ACCOUNTING BASICS & FINANCIAL REPORTS

Workbook

Forsythe Entrepreneurial Center | The Chicago Lighthouse

Table of Contents

Overview 3

Workshop 1: The Accounting Equation 5

Workshop 2: Double-Entry Bookkeeping 15

Workshop 3: Financial Statements 33

Workshop 4: The Balance Sheet 36

Workshop 5: The Income Statement 48

Workshop 6: The Cash Flow Statement 54

Workshop 7: Analyzing Financial Statements 61

Workshop 8: Accounting Ratios 69

Overview

This workbook is part of the Hadley series Accounting Basics and Financial Reports. As you complete the activities in this workbook, you will be practicing some of the calculations presented in the workshops. You will also determine some of the basics of the value of your company.

Workbook Organization

Each workshop section in this workbook includes the following:

- Key Questions: These are reflection questions you can answer for yourself when you complete the workshop and its workbook section. You don't need to write down your answers.
- Key Terms: These are important accounting terms to become familiar with as you begin to keep track of the financial facts of your business. Terms in each section are listed in the order they are presented in the video workshop.

The same terms and definitions are listed in the separate glossary document, but are in alphabetical order

- Activity: These questions give you practice in the methods of accounting introduced in the workshop. Your learning expert can help you work through any of the activities. If you have a business, use your own business information as much as you can.

Now, if you have already viewed Workshop 1: Accounting Equation, proceed to the Workshop 1 section of this workbook.

Workshop 1: The Accounting Equation

In this workshop, you learned about the Accounting Equation. The following workbook section reviews the many terms introduced and helps you calculate your company's current net worth.

Key Questions

These questions don't need answers in writing. By the time you finish listening to Workshop 1 and working through the workbook content, you'll have the answers to these questions for yourself.

- What is the formula for the accounting equation?
- What is another accounting term for Net Worth?
- Why is it important to pay attention to your net worth?

Key Terms

This first workshop includes quite a few terms and their definitions. You might want to download and save the glossary from the course page, so that you can refer to it throughout the workshop series and

in the future. Over time, you'll become more familiar with the meaning and use of these terms.

Net Worth: the amount you have left when you subtract liabilities (what you owe) from assets (what you own), also known as "owner's equity"

Assets: everything of value that the company owns

Liabilities: what the company owes to other businesses, including legal debts or obligations, like accounts payable (A/P), credit card balances and interest, insurance premiums, and notes payable (written promises to pay money the company owes)

Accounting Equation: Net Worth = Assets − Liabilities

Tangible Assets: items that have physical form and belong to the business, usually present on the premises of the business

Intangible Assets: assets that cannot be physically touched, including accounts receivable (A/R)

Accounts Payable: money your business owes for goods and services your business has received

Accounts Receivable: money your customers owe your business in exchange for goods or services your business provided

Current Assets: assets that are used or consumed within one year, for example, bank accounts, petty cash, inventory, and accounts receivable

Fixed Assets: assets that will continue providing benefits for more than a year, such as vehicles, furniture, computers, manufacturing equipment, and real estate

Current Liabilities: debts payable within one year, such as accounts payable (A/P) to vendors, overhead such as rent, utilities, taxes, licenses, insurance premiums, and permits

Long Term Liabilities: debts payable for longer than a year, usually with established terms and deadlines, including long term leases, notes payable, and mortgages

Capital: money a business invests, or profits it retains, in order to generate income.

Operating Costs: ongoing business expenses, mostly fixed costs, not directly attributed to creating a product or service, such as rent, utilities, wages; also known as overhead

Fixed Costs: any expense or cost that remains the same in the short run and does not change with increased production or sales

Operating Losses: the result of having operating costs being more than sales revenue, decreasing the Net Worth of the business

Overhead: ongoing business expenses not directly attributed to creating a product or service, such as rent, utilities, wages; expenses that create the ability to do the work of the business; also known as operating costs

Overhead in Your Business

Operating costs are also known as overhead. These are costs associated with operating the business, opening the doors, and are not linked to any income or product or person. Most of these are monthly expenses, though some are due once or twice per year. These are administrative costs when

you begin and run a business. These costs usually cannot be changed, negotiated, or lowered once agreed upon by the business owner and outside entities. For example, rent is usually based on an annual lease and will not be changed until the next year's lease.

Activities

These questions can help you apply the concepts and calculations explained in the workshop.

Activity 1 Calculate the Net Worth of Your Business

List your company's assets, or valuables, and their current dollar values. Add up the value of these items to get the total of your company's assets.

List your assets and the approximate current value of each here.

Place your cursor after the equal sign. Skip a space and then write the total value of your list of assets.

Total Assets =

Now list the vendors or lenders to which your company owes money. Add up the dollar amounts to get your company's Total Liabilities.

Write your list here.

Now write the total of your liabilities.

Liabilities =

Now use the value of your assets and liabilities to calculate your company's net worth. Subtract the value of your liabilities from the value of your

assets. The difference is the net worth of your company.

An easy way to remember this is the saying, “Net worth equals what you own minus what you owe.” A consistent increase in net worth shows that your company is growing.

Write your net worth after the equal sign.

Net Worth = ☐

Activity 2 Accounts Receivable and Accounts Payable

Here’s an example of Accounts Receivable: if your business did printing for a school district, based on a purchase order, you will often wait 30 or 60 days for payment after you deliver the printed items. Similarly, if you are a wholesaler sending your product to another business every month, sometimes you might not get paid right away. You’ll be waiting for that payment.

