

Connections

These pages will begin our formal study of how the three major financial statements interact...how they work in concert to give a true picture of the enterprise's financial health.

Remember the fundamental reporting function of each of the three main financial statements:

1. the income statement shows the manufacturing and selling actions of the enterprise that result in profit or loss.
2. The cash flow statement details the movements of cash into and out of the coffers of the enterprise.
3. the balance sheet records what the company owns and what it owes, including the owner's stake.

Income Statement

for the period

1	NET SALES	\$3,055,560
2	COST OF GOODS SOLD	2,005,830
1 - 2 = 3	GROSS MARGIN	1,049,730
4	SALES & MARKETING	328,523
5	RESEARCH & DEVELOPMENT	26,000
6	GENERAL & ADMINISTRATIVE	203,520
4 + 5 + 6 = 7	OPERATING EXPENSE	558,043
3 - 7 = 8	INCOME FROM OPERATIONS	491,687
9	NET INTEREST INCOME	(100,000)
10	INCOME TAXES	139,804
8 + 9 - 10 = 11	NET INCOME	\$251,883

Cash Flow Statement

for the period

a	BEGINNING CASH BALANCE	\$155,000
b	CASH RECEIPTS	2,584,900
c	CASH DISBURSEMENTS	2,796,438
b - c = d	CASH FLOW FROM OPERATIONS	(211,538)
e	PP&E PURCHASE	1,750,000
f	NET BORROWINGS	900,000
g	INCOME TAXES PAID	0
h	SALE OF CAPITAL STOCK	1,550,000
a + d - e + f - g + h = i	ENDING CASH BALANCES	\$643,462

Balance Sheet Connections

ENDING CASH on the Cash Flow Statement always equals CASH on the Balance Sheet.

Balance Sheet

as of period end

A	CASH	\$643,462
B	ACCOUNTS RECEIVABLE	454,760
C	INVENTORIES	414,770
D	PREPAID EXPENSES	0
A + B + C + D = E	CURRENT ASSETS	1,512,992
F	OTHER ASSETS	0
G	FIXED ASSETS @ COST	1,750,000
H	ACCUMULATED DEPRECIATION	78,573
G - H = I	NET FIXED ASSETS	1,671,427
E + F + I = J	TOTAL ASSETS	\$3,184,419
K	ACCOUNTS PAYABLE	\$236,297
L	ACCRUED EXPENSES	26,435
M	CURRENT PORTION OF DEBT	100,000
N	INCOME TAXES PAYABLE	139,804
K + L + M + N = O	CURRENT LIABILITIES	502,536
P	LONG-TERM DEBT	800,000
Q	CAPITAL STOCK	1,550,000
R	RETAINED EARNINGS	331,883
Q + R = S	SHAREHOLDERS' EQUITY	1,881,883
O + P + S = T	TOTAL LIABILITIES & EQUITY	\$3,184,419

According to the basic equation of accounting, **TOTAL ASSETS** equals **TOTAL LIABILITIES** plus **SHAREHOLDERS' EQUITY**. Then by definition, the *Balance Sheet* must always be "in balance."

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for the period

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a + d - e + f - g + h = i	ENDING CASH BALANCES	\$643,462

Balance Sheet Connections

For the *Balance Sheet* to stay "in balance," when you **subtract** from an asset account, you must also...

Balance Sheet

as of period end

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...either **add** the same amount to another asset account
or
subtract it from a liability account.

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Balance Sheet Connections

NET INCOME from the *Income Statement* is added to **RETAINED EARNINGS** on the Balance Sheet and thus **SHAREHOLDERS' EQUITY** increases.

Income Statement

for the period

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Cash Flow Statement

for the period

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Q + R = S	SHAREHOLDERS' EQUITY	1,881,883
O + P + S = T	TOTAL LIABILITIES & EQUITY	\$3,184,419

1 Sales Cycle
When a sale is made on credit, NET SALES increases at the top of the *Income Statement* and ACCOUNTS RECEIVABLE increases on the *Balance Sheet* by the same amount.

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Cash Flow Statement

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Balance Sheet

as of period end

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2

Sales Cycle

When a sale is made, product value is moved from INVENTORY on the Balance Sheet to COST OF GOODS on the Income Statement.

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3

Sales Cycle

When the customer pays for products shipped, the **ACCOUNT RECEIVABLE** on the *Balance Sheet* becomes a **CASH RECEIPT** in the *Cash Flow Statement*.

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4

Sales Cycle

When a sale is entered on the *Income Statement* NET INCOME (LOSS) is generated and is added to RETAINED EARNINGS on the Balance Sheet.

