Università
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Financial accounting 1

02 – Balance sheet and income statement

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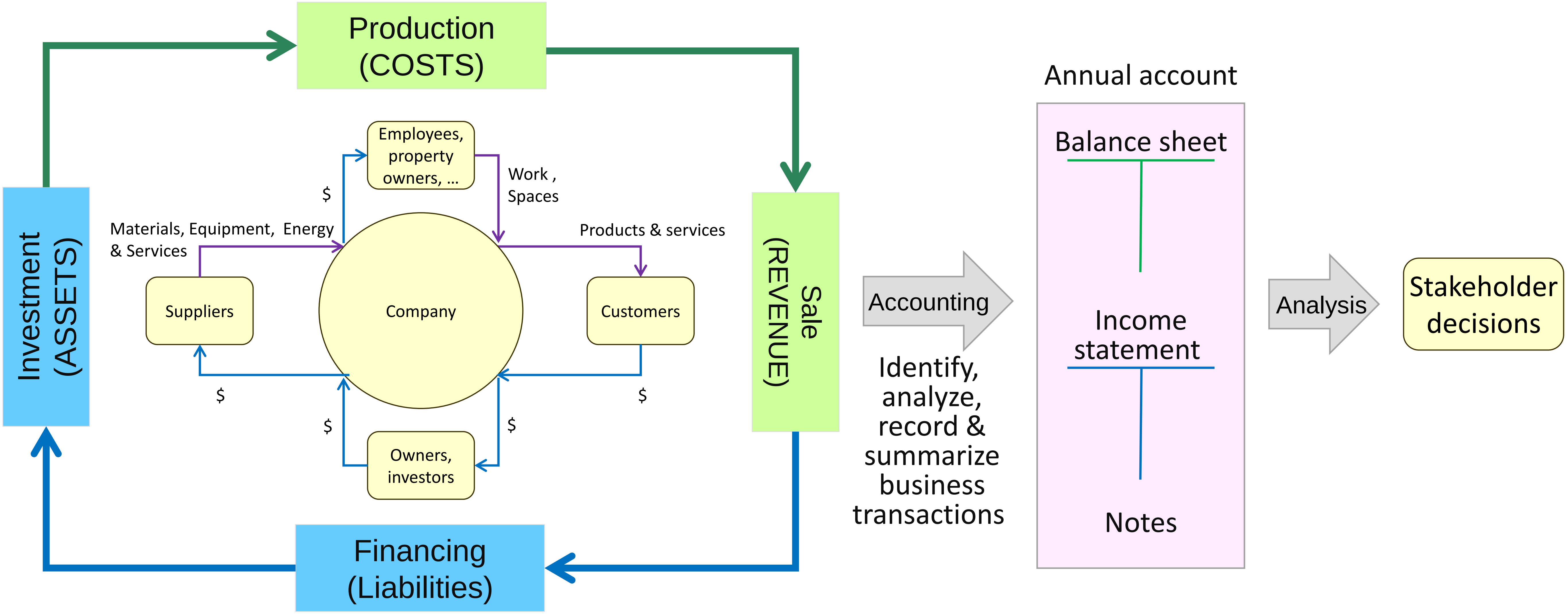
Summary of previous lesson



Chapter 2 - Objectives

- Understand the contents, the structure and be able to prepare a **balance sheet**
  - Assets, liabilities and equity
  - Minimal structure
- Understand the contents, structure and be able to prepare an **income statement**
  - Revenues, costs and net income
  - Minimal structure
- Be able to analyze business **transactions and undersand the effects on the balance sheet and income statement**

The presentation of accounts (CO 958)

CO 958 Financial reporting, aim and elements

1. *Financial reporting is intended to present the economic position of the undertaking in such a manner that third parties can make a* ***reliable assessment*** *of the same.*

2. *The accounts are filed in the* ***annual report****. This contains the annual accounts (the financial statements of the individual entity), comprising the* ***balance sheet****, the* ***profit and loss account*** *and the* ***notes to the accounts****. The regulations for larger undertakings and corporate groups are reserved.*

3. *The annual report must be prepared within six months of the end of the financial year and submitted to the responsible management body […] for approval. […]*

Comments

Financial accounting must fulfill its function as a *reliable information tool* for the various external stakeholders and management through the preparation, in each financial year, of the annual account (financial statements):

- the *balance sheet*, which provides information on the company's assets, liabilities and equity at the end of the financial year → liquidity, solvency
- the *income statement*, which provides information on the revenues, costs & net income (or loss) achieved by the company during the year → profitability
- The *notes to the accounts* give more information that completes and illustrates the other statements

Balance sheet: purpose and requirements (CO 959)

