FINANCE AT A GLANCE

How Revenues and Expenses Affect the Balance Sheet

Lesson 32

Recall from Lessons 2 and 3 that the equation

Assets = Liabilities + Equity

remains true after each of the transactions shown.

The examples shown in those lessons concerned only items of the balance sheet. In this lesson, we shall prove that this equation remains true even when the transactions involve items of the income statement.

It is important to remember that a profit increases Retained Earnings. Profit is made up of Revenues minus Expenses. Therefore revenues increase Retained Earnings, and expenses decrease Retained Earnings.

Let us use the transactions of MNO Furniture Ltd. (a furniture retailer) as examples. The balance sheet of this company as of January 1, 2009 is as follows:

	Jan 1, 2009
Cash	20,000
Inventories	180,000
Fixed Assets	300,000

Total Assets	**500,000**
Accounts Payable	50,000
Long-Term Debt	250,000
Capital Stock	100,000
Retained Earnings	100,000

Total Liabilities and Equity	**500,000**

We are going to show the effects of three transactions.

Transaction 1:
On January 5, the company sold a living room set, worth $2,000 at a price of $3,000. The buyer paid in cash. In this transaction, the revenue was $3,000, and the expense was $2,000 (the Cost of Goods Sold). The effects on the balance sheet are as follows:

To record the cash received : add $3,000 to Cash
To record the revenue : add $3,000 to Retained Earnings
To record the value of inventory taken out : deduct $2,000 from Inventories
To record the expense : deduct $2,000 from Retained Earnings

	Jan 1, 2009	Transaction 1	Jan 5, 2009
Cash	20,000	plus 3,000	23,000
Inventories	180,000	minus 2,000	178,000
Fixed Assets	300,000		300,000
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Total Assets	**500,000**		**501,000**
Accounts Payable	50,000		50,000
Long-Term Debt	250,000		250,000
Capital Stock	100,000		100,000
Retained Earnings	100,000	plus 3,000, minus 2,000	101,000
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Total Liabilities and Equity	**500,000**		**501,000**

Transaction 2:

On January 31, the Company received $100 in interest on its bank account. This $100 was a revenue, thereby increasing the Retained Earnings. The effects on the balance sheet are as follows:

To record the cash received : add $100 to Cash

To record the revenue : add $100 to Retained Earnings

	Jan 5, 2009	Transaction 2	Jan 31, 2009
Cash	23,000	plus 100	23,100
Inventories	178,000		178,000
Fixed Assets	300,000		300,000
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Total Assets	**501,000**		**501,100**
Accounts Payable	50,000		50,000
Long-Term Debt	250,000		250,000
Capital Stock	100,000		100,000
Retained Earnings	101,000	plus 100	101,100
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Total Liabilities and Equity	**501,000**		**501,100**

Transaction 3:

On February 15, the Company paid $1,000 cash for an advertisement. This transaction involved an expense, which meant a reduction in Retained Earnings. The effects on the balance sheet are as follows:

To record the cash paid : deduct $1,000 from Cash

To record the expense : deduct $1,000 from Retained Earnings

	Jan 31, 2009	Transaction 3	Feb 15, 2009
Cash	23,100	minus 1,000	22,100
Inventories	178,000		178,000
Fixed Assets	300,000		300,000
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Total Assets	**501,100**		**500,100**
Accounts Payable	50,000		50,000
Long-Term Debt	250,000		250,000
Capital Stock	100,000		100,000
Retained Earnings	101,100	minus 1,000	100,100
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Total Liabilities and Equity	**501,100**		**500,100**

In all of the above transactions involving revenues and expenses, the equation

Assets = Liabilities + Equity

remained true.

Until the next lesson,

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