CHAPTER 2

Imagine how the first people to see motion pictures must have felt. Before the invention of the movies, the only way to capture the world was static—a frozen image, like a photograph or a painting. Then, with the first motion pictures, people were able to see the world as it really is! Always moving and changing. With things happening simultaneously at different places.

At the end of the last chapter, we said that if the Balance Sheet is like a snapshot of a business, then the Income Statement is like a movie. Does a photograph have a beginning and an end? (No, unless you wish to enlist some strange philosophical argument that will bore even your best friend.) Now, does a movie have a beginning and an end? (You get two chances to answer, and the first one doesn't count!)

Thus, an Income Statement has a beginning and an end.

Now, since we're talking about a financial scorecard and not some zillion-dollar Hollywood extravaganza, what exactly does an income statement show us?

It's called an income statement, so let's start by asking how income is generated in our lemonade business? From…what?

Did you say, "Sales"? Very good!

So, we begin with sales. Did it cost us any product to generate those sales?

Yes. We need to find a name for what it costs us for goods sold.

Hmmmm. Any ideas out there?

Well, I'm going out on a limb now, but, with your permission, may I be bold enough to suggest Cost of Goods Sold?

Now, what does Cost of Goods Sold mean? The important thing is this: Cost of Goods Sold relates only to what? Our product or our lemonade.

Okay, let's do some figuring. If we subtract out the Cost of Goods Sold, not all the other stuff we spent money on, from Sales, what do we get?

Gross Profit.

Gross Profit is sales minus cost of goods sold. (Net Profit is something different, which we'll get to shortly.)

Sales
-COGS (Cost of Goods Sold)

= Gross Profit

Why do we call it gross profit? The word "gross" in German means "big" or "fat," so why is this the "fat profit"?

Because we haven't taken out all the other costs of doing business.

And what are examples of some of the other costs of doing business?

Did I hear someone say, "Expenses"? If so, you're right!

Just to have our lemonade stand open out on the sidewalk did we have certain expenses? Yes! We had glass rental and rent to the neighbors for our location and some advertising. So, are Expenses the cost of being in business, regardless whether or not we sell a single glass of lemonade? 'Fraid so!

A moment ago, we said the lemonade or the Cost of Goods Sold is subtracted from our Sales and then we've got our Gross Profit. Now, let's subtract out all the other Expenses and we get what? (Now, those of us curious about Net Profit, chime in!)

Sales
-COGS

= Gross Profit
-Expenses

= Net Profit

Notice how Net Profit is at the bottom line of this formula? So, it stands to reason that Net Profit is often called the...?

Bottom line.

You can see that our Income Statement separates costs into two categories—Cost of Goods Sold for all the costs of producing our product, and Expenses for all the non-production costs of running the business. For a business that does not have a tangible product (i.e., a service business) the two categories are Cost of Sales or Cost of Services and Expenses.

Now, go back to Chapter One and put in the numbers for the formula below, so we can see where we stand with the bottom line.

Sales	$_____
-COGS	$_____
Gross Profit	$_____
-Expenses	$_____
Net Profit	$_____

Let's take a moment and review.

The purpose of the Income Statement is to keep track of sales minus Cost of Goods Sold, which gives us Gross Profit. Then, we subtract all the other Expenses, which gives us our what?

Net Profit.

What is another name for net profit?

Net Income or the bottom line.

So—earnings, net profit, net income and the bottom line—are they all the same?

Absolutely!

Okay, let's get back to business! We're going to go through a detailed Income Statement line by line. You may want to get a straight edge (a ruler; even an envelope or a piece of paper will do), to help you keep things clean and simple.

INCOME STATEMENT

INCOME STATEMENT	Begin: Monday A.M. End: Sunday P.M.			
SALES				$
Beginning Inventory		$		
+ Purchases				
Sugar				
Lemons				
Total Available for Sale			$	
- Ending Inventory				
= COST OF GOODS SOLD				
GROSS PROFIT =				
EXPENSES				
•				
•				
•				
= TOTAL EXPENSES				
NET PROFIT				$

We said that an Income Statement was like a motion picture in that it has a beginning and an end. This length of time can be a week, a month, a quarter of a year, etc. Whatever the length, it's called the ACCOUNTING PERIOD.

Remember when you were a kid and how it was hard to look beyond the next day or two, much less well into the next week or month? Remember how agonizing it was to wake up early and have to wait and wait and wait and wait until your afternoon party guests started to arrive? So, since we're running a lemonade stand, let's not make our accounting period too long. Say, a week.