CO 959 Purpose of the balance sheet

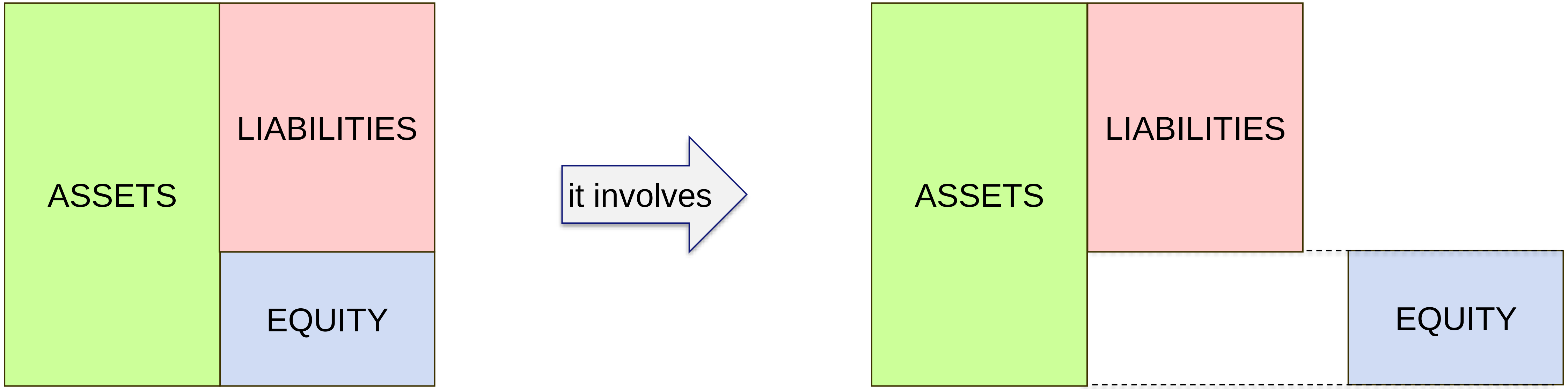
1. *The **balance sheet** shows the asset and financing position of the undertaking on the balance sheet date. It is structured into **assets** and **liabilities**..*

Comments:

The balance sheet shows the value and composi-tion of the *assets of the company* and *financing choices* (liabilities and equity). They are 2 sides of the same entity: company's *wealth* at a given date.

ASSETS	LIABILITIES & EQUITY
Resources How the capital was invested (investment)	**Sources** How the capital was obtained (financing)
Value and composition of company's **assets**	**Rights to** the company's assets
What the company **owns**	What the company **owes** to owners and others

Balance sheet: the balance sheet equation



ASSETS	=	LIABILITILES + EQUITY
What the company owns (assets)		What the company owes to others and owners

ASSETS	-	LIABILITIES	=	EQUITY
What the company owns		What it owes to various creditors		What it owes to the owners

Balance sheet: assets (CO 959)

CO 959 Purpose of the balance sheet

2. *Items must be entered on the balance sheet as **assets** if due to past events they may be disposed of, a cash inflow is probable and their value can be reliably estimated. Other assets may not be entered on the balance sheet*

Comments

Assets are the set of all tangible, intangible and financial resources available to the company. Yet, for reasons of reliability, accounting only includes resources that meet the following conditions:

- *may be disposed of* (is owned by the company or controlled by it thanks to a "financial" leasing)
- *due to past events* (it excludes future assets)
- a *cash inflow is probable* (via sale or use)
- and their *value can be reliably estimated* (for instane by their historical cost).

Note that this implies that assets do not include human resources and rented resources.

Balance sheet: current and capital assets (CO 959)

CO 959 Purpose of the balance sheet

3. *Cash and cash equivalents and other assets that will probably become cash or cash equivalents assets or otherwise be realised within one year of the balance sheet date or within the normal operating cycle must be entered on the balance sheet as* ***current assets****. All other assets are entered on the balance sheet as* ***capital assets****.*

Comments

The distinction between current and capital assets is given by the **lenght of use** or **realization** compared to the balance sheet closing date.

Current assets include cash, assets that will be converted into cash within a year (e.g. short-term securities, accounts receivables) and single-use resouces (e.g. inventories);

Capital assets are resources that are intended to be *used for several years* (e.g. vehicles, buildings, patents, etc.) or that will be *realized beyond one year* (e.g. financial investments, loans granted or securities held for several years).

