Applying the balance sheet-income statement relationship equation to transactions
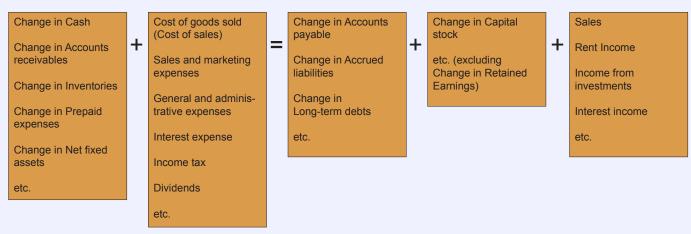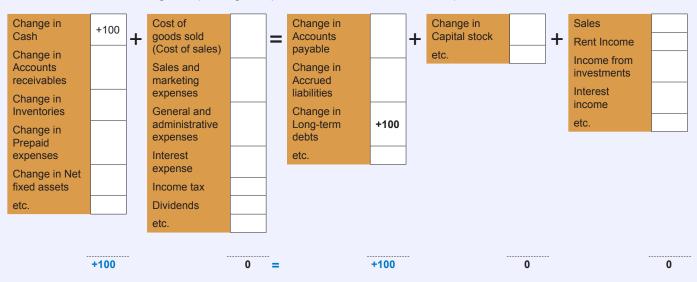
Lesson 36

In this lesson, we shall show, by means of examples, that the recording of transactions conforms with the **balance sheet-income statement relationship equation.** In Lesson 35, we diagramatically presented this equation as follows:

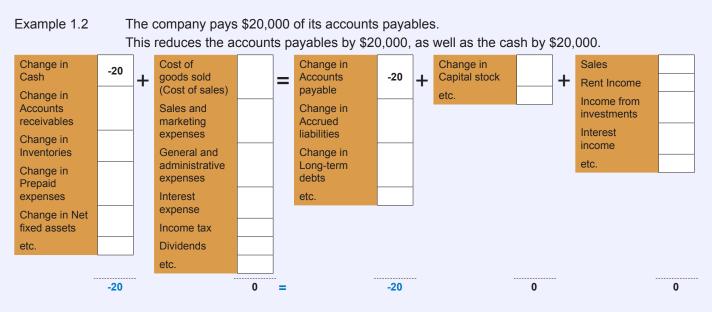| Change in Cash

Change in Accounts receivables

Change in Inventories

Change in Prepaid expenses

Change in Net fixed assets

etc. | **+** | Cost of goods sold (Cost of sales)

Sales and marketing expenses

General and adminis-trative expenses

Interest expense

Income tax

Dividends

etc. | **=** | Change in Accounts payable

Change in Accrued liabilities

Change in Long-term debts

etc. | **+** | Change in Capital stock

etc. (excluding Change in Retained Earnings) | **+** | Sales

Rent Income

Income from investments

Interest income

etc. |

The examples that we will present can be grouped into two types. One type covers transactions that affect both side of the equation. This means that the total of the items on the left side of the equation equals the total on the right side. The other type involves items that are all on only one side of the equation. The transactions we will use in this and the next lesson are those of a trading company.

Type 1. Transactions that affect both sides of the equation.
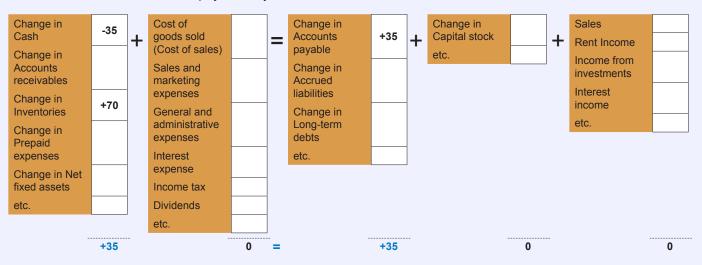
Example 1.1   The company avails of an additional bank loan amounting to $100,000. The bank deposits the funds into the company bank account. This involves an increase in long-term debt amounting to $100,000, as well as in the cash balance maintained with the bank. We can post these figures into the diagram. (The figures posted are in thousand dollars.)

