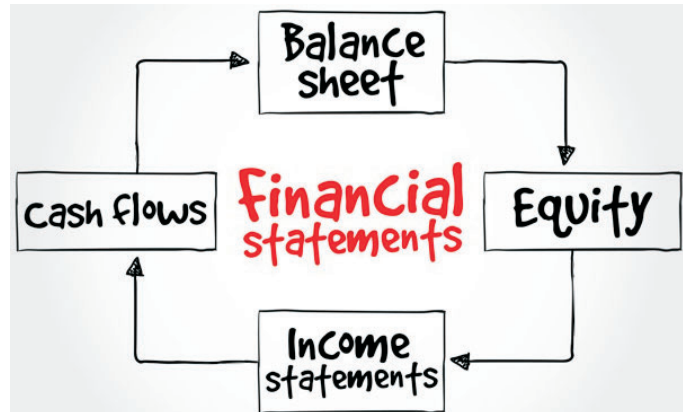


Financial Statement Line Item Relationships

HAVE YOU EVER tried completing a jigsaw puzzle only to find one piece is missing from the box? Financial statements give the picture of the overall health of a business. However, if you only look at some of the financial statement reports and not all of them, it is similar to having pieces missing from a puzzle. The four financial statement reports are balance sheet, income statement, statement of owner's equity, and statement of cash flows. They fit together to give a full picture of a company's financial performance.



Objective:



Summarize the interrelationship of financial statement reports.

Key Terms:



accounting period	financing activities	owner contributions
accrual basis of accounting	general and administrative expenses	owner's equity
asset	gross profit	selling expenses
balance sheet	income statement	statement of cash flows
cash basis of accounting	investing activities	statement of owner's equity
cash flow statement	liability	statement of retained earnings
cost of goods sold	net income	supplemental information
dividends	net loss	
drawing	operating activities	
financial statement		

Understanding Financial Statement Line Item Relationships

A **financial statement** is a series of reports that summarize the business's financial results, condition, and cash flows. The financial statement tells the story of the company's operations and financial health. It is important to remember that an individual financial statement should not be viewed in isolation. Instead, it should be viewed as part of the whole set, which includes the balance sheet, income statement, statement of cash flows, and statement of owner's equity.

BALANCE SHEET

A **balance sheet** is the part of the financial statement that reports the assets, liabilities, and owner's equity at a specific point in time. In essence, the balance sheet reflects the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.

Assets

An **asset** is a resource that has economic value and an expectation of providing future benefits. Cash, accounts receivable, inventory, property, plants, and equipment are assets. The asset section of the balance sheet presents all that the business owns. An asset is valued at its historical cost.

Liabilities

Liability is financial debt or obligations that occur as part of doing business. A liability is something the business "owes" and includes:

- ◆ Accounts payables to vendors
- ◆ Notes payable
- ◆ Unearned revenue

COMPANY NAME HERE			
Balance Sheet			
For the Period Ended _____			
Assets	Amount	Liabilities	Amount
Current Assets		Current Liabilities	
Cash		Account Payable	
_____		_____	
_____		_____	
Fixed Assets		Long Term Liabilities	
_____		_____	
_____		_____	
Intangible Assets		Share holders equity	
_____		_____	
_____		_____	
Other Assets		Secured Loans's	
_____		_____	
_____		_____	
TOTAL ASSETS		TOTAL LIABILITIES	

FIGURE 1. A balance sheet is the part of the financial statement that reports the assets, liabilities, and owner's equity at a specific point in time. In effect, the balance sheet reflects the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.

Owner's Equity

Owner's equity is the amount remaining after the value of all liabilities is subtracted from the value of all assets. It is the capital available to owners. Owner's equity may be viewed as the owner's share of the assets. The formula to calculate owner's equity is: $\text{Assets} - \text{Liabilities} = \text{Owner's Equity}$. Whatever the company owns minus whatever the company owes to others is what is left for the owners. Owner's equity reported on the balance sheet is computed as follows:

Beginning Owner's Equity	
+ Owner Contributions	
+ Net Income or – Net Loss	
– Owner Withdrawals (drawing or dividends)	
	<hr/>
Owner's Equity Balance Reported on Balance Sheet	

Balance Sheet Relationship to Other Financial Statement Reports

The balance sheet is related to other financial statements in several ways:

- ◆ The inventory balance included in total assets of the balance sheet is used as part of the income statement's calculation of cost of goods sold (COGS).
- ◆ The total owner's equity displayed must be calculated by adding in the net income calculated on the income statement.
- ◆ All adjusting entries include an adjustment to one balance sheet account and one income statement account. Whenever the balances of prepaid expenses are adjusted to reflect the balance for the end of the period, an expense account on the income statement is also adjusted. Whenever unearned revenue (a liability) is adjusted, a revenue account on the income statement is also adjusted.
- ◆ Changes in account balances on the balance sheet are reflected in the reconciliation of the cash flow statement.