Balance sheet: liabilities (CO 959)

CO 959 Purpose of the balance sheet

4. ***Borrowed capital*** *and* ***shareholders' equity*** *must be entered on the balance sheet as liabilities.*

5. *Liabilities must be entered on the balance sheet as borrowed capital if they have been caused by past events, a cash outflow is probable and their value can be reliably estimated.*

6. *Liabilities must be entered on the balance sheet as* ***current liabilities*** *if they are expected to fall due for payment within one year of the balance sheet date or within the normal operating cycle. All other liabilities must be entered on the balance sheet as* ***long-term liabilities****.*

7. *The* ***shareholders' equity*** *must be shown and structured in the required legal form.*

Comments

Liabilities are the set of commitments assumed by the company towards external entities (e.g. debts to suppliers, bank loans, ...):

→ does not confer ownership/decision rights
→ has a certain deadline
→ remunerated regardless of the results (interest)
→ assume a secondary risk (after equity)

Equity is the sum of the owners' contributions and any retained earnings:

→ confers ownership and decision rights
→ is granted for an indefinite period
→ remunerated only in case of profit (dividends)
→ assume a primary risk (reduced by losses)

Balance sheet: minimum structure (CO 959a)

1 *Among the **assets**, the **liquidity** ratio must be shown based on at least the following items, both **individually** and in the **specified order** →*

2 *The **due date** of **liabilities** must be shown based on at least the following items, both **individually** and in the **specified order** →*

3 ***Other items** must be shown individually on the balance sheet or in the notes to the accounts, **provided this is essential** so that third parties can assess the asset or financing position **or is customary** as a result of the activity of the company.*

4 ***Receivables and liabilities vis-à-vis direct or indirect participants** and **management** bodies and vis-à-vis undertakings in which there is a direct or indirect **participation** must in each case be shown separately on the balance sheet or in the notes to the accounts.*

Current assets
a. cash and cash equivalents and current assets with a stock exchange price
b. trade receivables,
c. other current receivables
d. inventories and non-invoiced services
e. accrued income and prepaid expenses

Capital assets
a. financial assets
b. shareholdings
c. tangible fixed assets
d. intangible fixed assets
e. non-paid up basic, shareholder or foundation capital.

Current borrowed capital:
a. trade creditors
b. current interest-bearing liabilities
c. other current liabilities
d. deferred income and accrued expenses

long-term borrowed capital
a. long-term interest-bearing liabilities
b. other long-term liabilities
c. provisions and similar items required by law

Equity
a. basic, shareholder or foundation capital
b. statutory capital reserves
c. statutory retained earnings
d. voluntary retained earnings
e. own capital shares
f. profit carried forward or loss carried forward
g. annual profit or annual loss

Balance sheet: Swiss chart of accounts for SME (excerpt)

1 Assets

10 Current assets

100 Cash and cash equivalents and current assets with a stock exchange price
1000 Cash
1020 Bank
1060 Current assets with a stock exchange price

110 Accounts receivables (trade receivables)
1100 Accounts receivables (trade receivables)
1109 Allowance for doubtful accounts

114 Other current receivables
1140 Short-term loans
1160 Receivables from shareholders
1170 Prepaid VAT 1 (on materials, goods, services and energy)
1171 Prepaid VAT 2 (on investments and other operating expenses)
1176 Withholding tax receivables
1190 Other short-term receivables

120 Inventories and non-invoiced services
1200 Inventories of commercial goods
1208 Advance payments for commercial goods
1210 Inventories of raw materials
1260 Inventories of finished products
1270 Inventories of in-process products
1280 Non-invoiced services (work in progress)

130 Accrued income and prepaid expenses
1300 Prepaid expenses
1301 Accrued income

14 Fixed assets (capital assets)

140 Financial assets
1400 Long-term securities
1440 Long-term loans
1460 Long-term loans to shareholders

148 Investments (shareholdings)
1480 Investments (shareholdings)

150 Tangible fixed assets
1500 Machinery and equipment
1509 Adjustment of machinery and equipment value
1510 Furniture and fixtures
1519 Adjustment of furniture and fixtures value
1520 Office machinery and ICT
1529 Adjustment of office machines and ICT value
1530 Vehicles
1539 Adjustment of vehicles value
1598 Advance payments for movable fixed assets
1600 Real estate
1608 Advance payments for real estate
1609 Adjustment of real estate value

170 Intangibile fixed assets
1700 Patents, know-how, licenses, rights, development
1709 Adjustment of patents, know-how, licenses, rights, development value
1770 Goodwill
1799 Adjustment of goodwill value

180 Non-paid up capital
1850 Non-paid up capital

Balance sheet: Swiss chart of accounts for SME (excerpt)

2 Liabilities

20 Short-term liabilities (current borrowed capital)

200 Accounts payables (trade creditors)
2000 Accounts payables (trade creditors)
2030 Advance payments from third parties

210 Short-term interest-bearing liabilities
2100 Short-term bank current account
2108 Short-term mortgages
2120 Short-term leasing commitments
2140 Other short-term interest-bearing debts

220 Other short-term liabilities
2200 VAT due
2201 VAT settlement
2206 Withholding tax payable
2210 Other short-term liabilities
2261 Dividends
2270 Social insurances and social security institutions

230 Deferred income and accrued expenses
2300 Accrued expenses
2301 Deferred income
2310 Short-term provisions

24 Long-term liabilities

240 Long-term interest-bearing liabilities
2400 Long-term bank loans
2420 Long-term leasing commitments
2430 Bond loans
2451 Long-term mortgages

