

## 5.6: Preparing financial statements from accounting equation worksheet.

### Learning Objectives

Upon completion of this section, students will be able to:

- Describe how the expanded accounting equation is used to produce financial statements
- Identify the process for rolling results of the accounting equation over to the following year

*Question: What do you do with the accounting equation when it is completed and all the increases and decreases for an accounting period have been entered?*

While the expanded accounting equation is a useful tool to consider transactions and their impact on various accounting elements, by itself it does not communicate very well the financial picture of a company. Remember that is the job of the four financial statements we learned about back in chapter 3. So we need to see how what we have learned in chapter 5 ties back to our preparation of the financial statements introduced in chapter 3. Before we do this, we should understand that in real life accounting is done using sophisticated computers and software that allows for the simultaneous tracking of literally as many as millions of transactions. However, even these highly automated systems, do the same thing – summarize transactions into changes to assets, liabilities, equity, revenues and expenses – that we are going to do with these simple illustrations.

Date	ASSETS =			LIABILITIES			+ STOCKHOLDERS EQUITY			
	CURRENT		LONG TERM	CURRENT		LONG TERM	CAPITAL STOCK	+ RETAINED EARNINGS		
	Cash	Inventory	Equipment	Accounts Payable	Unearned Revenue	Note Payable		– Dividends	+ Revenues	– Expenses
Jan 5	Increase \$5000						Increase \$5000			
Jan 8	Increase \$7000					Increase \$7000				
Jan 10		Increase \$1500		Increase \$1500						
Jan 14	Decrease \$1000		Increase \$2500			Increase \$1500				
Jan 20	Increase \$3000				Increase \$3000					
Jan 21	Increase \$4000	Decrease \$1500							Increase \$4000	Increase \$1500
Jan 24				Increase \$730						Increase \$730
Jan 31					Decrease \$500				Increase \$500	
Jan 31	Decrease \$1500			Decrease \$1500						
Jan 31	Decrease \$200							Increase \$200		
Jan 31			Decrease \$50							Increase \$50

So we added a column for the date for each transaction. That is to emphasize the periodic nature of accounting. We need an accounting period – in this example one month from January 1 to January 31 – and if the transaction takes place during that accounting period then it gets accounted for and if not it does not (we will look at February transactions below). We could use a year or a quarter as our accounting period but either way we need a start and an end. Our illustration above shows the equation for a brand new company – so there is zero assets, liabilities or equity when we begin.

January 5 Issued stock to shareholders for 5,000 in cash

January 8 Borrowed \$7000 from the bank

January 10 Purchased inventory on credit

January 14 Purchase equipment with \$1000 in cash and borrowing \$1500

January 20 Received cash from a customer for services to be provided the next month

January 21 Sold inventory to a customer B for \$4000 in cash. The inventory cost \$1500

January 24 Recorded bill from electric company for \$730 for electricity used during January to be paid in February.

January 31 Provided services to customer B worth \$500 (early) from contract agreed to on January 21.

January 31 Paid for the inventory purchased on credit

January 31 Paid dividends of \$200 in cash

January 31 Used up equipment over the passage of time (one month)

*So how many of those transactions could you have guessed? Do you see how each row balances both sides of the accounting equation like our examples in earlier sections?*

When we are confident that no other transactions took place in January then we can do some summarizing like this (lines up with the columns from our accounting equation):

Cash	Inventory	Equipment	Accounts Payable	Unearned Revenue	Notes Payable	Capital Stock	Dividends	Revenues	Expenses
16,300	0	2,450	730	2500	8500	5000	200	4500	2280

These amounts came from adding up the increases and subtracting the decreases so that we have one amount for each account (on our chart of accounts and accounting equation). Normally, we would have separate columns for each kind of expense (Cost of Goods, Utilities, Depreciation) based on your chart of accounts but we put them all together to save space. Lets check to see that our totals balance like they are supposed to:

Assets =  $16,300 + 0 + 2,450 = \$18,750$

Liabilities =  $730 + 2500 + 8500 = \$11,730$

Stockholders Equity =  $5,000 - 200 + 4500 - 2280 = \$7,020$

$\$18,750 = 11,730 + 7,020 = \$18,750$

**Just how we planned it would work.**

We now have all the information we need for financial statements:

#### Income Statement for January

Revenues	4,500	
– Cost of Goods Sold	1,500	this is an expense
Gross Profit	3,000	

– Expenses 780 (we could break them into more detail as desired by those reading the financial statements with more columns or descriptions on each expense)

Net Income \$ 2,220

### **Statement of Changes in Equity for January**

	Capital Stock	Retained Earnings
Beginning of January	0	0
Stock Purchase	5,000	
Net Income		2,220
Dividends		(200) Parentheses means to subtract
Ending of January	\$5,000	\$2,020

