

FINANCIAL FOUNDATIONS

An Educational Ebook Series for Small Business Owners

BOOK 04

Income Statement to Balance Sheet

Understand the bridge between your P&L and your balance sheet.



TLC Business Solutions · Expert Bookkeeping & Accounting Services

Income Statement to Balance Sheet

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CHAPTER 4

How the Income Statement Feeds into the Balance Sheet

Where profit becomes equity — understanding the invisible bridge between your P&L and your balance sheet.



TLC Business Solutions · Expert Bookkeeping & Accounting Services

Income Statement to Balance Sheet

CHAPTER 4

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SECTION 01

Two Statements, One Story

If you have ever stared at your Profit & Loss statement and then your Balance Sheet and wondered how they possibly relate, you are asking exactly the right question. The two reports look different, measure different things, and yet they are two halves of the same financial story.

The **Income Statement** (also called the Profit & Loss, or P&L) is a movie. It shows what happened over a period of time — a month, a quarter, a year. It collects your revenue, subtracts your expenses, and reveals whether you made a profit or took a loss during that window.

The **Balance Sheet**, by contrast, is a photograph. It captures a single moment — the last day of that same period — and lists everything your business owns (assets), everything it owes (liabilities), and what remains for the owner (equity).

Here is the connection that ties the movie to the photograph: **the profit or loss shown on the Income Statement becomes part of the equity shown on the Balance Sheet.** Every dollar of profit your business earns that you do not pay out to yourself stays in the company as **Retained Earnings** — an equity account. Every dollar of loss reduces it.

THE BIG IDEA

The Income Statement does not float off into the ether once the year ends. Its bottom line — net income — lands directly on the Balance Sheet, inside equity. The P&L explains *how* your equity grew or shrank during the period.

Two different questions, one shared answer

Think of the two statements as answering two complementary questions. The Income Statement answers: *“How did we perform between date A and date B?”* The Balance Sheet answers: *“Where do we stand as of date B?”* The bridge between them is net income. Without that bridge, the two reports would tell unrelated stories. With it, performance flows directly into position.

Once you internalize this link, a lot of accounting begins to click into place. A strong month on the P&L shows up almost immediately as stronger equity on the Balance Sheet. A losing month quietly erodes it. The statements are not competitors — they are collaborators, and net income is the handoff between them.

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SECTION 02

How Net Income Flows into Retained Earnings

The mechanism that moves profit from the Income Statement onto the Balance Sheet is one of the most important — and most misunderstood — routines in bookkeeping: the closing process.

Throughout the year, your revenue and expense accounts accumulate activity. At the end of the period, those accounts need to be zeroed out so the next period can start fresh. That leftover balance — revenue minus expenses — is your **net income** (or net loss). It does not vanish. It is transferred into an equity account called **Retained Earnings**.

$$\text{Retained Earnings (new)} = \text{Retained Earnings (old)} + \text{Net Income} - \text{Owner Distributions}$$

Net income is a credit to equity

In the language of debits and credits, revenue increases equity and expenses decrease it. When you close the books, you are essentially asking: “How much did equity change this period because of operations?” A net income is a positive change — a credit to Retained Earnings. A net loss is a negative change — a debit that pulls Retained Earnings down.

REMEMBER

Profit is not cash sitting in a drawer, and Retained Earnings is not a bank account. Retained Earnings is an *equity total* — the cumulative profit you have kept in the business over its entire life, less any amounts you have taken out. It lives on the Balance Sheet, and it grows or shrinks each time you close a period.

The closing process in four steps

1. **Close revenue accounts** to a temporary clearing account (often called Income Summary). Every revenue account is zeroed.
2. **Close expense accounts** to the same Income Summary. Every expense account is zeroed.
3. **Close Income Summary** to Retained Earnings. The balance of Income Summary equals net income, and it now moves into equity.

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4. Close owner draws or distributions to Retained Earnings, reducing equity for amounts the owner pulled out.

After step four, every revenue and expense account reads zero — a clean slate for the new period — and Retained Earnings on the Balance Sheet has absorbed the period's result. That is the exact moment the Income Statement “feeds” the Balance Sheet.

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SECTION 03

The Income Statement as a Subsidiary of the Equity Account

Here is a mental model that makes the entire relationship snap into focus: think of the Income Statement as a subsidiary of the Equity account.

In accounting, a **subsidiary ledger** is a detailed record that supports — and rolls up into — a single controlling account in the general ledger. The classic example is Accounts Receivable: the general ledger shows one total, while a subsidiary ledger breaks it down by customer. The pieces always add up to the whole.