250 Other long-term liabilities
2500 Other long-term liabilities

260 Long-term provisions
2610 Long-term provisions

28 Equity (corporations)

280 Shareholder capital / Foundation capital
2800 Shareholder capital / Foundation capital

290 Reserves, profit and loss
2900 Statutory capital reserves
2950 Statutory earnings reserves (statutory retained earnings)
2960 Voluntary earnings reserves (voluntary retained earnings)
2970 Profit carried forward or loss carried forward
2979 Annual profit or annual loss

28 Equity (for sole proprietorships)

2800 Basic capital at the beginning of the year
2850 Private account
2891 Annual profit or annual loss

Balance sheet: examples (Coop)

Consolidated balance sheet

in CHF million	Notes	31.12.2023	31.12.2022
Cash and cash equivalents	9	1 184	1 275
Receivables from goods and services	10	1 452	1 426
Other short-term receivables	11	302	443
Prepayments and accrued income		720	709
Inventories	12	3 753	3 871
Current assets		7 411	7 724
Tangible fixed assets	13	13 581	13 158
Financial assets	14	218	219
Intangible assets	15	780	936
Non-current assets		14 580	14 313
Assets		21 991	22 037

Payables from goods and services		1 888	1 991
Short-term financial liabilities	16	686	778
Other short-term liabilities	17	470	416
Short-term provisions	18	306	307
Accrued liabilities and deferred income		1 625	1 711
Short-term liabilities		4 975	5 204
Long-term financial liabilities	16	3 838	4 105
Long-term provisions	18	1 205	1 182
Long-term liabilities		5 043	5 287
Liabilities		10 018	10 491
Retained earnings		10 959	10 540
Capital reserves		−259	−244
Profit		575	563
Equity excluding minority interests		11 274	10 859
Minority interests		699	686
Equity incl. minority interests		11 973	11 545
Liabilities and equity		21 991	22 037

Balance sheet: examples (Swiss Post)

Balance sheet

Swiss Post Ltd | Balance sheet

CHF million	31.12.2022	31.12.2023
Assets		
Current assets		
Cash and cash equivalents	259	813
Trade accounts receivable	22	58
Other current receivables	2,145	1,670
Inventories and unbilled services	4	5
Accrued income and prepaid expenses	60	73
Total current assets	**2,490**	**2,619**
Fixed assets		
Financial assets	1,426	1,598
Interests	7,631	7,654
Property, plant and equipment	31	33
Intangible assets	374	301
Total fixed assets	**9,462**	**9,586**
Total assets	**11,952**	**12,205**
Equity and liabilities		
Liabilities		
Trade accounts payable	26	36
Current interest-bearing liabilities	362	397
Other current liabilities	29	26
Accrued expenses and deferred income	40	37
Total current liabilities	**457**	**496**
Non-current interest-bearing liabilities	775	775
Provisions	46	51
Total non-current liabilities	**821**	**826**
Total liabilities	**1,278**	**1,322**
Equity		
Share capital	1,300	1,300
Statutory capital reserves		
Other capital reserves	8,621	8,621
Distributable profit		
Profit carried forward	–	703
Net annual profit	753	259
Total equity	**10,674**	**10,883**
Total equity and liabilities	**11,952**	**12,205**

Balance sheet: documentation / inventory (CO 958c)

CO 958c Recognised financial reporting principles

2. The sum entered for the individual items on the balance sheet and in the notes to the account must be **proven** by an **inventory** or by some **other method**.

Comments

The inventory records in detail the quality, **quantity** and **value characteristics** of a company's assets and debts at a specific moment. They are useful for control purposes. At the end of the year, partial inventories are carried out on the main assets (full inventories are carried out in special cases like sales and liquidations):

- **cash**
- **receivables** from customers
- **inventories** materials & products
- **fixed assets**
- **payables** to suppliers

Article	Quantity	Unit Cost Price	Extension at Cost
Armchairs, wood	24	$60.00	$1,440.00
Armchairs, tapestry	8	97.50	$780.00
Armchairs, Windsor	12	90.00	$1,080.00
Beds, bunk	8	85.00	$680.00
Bedroom suites	4	329.20	$1,316.80
Tables, coffee	30	63.00	$1,890.00
Chairs, kitchen	24	23.00	$552.00
Dining tables	8	117.40	$939.20
Dining suites	5	288.80	$1,444.00
Sofa sets	9	330.00	$2,970.00
Total			$13,092.00

Income statement (CO 959b)

CO 959b Profit and loss account; minimum structure

1. *The profit and loss account shall* ***present the earnings of the company over the financial year.*** *It may be prepared according to the period-based accounting method or the cost of sales method.*

Comments:

The profit and loss acocunt (income statement) shows the economic situation of the company. It shows the *net income earned by the business in a given period* and how it was generated by detailing *costs* and *revenues*.