So, let's begin on Monday and end on Sunday. Wow, we've been in business one whole week! That's longer than a lot of good ideas last.

Do you remember what our total sales were for the week?

If not, check back in Chapter One.

Hopefully, you came up with twenty-five dollars in total Sales. Put it all the way to the right on the Income Statement. Why? Because it's a total figure, and we're going to do something with it in a little while.

By the way, you probably notice that it's pretty awkward to have to go back to look up all the information. Do you know how a business organizes the information so it is found easily? Businesses create what's called a GENERAL LEDGER, which is a moment by moment record of every thing that happens. In the good old days of business, every entry in the General Ledger was recorded by hand. (Remember Scrooge poring over his ledger in *A Christmas Carol*?) Today, almost all businesses use a computer. The software is programmed to create categories for each item and sums them for the financial statements.

Let's drop down to the next line. What's it say? Beginning Inventory.

Did we have any inventory before we started this week? No. We didn't even have a business before this week!

So reason dictates that the amount of the Beginning Inventory is what? Zero. Go ahead and write it in.

Then, to start the business, you went and bought what? Sugar for $2.00 and Lemons for $10.00. Write that in.

Drop down to the next line.

Given all this, how much available for sale did you have during the week? (Beginning Inventory + Purchases.) But did you sell it all? No.

Drop down to the next line.

What do we subtract out? The lemonade not sold. What's it called? Ending Inventory.

Okay, since we didn't sell it, we can't count it as a part of the Cost of Goods that we actually sold. Right? Right.

Drop down to the next line.

Math time. Take Beginning Inventory + Purchases - Ending Inventory. The result is the actual Cost of Goods Sold. Which is…? (Write your answer on the Income Statement.)

Write in the COGS. While you are doing it, notice that this figure is also where? On the right.

Which means we're going to do what with it?

Subtract it.

Now, subtract the Cost of Goods Sold from our Sales—and what do you have? (Write it in the next line, way to the right).

What do we call this amount. It's our Gross Profit!

Now, what do have to subtract next? Expenses.

Our Expenses include…what? Well, there was Glass Rental and Advertising, and Rent. Go back to Chapter One for the actual costs, then write them on your Income Statement.

What are your total Expenses? Add up the Expenses.

Notice that this total figure goes where…? All the way over on the right.

Which means we're going to…? Subtract it.

Subtract it from what? The Gross Profit.

Which leave us with…? Our Net Profit

In what amount? (Write it down on the Income Statement.)

Take a moment and wipe your brow and rest your racing pulse.

Now compare the numbers on the Income Statement to the numbers on your last balance sheet that is on page 18. Do you see any numbers that are the same on the Balance Sheet and Income statement? Earnings and Net Profit.

So, are these two figures the same—Earnings week to date (on the balance sheet) and Net Profit (on the income statement)? Yes!

A while back we compared financial scorecards to snapshots and motion pictures. Let's try looking at them in another way.

A Balance Sheet is like the map of the state you live in. What do you see on a state map? (Cities, main roads, rivers, mountains, etc.) Basically, a pretty big picture short on details.

Let's focus on one item on the Balance Sheet: Earnings. Pretend it's like the city or town you live in. The state map shows you where it is, but does not give you any details. What kind of map do you need to see the streets, the streams, the local landmarks? (A city or town map.) It's like a blow up and that's what the Income Statement is. It's a blow up or detailed "city map" of how we got to our Earnings. The Balance Sheet just says you had $10 in Earnings. The Income Statement shows that you had $25 in Sales, $10 in COGS, and $5 in Expenses.

Returning to the world of accounting, we take earnings week to date on the Balance Sheet and blow it up and what do we get?

The Income Statement!

Let's look at the numbers on your last Balance Sheet in Chapter One and the Income Statement we just filled out on page 25.

ASSETS		LIABILITIES	
CASH	$13.00	NOTES PAYABLE	$ 0.00
INVENTORY	$ 2.00	OWNER'S EQUITY	
		ORIGINAL INVESTMENT	$ 5.00
		EARNINGS WEEK TO DATE	$10.00
TOTAL ASSETS	$15.00	TOTAL LIABILITIES & OWNER'S EQUITY	$15.00

INCOME STATEMENT	Begin: Monday A.M. End: Sunday P.M.		
SALES			$ 25.00
Beginning Inventory	$ 0.00		
+ Purchases			
Sugar	2.00		
Lemons	10.00		
Total Available for Sale		$ 12.00	
- Ending Inventory		2.00	
= COST OF GOODS SOLD			10.00
GROSS PROFIT =			15.00
EXPENSES			
• Glass Rental	2.00		
• Advertising	1.00		
• Rent	2.00		
= TOTAL EXPENSES			5.00
NET PROFIT			$ 10.00

Where, again, are the two financial statements related? Net Profit and Earnings.