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for the period

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8 + 9 - 10 = 11	NET INCOME	\$251,883

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1

Expense Cycle
EXPENSES, when incurred and entered in the *Income Statement*, become **ACCOUNTS PAYABLE** on the *Balance Sheet*.

Expenses reduces **NET INCOME** in the *Income Statement* and also in **RETAINED EARNINGS** on the *Balance Sheet*.

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2

Expense Cycle

When paid, ACCOUNTS PAYABLE on the Balance Sheet become CASH DISBURSEMENTS and lower CASH.

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1
Investment Cycle
NET BORROWINGS, when entered on the *Cash Flow Statement*, increase both **CASH** and **DEBT** on the *Balance Sheet*.

Repayment in *less* than one year

or

Repayment in *more* than one year

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C	INVENTORIES	414,770
D	PREPAID EXPENSES	0
A + B + C + D = E	CURRENT ASSETS	1,512,992
F	OTHER ASSETS	0
G	FIXED ASSETS @ COST	1,750,000
H	ACCUMULATED DEPRECIATION	78,573
G - H = I	NET FIXED ASSETS	1,671,427
E + F + I = J	TOTAL ASSETS	\$3,184,419
K	ACCOUNTS PAYABLE	\$236,297
L	ACCRUED EXPENSES	26,435
M	CURRENT PORTION OF DEBT	100,000
N	INCOME TAXES PAYABLE	139,804
K + L + M + N = O	CURRENT LIABILITIES	502,536
P	LONG-TERM DEBT	800,000
Q	CAPITAL STOCK	1,550,000
R	RETAINED EARNINGS	331,883
Q + R = S	SHAREHOLDERS' EQUITY	1,881,883
O + P + S = T	TOTAL LIABILITIES & EQUITY	\$3,184,419

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Investment Cycle
Selling stock increases both
CASH and CAPITAL STOCK on
the Balance Sheet.

Income Statement

for the period

1	NET SALES	\$3,055,560
2	COST OF GOODS SOLD	2,005,830
1 - 2 = 3	GROSS MARGIN	1,049,730
4	SALES & MARKETING	328,523
5	RESEARCH & DEVELOPMENT	26,000
6	GENERAL & ADMINISTRATIVE	203,520
4 + 5 + 6 = 7	OPERATING EXPENSE	558,043
3 - 7 = 8	INCOME FROM OPERATIONS	491,687
9	NET INTEREST INCOME	(100,000)
10	INCOME TAXES	139,804
8 + 9 - 10 = 11	NET INCOME	\$251,883

Cash Flow Statement

for the period

a	BEGINNING CASH BALANCE	\$155,000
b	CASH RECEIPTS	2,584,900
c	CASH DISBURSEMENTS	2,796,438
b - c = d	CASH FLOW FROM OPERATIONS	(211,538)
e	PP&E PURCHASE	1,750,000
f	NET BORROWINGS	900,000
g	INCOME TAXES PAID	0
h	SALE OF CAPITAL STOCK	1,550,000
a + d + e + f + g + h = i	ENDING CASH BALANCES	\$643,462

Balance Sheet

as of period end

A	CASH	\$643,462
B	ACCOUNTS RECEIVABLE	454,760
C	INVENTORIES	414,770
D	PREPAID EXPENSES	0
A + B + C + D = E	CURRENT ASSETS	1,512,992
F	OTHER ASSETS	0
G	FIXED ASSETS @ COST	1,750,000
H	ACCUMULATED DEPRECIATION	78,573
G - H = I	NET FIXED ASSETS	1,671,427
E + F + I = J	TOTAL ASSETS	\$3,184,419
K	ACCOUNTS PAYABLE	\$236,297
L	ACCRUED EXPENSES	26,435
M	CURRENT PORTION OF DEBT	100,000
N	INCOME TAXES PAYABLE	139,804
K + L + M + N = O	CURRENT LIABILITIES	502,536
P	LONG-TERM DEBT	800,000
Q	CAPITAL STOCK	1,550,000
R	RETAINED EARNINGS	331,883
Q + R = S	SHAREHOLDERS' EQUITY	1,881,883
O + P + S = T	TOTAL LIABILITIES & EQUITY	\$3,184,419

Over time, depreciation expenses in the *Income Statement* increases **ACCUMULATED DEPRECIATION**, lowering **NET FIXED ASSET** value

When equipment (PP&E) is purchased, **FIXED ASSETS @ COST** increases and **CASH** decreases.

Fixed Asset Cycle