Revenues: The value generated from the sale of products or services or accessory activities (they increase net assets)

−

Costs: The value from the resources consumed to carry out the company's activities (they reduce net assets)

=

Result: The net income created from the company during a period (a **profit** if positive, a **loss** if negative)

Income statement: minimum structure (CO 959b)

CO 959b Profit and loss account; minimum structure

2. If the period-based accounting method is used (**nature of expense method**), a mini-mum of the following items must be shown individually and in the specified order →

3 If the **cost of sales method** is used (activity-based costing method), a minimum of the following items must be shown individually and in the specified order →

4 If the cost of sales method is used, the **notes to the accounts** must also show the staff costs and, as a single item, depreciation and valuation adjustments to fixed asset items.

5 **Other items** must be shown individually in the profit and loss account or in the notes to the accounts to the extent that this is essential […]

Nature of expense method

1. net proceeds from sales of goods and services;
2. changes in inventories of unfinished and fi-nished goods and in non-invoiced services;
3. cost of materials;
4. staff costs;
5. other operational costs;
6. depreciation and valuation adjustments on fixed asset items;
7. financial costs and financial income;
8. non-operational costs and income;
9. extraordinary, non-recurring or prior-period costs and income;
10. direct taxes;
11. annual profit or annual loss.

Cost of sales method

1. net proceeds from sales of goods and services;
2. acquisition or manufacturing costs of goods and services sold;
3. administrative costs and distribution costs;
4. financial costs and financial income;
5. non-operational costs and income;
6. extraordinary, non-recurring or prior-period costs and income;
7. direct taxes;
8. annual profit or annual loss.

Income statement: multi-step income statement

To provide more information, the income statement can be structured in different steps (subtotals):

- **Operating income** includes costs and revenues of the company's main activity (they are continuous and depend on the evolution of its sector). We can further distinguish gross profit and EBIT.
- **Non-operating result** includes revenues and costs relating to accessory activities to the main activity like rental properties and securities (depend on the evolution of the relevant sectors).
- **Extraordinary result includes** revenues and costs are exceptional (unlikely to repeat like damage from natural disasters) or relating to previous periods (e.g. profits/losses from disposal of fixed assets...)

	Net revenues
-	Costs of goods sold
=	**Gross profit**
-	Other operating costs
=	**Earnings before interest and taxes (EBIT)**
+/-	Financial result
=	**Operating income**
+/-	Non-operating income
+/-	Extraordinary income
=	**Earnings before taxes (EBT)**
-	Taxes on profits
=	**Annual profit or loss**

Income statement: Swiss chart of accounts for SME (ex.)

3	**Revenues from sales and services**
3000	Revenues from manufactured products
3200	Revenues from resale of goods
3400	Revenues from services provided
3680	Other revenues from deliveries and services
3700	Own contributions and own consumption
3800	Deductions in revenues (discounts, rebates, refunds, ...)
3805	Losses on receivables

4	**Costs for material, goods, services and energy**
4000	Costs of materials
4200	Costs of goods sold
4400	Costs for third-party services
4290	Deductions in costs of materials, goods and third-party services

5	**Personnel expenses**
5000	Salaries
5700	Social charges
5800	Other personnel expenses

6	**Other operating expenses, depreciation, financial result**
6000	Rent
6100	Maintenance, repairs and replacements costs
6200	Vehicle and transport costs
6300	Insurance, duties, taxes and permits costs
6400	Energy and disposal costs
6500	Administrative and IT costs
6550	Formation and capital increase costs
6570	Leasing costs
6600	Advertising and marketing costs
6700	Other operating costs
6800	Depreciation and value adjustment on fixed assets
6900	Financial costs
6950	Financial revenues

8	**Extraordinary and non-operational results**
8000	Non-operational costs
8100	Non-operational revenues
8500	Extraordinary, exceptional, or out-of-period costs
8504	Extraordinary losses on disposal of fixed assets
8510	Extraordinary, exceptional, or out-of-period revenues
8514	Extraordinary gains on disposal of fixed assets
8900	Direct taxes

9	**Closing**
9200	Profit / loss for the year

Income statement: examples (Coop)

in CHF million	Notes	2023	2022
Net sales from goods and services	1	33 558	33 104
Other operating income	2	1 108	1 102
Merchandise expenses		22 890	22 679
Personnel expenses	3	5 779	5 553
Other operating expenses	4	3 723	3 790
Earnings before interest, tax, depreciation and amortization (EBITDA)		2 274	2 184
Depreciation on tangible fixed assets	5	1 175	1 075
Amortization on intangible assets	5	235	267
Operating result (EBIT)	1	864	843
Result of associated organizations		2	9
Result from foreign currencies		–41	–17
Financial result	6	–27	–31
Ordinary result		797	803
Non-operating result	7	1	2
Result before income taxes (EBT)		798	806
Income taxes	8	76	95
Result after income taxes		722	711
Minority interests		147	148
Profit		575	563

