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This is Dr. Bob Nolley. And welcome to this lesson on Standardizing Financial Statements. Of all the financial statements and worksheets to get generated in the world of finance, the two most important are the balance sheet and the income statement.

First, let's take a look at the balance sheet. The balance sheet, that is sometimes also called a statement of financial position, is a summary of the financial balances of the organization. A balance sheet has three parts-- assets, liabilities, and owners equity.

The main categories of assets are listed first usually in the order of liquidity. Assets are followed by the liabilities. And the difference between the assets and liabilities is what is known as equity. It's important to remember that the balance sheet balances because of the fundamental accounting equation that says assets equal liabilities plus equity.

A balance sheet is often described as a snapshot of a company's financial condition. Of all the basic financial statements, the balance sheet is the only one that applies to a single point in time at the end of the business year. Let's take a look.

Here is a sample balance sheet for fictitious company, the ABC Company. And here we see the section for the assets in the first section. Underneath this section of the current assets, those are the ones that can be converted into cash very quickly in the short-term, usually in less than a year. These include cash, accounts receivable, which is what your customers owe you, inventory, prepaid expenses, and any short-term investments that you have.

The next subsection of assets is the long-term assets or the fixed assets. This includes longer term investments or property plant equipment, real estate, less depreciation, and any intangible assets as well. And there's also a subsection for other assets, like for taxes that are owed. And all these are totaled up under the line item total assets.

Let's take a look at the liability section. Just like the current assets being first in the assets section, the current liabilities are first in the liability section. Accounts payable, or bills that you owe, short-term loans, income taxes you have to pay, and other accrued salaries and wages that have been expenses by the company but haven't been paid yet, along with any unearned revenue.

Next is the long-term liabilities. This would include any long term debt or deferred taxes. Finally, the last section is the owner's equity. It includes the owner's original investment in the company, plus any retained earnings. These are the net profits that have been earned over the life of the company. Together, the owners equity and the liabilities equal the total assets. So the balance sheet balances.

Now, let's take a look at the income statement. The income statement shows how the revenue is transformed into income. Sometimes it's called the profit and loss statement, or the P&L, the revenue statement, or the statement of financial performance, or the earnings statement, or an operating statement, or the company's financial statement.

In the income statement, revenue is the money that the company has received from the sale of products or services before expenses are taken out. The income statement displays the revenue that is recognized for a specific period, and the costs and expenses that are charged against those revenues, like write-offs and appreciation and taxes. The purpose of the income statement is to show managers and investors whether the company made or lost money during the period being reported.

The important thing about the income statement is this, it represents a period of time that is different from the balance sheet, which represents a single moment in time. Let's take a look at an example.

Here's an example for XYZ retailers. The top section shows us revenue. And this includes sales. In this, it's $250,000. And then from that we'd subtract the cost of goods sold. We figure that out by the change in inventory. And that gives us the gross profit.

To the gross profit we can add any other operating revenue not directly related to the business such as rent we bought of received or other commissions. And this gives us the total revenue. Generally, this total revenue is sales minus the cost of goods sold.

Now, the expenses section shows us cash outflows or some other using up of assets or incurring of liabilities during the period being reported from delivering your products, goods, and services, or carrying out any other activities that are part of major operations. The first expenses listed are for selling general administrative expenses, often called SGA. SGA represents all the expenses needed to sell the products, salary of the salespeople, commissions, travel expenses, advertising, freight, website design, as shown here. These are all the expenses necessary to sell and deliver the products or services.

The last section is to show expenses that are non-operating expenses, like financing costs or income tax expenses or other irregular items. And the other bottom line is the net profit, the EBIT-- earnings before interest and taxes. For XYZ company, that's $60,000. Is this number the net profit? And it is called the bottom line.

The bottom line is the net income that is calculated after subtracting all of the expenses from revenue since it's the last line of the income statement. It's usually informally called the bottom line. And it's important to investors because it is the profit for the period for the year that represents the profit that's attributable to the shareholders.

Here are some final key takeaways. The balance sheet is the only statement that applies to a single point in time. The main categories of assets are usually listed first in the order of liquidity. And it's followed by the liabilities. And the difference between the assets and the liabilities is known as equity.

The income statement displays the revenues for a specific period like an accounting year and the cost and expenses charged against those revenues. It shows a full accounting period. And it starts with revenue and subtracts the cost of goods sold, giving us the gross profit. It then lists all the expenses leading us to the bottom line. This is our net profit.

This is Dr. Bob Nolley. And I'll see you in the next lesson.

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