Make a list of customers who owe your business money for products or services that you have

already delivered to them. You can also think about the future. What kind of situations can you think of that might result in waiting for payment?

Write your list here.

Payables include products or services you have used or received that you may not yet have paid for. For example, you receive an electric bill after you receive the electricity. You may have a monthly delivery of inventory, or continuing wi-fi service that you pay for every month.

List Your Accounts Payable, both those you have presently, and any that you anticipate in the future. You'll have to have some cash on hand when these bills come due!



Activity 3 Calculating Operating Cost (Overhead)

The following list gives the names of some operating costs. Enter monthly numbers for your business for each item. You may need to adjust some items that are paid annually or semi-annually to have a monthly figure. Some will require an average. Rent stays the same every month, but the utilities vary. Enter an average number.

Rent (monthly) $

Internet, telephone (average) $

Utilities (average) $

Office Supplies (average)$

Equipment leases (monthly) $

Business Insurance (adjust to monthly) $

Property Taxes (adjust to monthly) $

Add to find your Total Average Monthly Operating Costs =

This is what your business will have to spend even when you receive no revenue, such as when you are on vacation. These fixed costs apply when you are setting up your business and you haven't even opened up your doors. Keep these monthly costs in mind, now and in the future.

Once you are operating, you may want to compare your monthly overhead to other similarly-sized companies in the same line of business as your company. We'll work more with comparisons across industry in a future workshop.

Wrapping Up Workshop 1

This workshop introduced many of the terms used to keep track of accounting for a business. The definitions in the Key Terms section for each of the workshops are also listed, in alphabetical order, in the glossary. You may want to download the glossary for future reference. And now, on to Workshop 2.

Workshop 2: Double-Entry Bookkeeping

Now that you are somewhat familiar with the Accounting Equation, including related terms and concepts, you might be wondering how to keep track of all those assets and liabilities used to determine your company's net worth. The Workshop 2 video introduced Double-Entry Bookkeeping and related terms. Learn how to record double-entries in the activities that follow.

Key Questions

- What is the meaning of Double-Entry Bookkeeping?
- What are the two entries that give this bookkeeping method its name?
- What are the three steps of Double-Entry Bookkeeping?

Key Terms

T-Account: a T-shaped diagram used in each account to record debits and credits, along with a description of each transaction

Debit: applied when an asset account increases or a liability account decreases

Credit: applied when an asset account decreases or a liability account increases

Book of Original Entry: an accounting journal that lists every transaction that occurs in a business

General Ledger: a master document that provides a complete set of accounts established and maintained by a business, with a page for each account showing the date and the balance of the last activity

Trial Balance: a summary of the balances in all accounts; has debits equaling credits as of a specific date, such as end of month, end of year

Source documents: transaction documentation, for example, invoices, receipts, and checks

Asset Accounts: include Cash, Inventory, Accounts Receivable, Prepaid Expenses, Equipment, Vehicles, and Buildings

Revenue Accounts: include Product Sales, Fees for Service, interest income, and dividends from investments

Liability Accounts: include Accounts Payable, Credit Cards Payable, bank fees, notes payable (loans), Equipment Leases, and income taxes

Expense Accounts: include Advertising, Insurance, Office Supplies, Rent, Utilities, and Salaries

Owner's Equity (Net Worth) Accounts: include real estate and retained earnings; calculated by subtracting liabilities from assets

Book of Original Entry

The following table shows how the Book of Original Entry is used.

Date	Description
6/12/22	Marcus Washington picked up suit and winter coat. Paid $23.00.

6/12/22	Paid $76.00 for chemicals to Quick Clean Supplies
6/13/22	Sold box of hangers to Fast Clean shop across town. Check from Fast Clean $51.50.

Skipping lines between entries makes the list easier to read later. Some bookkeepers might enter a running balance below each transaction. Later, you (or your bookkeeper) will enter each transaction in two places with a debit in one account and a credit in the other.

Creating the T-Account

The table that follows has five columns. They are titled, from left to right, Date, Description, Debit, Credit, and Balance. We show just a part of a blank table here, with three blank rows under the column headings.

Account Name

Date	Description	Debit	Credit	Balance

Did you notice the letter *T* in the table? The horizontal line runs under the names of the columns. The vertical line separates the debit side on the left from the credit side on the right. Most records of debits and credits also include a running balance. In this table, the running balance is the far-right column, to the right of the credit column.

Learning the Types of Accounts

For each of the accounts listed below, you will eventually need to be able to name the type of account, that is, is the account an asset, expense, liability, revenue, or owner's equity account? Practice this activity until you can easily recall the type of account for every account used by your business. You might want to have a friend read these to you in random order to see if you can quickly name the type of account for each one.

Cash

Utilities

Sales

Inventory

Note Payable

Accounts Payable

Interest Income

Income Taxes

Rent

Dividends from Investments

Bank Fees

Salary

Accounts Receivable

Equipment and Property

What accounts does your business use that aren't listed here?

Activities

Example 1 Jake's Deli

This example walks you through the Double-Entry Bookkeeping process.

Jake's Deli sold a $40 party tray to the local school district for morning coffee break at a meeting. The district sent an employee to the deli to pick up the party tray. That employee paid cash. Apply the double-entry process to this transaction in Jake's general ledger.