INCOME STATEMENT


The **income statement** is the part of the financial statement that reports a company's financial performance over a specific period of time. It is referred to as the profit and loss statement or P&L. The income statement may be simple and report on income and expenses, or it may include computations of costs of goods sold (COGS) and subcategories of expenses. On the income statement, expenses are subtracted from revenue to calculate the net income or net loss for the period. The **accounting period** is the timeframe for which the company is reporting the results of its operations. Generally, the accounting period is a month, a quarter (three months), or one year.

- ◆ Section 1 of the income statement is the revenue (income) information. This is where the company reports sales or service revenue for the period.

◆ Section 2 of the income statement is expenses information. Depending on business type or size, this section may be extremely detailed. For example:

- If it is a merchandising business, a cost of goods sold section will be included on the income statement. **Cost of goods sold** is the total original price of all the merchandise sold during a fiscal period. COGS is calculated as: Beginning Inventory + Purchases – Ending Inventory = Cost of Goods Sold.
- If a company is a merchandising business and calculates COGS, it will also calculate gross profit. **Gross profit** is the revenue remaining after the cost of merchandise sold is deducted. Gross profit is calculated as: Sales – COGS = Gross Profit. In addition, the other expenses of the business may be reported in subcategories.

- **Selling expenses** are the costs incurred by the business related to selling and distributing the product to customers. These expenses may include marketing, sales commissions, salaries, and sales office expenses.
- **General and administrative expenses** are the costs incurred by the business in conducting its day-to-day business operations. These expenses may include office salaries, accounting fees, insurance costs, supply costs, etc.

INCOME STATEMENT			
For the period ending <input type="text"/>		\$	\$
INCOME			
<input type="text"/>		—	
<input type="text"/>		—	
<input type="text"/>		—	
<input type="text"/>		—	
EXPENSES			
<input type="text"/>			—
<input type="text"/>			—
<input type="text"/>			—
<input type="text"/>			—
<input type="text"/>			—
<input type="text"/>			—
NET PROFIT		<input type="text"/>	




FIGURE 2. The income statement is a financial statement report of a company's financial performance over a specific period of time.

Net Income

Once revenues and expenses are reported on the income statement, net income is calculated. **Net income** is the difference between total revenue and total expenses when total revenue is greater. Net income is calculated as: Revenues – Expenses = Net Income. If expenses are greater than revenues, the company will report a net loss. **Net loss** is the difference between total revenue and total expenses when total expenses are greater.

Income Statement Relationship to Other Financial Statement Reports

The income statement is related to the other parts of a financial statement in several ways. The net income from the income statement is used to calculate owner's equity on the statement of owner's equity. In addition, owner's equity is reported on the balance sheet in the owner's equity section. Net income is the first line reported in the cash flows statement and is used to calculate cash flows from operations.

STATEMENT OF CASH FLOWS

The **statement of cash flows** is the part of the financial statement that reports the inflow and outflow of cash for the accounting period of the income statement: operating activities, investing activities, financing activities, and certain supplemental information for the period. **Cash flow statement** is another name for a statement of cash flows. The statement of cash flows contrasts the income statement, which presents net income or net loss on the accrual basis of accounting. The **accrual basis of accounting** is a system that matches revenues and expenses based on when they occur, not when cash is exchanged. Therefore, the income statement does not display the actual cash generated and used, rather revenues and expenses. The statement of cash flows reports the inflows and outflows for the categories mentioned below.

Operating Activities

Section 1 is a report of the cash flows from operating activities. **Operating activities** are business functions related to services (e.g., manufacturing or marketing). Items are converted on the income statement from the accrual basis of accounting to the cash basis of accounting. The **cash basis of accounting** is a process that reports revenue when cash is received and expenses when cash is disbursed.

Investing Activities

Section 2 is a report of the cash flows from investing activities. **Investing activities** are cash flows from the sale and the purchase of property, plant and equipment, and long-term investments.

Financing Activities

Section 3 is a report of the cash flows from financing activities. **Financing activities** are cash flows from activities related to the company's stock, bonds, and dividends.



FURTHER EXPLORATION...

ONLINE CONNECTION:

The SEC's Guide to Financial Statements

The U.S. Securities and Exchange Commission has published a "Beginner's Guide to Financial Statements" that provides insight into reading financials. You can find the guide at:

<https://www.sec.gov/investor/pubs/begfinstmtguide.htm>



Supplemental Information

Section 4 is a report of supplemental information. **Supplemental information** is information about material exchanges that do not involve any cash (e.g., trading assets).