### **Balance Sheet as of End of January**

#### Current Assets

Cash 16,300

#### Longterm Assets

Equipment 2450

Total Assets **\$18,750**

#### Current Liabilities

Accounts Payable 730

Unearned Revenue 2,500

#### Long term Liabilities

Notes Payable 8,500

Total Liabilities \$11,730

Capital Stock 5,000

Retained Earnings 2,020

Total Equity \$7,020

Liabilities and Equity **\$18,750**

### **Statement of Cash Flows for January**

#### Operating

Cash from sales 4,000

Cash from customers prior to earning it 3,000

Cash for inventory (1,500)

Total Operating \$ 5,500

#### Investing

Purchase of new Equipment (1,000)

#### Financing

Sale of stock 5,000

Borrowing from bank 7,000

Dividends paid	(200)
Total Financing	\$11,800
Ending Cash	$0 + 5,500 + (1,000) + 11,800 = \$16,300$ (zero to start with since this is a new company)

So all the information on our financial statements came from the expanded accounting equation – for the Income Statement, Statement of Equity and Balance Sheet from the totals at the bottom of the worksheet (or is calculated from those totals). Even the cash flow statement which uses each entry in the cash column and classifies them as operating, investing or financing can be created from the accounting equation worksheet. Because our accounting equation stayed in balance, the balance sheet is in balance. While each of the items on the financial statements comes from the accounting equation worksheet the reverse is also true – **each total has a place to go on the financial statements**. We do the financial statements in the order given because they work together and we cannot complete the later financial statements without information from the earlier ones.

*Question: So what about February? How does the accounting equation worksheet move forward to the next accounting period?*

So the business can determine what accounting period to use. It could be a month, a quarter or a year or maybe even some other period as long as we have a distinct starting date and ending date. So for our illustration, February becomes our new accounting period and we start a new accounting equation worksheet. Some of the information from January comes forward as shown below:

Date	ASSETS			+ LIABILITIES			+ EQUITY STOCKHOLDERS			
	CURRENT		LONG TERM	CURRENT		LONG TERM	CAPITAL STOCK	+ RETAINED EARNINGS = 2,020		
	Cash	Inventory	Equipment	Accounts Payable	Unearned Revenue	Notes Payable		- Dividends	+ Revenue	- Expenses
From January	16,300	0	2,450	730	2,500	8,500	5,000	0	0	0
Feb 2	Decrease 500					Decrease 500				
Feb 5					Decrease 2,500				Increase 2,500	

So asset accounts like cash and liability accounts like unearned revenue and equity accounts like capital stock come to the new accounting period exactly where we left off from the accounting period before. Retained earnings is not directly from the January accounting equation worksheet but rather from the statement of stockholders equity (it is the retained earnings at the end of January). Dividends, revenue and expenses do not carry to the new accounting equation worksheet but rather start over at zero. That way we can measure how much revenue and expense and dividends (and gains and losses if we have them) happened during the accounting period. So each income statement and cash flow statement and statement of stockholders equity, the reporting is the change in the items reported during the accounting period. The income statement for February given only the transactions listed above would show only revenue of 2,500 earned in February. For the statement of stockholders equity for February the beginning retained earnings would be 2,020. The balance sheet carries forward where transactions in the new accounting period modify the balances in those accounts so for unearned revenue, the new balance would be zero because the earning of the revenue resulted in a decrease in unearned revenue of 2,500. Start with 2,500 from January and then decrease by 2,500 and the new amount would be reported on the balance sheet (not the change). Notes payable would change from 8,500 to 8,000 which would be what is reported.

### Key Takeaways

Income statements, statements of equity and cash flow statements report the change in accounts from the beginning of the accounting period to the end of the accounting period. Balance sheets report the amount in an account at the end of an accounting period not the changes. Balance sheets carry forward to start the new accounting period while revenues, expenses, dividends start over at zero with a new accounting period.

### Check Yourself

Which of the following would start over at zero at the beginning of a new accounting period?

- A. Unearned Revenue
- B. Accounts Receivable
- C. Inventory
- D. Utilities expense

D is the correct answer. Revenues and expenses start over at zero each new accounting period while liabilities (unearned revenue) and assets (Accounts Receivable and Inventory) carry forward to the new accounting period from the old.

Which of the following would be an **INCORRECT** heading for an accounting period as shown on the financial statements?

- A. Cash flow statement from January 1 to December 31, 2023
- B. Balance sheet from January 1 to December 31, 2023
- C. Income statement for year ending December 31, 2023
- D. Statement of stockholders equity beginning with January 1 and ending with December 31, 2023

B is the correct answer. Only the balance sheet does not refer to a beginning and ending date but only a single date at the end of the accounting period. The heading for the income statement implies both a beginning and ending since it refers to the accounting period (a year) and the ending date.

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