As you learned in the workshop video, you can use a three-step process to decide how to record transactions as debits and credits. You'll use these

three steps frequently. Eventually, you'll memorize the rules and understand how they work. The rules also appear in a table in the glossary document for future reference.

Three Steps of Double-Entry Bookkeeping

Step 1. Identify the type of account. Is the account an Asset, Expense, Liability, Revenue, or Owner's Equity (Net Worth) account?

Step 2. Determine if the transaction increases or decreases the account's balance.

Step 3. Apply the rules as shown in the table that follows. The table has three columns with headings, Type of Account, Increased By, and Decreased By.

Below the Type of Account heading, five rows show the five types of accounts. Move across the row for each one of the types to find out whether to apply a debit or a credit when the account is increased or decreased.

Double Entry Bookkeeping

Type of Account	Increased By	Decreased By
Asset	Debit	Credit
Expense	Debit	Credit
Liability	Credit	Debit
Revenue	Credit	Debit
Net Worth	Credit	Debit

Now, back to the example of the party tray from Jake's Deli.

The two accounts affected by the party tray transaction are Sales and Cash.

Sales is a revenue account. The account is increased. When a revenue account is increased, you'll record the increase with a credit in the Sales account.

Cash is an asset account. The account is increased. When an asset account is increased, you'll record the increase with a debit in the Cash account.

The net result for your double-entry is Credit Sales and Debit Cash. You can see the entries made in the following T-accounts. Calculate the new balance for each account, based on whether the account increased or decreased. If you need help, ask your learning expert.

Sales Account (a revenue account)

Date	Description	Debit	Credit	Balance
12/30	Balance			
12/30	Party tray		$40	
12/30	New balance			

Cash Account (an asset account)

Date	Description	Debit	Credit	Balance
12/30	Balance			
12/30	Party tray	$40		
12/30	New balance			

Example 2 Harry's Dry Cleaning

Harry's Dry Cleaning has been in business for 50 years. To mark the anniversary, the owner of Harry's had 200 special garment bags made for preferred customers with customized brand labeling. Mike paid the marketing products company $600 in cash for the 200 bags. Apply the double-entry process to this transaction.

Remember the steps: Identify type of account, then determine if the transaction is an increase or a decrease in the account's balance, then apply the debit/credit rules.

Harry's paid Cash to the marketing company. Cash is an asset account. Is the cash account increased or decreased? Should a debit or credit be applied to the account?

The new garment bags are now in the marketing budget of Harry's Dry Cleaning. Marketing is an expense account. (Why doesn't this go into the inventory account? Ask your learning expert.)

Is the marketing expense account being increased or decreased? Should a debit or credit be applied to the account?

Enter the transaction into the tables that follow. Enter the new balance in each account after the debit or credit.

Cash Account

Date	Description	Debit	Credit	Balance
	Balance			1780.00
	Paid DEF Marketing			
	New balance			

Marketing Account

Date	Description	Debit	Credit	Balance
	Balance			245.00
	200 garment bags			
	New balance			

Did you determine that the net result is Debit Inventory and Credit Cash? If so, you followed the rules correctly. Next is another chance for you to try the rules.

Example 3 Julie's Day Spa Gets a Loan

The carpet in Julie's Day Spa was stained when plants were overwatered. Julie applied for a $900 loan to replace the carpeting. Apply the double-entry process to this transaction. Keep in mind that the loan is money given to Julie's business to make repairs. She has more cash available to the business after she gets the loan.

Cash and Bank Loan Payable are affected by this transaction. What type of account is each one? Is there an increase or decrease? Should a debit or credit be applied to the account? Enter your debit and credit.

Cash Account

Date	Description	Debit	Credit	Balance
	Balance			455.00
	New balance			

Bank Loan Payable Account

Date	Description	Debit	Credit	Balance
	Balance			455.00
	New balance			

The net result is Debit Cash and Credit Bank Loan Payable.

Example 4 The Full Process, Including Book of Original Entry and General Ledger Double-Entry

For every sale in the gift shop of a museum, the salesclerk records the sale in the Book of Original Entry. Later, the clerk, bookkeeper, or another person will enter the transaction in two accounts in the general ledger. On June 19, 2022, the first sale was a customer purchase of a Van Gogh scarf for $29.95. Record the sale in the following Book of Original Entry and the two accounts in the general ledger. The last transaction from June 18th has already been recorded. Record the next directly below, or skip a line first.

Book of Original Entry

Date	Description
6/18/22	32.95 (no tax) cash to customer for return of a children's art kit that was incomplete.
6/19/22	

The purchase of the Van Gogh scarf affects two accounts, Cash and Sales Revenue. Are the accounts increased or decreased? Use the rules to debit or credit the two accounts in the tables that follow.

Cash Account

Date	Description	Debit	Credit	Balance
6/18	Balance			511.00
6/19	Van Gogh Scarf			
6/19	New balance			

Sales Revenue Account

Date	Description	Debit	Credit	Balance
6/18	Balance			511.00
6/19	Van Gogh Scarf			
6/19	New balance			

The net result is debit Cash and credit Sales Revenue.

Wrapping Up Workshop 2

In this workshop, you learned about how to keep track of debits and credits for your business. With practice, you'll master the rules for double-entry bookkeeping, but for now, you might find it helpful to print out the workbook examples or create your own "cheat sheets." You can also find the table of debits and credits in the Glossary and Formulas downloadable document.