Any other number the same? YES! Inventory

Why do you think our Ending Inventory is on the Balance Sheet and the Income Statement? Because we haven't used it!

We can't take it as part of our Cost of Goods Sold because we haven't sold it. So, we subtract it from our total available for sale. And on the Balance Sheet, since we haven't sold it, does it have value? Yes!

Is it something we can sell at another time? Yes! So, we leave it here in Ending Inventory.

So this is the end of the week, and what kind of Balance Sheet is this? An Ending Balance Sheet.

And, if this is an Ending Balance Sheet, what kind of inventory is this? Ending Inventory.

Let's just look at these two financial statements and how they're linked together. We started with what kind of Balance Sheet on Monday? A Beginning Balance Sheet.

And we ended on Sunday night with our what? Ending Balance Sheet. They give us two snapshots in time. Now, the truth is, we actually completed a bunch of Balance Sheets—one for each transaction. We will keep doing that throughout this book, but companies just generate a Beginning and Ending Balance Sheet at the start and end of their accounting period.

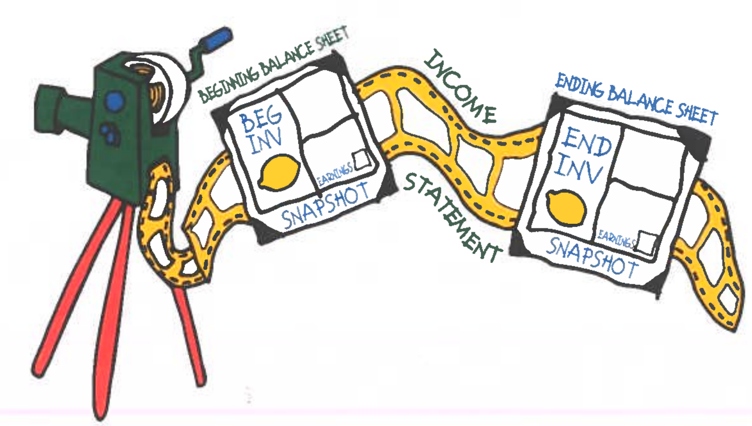
So, at the start of this week, our beginning inventory was what? ZERO. And ending Inventory is what? Two Dollars.

Our beginning Earnings are what? Zero. And our ending Earnings are what? Ten Dollars.

The thing that connects the beginning and ending balance sheets is what? The movie or the Income Statement.

It's like this. The Beginning Balance Sheet shows us where we started, the Ending Balance Sheet shows us where we are, and what shows us how we got there?

The Income Statement.



You're doing great! Both as an entrepreneur and in understanding the basics of accounting.

Since you're doing so great, here's a little challenge. One item that occurred this week does not show up on our final Balance Sheet or on the Income Statement.

Here are three questions for you:

What item is it?

Why is it not on either statement?

What does the absence of this item tell us about our record keeping so far?

The answer to question one is, the loan payback to Mom and Dad. Why is that not on the Balance Sheet? Because it's paid back. A loan only shows up on the Balance Sheet when you still owe it.

To understand why it's not on the Income Statement you have to ask yourself how you got the money. Did you earn it? No. Your parents loaned it to you. Did it really cost you anything to pay it back? Not really, you just gave them back their money after using it for a while. So the principal of a loan, the actual amount borrowed, does not go on an Income Statement because you didn't "earn it." What would have affected Earnings? Interest. Interest on the loan which would have shown up as an expense. Thank goodness Mom and Dad didn't think of that!

Getting to question three—what does this tell us about our records? They are incomplete.

Guess what, two financial statements do not present the whole picture! You need at least three statements. And what is the third one? (You probably already know, but just in case, what was affected both when you got and paid the loan? Of course, CASH FLOW. So, the third statement keeps track of Cash Flow. We will develop it in detail in a later chapter.)

Phew! It's the end of the week. Want to work on Sunday? What? And miss a great day to relax, to hit the local swimming hole or pal around with friends? Let's take Sunday off.

What are we going to do with those ten glasses of left over Inventory? Put it in the refrigerator and put a sign on it that says:

For commercial use only!

Do not touch upon penalty of death!

Time for a break.

Before you leave, give yourselves a gold star for doing such a good job your first week in the business. Good Job!