THE UNIVERSITY of ADELAIDE

Veterinary Introduction to Business and Enterprise

Financial Statements Explained

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VIBE Learning Guide

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Introduction

Veterinarians are not accountants, however there is a need for veterinarians to understand management accounting. Management accounting is the provision of financial and non-financial information to business managers for the purpose of decision-making. The most common forms of information for decision-making are financial statements. Under international accounting standards all businesses, including not-for-profit businesses, need to have at least two general purpose financial statements. Depending on the country and the legal entity of the business several other financial statements may be required, however these are not covered in this learning guide. The two financial statements that the veterinarian needs to be familiar with are:

- statement of financial position (previously termed the balance sheet)
- income statement (previously termed the profit and loss statement)

A brief summary of the components of each of these financial statements and examples from the case studies follows.

Statement of financial position (balance sheet)

The statement of financial **position** is a statement of assets, liabilities and owners' equity as at a specific date. It is also called a balance sheet or statement of assets and liabilities. The statement of financial position for a business shows:

- what the business owns (assets)
- how it is financed (debt), and
- how much equity the owners have in the business.

The statement of financial position is based on the fundamental accounting equation:

asset(s) = liabilities + owners' equity.

Consider your house (or your future house). It is an asset owned by you and financed partly by debt (your mortgage) and partly by your equity. Assume that the house is worth $350,000 and you have a mortgage of $180,000. Your balance sheet for the house would be:

asset(s)($350,000) = liabilities ($180,000) + owners' equity ($170,000).

The mix of debt and equity that we use to finance our assets is called leverage, or gearing.

For an example of a statement of financial position (balance sheet) please see Table 1 below.

Table 1. Summarised statement of financial position for Lamone and Yackaville Veterinary Practice 30th June 2013

Summary statement of financial position (balance sheet) Lamone and Yackaville Veterinary Practice 30th June 2013				
Current assets	Cash and receivables	$115,236		
	Inventory	$112,085		
	Prepayments	$6,908	$234,229	
Non-current assets	Fixed Assets	$332,949		
	Accumulated depreciation	-$50,000		
	Intangible assets	$35,000	$317,949	
Total assets				$552,178
Current liabilities	Accounts payable to trade creditors	$95,057		
	Superannuation, PAYG, and Leave provisions	$25,264		
	GST NET payable	$5,000	$125,321	
Non-current liabilities	Loans – equipment, trailer, motor vehicles	$241,018	$241,018	
Total liabilities				$366,339
	Contributed capital	$150,000		
	Retained earnings after drawings and current year earnings	$35,838		
Total owner' equity				$185,839
Total liabilities and owners' equity				$552,178

As stated above, the statement financial position is based on the fundamental accounting equation:

asset(s) = liabilities + owners' equity.

More information about the components of the financial statement follows.

Assets

Assets are resources owned or controlled by a business that are expected to have current or future economic benefit. They are obtained or controlled by a business as a result of past transactions or events.

The essential characteristics of an asset are:

- a probable future benefit exists involving capacity to contribute directly or indirectly to future net cash inflows;
- the business can obtain benefit and control access of others to the benefit;
- the transaction or event that gave rise to the business's claim to, or control of, the benefit has already occurred.

Assets are often split into two sub classifications:

- current assets
- non-current assets.

Current assets are those assets to be converted into cash or used within the next accounting period, or 12 months. These assets include cash, inventory, accounts receivables (amounts owing from customers or debtors) and short term investments.

Non-current assets are expected to remain in use for more than 12 months. These assets include equipment, land, buildings and motor vehicles.

Current and non-current assets can be monetary or non-monetary in nature. Monetary assets are in cash terms or are claims to cash. These include cash at the bank or held by the business, accounts receivable and short or long term investments which are claims to cash. Non-monetary assets are physical assets such as inventories, furniture, plant and equipment. These assets pose a valuation problem because the original dollar value is attributed to assets when preparing financial statements. Most physical assets wear out and/or decline in value over time. A process of depreciation to allocate the decline in value of the asset over its useful service life in a systematic and rational manner is shown in a subsequent line as accumulated depreciation. There are also intangible non-current assets such as copyrights, patents and goodwill.

To illustrate these definitions of assets, consider the following in Table 2 below:

Table 2. Examples of assets and non-assets, and current or non-current assets

<table>
<tr><td>Asset or not?</td><td>Information</td><td>Asset or not? Yes or No</td></tr>
<tr><td>People</td><td>‘Our greatest asset is our people’. Are people assets of a business? People can be considered assets. However, a business cannot always obtain the benefit from people involved with the business. For example, consider the contracts of professional sports people. A club may be able to stop a prized player from playing for the opposition, but they cannot force the player to play for them at the best of his or her ability. Accordingly, people are not included as business assets.</td><td>No</td></tr>
<tr><td>Car purchased outright</td><td></td><td>Yes, non-current asset</td></tr>
<tr><td>Car purchased with a loan</td><td></td><td>Yes, non-current asset</td></tr>
<tr><td>Car purchased with a four year lease</td><td rowspan="2">Is leased equipment an asset? Interestingly, if we lease an asset as an alternative to buying it, accounting standards see the lease as a financing arrangement and an asset recognised as ‘lease rights’. As such, business rights over leased items are assets. Note, there is also the liability of lease obligations.</td><td rowspan="2">Yes, non-current assets</td></tr>
<tr><td>Lease of Plant & Equipment (initial purchase, not wear and tear replacement of low value items)</td></tr>
<tr><td>Drugs</td><td>Is inventory an asset?</td><td>Yes, current assets</td></tr>
</table>