In Workshop 3, you'll get an overview of the three most important reports you'll write to track the progress of your business. Move to the next workshop when you're ready for more!

Workshop 3: Financial Statements

This workshop presents the three most important financial statements for a business and their key features. In the first two workshops, you learned many terms that explain accounting practice and the parts of the Accounting Equation. These statements keep track of your business in a way that goes beyond simply recording transactions.

Key Questions

- What are the three different financial statements?
- Why do you need three different financial statements to judge the financial health of your business?
- How are financial statements used by people outside your business?

Key Terms

Remember to download and use the glossary document to see all the Key Terms and formulas for the Accounting Basics and Financial Reports series of workshops.

Balance Sheet: a record of the net worth of your business at a point in time, including its assets and liabilities; more formally called "statement of financial position"

Income Statement: a record of revenues and expenses for a specific period of time, showing whether a business is making a profit or losing money

Cash Flow Statement: a record of cash coming into and out of your business, showing the amount of cash on hand

Activity

In the next workshops, you will create these statements for your own business. As we look ahead to those statements, think about these questions now.

1. What do you think your balance sheet will tell about your business?
2. What will your income statement show? Are you making a profit with your products or services? What could you do to increase profits?
3. How much cash is flowing into and out of your business? Where do you keep your physical and electronic cash?

Wrapping Up Workshop 3

In this workshop, you learned about the three most vital documents used to create an overall picture of the financial health of your business. You may not have the details and the numbers established at this point, but you can already be thinking about what the Balance Sheet, Income Statement, and Cash Flow Statement would tell you about your business. Do you have any unanswered questions about your own business at this point? Contact your learning expert for help.

Workshop 4: The Balance Sheet

In Workshop 4, the focus is on just one of the key financial statements used to keep track of a business's financial health. The Balance Sheet may be the easiest to understand, showing the assets and liabilities of your business at a given point in time. You're probably able to describe your own personal assets and liabilities. It's vital to determine the assets and liabilities of a business.

Key Questions

- What "balance" is shown in the Balance Sheet?
- What important information is not shown in the Balance Sheet?

Key Term

Statement of Financial Position: another name for the Balance Sheet

The Balance Sheet

The Balance Sheet is set up according to the Accounting Equation, Assets = Liabilities + Net Worth. Your balance sheet will show Assets, Liabilities, and components of the owner's equity of the company. You'll see examples in the Activities section.

Net Worth, or Owner's Equity, includes what the owner has invested in the business and any profits retained in the business. For a new small business, the balance sheet will give a rough idea of what the business is worth, if sold.

The Balance Sheet is usually arranged with all the assets on the left, and the liabilities on the right. Below the liabilities, the net worth or owner's equity is shown. For a small business or one just starting out, the net worth or owner's equity will just be the dollar amount that the owner has put in to get the business started.

Activities

Activity 1 Review a Balance Sheet

A Balance Sheet is usually displayed as a table or several columns of information, with assets on the left side and liabilities and net worth on the right side. The following information is displayed as a list to accommodate the large print format of this workbook. First, you will find a list of assets and the total after the list. Then you'll find information and totals of liability and net worth.

Assets (all amounts in dollars)

Current Assets list and total

Cash and cash equivalents 100,000

Accounts receivable 20,000

Inventory 29,000

Total current assets 149,000

Equipment and Land 24,300

Buildings 250,000

Equipment 45,000

Other Assets

Intangible assets 3,800

Total Assets 472,100

Liabilities and Owner's Equity

Current Liabilities list and total

Accounts payable 30,000

Notes payable 10,000

Accrued expenses 7,000

Total current liabilities 47,000

Long Term Debt 200,000

Total Liabilities 247,000

Net Worth or Owner's Equity

Capital put into business 225,100

Total Net Worth 225,100

Answer the following questions in the space after the question.

1. What are the Total Assets of this company?

2. What are the Total Liabilities of this company?

3. How much capital as equity has been invested in this business?

4. Is the sum of the liabilities plus the net worth (owner's equity) equal to the total amount of assets? This is the balance reported in the Balance Sheet.

Activity 2 Make a Balance Sheet for Your Business

Make your own Balance Sheet lists and totals. To make these lists, just enter your item and its dollar amount in the steps that follow. Your answers will automatically populate the full balance sheet that follows these questions.

1. First list your assets and assign a dollar amount to each one. Remember to include cash on hand, any accounts receivable, and assets such as computers and other equipment. Don't stop there, though. Consider all categories of assets you have. After you have listed all your asset items, add them up to get your Total Assets.

   ### Your Assets list and total

   Cash and cash equivalents

   Accounts receivable

   Inventory

   Equipment and Land

   Buildings

   Equipment

Other Assets

Intangible assets

Total Assets

2. Now do the same for your liabilities. Remember to include accounts payable, equipment leases, bank loans, and other items. Then total the amounts and label the number.

Your Liabilities

Accounts payable

Notes payable

Accrued expenses

Long Term Debt

Total Liabilities

3. The next step is to calculate how much you have invested in your business. For a small business, your equity is just the capital you have put out to get the business going.

   Your Owner's Equity

   Capital put into business

   Total Equity

4. The last step is to add the equity to your liabilities and determine whether that sum is the same as your Total Assets.