Now apply that idea to equity. The Equity section of your Balance Sheet is the controlling account. One of its most important pieces is Retained Earnings — the profit you have kept. The Income Statement is, in effect, the subsidiary detail that explains this period's contribution to that equity total.

THE REFRAME

Revenue increases equity. Expenses decrease equity. Net income is simply the net change in equity caused by doing business. The Income Statement is the itemized breakdown of that change — a subsidiary view of one slice of Equity.

Why this view is so useful

When you treat the P&L as a subsidiary of equity, several things stop being confusing:

- **The closing process makes sense.** You zero out the P&L because it is a temporary, supporting detail. Once you have folded its result into Retained Earnings, the detail has done its job for the period.
- **Revenue and expenses behave like equity movements.** A sale does not just “make money” — it increases your ownership stake in the business. A bill paid does not just “cost money” — it decreases that stake.
- **The accounting equation stays balanced.** $\text{Assets} = \text{Liabilities} + \text{Equity}$. Profit grows equity; a loss shrinks it. The Income Statement is the narrative behind that growth or shrinkage.

This is why accountants sometimes say the Income Statement is “temporary” while the Balance Sheet is “permanent.” The P&L is the detailed, period-by-period commentary that eventually gets absorbed into the permanent record of equity.

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SECTION 04

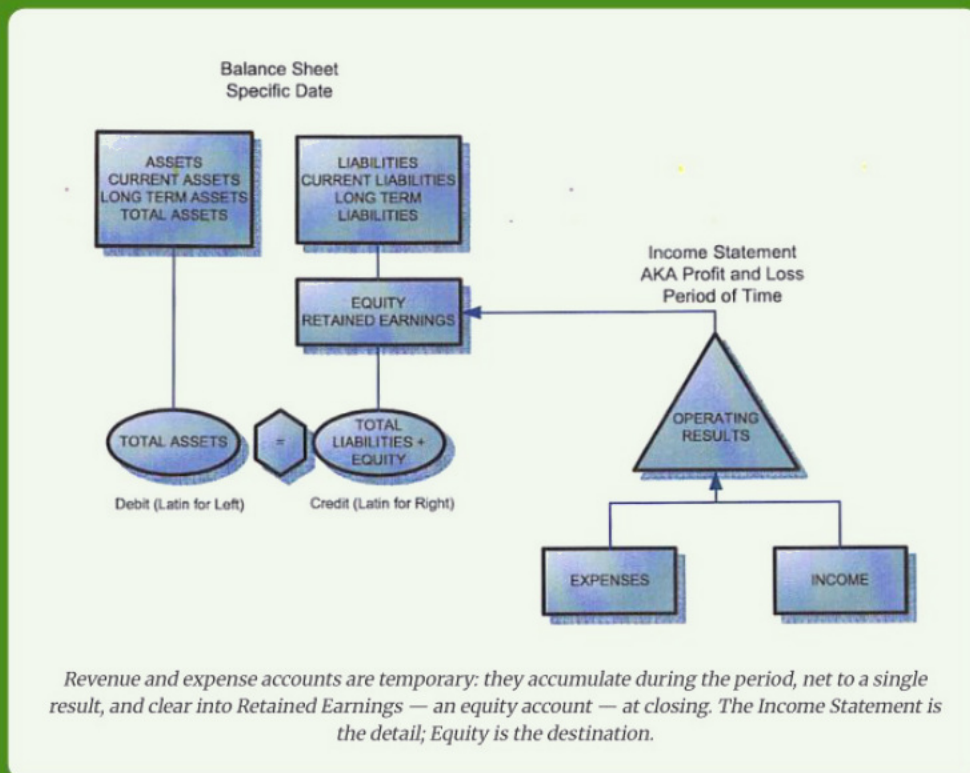
Revenue & Expenses: Temporary Accounts That Clear Out

Revenue and expense accounts are called **temporary** (or **nominal**) accounts for a reason: they exist only to measure a single period, and then they are emptied into equity.

Contrast them with **permanent** accounts — assets, liabilities, and equity. Permanent accounts carry their balances forward forever. Your Cash, your Accounts Payable, and your Retained Earnings never reset; they simply roll into the next period with their ending balance becoming the new beginning balance.

Temporary accounts are different. At the close of each period, every revenue and expense account is brought to zero. Their balances are squeezed, netted, and poured into Retained Earnings. The diagram below shows that flow: revenue and expenses funnel through net income and land in equity.