Liabilities

Liabilities are the economic obligations of an enterprise and represent the obligations of a business to transfer assets or provide services in the future as a result of past transactions or events. Typically, liabilities are amounts owed to creditors, employees, government and others. A liability may also include an obligation to undertake a service. For example, an annual magazine subscription paid in advance creates a liability to the publisher to post issues to the customer for the next 12 months. Similarly, a veterinary practice with annual wellness programs paid in advance would account for these as a liability to provide services to pet owner customers for the next 12 months.

The essential characteristics of liabilities are:

- the duty to honour the future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand;
- the business has little or no discretion to avoid the future sacrifice;
- the transaction, or other event, obligating the business has already happened.

Owner’s equity

Owner’s equity represents the interest of owners or shareholders in the assets of a business. For a company it is usually referred to as ‘share capital’, while for an unincorporated business it is referred to as ‘proprietorship’.

Owner’s equity reflects the cumulative net result of past transactions, and other events or circumstances, affecting the business. Accumulated profits or losses are recorded as part of owner’s equity.

The characteristics of equity are:

- It is a general interest in a business entity’s assets not a claim to specific assets. For example, if I own half the shares in a company the shares are a general interest in all of the assets. I cannot directly identify my shares with particular assets or liabilities, thus I own a 50% share in all assets (and liabilities);
- Amount of equity is affected by the business entity’s operations and other events as well as by the owner’s investments in the business and distributions to owners. Profits and new contribution by owners increase owner’s equity, while losses and dividends reduce it.
- Owner’s equity is the interest that bears the ultimate risks of business failure and reaps the rewards of success. In the winding up of a company, the owners are the last to be paid, that is, after all of the creditors (those who have lent capital to the company) have been paid.

Another way of representing the fundamental accounting equation is from the view of owner’s equity:

Owners’ equity = assets – liabilities

As in the example of a house owner:

Owners’ equity ($170,000) = assets ($350,000) – liabilities ($180,000)

As in the example of the veterinary practice (see Table 1):

Owners’ equity ($185,000) = assets ($552,177) – liabilities ($366,339)

Income statement (profit and loss statement)

The income statement (profit and loss statement) is a statement of sales revenues, expenses, gains and losses showing the results of a business entity's operations in a period. It is also called the operating statement, the profit and loss account or the revenue statement. It is the statement of financial **performance** or profitability.

Profit or loss is measured as:

profit = revenue – expenses

For an example of a twelve month income statement (profit and loss) please see Table 3 below.

Table 3: Example of a summarised income statement (profit and loss)

Summarised Lamone and Yackaville Veterinary Practice Income Statement (Profit and Loss) 2012 - 2013			
Total Sales			$1,404,652
Less: **Variable Costs** (items)	Cost of Goods Sold	$406,500	$406,500
Less: **Expenses** (fixed costs or overhead)	Salaries	$631,496	$934,174 **(total overhead)**
	Total employee related expenses	$19,485	
	Other fixed operating costse.g. rent, electricity, repairs, insurance, telephone	$235,810	
	Interest	$14,204	
	Depreciation	$33,179	
Equals: **Net Income (profit or loss)**			$63,978

Profit

Let us now consider some basic rules that business managers (and accountants) use to determine whether a profit or loss has been made. Remember, the income statement (profit and loss statement) reports the financial performance of a business over a period of time.

Profit is defined, in an economic sense, as:

> the maximum value that can be withdrawn by the owners of a business entity, during a period, without reducing equity below the level determined for the beginning of that period.

Profit is measured as excess of revenue over expenses:

profit = revenue – expenses

Revenue and expenses

Definitions of revenue and sales for the purpose of management accounting for a simple sales related micro or small enterprise, such as a veterinary business, are:

- revenue = total sales, and
- expenses are monies paid for costs incurred in day to day running of the business.

Expenses can be further categorised into variable costs and general expenses (fixed costs or overhead). For a typical veterinary business in Australia, all operational costs apart from ordered items/services can be considered fixed costs. Wages are sometimes seen as a variable cost for some businesses, but in the case of a typical Australian veterinary practice wages are not able to be adjusted very much in response to demand. Furthermore, veterinary practices function best with a core team of long term skilled staff.

Revenue and expenses can only be reliably measured when sales invoices created for clients of the business and invoices received from suppliers to the business are accurately recorded.

For more on invoicing of clients please read the Learning Guide 'How to Charge'.

For more on using financial statements to calculate veterinary fees please read the Learning Guide 'Fee Setting for Veterinary Services'.

For more on using financial statements to monitor financial performance please read the Learning Guide 'Key Performance Indicators for Veterinary Business'.

References and acknowledgements

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Authors

Dr Adele Feakes, Lecturer, School of Animal and Veterinary Sciences, Roseworthy campus, The University of Adelaide

Dr Dana Thomsen, Researcher, School of Animal and Veterinary Sciences, Roseworthy campus, The University of Adelaide