   Total Liabilities + Total Equity =

Balance Sheet

Your Assets

Cash and cash equivalents

Accounts receivable

Inventory

Equipment and Land

Buildings

Equipment

Other Assets

Intangible assets

Total Assets

Your Liabilities

Accounts payable

Notes payable

Accrued expenses

Long Term Debt

Total Liabilities

Your Owner's Equity

Capital put into business

Total Equity

Total Liabilities + Total Equity =

Just like the first activity, determine whether the Total Assets equal the sum of Total Liabilities and Equity. If they aren't equal, your learning expert can help you find any missing items.

Activity 3 Google Search

Try a Google search to find examples of Balance Sheets created for various kinds of businesses. Look for a business that is similar to your business, for example, a retail, distribution, or service business. You can enter search terms that narrow your search to businesses like yours, for example, “Balance Sheet retail food business” or “Balance Sheet day spa business.”

You may have to search around. You may also see “templates” for Balance Sheets. Templates won’t be helpful right now because they will not have any numbers. When you begin to use accounting software, which we recommend, the software itself will be a template and will get filled up with your numbers. You’ll be able to view the Balance Sheet and print it out if you want to.

For now, you just want to get a look at the way a Balance Sheet is assembled and the assets and liabilities that are relevant to your line of business. Your learning expert can provide some examples that will be accessible for screen reader users.

Wrapping Up Workshop 4

This might be a good time to look at various kinds of accounting software. Your learning expert can help you to identify the software that will work best with your access technologies. You can use Excel or another spreadsheet program, but if you do not know how to take advantage of the formulas in spreadsheet software, it won't be very helpful for your accounting. One of the many advantages of using software created for accounting is that, once you have entered the numbers, the calculations and report layouts are all completed by the software.

In the next workshop, we'll look at the second of the three most important financial statements, the Income Statement.

Workshop 5: The Income Statement

In the video workshop, you learned about the second of the three most important ways to measure the financial health of your business, the Income Statement. The Income Statement covers a specific period of time. Start with the Gross Income and subtract any Expenses. The result is your Net Income, sometimes called profit. Over time, you'll come to understand all the various expenses you'll need to consider, but if you're just starting out, you probably don't have depreciation or loan interest figured out. For now, get as close as you can!

Key Questions

- What important information is shown on the Income Statement?
- What important information is not shown on the Income Statement?
- How would you use the Income Statement to make decisions?
- Who uses the Income Statement and how do they use it?

Key Terms

Operating Statement: another name for the Income Statement

Profit and Loss Statement: another name for the Income Statement

Operating Expenses: costs or expenses of running the business

Top Line: revenue from the sale of products and services for a specific time period

Gross Income: the total revenue your company earned, before subtracting expenses and costs; also called the "top line"

Net Income: how much your company actually earned or lost during the specific time period of the Income Statement, also called "the bottom line"

Net Profit: the "leftover" used to pay the business owner and grow the business

The Income Statement

Unlike the Balance Sheet, which records assets and liabilities at a moment in time, the Income Statement looks at your business over a period of time, like a month, a quarter, or a year. It tells you whether your company made a profit in that time period and how much. Start with your Gross Income and subtract all your expenses to find your Net Income (profit).

If you have accounting software, experiment with the statements the software can create. If you've been recording transactions and other data in your software, you can easily generate a nice-looking Balance Sheet or Income Statement.

In the sample Income Statement that follows, remember that parentheses around a number indicate subtraction.

Income Statement for ABC Cleaning Company

Revenues:	
Gross Income (right column)	$280,000

Expenses:	
Operating Expenses (left column)	$139,485
Other Expenses (left)	$8,550

Total Expenses (right)	**($148,035)**

Net Income (right)	**$131,965**

Activity 1 Calculate your Net Income

1. Do you have a good idea of your business's income or revenue? If so, record the Gross Income in the following space.

Gross Income = [ ]

2. Make a list of expenses for your business. Consider your operating costs and other expenses, including non-recurring or unusual items. List the items on another paper and provide a total here.

Total Expenses =

3. Subtract your Total Expenses from your Gross Income. The result is your Net Income (profit).

Gross Income − Total Expenses =

Activity 2 Google Search

Try a Google search again, but with the terms Income Statement and the line of business you are running, such as dry cleaning, coffee shop, wholesale, or sales of business supplies.

Wrapping Up Workshop 5

In Workshop 5, you learned how to determine net income or profit over a period of time. Later, when you use small business accounting software, the formulas will tabulate automatically, but now you'll understand what the numbers actually tell you about your business.

Workshop 6 presents the Cash Flow Statement, the most complex of the three important statements that measure the financial health of your business. Before Workshop 6, we encourage you to check in with your learning expert. Once you and your learning expert have reviewed your Balance Sheet and Income Statement, you'll be ready for Workshop 6.

Workshop 6: The Cash Flow Statement

Now we've reached the last statement presented in this series. The Cash Flow Statement presents information needed by suppliers and lenders.

When first starting your business, your Balance Sheet and Income Statement should suffice to guide your day-to-day planning and decisions. You may not create a cash flow statement for your business for a while yet, but the information it provides is important. Be aware that your cash flow can get stopped up if you are waiting for accounts receivable to come in. Will you have enough cash on hand to pay your employees or buy critical inventory?