Change in Cash	**+100**			Cost of goods sold (Cost of sales)		**=**	Change in Accounts payable		**+**	Change in Capital stock		**+**	Sales	
Change in Accounts receivables				Sales and marketing expenses			Change in Accrued liabilities			etc.			Rent Income	
Change in Inventories				General and administrative expenses			Change in Long-term debts	**+100**					Income from investments	
Change in Prepaid expenses				Interest expense			etc.						Interest income	
Change in Net fixed assets				Income tax									etc.	
etc.				Dividends										
				etc.										

+100	**0**	**=** **+100**	**0**	**0**

Example 1.2   The company pays $20,000 of its accounts payables.
This reduces the accounts payables by $20,000, as well as the cash by $20,000.

Change in Cash	**-20**	+	Cost of goods sold (Cost of sales)		=	Change in Accounts payable	**-20**	+	Change in Capital stock etc.	
Change in Accounts receivables			Sales and marketing expenses			Change in Accrued liabilities				
Change in Inventories			General and administrative expenses			Change in Long-term debts				
Change in Prepaid expenses			Interest expense			etc.				
Change in Net fixed assets			Income tax							
etc.			Dividends							
			etc.							

Right side headers: Sales, Rent Income, Income from investments, Interest income, etc.

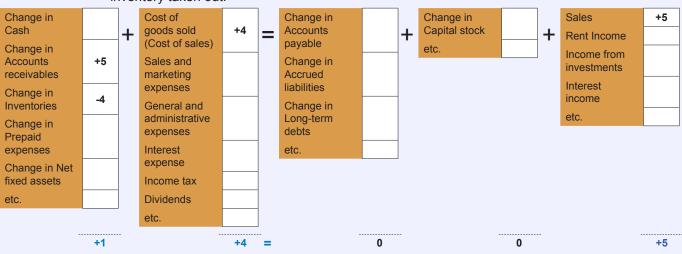| **-20** | | **0** | = | **-20** | | **0** | | **0** |

Example 1.3   The company purchases inventory worth $70,000. Half of it is paid for in cash, the other half is on credit. This increases the inventories by $70,000, decreases the cash by $35,000, and increases the accounts payables by $35,000.

Change in Cash	**-35**	+	Cost of goods sold (Cost of sales)		=	Change in Accounts payable	**+35**	+	Change in Capital stock etc.	
Change in Accounts receivables			Sales and marketing expenses			Change in Accrued liabilities				
Change in Inventories	**+70**		General and administrative expenses			Change in Long-term debts				
Change in Prepaid expenses			Interest expense			etc.				
Change in Net fixed assets			Income tax							
etc.			Dividends							
			etc.							

Right side headers: Sales, Rent Income, Income from investments, Interest income, etc.

| **+35** | | **0** | = | **+35** | | **0** | | **0** |

Example 1.4   The company sells an item for $5,000 on credit. That item was acquired for $4,000.
This brings in a sales revenue worth $5,000, and increases the accounts receivables by $5,000.
This likewise incurs an expense of $4,000 being the cost of goods sold, which is also value of the inventory taken out.

Change in Cash		+	Cost of goods sold (Cost of sales)	**+4**	=	Change in Accounts payable		+	Change in Capital stock etc.		+	Sales **+5**
Change in Accounts receivables	**+5**		Sales and marketing expenses			Change in Accrued liabilities						Rent Income
Change in Inventories	**-4**		General and administrative expenses			Change in Long-term debts						Income from investments
Change in Prepaid expenses			Interest expense			etc.						Interest income
Change in Net fixed assets			Income tax									etc.
etc.			Dividends									
			etc.									

| **+1** | | **+4** | = | **0** | | **0** | | **+5** |

In all four examples, the equality of the left side and right side of the equation remains true.

Type 2 transactions will be presented in the next lesson.