

## Understanding Basic Financial Statements

During the accounting cycle, the accounting system is used to track, organize and record the financial transactions of an organization. At the close of each period, the information is used to prepare the financial statements, which are usually composed of a balance sheet (statement of financial position); income statement (statement of income and expenses); statement of retained earnings (owners' equity); and a statement of cash flow.

*A sample set of financial statements) is shown below.*

Financial statements prepared by a Chartered Accountant with a Review Engagement Report or Audit Opinion attached, are prepared (unless noted otherwise) according to "Canadian generally accepted accounting principles", or GAAP. Financial statements that are only compiled or that have a "Notice to Reader" attached, are not necessarily prepared according to GAAP.

### Balance Sheet

The balance sheet is based on the equation: assets = liabilities + owners' equity. It indicates everything the company owns (assets), everything the company owes to creditors (liabilities) and the value of the ownership stake in the company (shareholders' equity, or capital). The balance sheet date is the ending date of the period or year, and is a continuation of the amounts recorded since the inception of the company or organization. The balance sheet is a "snapshot" of the financial position of the company at the balance sheet date and shows the accumulated balance of the accounts. Assets and liabilities are separated between *current* and *long-term*, where current items are those items, which will be realized or paid, within one year of the balance sheet date. Typical current assets are cash, prepaid expenses, accounts receivable and inventory.

### Income Statement

An income statement is a type of summary flow report that lists and categorizes the various revenues and expenses that result from operations during a given period - a year, a quarter or a month. The difference between revenues and expenses represents a company's net income or net loss. The amounts shown in the income statement are the amounts recorded for the given period - a year, a quarter or a month. The next period's income statement will start over with all amounts reset to zero. While the balance sheet shows accumulated balances since inception, the income statement only shows the amounts earned or expensed during the period in question.

### Statement of Retained Earnings

The statement of retained earnings shows the amount of accumulated earnings that have been retained within the company since its inception. At the end of each fiscal year-end, the amount of net income or loss is added to the opening amount of retained earnings to arrive at the closing retained earnings. Retained earnings can be decreased by such items as dividends paid to shareholders. On the sample financial statements shown below, the statement of retained earnings is combined with the income statement presentation.

### Statement of Cash Flow

The statement of cash flow shows all sources and uses of a company's cash during the accounting period. Sources of cash listed on the statement include revenues, long-term financing, sales of non-current assets, an increase in any current liability account or a decrease in any current asset account. Uses of cash include operating losses, debt repayment, equipment purchases and increases in current asset accounts.

**XYZ COMPANY LIMITED**  
**BALANCE SHEET**  
**AS AT**  
**JUNE 30, 2002**

**UNAUDITED - See "Notice to Reader"**

	<u>2002</u>	<u>2001</u>
<b><u>ASSETS</u></b>		
CURRENT		
Cash	\$ 11,552	\$ --
Accounts receivable	42,970	50,595
Deposits and prepaid expenses	2,942	2,688
Inventory	159,144	156,657
	<u>216,608</u>	<u>209,940</u>
PROPERTY, PLANT AND EQUIPMENT (Note 2)	59,890	76,318
INVESTMENTS	<u>--</u>	<u>45,001</u>
	<u>\$ 276,498</u>	<u>\$ 331,259</u>
<b><u>LIABILITIES</u></b>		
CURRENT		
Bank overdraft	\$ --	\$ 9,474
Bank loan	--	60,000
Accounts payable and accrued liabilities	82,053	91,343
Long-term debt - current portion	25,200	--
Income tax payable	14,387	--
	<u>121,640</u>	<u>160,817</u>
DUE TO SHAREHOLDER (Note 3)	51,591	231,791
LONG-TERM DEBT (Note 4)	<u>86,100</u>	<u>--</u>
	<u>259,331</u>	<u>392,608</u>
<b><u>SHAREHOLDER'S EQUITY</u></b>		
STATED CAPITAL (Note 5)	1	1
RETAINED EARNINGS (DEFICIT)	<u>17,166</u>	<u>(61,350)</u>
	<u>17,167</u>	<u>(61,349)</u>
	<u>\$ 276,498</u>	<u>\$ 331,259</u>
APPROVED		

The accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

**XYZ COMPANY LIMITED**  
**STATEMENT OF INCOME AND RETAINED EARNINGS**  
**FOR THE YEAR ENDED**  
**JUNE 30, 2002**

**UNAUDITED - See "Notice to Reader"**

	<b><u>2002</u></b>	<b><u>2001</u></b>
<b>REVENUE</b>	\$ <u>1,104,786</u>	\$ <u>1,133,736</u>
<b>COST OF SALES</b>		
Opening inventory	156,657	146,278
Delivery	1,607	1,249
Purchases	<u>740,994</u>	<u>794,101</u>
	899,258	941,628
Closing inventory	<u>159,144</u>	<u>156,657</u>
	<u>740,114</u>	<u>784,971</u>
<b>GROSS PROFIT</b>	<u>364,672</u>	<u>348,765</u>
<b>OPERATING EXPENSES</b> (schedule)	<u>286,817</u>	<u>339,905</u>
<b>INCOME FROM OPERATIONS</b>	<u>77,855</u>	<u>8,860</u>
<b>OTHER INCOME (EXPENSES)</b>		
Loss on disposal of property, plant and equipment	--	(387)
Gain on sale of investment	16,149	--
Miscellaneous	<u>(1,101)</u>	<u>337</u>
	<u>15,048</u>	<u>(50)</u>
<b>NET INCOME BEFORE TAX</b>	92,903	8,810
<b>INCOME TAX EXPENSE</b>	<u>14,387</u>	<u>--</u>
<b>NET INCOME</b>	78,516	8,810
<b>(DEFICIT) - Beginning of Year</b>	(61,350)	(54,160)
<b>DIVIDENDS</b>	<u>--</u>	<u>(16,000)</u>
<b>RETAINED EARNINGS (DEFICIT) - End of Year</b>	\$ <u><u>17,166</u></u>	\$ <u><u>(61,350)</u></u>

The accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

**XYZ COMPANY LIMITED**  
**STATEMENT OF CASH FLOW**  
**FOR THE YEAR ENDED**  
**JUNE 30, 2002**

**UNAUDITED - See "Notice to Reader"**

	<u>2002</u>	<u>2001</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income for the year	\$ 78,516	\$ 8,810
Adjustment for:		
Amortization	17,854	16,856
Loss on disposal of property, plant and equipment	--	387
Gain on disposal of investment	<u>(16,149)</u>	<u>--</u>
Cash derived from operations	80,221	26,053
Decrease (increase) in working capital items		
Accounts receivable	7,625	23,380
Deposits and prepaid expenses	(254)	688
Inventory	(2,487)	(904)
Accounts payable and accrued liabilities	(9,290)	34,543
Long-term debt - current portion	25,200	--
Income tax payable	<u>14,387</u>	<u>2,206</u>
Cash flows from operating activities	<u>115,402</u>	<u>85,966</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Acquisition of property, plant and equipment	(1,426)	(10,342)
Proceeds from disposal of property, plant and equipment	--	3,113
Proceeds from disposal of investment	61,150	--
Dividends	<u>--</u>	<u>(16,000)</u>
Cash flows from investing activities	<u>59,724</u>	<u>(23,229)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Advances from (repayments to) shareholder	(180,200)	(150,000)
Acquisition of (repayment of) long-term debt	<u>86,100</u>	<u>--</u>
	<u>(94,100)</u>	<u>(150,000)</u>
<b>NET INCREASE (DECREASE) IN CASH RESOURCES</b>	81,026	(87,263)
CASH (DEFICIENCY) RESOURCES - Beginning of Year	<u>(69,474)</u>	<u>17,789</u>
<b>CASH RESOURCES (DEFICIENCY) - End of Year</b>	<u>\$ 11,552</u>	<u>\$ (69,474)</u>
<b>Cash resources (deficiency) is comprised of:</b>		
Cash	\$ 11,552	\$ --
Bank overdraft	--	(9,474)
Bank loan	<u>--</u>	<u>(60,000)</u>
	<u>\$ 11,552</u>	<u>\$ (69,474)</u>

The accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

**XYZ COMPANY LIMITED  
SCHEDULE OF OPERATING EXPENSES  
FOR THE YEAR ENDED  
JUNE 30, 2002**

**UNAUDITED - See "Notice to Reader"**

	<b><u>2002</u></b>	<b><u>2001</u></b>
<b>OPERATING EXPENSES</b>		
Advertising	\$ 18,801	\$ 30,715
Amortization	17,854	16,856
Bad debts	199	179
Bank charges and interest	5,510	9,356
Insurance	4,779	4,035
Interest on long-term debt	11,876	--
Legal and accounting	13,155	11,766
Management fees	--	12,525
Memberships and licences	3,212	3,413
Office and general	12,382	15,155
Rent and utilities	18,795	21,955
Repairs and maintenance	4,289	4,979
Subcontracting	19,825	18,692
Supplies	4,571	8,557
Travel	3,736	8,003
Wages and benefits	142,713	168,806
Vehicle	5,120	4,913
	<u>\$ 286,817</u>	<u>\$ 339,905</u>

The accompanying summary of significant accounting policies and notes are an integral part of these financial statements.

**XYZ COMPANY LIMITED  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED  
JUNE 30, 2002**

**UNAUDITED - See "Notice to Reader"**

**1. SIGNIFICANT ACCOUNTING POLICIES AND GENERAL INFORMATION**

**Nature of Business**

The company is a Canadian-controlled private corporation subject to the Business Corporations Act, 1982 (Ontario), was incorporated in May 1995 and operates as a manufacturer of widgets in Anytown, Ontario.

**Significant Accounting Policies**

**INVENTORY**

The inventory is valued at the lower of cost or market, with cost being determined on a first-in, first-out basis.

**PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment are stated at cost less accumulated amortization. Amortization is recorded at rates designed to amortize the cost of capital assets over their estimated useful lives.

Amortization rates used are as follows:

Furniture and equipment	20% declining balance
Vehicle	30% declining balance
Computer equipment	30% declining balance
Leasehold improvements	straight-line 5 years

**2. PROPERTY, PLANT AND EQUIPMENT**

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net Book Value 2002</u>	<u>Net Book Value 2001</u>
Furniture and equipment	\$ 21,500	\$ 11,300	\$ 10,200	\$ 12,750
Vehicle	26,486	15,460	11,026	15,752
Computer equipment	22,210	6,457	15,753	20,466
Leasehold improvements	37,350	14,439	22,911	27,350
	<u>\$ 47,986</u>	<u>\$ 26,760</u>	<u>\$ 59,890</u>	<u>\$ 76,318</u>

**XYZ COMPANY LIMITED  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED  
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**3. DUE TO SHAREHOLDER**

The amount due to the shareholder bears interest at a rate determined annually and has no fixed terms of repayment.

Interest paid for 2002 was \$1,823 (2001 - \$6,831)

**4. LONG - TERM DEBT**

Bank term loan bearing interest at prime plus 2%, repayable in monthly principal instalments of \$2,100.00 plus interest to November 2007, secured by a general security agreement on the assets of the company and a personal guarantee from the shareholder.

	<u>2002</u>	<u>2001</u>
	\$ 111,300	\$ --
Less current portion	<u>25,200</u>	<u>--</u>
	<u>\$ 86,100</u>	<u>\$ --</u>
Approximate principal repayments are as follows:		
2004	\$ 25,200	
2005	25,200	
2006	25,200	
2007	<u>10,500</u>	
	<u>\$ 86,100</u>	

**5. STATED CAPITAL**

Authorized:

- Unlimited number of Common shares
- Unlimited number of non-cumulative, redeemable, voting, Class "A" Special shares

	<u>2002</u>	<u>2001</u>
Issued:		
1 Common shares	<u>\$ 1</u>	<u>\$ 1</u>