Key Questions

- What important information is shown in the Cash Flow Statement?
- How can the Cash Flow Statement help outsiders, like large suppliers and lenders, get a clear picture of a business's financial health?

Key Terms

Net Cash Flow: generated from operations, this figure includes revenue from customers minus money paid to suppliers for inventory

Cash Changes: changes to the Net Cash Flow from financing activities, like making principal payments on a loan, and any interest and fees

Constructing the Cash Flow Statement

The following Cash Flow Statement shows money generated by Ben's Brewery and the expenses it pays. It also shows the remaining Cash Flow available to maintain stability and to plan for future growth.

This is a typical small business Cash Flow statement for a twelve-month period. Look for four important sections in the statement.

1. Cash Flow from Operations, which includes Net Income.

2. Additions to Cash

3. Subtractions from Cash.

4. Net Cash from Operations, $40,000.

Cash the company receives, such as the increase in accounts payable, is entered as positive numbers. Remember that what the company pays out, such as the increase in inventory, is entered as negative numbers shown in parentheses.

Cash Flow Statement – Ben's Brewery

Year Ending 12/31/18

Cash Flow from Operating Activities

Description	Account	Amount
Net Income	Net Income	$60,000
Additions to Cash	Depreciation of Equipment	$20,000
	Increase in Accounts Payable	$10,000
Subtractions from Cash	Increase in Accounts Receivable	($20,000)
	Increase in Inventory	($30,000)

Cash Flow from Operating Activities		$40,000

After you add and subtract these values, the total, forty thousand dollars, is entered as Cash Flow from Operating Activities.

The bottom line of this first section of the Cash Flow Statement, $40,000, is the single most important line on this document.

Sometimes a business has Cash Flow from Investing, which in this case, is just from purchase of equipment. The negative amount is shown in parentheses. The Brewing Vat cost $5,000.

Because of this loan, double-entry bookkeeping is used to record the transaction in two places, Cash Flow from Investing, and Cash Flow from Financing.

Cash Flow from Investing

Description	Account	Amount
Cash Spent	Brewing Equipment	($5,000)

Cash Flow from Financing

Description	Account	Amount
Cash Received	Note Payable (for Brewing Equipment)	$5,000

Finally, the numbers from top to bottom are added and subtracted to get $40,000 Cash Flow from Operating Activities.

The Cash Flow Statement shows exactly where you spent and received money. The increase in cash from the 12 months ending on December 31, 2018 is $40,000.

When you begin a new relationship with a vendor or lender, they may ask you for a Cash Flow Statement. They'll use it to decide whether or not your company is credit-worthy.

Activity: Organizing Documentation of Changes in Assets

Your business may not yet have enough activity to impact the Cash Flow Statement. Start thinking about transactions that could be important to reflect in a Cash Flow Statement. Have you sold or traded in any equipment? Have you upgraded your computers? Have you made any other significant changes in your assets?

You may want to create a file system for changes in assets. Save both hard copy and electronic documents to create a trail of ownership for any assets.

Wrapping Up Workshop 6

Now you have a grasp on the information in each of the three most important reports, the Balance Sheet, the Income Statement, and the Cash Flow Statement. You'll be able to use the information to follow the progress of your business.

You can also use these statements to present your business to others, for example, when you are seeking a bank loan.

In Workshop 7, you'll explore ways to use the three statements in making business decisions.

Workshop 7: Analyzing Financial Statements

In the video for Workshop 7, you learned how to analyze the three statements to track your business's financial health, make effective decisions, and plan for the future. Was this a new idea for you? This workbook section and the next will make it easier to understand and use ratios.

Key Questions

- Why should a business owner compare data across time periods, for example, from last year to this year?
- What can ratios tell you about your business's performance?
- Why should you compare your business to other similar businesses?

Key Terms

Trend Analysis: studying changes in financial data by comparing the same numbers across time periods

Horizontal Analysis: another name for Trend Analysis

Financial Ratios: comparisons of current performance with past performance or another business's performance

Asset-to-Debt Ratio: ratio that compares changes in debt to changes in assets, using data from Balance Sheets

Return on Assets: a ratio that determines how well a business is using its capital

Asset Management Ratio: a financial ratio that determines the amount of earnings generated by investments or other assets

Liquidity Ratio: a category of financial ratios assessing whether the value of your assets can cover your debts when they come due; for example, a business line of credit

Debt Management Ratio: a financial ratio that assesses whether your business's earnings provide enough cash to pay your debts

Profitability Ratio: indicates the amount of net income earned on each $100 of sales, usually averaging 5% to 10%

Current ratio: a test of a business's short-term solvency, that is, capability, of paying off debts right now and in the next 12 months

Activities

Activity 1: Percentage of Gross Income Accounted for by Total Expenses

Consider the following Income Statement. The questions for this activity are on the next page.

ABC Cleaning Company

Year-end Income Statement

Gross Income	$280,000

Expenses (in left column):	
Operating Expenses	$139,485
Other Expenses	$8550

Total Expenses	($148,035)

Net Income	$131,965

ABC Cleaning Company has Gross Income of $280,000 and Total Expenses of 148,035. Divide the Total Expenses by the Gross Income to determine the percentage of gross income that is accounted for by expenses. Round to the nearest percent.

Total Expenses ÷ Gross Income = _____

If your answer rounds off to 53 percent, you are correct. Does this seem like a large or small amount of expenses?