Income statement: examples (Swiss post)

CHF million	2022	2023
Operating income		
Trade income	809	821
Other operating income	0	0
Income from investments	809	344
Total operating income	**1,618**	**1,165**
Operating expenses		
Materials expenses	–	0
Personnel expenses	–440	–484
Other operating expenses	–323	–324
Impairment losses on financial assets and interests	–54	–77
Depreciation and impairment losses on property, plant and equipment	–12	–13
Depreciation of intangible assets	–82	–83
Total operating expenses	**–911**	**–981**
Operating profit	**707**	**184**
Financial income	92	128
Financial expenses	–46	–53
Total net financial income	**46**	**75**
Income from other accounting periods	–	0
Net annual profit before tax	**753**	**259**
Direct taxes	–	–
Net annual profit	**753**	**259**

Analysis of business transactions

Accounting must inform stakeholders about the company's financial, asset and income situation. However, assets and income are dynamic quantities, which change at every business transaction. Waiting until the end of the year would not be practical and it is better to analyze every single transaction.

Since the equation **assets = liabilities + equity** is always true, it can be deduced that **each business transaction must have effects on two or more balance sheet and/or income statement items**.

When faced with a management issue, you essentially need to ask yourself two questions:

1. **Which balance sheet or income statement elements (accounts) are affected?**
2. **How much do they increase or decrease?**

Analysis of business transactions (example)

1. The owner gives the company 100 in cash:
   → + assets (cash +100)
   → + liabilities/equity (paid-in capital +100)

Balance sheet after operation 1

Cash	**0 → 100**		
		Paid-in capital	**0 → 100**
TOTAL	100	TOTAL	100

Income statement after operation 1

2. Part of the cash (80) is transferred to the bank account
   → + assets (bank +80)
   → - assets (cash -80)

Balance sheet after operation 2

Cash	**100 → 20**		
Bank	**0 → 80**		
		Paid-in capital	100
TOTAL	100	TOTAL	100

Income statement after operation 2

3. The company buys furniture for 50, paid with the bank
   → + assets (furnitures +50)
   → - assets (bank -50)

Balance sheet after operation 3

Cash	20		
Bank	**80 → 30**		
Furnitures	**0 → 50**	Paid-in capital	100
TOTAL	100	TOTAL	100

Income statement after operation 3

4. The company purchases goods on credit for 150
   → + assets (goods inventory + 150)
   → + liabilities (accounts payable +150)

Balance sheet after operation 4

Cash	20	**Acc. payables**	**0 → 150**
Bank	30		
Inventories	**0 → 150**		
Furnitures	50	Paid-in capital	100
TOTAL	250	TOTAL	250

Income statement after operation 4

Nosetti O. (1989), *Introduzione alla contabilità finanziaria*, pp. 47-49

Analysis of business transactions (example)

5. All goods are sold for 200 on credit
→ + assets (accounts receivable +200)
→ - assets (inventories -150)
→ + "equity" → **+ revenues** (sales revenues +200)
→ - "equity" → **+ costs** (cost of goods sold +150)

Balance sheet after operation 5

Cash	20	Acc. payable	150
Bank	30		
Acc. receivable	**0 → 200**		
Inventories	**150 → 0**	Paid-in capital	100
Furnitures	50	**Annual income**	**0 → 50**
TOTAL	300	TOTAL	300

Income statement after operation 5

Goods costs	**0 → 150**	**Revenues**	**0→200**
TOTAL	150	TOTAL	200
Net income	**50**		

6. Customers pay part of the invoices by paying 90 to the bank account
→ + Assets (bank +90)
→ - Assets (accounts receivable -90)

Balance sheet after operation 6

Cash	20	Acc. payable	150
Bank	**30 → 120**		
Acc.receivable	**200 → 110**		
Inventories	0	Paid-in capital	100
Furnitures	50	Annual profit	50
TOTAL	300	TOTAL	300

Income statement after operation 6

Goods costs	150	Revenues	200
TOTAL	150	TOTAL	200
Net income	50		

7. The company pays invoices to suppliers for 80 from the bank account
→ - Assets (post -80)
→ → - liabilities (debts FP -80)

Balance sheet after operation 7

Cash	20	**Acc. payable**	**150 → 70**
Bank	**120 → 40**		
Acc. receivable	110		
Inventories	0	Paid-in capital	100
Furnitures	50	Annual profit	50
TOTAL	220	TOTAL	220

Income statement after operation 7

Goods costs	150	Revenues	200
TOTAL	150	TOTAL	200
Net income	50		

Nosetti O. (1989), *Introduzione alla contabilità finanziaria*, pp. 47-49

Analysis of business transactions (example)