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The journey of a single dollar

Follow one dollar of revenue through the cycle. When you earn it, it sits in a revenue account — a temporary account that, remember, ultimately represents an increase to equity. If matching expenses consume sixty cents of it, the remaining forty cents is net income. At closing, that forty cents leaves the temporary accounts (which reset to zero) and takes up permanent residence in Retained Earnings on the Balance Sheet.

TEMPORARY VS. PERMANENT

Temporary accounts (revenue, expenses, gains, losses, and the Income Summary clearing account) measure a period and then clear to zero. **Permanent accounts** (assets, liabilities, equity) carry forward indefinitely. The closing entry is the doorway between the two: temporary balances walk through it and become permanent equity.

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Why the reset matters

The annual reset is not bookkeeping busywork — it is what lets you compare periods cleanly. Because revenue and expense accounts start each year at zero, your 2026 P&L describes 2026 alone, not 2026 piled on top of 2025. Meanwhile, your Retained Earnings balance grows year after year, preserving the entire cumulative history of profit kept in the business. The temporary accounts give you a fresh, isolated measurement; the permanent equity account keeps the running total.

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SECTION 05

Putting It Together: A Worked Example

Let us watch a single month of activity travel from the Income Statement onto the Balance Sheet. Suppose TLC Sample Co. starts June with \$14,000 in Retained Earnings. Here is its P&L for June.

TLC SAMPLE CO. — JUNE INCOME STATEMENT	AMOUNT
Revenue (Sales)	\$20,000
Gross Revenue	\$20,000
Cost of Goods Sold	–8,000
Operating Expenses (rent, utilities, wages)	–6,000
Net Income for June	\$6,000

The P&L reports \$6,000 of net income for June. Now watch what happens at closing. That \$6,000 leaves the temporary revenue and expense accounts (which drop to zero) and is added to Retained Earnings on the Balance Sheet.

EQUITY ON THE BALANCE SHEET — JUNE 30	AMOUNT
Retained Earnings, June 1 (beginning)	\$14,000
Add: Net Income for June (from the P&L)	+6,000
Less: Owner Distributions	–0
Retained Earnings, June 30 (ending)	\$20,000

TRACE THE HANDOFF

The \$6,000 net income on the Income Statement becomes the +\$6,000 adjustment to Retained Earnings on the Balance Sheet. The P&L explained *how* equity grew this month; the Balance Sheet now *reflects* that growth. Same number, two roles. That is the feed.

If June had instead produced a \$3,000 loss, the closing entry would have subtracted \$3,000

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from Retained Earnings, dropping it to \$11,000. Either way, the Income Statement's bottom line is the exact amount by which the equity section of the Balance Sheet changes — before any owner contributions or distributions. Once you can see this handoff, you can read either statement and predict what the other will show.

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SECTION 06

Key Takeaways

If you remember nothing else from Chapter 4, remember these six points.

- 1 The two statements are linked by net income.** The Income Statement measures performance over a period; the Balance Sheet captures position at a moment. Net income is the bridge that turns performance into position.
- 2 Profit flows into Retained Earnings.** At the close of each period, net income is transferred into Retained Earnings — an equity account on the Balance Sheet. Profit grows it; losses shrink it.
- 3 The Income Statement is a subsidiary of Equity.** Revenue increases equity and expenses decrease it. The P&L is the detailed, period-level breakdown of how one slice of equity changed.
- 4 Revenue and expenses are temporary accounts.** They exist to measure a single period and then clear to zero. Assets, liabilities, and equity are permanent — they carry forward indefinitely.
- 5 Closing is the doorway.** The closing process zeroes out temporary accounts and pours their net result into Retained Earnings. This is the exact moment the P&L feeds the Balance Sheet.
- 6 Retained Earnings is cumulative, not cash.** It is the running total of profit kept in the business over its whole life — less distributions — not a bank balance. Read it as a measure of built-up ownership, not spendable money.

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BOTTOM LINE

Once you see the Income Statement as the story and the Balance Sheet as the standing result — with net income as the thread connecting them — your financial statements stop being separate reports and start reading like one continuous narrative about your business.

Income Statement to Balance Sheet



Build Your Financial Foundations with TLC

Understanding how your statements connect is the first step toward running a healthier business. The TLC Business Solutions team helps small business owners turn accurate bookkeeping into confident decisions.

Let's make your numbers tell a clear, profitable story.

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