Activity 2: Calculate the "Current Ratio" for Ben's Brewery.

Lenders use the Current Ratio regularly, often requiring that a Current Ratio of at least 2.0 is maintained over the length of a loan. A Current Ratio of 2.0 means that for every $2 of assets, the debt is $1. A number above 0.5 is acceptable, and below 0.5 is cause for alarm.

To calculate the Current Ratio, find the Total Assets by summing up Cash on Hand, Inventory, and Accounts Receivable. Then divide that sum by the debt.

Ben's Brewery has Assets of $40,000 Cash on Hand, $32,000 Inventory, and $25,000 Accounts Receivable. Find the total of these three Asset items.

Total Assets = _____

The brewery has $38,000 of Accounts Payable and a $5000 Note Payable for their new brewing vat.

Total Debt = _____

If you have Assets of $97,000 and Debt of $43,000, you're correct.

Now divide the Total Assets by the Total Debt to get the Current Ratio. You'll need to round the result to two decimal places.

Current Ratio of Ben's Brewery =

When you divide Ben's Total Assets by his total Debt, you should have gotten a ratio of 2.26.

This ratio means that Ben has $2.26 of Assets for every $1 of Debt. Is Ben in a good position with his lenders with this ratio?

You might want to try calculating the Current Ratio of your own business. If you need help, ask your learning expert.

Wrapping Up Workshop 7

This workshop introduced the concept of financial ratios, which are calculations that compare the numbers on financial statements. Once again, the workshop presented many new terms. But don't worry: the next workshop will expand on this topic.

You're getting near the end of the workshop series, but you are just at the beginning of using the data on your financial statements. You'll learn more and more over time about managing the progress of your business and comparing it to other businesses across your sector of the economy. When you're ready for more, move on to Workshop 8.

Workshop 8: Accounting Ratios

This is the last workbook section for the Accounting Basics and Financial Reports workshop series. If you've watched every workshop and worked through all the workbook activity, you're probably getting the hang of beginning accounting. You're recording every number, saving every receipt or other original source document, and thinking about ways to use your learning to build your business. This last section of the workbook digs deeper into financial ratios and takes you through activities to calculate ratios.

This section has more activities to complete, but it's worth taking time to work through all of them.

Key Questions

- What is the benefit of comparing your business's data from one year or one month to the next?
- What is the benefit of comparing your business's ratio results to industry standards for similar businesses?

Key Terms

Comparative Balance Sheet: a Balance Sheet that shows the data from two different points in time; used to determine upward or downward trends.

Activities

Activity 1: Calculating Percent Increase and Decrease

The following three tables present a comparative balance sheet in three sections. This Balance Sheet compares the years 2017 and 2018. Not shown here are two more columns, where the amount and percent of increase or decrease for each account and for the totals from 2017 to 2018 are calculated.

We'll be using these numbers in the activities that follow. On a Balance Sheet, the Total Assets should equal the sum of the Total Liabilities and Owner's Equity. The first table section shows the Assets. The last row of each table section shows the total for each year.

Assets	2017	2018
Cash	$5,000	$5,500
Accounts Receivable	$4,000	$6,500
Tools and Equipment	$15,000	$14,000
Total Assets	$24,000	$26,000

1. Under Assets, the Cash Account has $5,000 in 2017 and $5,500 in 2018. Subtract to find the amount of increase. Then divide by the 2017 amount to get the percent increase.

   Amount of increase =

   Percent of increase =

If you answered $500 and 10 percent, you are correct.

2. Accounts Receivable has $4,000 in 2017 and $6,500 in 2018. Subtract to find the amount of increase. Then divide by the 2017 amount to get the percent increase.

   Amount of increase = ☐

   Percent of increase = ☐

If you answered $2,500 and 62.5 percent, you are correct. Consider this follow-up question. One way to increase Total Assets is to reduce Accounts Receivable. How could a business owner reduce Accounts Receivable?

3. Tools and Equipment are $15,000 in 2017, and $14,000 in 2018. Notice that the figure has decreased in 2018. Subtract to find the amount of decrease. Then divide by the 2017 amount to get the percent decrease. Remember that the amount of decrease would be shown in parentheses in the table. The percent of decrease is written with a negative sign.

   Amount of decrease = ☐

   Percent of decrease = ☐

If you answered decrease of $1,000 and negative 6.7 percent, you are correct.

4. Total Assets in 2017 are $24,000 and in 2018 are $26,000. Find the total amount of increase and the total percent increase.

   Amount of increase = ☐

   Percent of increase = ☐

If you answered $2,000 and total percent increase of 8.3 percent, you are correct. We'll refer to this number again at the very end of this activity, when you verify that the Total Assets equal the Total Liabilities and Owner's Equity.

The next table section presents the Liabilities for 2017 and 2018.

Liabilities	2017	2018
Accounts Payable	$500	$600
Note Payable	$10,000	$8,800
Total Liabilities	$10,500	$9,400

5. Accounts Payable has $500 in 2017 and $600 in 2018. Find the total amount of increase and the total percent increase.

   Amount of increase = ☐

   Percent of increase = ☐

If you answered $100 and 20 percent, you are correct.

6. Note Payable has $10,000 in 2017 and $8,800 in 2018. The Note Payable has decreased in 2018. Find the amount of decrease and the percent decrease.