8. Payment of general business expenses of 15 from the bank account

→ - assets (bank -15)

→ **- "equity"** → + **costs** (other costs +15)

Balance sheet after operation 8

Cash	20	Acc. payable	70
Bank	**40→ 25**		
Inventories	0		
Acc. receivable	110	Paid-in capital	100
Furnitures	50	**Net income**	**50 → 35**
TOTAL	205	TOTAL	205

Income statement after operation 8

Goods costs	150	Revenues	200
Other costs	**15**		
TOTAL	165	TOTAL	200
Net income	**35**		

9. The value of the furniture depreciates by 10 due to wear and tear

→ - assets (furnitures -10)

→ **- "equity"** → + **costs** (depreciation +10)

Balance sheet after operation 9

Cash	20	Acc. payable	70
Bank	25		
Inventories	0		
Acc. receivable	110	Paid-in capital	100
Furnitures	**50 → 40**	**Net income**	**35 → 25**
TOTAL	195	TOTAL	195

Income statement after operation 9

Goods costs	150	Revenues	200
Other costs	15		
Depreciation	**10**		
TOTAL	175	TOTAL	200
Net income	**25**		

Nosetti O. (1989), *Introduzione alla contabilità finanziaria*, pp. 47-49

Analysis of business transactions (transaction types)

Two types of transactions can be distinguished:

- **financial transactions** that modify company's balance sheet without generating any income since a movement in assets/liabilities is offset by a countermovement in the assets/liabilities of equal value (transfers between various elements of the balance sheet or contributions and withdrawals made by the shareholders)

- **economic transactions** that increase or reduce the company's net income (and hence net assets value), modifying an asset/liability element without a asset/liability counterpart, thus generating revenues or costs.

Examples:

→ + Assets / - Assets (e.g. purchasing furniture with cash)

→ + Assets / + Liabilities (e.g. purchase of goods on credit)

→ - Liabilities / - Assets (e.g. payment of supplier invoices)

→ - Liabilities / + Liabilities (e.g. transforming debt into equity)

→ + Assets / + Revenues (e.g.: selling services on credit)

→ – Liabilities / + Revenues (e.g. dissolution of provisions)

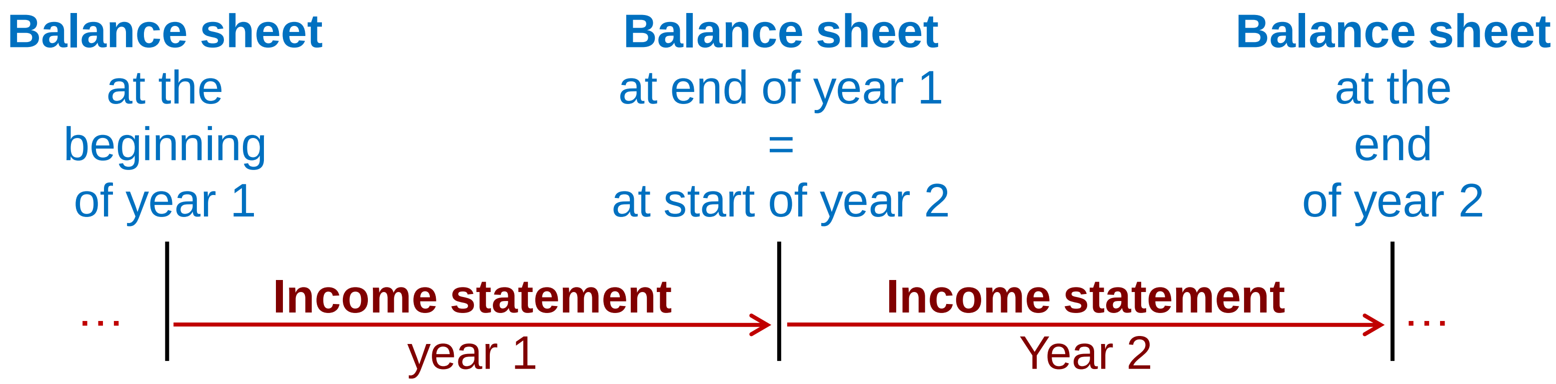
→ + Costs / - Assets (e.g. payment of wages to workers)

→ + Costs / + Liabilities (e.g. creation of provisions)