STATEMENT OF CASH FLOWS RELATIONSHIP TO OTHER REPORTS

The statement of cash flows is related to the other financial statements in the following ways:

- ◆ Net income from the income statement is used to reconcile cash from operation activities. Cash from operating activities can be compared to net income to determine if the profits from the business are generating increased cash.
- ◆ Any balance sheet items that have a cash impact are linked to the cash flow statement as a source or use of cash. For example, when property is purchased or a loan is procured, those items are reported as a cash inflow or outflow.
- ◆ The overall change in the balance in cash from one balance sheet to another will be the net change in cash reported on the statement of cash flows.

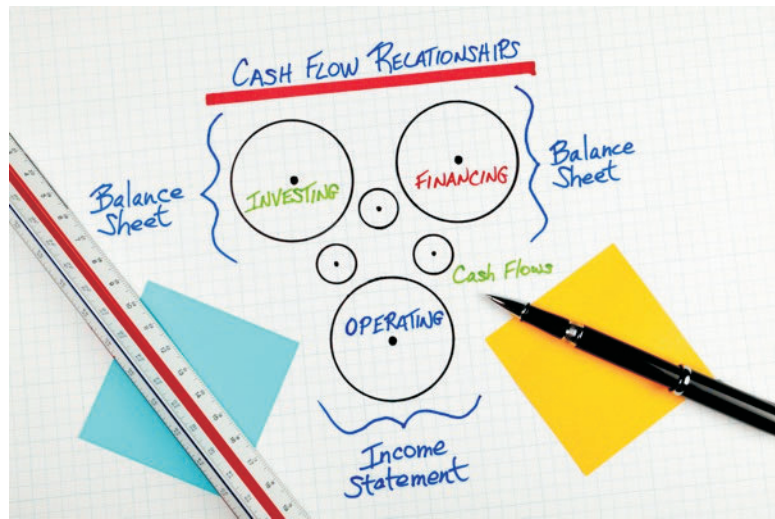


FIGURE 3. The statement of cash flows reports the inflow and outflow of cash for the accounting period.

STATEMENT OF OWNER'S EQUITY

The **statement of owner's equity** is the part of the financial statement that reconciles changes in the retained earnings account for a corporation. Owner's equity changes are reported as follows:

Beginning Owner's Equity
+ Owner Contributions
+ Net Income or – Net Loss
– Owner Withdrawals (drawing or dividends)
Ending Owner's Equity

Owner contributions are types of capital investment (e.g., money or assets). For a corporation, owner contributions are from purchases of capital stock, and this statement of owner's equity is called the **statement of retained earnings**. For a sole proprietorship and for a partnership, owner withdrawals are referred to as **drawing**. For a corporation, **dividends** are owner withdrawals.

Statement of Owner's Equity Relationship to Other Financial Statement Reports

The statement of owner's equity is related to the other financial statement reports in the following ways:

- ◆ Ending owner's equity calculated on the statement of owner's equity is reported in the owner's equity section of the balance sheet.
- ◆ Net income reported on the income statement is used in the calculation to reconcile owner's equity on the statement of owner's equity.
- ◆ Owner withdrawals are reported in the financing section of the statement of cash flows.
- ◆ Owner contributions and withdrawals also impact the related asset accounts on the balance sheet by increasing or decreasing the account balance.

Summary:



The financial statements of a company tell the story of the company's operations and financial health. It is important to remember that individual financial statements should not be viewed in isolation. Instead, they should be viewed as a part of the whole set, which includes the balance sheet, income statement, statement of cash flows, and statement of owner's equity.

Checking Your Knowledge:



1. What information is reported on the balance sheet?
2. What information is reported on the income statement?
3. Explain how the income statement and the statement of cash flows are linked.
4. How will the statement of owner's equity differ from a sole proprietorship to a corporation?
5. How are the four financial statements related?

Expanding Your Knowledge:



Use an Internet search engine to find copies of a well-known company's financial statements. Follow the numbers that flow from one statement to another. You may find the statements on the company website or at Yahoo! Finance.

Web Links:



Company Financials

<https://finance.yahoo.com/>

Khan Academy's Three Core Financial Statements

<https://www.khanacademy.org/economics-finance-domain/core-finance/accounting-and-financial-stateme/financial-statements-tutorial/v/balance-sheet-and-income-statement-relationship>

The Relationship Between Financial Statements

<http://www.investopedia.com/walkthrough/corporate-finance/2/relationship-financial-statement/relationship.aspx>