   Amount of decrease = ☐

   Percent of decrease = ☐

If you answered $1,200 and negative 12 percent, you are correct. Take a moment to consider these questions: Why did the Note Payable account decrease? Is the decrease good or bad for the business?

7. Total Liabilities in 2017 are $10,500 and in 2018 are $9,400. The Total Liabilities has decreased. Find the total amount of decrease and the total percent decrease.

   Amount of decrease = ☐

   Percent of decrease = ☐

If you answered $1,100 with total percent decrease of negative 10.5 percent, you are correct.

The final table section presents the Owner's Equity for 2017 and 2018.

Owner's Equity	2017	2018
Owner's Investment	$11,000	$13,350
Retained Earnings	$2,500	$3,250
Total Owner's Equity	$13,500	$16,600

8. Under Owner's Equity, Owner's Investment is $11,000 in 2017 and $13,350 in 2018. Find the amount of increase and the percent increase.

   Amount of increase = _____

   Percent of increase = _____

If you answered $2,350 and 21 percent you are correct.

9. Retained Earnings in 2017 is $2,500 and in 2018 is $3,250. Find the amount of increase and the percent increase.

   Amount of increase = _____

   Percent of increase = _____

If you answered $750 and 30 percent, you are correct.

10. Total Owner's Equity in 2017 is $13,500 and in 2018 is $16,600. Find the amount of increase and the percent increase.

    Amount of increase = _____

    Percent of increase = _____

If you answered $3,100 and 23 percent, you are correct.

11. The Total Liabilities and Owner's Equity in 2017 is $24,000 and in 2018 is $26,000. Find the amount of increase and the percent increase.

    Amount of increase = _____

    Percent of increase = _____

If you answered $2,000, and 8.3 percent, you are correct.

We can see that in each year, the Total Assets equal the Total Liabilities and Owner's Equity. As a final check, we notice that the amount and percent of change in Assets is the same as in Total Liabilities and Owner's Equity.

Overall, is this business worth more in 2018 than it was in 2017?

Activity 2: Accounts Receivable Turnover Ratio

In these last four activities of the workshop series, you'll have the opportunity to calculate some ratios yourself. After you do these activities, we recommend that you try some of the formulas using numbers from your own business. First, try the calculations for some sample businesses.

Sandy's Rugs, a local business in Hammond, Indiana, has a year-end balance sheet that indicates Accounts Receivable of $6,000 and a year-end Income Statement showing a sales figure of $70,000. The formula for the Accounts Receivable Turnover Ratio is Accounts Receivable multiplied

$$\frac{\text{Accounts Receivable x 365 Days}}{\text{Sales}}$$

by 365 days divided by Total Annual Sales.

Try the calculation yourself. First multiply 6,000 × 365. Then divide that number by the Sales of $70,000.

Did you come up with 31.3 days? This result indicates that it takes this business, on average, just over 31 days to collect the money it is due.

Generally, the lower the resulting number, the better it is for the business. Sandy knows that he won't receive his money from Accounts Receivable for a month after his sales. He might want to investigate the reason for the delay in collecting the money. He could make some improvements such as offering a customer discount for payment within ten days.

Activity 3: Inventory Turnover Ratio

Again, consider that Sandy's Rugs has a year-end Balance Sheet that indicates an Inventory figure of $4,000, and the year-end Income Statement provides a Cost of Goods Sold figure of $14,000. The formula for the Inventory Turnover Ratio is

$$\frac{\text{Inventory x 365 Days}}{\text{Cost of Goods Sold}}$$

Inventory times 365 days divided by Cost of Goods Sold.

Try this calculation. Multiply 4,000 × 365 and then divide by 14,000. The result, 104.3 days, is the time it takes to turn over inventory. A number over 90 days can warn a business owner of inefficiency due to having too much inventory on hand. As with the Accounts Receivable Turnover Ratio, the lower this resulting inventory turnover number, the better it is for the business.

Activity 4: Profit Margin on Sales Ratio

The Computer Shop has a year-end Income Statement that indicates a Net Profit figure of $44,000 and a Sales total of $160,000. The Profit Margin on Sales Ratio is Net Profit divided by Sales.

$$\frac{\text{Net Profit}}{\text{Sales}}$$

For this calculation, simply divide 44,000 by 160,000.

This result indicates that for every dollar of sales, The Computer Shop earns a profit of 27.5 cents. If the owners think the margin is too low, either the business's prices are too low or the expenses are too high, or both. The higher the resulting number, the better it is for the business.

Activity 5: Return on Investment Ratio

The Computer Shop's year-end income statement indicates a Net Profit figure of $15,000 and the year-end balance sheet indicates a Total Assets figure of $180,000. The Return-on-Investment Ratio is Net Profit divided by Total Assets.

$$\frac{\text{Net Profit}}{\text{Total Assets}}$$

When you divided the Net Profit by the Total Assets, you should have 0.083, or 8.3 percent.

This result indicates that for every dollar of investment in assets, the Computer Shop earns a profit of 8.3 cents.

Wrapping Up Workshop

Congratulations! You've reached the end of the Workbook for the Accounting Basics and Financial Reporting workshop series. Be sure to save a copy of the workbook and the glossary in your business files.

If you still have questions on topics in this series, review the workshop itself and the relevant workbook section. Then take your questions to your learning expert. You'll help yourself and you'll find that you aren't the first person with the same question, nor the last.

Good luck as you move on with your business!