Balance sheet and income statement relationships

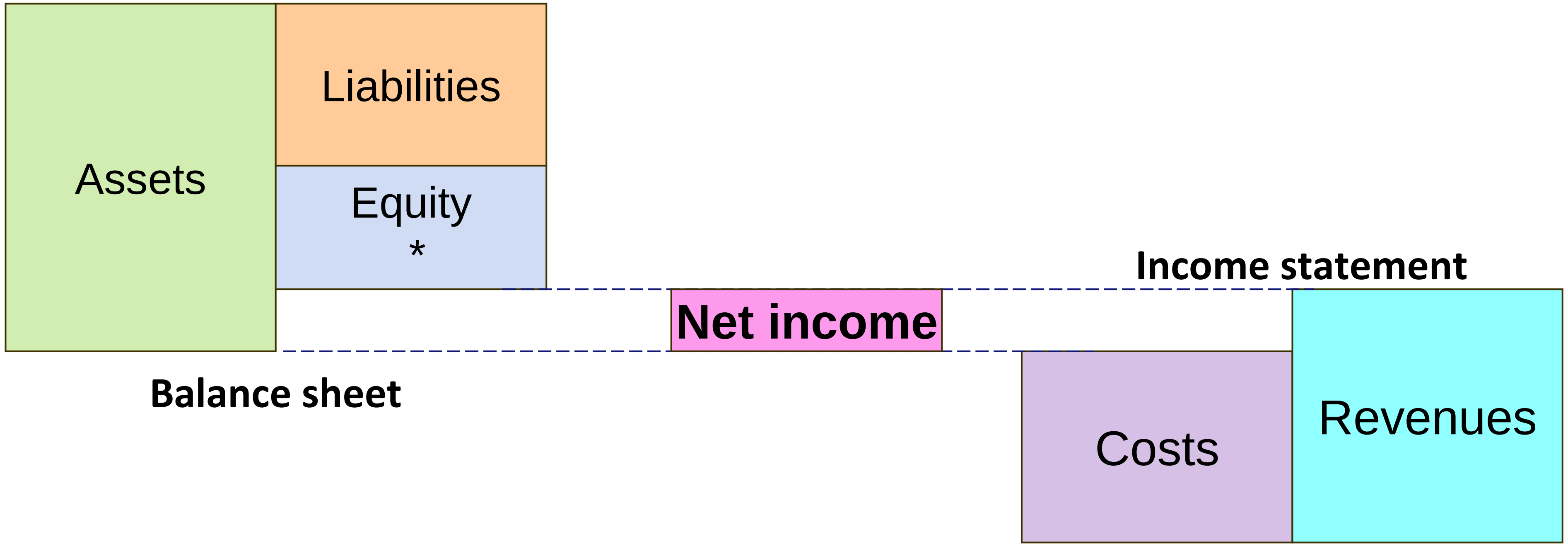
The **balance sheet** shows the state of the assets, liabilities and equity **at a given date** (usually the beginning and ending of a period). It is like a **photo snapshot** that shows the situation at a given moment but does not explain what happened to get there.

The **income statement** shows the net income generated **in a period**. It is like a **movie** that explains what happened (from an income perspective) between the starting and ending balance sheets, not only how much income was achieved but also how it was generated.



Balance sheet and income statement relationships

Since **costs** and **revenues** correspond to **reductions** and **increments** of net worth:



At the end of the period (when closing the books), the net income is transferred to the balance sheet under equity as an annual profit (positive amount) or loss (negative amount).

* Excluding the current year's result

Balance sheet and income statement relationships

When opening the accounts the next year:

- the **balance sheets carries over the next year**, with the only difference that annual income or loss is added to the retained earnings account **→ permanent accounts**
- the **income statement does not carry over the next year**: all revenues and costs accounts are reset to zero in order to be able to measure the income generated in the next accounting period **→ temporary accounts**

Ending balance sheet (December 31, Year 1)

Cash	20	Acc. payable	70
Bank	25		
Inventories	0		
Acc. receivable	110	Paid-in capital	100
Furnitures	40	**Annual income**	**25**
TOTAL	**195**	**TOTAL**	**195**

Ending income statement (Year 1)

Goods costs	150	Revenues	200
Other costs	15		
Depreciation	10		
TOTAL	175	TOTAL	200
Net income	**25**		

Beginning balance sheet (January 1, Year 2)

Cash	20	Acc. payable	70
Bank	25		
Inventories	0		
Acc. receivable	110	Paid-in capital	100
Furnitures	40	**Retained earnings**	**25**
TOTAL	195	TOTAL	195

Beginning income statement (Year 2)

Information obtainable from the financial statements

Liquidity
Short term-assets are enough to cope with short-term commitments?

Solvency
Long-term assets are financed with long term sources?

Current assets	**Short-term liabilities**
Fixed Assets	**Long term liabilities**
	Equity

Solvency
Assets structure provides enough flexibility to cope with economic changes?

Solvency
Financing choices give autonomy and acceptalbe risks?

Solvency
Enough capital and reserves to absorb losses ?

Profitability
Return on capital (equity and total) is acceptable?

PFP Revenues
Costs of goods sold
Gross profit
Other operating revenues
Other operating costs
EBIT
Financial costs
Extraneous result
Extraordinary result
EBT
Taxes
Net income

Profitability
Profit margins are satisfying?