$4,000	\$ _____

Tangible Assets

Another element that affects business value is the value of the tangible assets on the Balance Sheet. The value shown for assets is not the original purchase price, but the depreciated value of the asset. Depreciation is also an advanced topic, but it generally means that most assets will lose value over time, and so the Balance Sheet should properly reflect this change in value.

For example, a computer may cost \$900 brand new today, but if you tried to sell that computer in one year, you may only get a few hundred dollars for it. The Balance Sheet should show the computer at this reduced value.

See the table below and complete the additional example. Notice that the value of the computer has changed from Year 1 to Year 2 on the Balance Sheet because it has depreciated.

	YEAR 1	YEAR 2
ASSETS	Cash \$8,000 Computer \$900	Cash \$8,000 Computer \$400
LIABILITIES	Bank Loan \$7,000	Bank Loan \$7,000
EQUITY	\$1,900	\$ _____

Equity

How does a business create value, or **equity**? Reviewing the Balance Sheet formula:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

This may suggest to increase assets. But, how does a business increase the value of an asset? Most assets lose value over time, like furniture and computers. Real estate may or may not increase in value over time.

Buying a new asset will not increase equity. This is because if a business buys a new asset, then cash may be reduced to pay for the new asset. In this case, the equity has not changed, as shown in the table below.

ASSETS	Cash \$8,000	Cash \$6,000 Computer \$2,000
LIABILITIES	Bank Loan \$7,000	Bank Loan \$7,000
EQUITY	\$1,000	\$1,000

What if the business buys the computer using a credit card? In this case, the credit card balance will appear as a liability, and again the equity does not change, as shown in the table below.

ASSETS	Cash \$8,000	Cash \$8,000 Computer \$2,000
LIABILITIES	Bank Loan \$7,000	Bank Loan \$7,000 Credit Card \$2,000
EQUITY	\$1,000	\$1,000

Buying, renting, or leasing assets does not increase the value or equity of a business. It's what the business does with those assets that may contribute to increasing equity.

For example, buying a new computer may allow you to serve more customers to sell more product and generate more revenue and profit. This additional profit increases equity. Buying the computer did not directly increase equity, but how it was used did.

Again, reviewing the Balance Sheet formula:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

This may suggest that decreasing Liabilities will increase equity. But, decreasing a liability normally means using an asset, like cash.

For example, you can pay off a \$7,000 bank loan to eliminate the liability, but if you use cash to pay the loan, then your

asset will also decrease, as shown in the table below.

ASSETS	Cash \$8,000	Cash \$1,000
LIABILITIES	Bank Loan \$7,000	
EQUITY	\$1,000	\$1,000

Increasing Equity

Equity is most often increased in two ways:

Profit

As a business generates profits over its history, the total cumulative profits (and losses) over its entire time in business are added to its equity.

Selling Shares

When a business sells stock or shares in the business, which means ownership in the business, those who buy the shares give the money to the business and this money is recorded as equity.

Equity is reduced if the business suffers losses (negative profit) or if the business issues dividends to its shareholders (owners). A dividend is simply a share of the profits (which are shown as equity).

Profit (Retained Earnings)

Profit increases equity. For example, if you make or buy 100 widgets for \$5 each and sell them for \$7, you will make a profit of \$2 per widget, as shown in the table below. This assumes there were no other expenses incurred with buying and selling the widgets.

BUY \$500	100 Widgets \$5 Each
SELL \$700	100 Widgets \$7 Each
PROFIT \$200	\$700 – \$500

The \$200 profit shown above gets added to the equity on the Balance Sheet, as shown in the table below. Notice that before the widgets are purchase, you have \$1,000 cash. Then \$500 is used to purchase the widgets, so cash is reduced by \$500 and widgets are added as an asset that you own. Then, the widgets are sold for \$700 that is added to cash, and the widgets no longer appear as assets.

	BEFORE	DURING	AFTER
ASSETS	Cash \$1,000	Cash \$500 Widgets \$500	Cash \$1,200
LIABILITIES			
EQUITY	\$1,000	\$1,000	\$1,200

Profit is the most common way that businesses increase Equity. Profit is tracked on the **Income Statement** (or Profit and Loss or P&L). The profit (more specifically, the net profit) at the bottom of the Income Statement is added to the equity on the Balance Sheet.

Profit is added under equity as what is called **retained earnings** — more on this below.

Selling Shares

When a business sells stock (shares) in the business, which means ownership in the business, those who buy the shares give the money to the business and this money is recorded as equity.

For example, let's say you sell a certain number of shares for a total of \$500. The new shareholder gives your company \$500 cash and you record this transaction on the Balance Sheet by increasing cash by \$500 and increasing equity by \$500, as shown in the table below. Money gained through the sales of shares is not considered profit and does not appear on the Income Statement.

Notice that the Balance Sheet equation still remains in balance: **Assets – Liabilities = Equity**

	BEFORE	AFTER
ASSETS	Cash \$1,000	Cash \$1,500
LIABILITIES		
EQUITY	\$1,000	\$1,500

Balance

The Balance Sheet has the word “balance” in the name to indicate that it must always remain in balance. This means that the formula always remains true:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

The formula can also be rearranged as follows:

$$\text{Assets} - \text{Equity} = \text{Liabilities}$$

$$\text{Liabilities} + \text{Equity} = \text{Assets}$$

Whichever format the formula takes, it must always balance, otherwise it indicates that there has been an accounting error made that needs to be corrected. See the example below.

	IN BALANCE	OUT OF BALANCE
ASSETS	Cash \$3,000	Cash \$2,500
LIABILITIES	Bank Loan \$1,000	Bank Loan \$1,000
EQUITY	\$2,000	\$2,000

In the table below, identify if each Balance Sheet example is in or out of balance and by how much. Enter \$0 if in balance.

ASSETS	Cash \$5,500	Cash \$2,500 Computer \$300	Cash \$3,500 Furniture \$500
LIABILITIES	Bank Loan \$1,500	Bank Loan \$2,000	Bank Loan \$2,000 Credit Card \$500
EQUITY	\$4,000	\$900	\$1,000
IN OR OUT OF BALANCE?	\$ _____	\$ _____	\$ _____

Dividends and Retained Earnings

Profit is added under equity as what is called **retained earnings**. “Earnings” means profit. “Retained” means held or kept — as opposed to profit or earnings that are paid out to company shareholders.

When profit is paid out to the company shareholders, it is

called a dividend. When profit is paid out of a company, the equity in the company is reduced, as shown in the table below. Notice also that cash has been reduced by the amount of the dividend paid.

	BEFORE \$1,000 DIVIDEND	AFTER \$1,000 DIVIDEND
ASSETS	Cash \$9,000	Cash \$8,000
LIABILITIES	Bank Loan \$1,000	Bank Loan \$1,000
EQUITY	\$8,000	\$7,000

Complete the table below with additional examples.

	BEFORE \$2,000 DIVIDEND	AFTER \$2,000 DIVIDEND
ASSETS	Cash \$7,000	Cash \$ _____
LIABILITIES	Bank Loan \$2,000	Bank Loan \$2,000
EQUITY	\$5,000	\$ _____

Period

When generating a Balance Sheet, you have to choose a date. The data that will be displayed will include all past history up to and including the date you select.

Sample Balance Sheet

Below is a sample Balance Sheet.

