

3.5: Preparing Financial Statements

Preparing Financial Statements

After the adjusted trial balance, we will prepare the financial statements. The financial statements are how a business communicates or publishes its story. We will be focusing on three financial statements:

1. **Income Statement:** Calculates net income or loss of a company by showing revenues – expenses. If revenues are greater than expenses, you have net income. If revenues are less than expenses, you have net loss.
2. **Statement of Retained Earnings:** Calculates an ending balance in the retained earnings account using net income or loss calculated on the income statement. This statement takes the beginning balance in retained earnings + net income (or – net loss) – dividends to get the ending retained earnings balance. The ending retained earnings balance is reported on the balance sheet.
3. **Balance Sheet:** Proves the accounting equation of Assets = Liabilities + Equity and uses ending retained earnings calculated on the statement of retained earnings in equity.

This video will review the basic financial statements after the adjusted trial balance.



The balance sheet shown in the video is the simplified version we learned at the beginning of the course. If you look at the balance sheets produced by companies now, they are a little more detailed. A **classified balance sheet** adds groupings and subtotals to make the balance sheet easier for investors to read and analyze. The balance sheet can be done in report form where assets are first and liabilities and equity are below. Or in a side-by-side presentation. The classified balance sheet still proves the accounting equation but it separates assets and liabilities into subgroups:

- **Current Assets:** Can be converted to cash within a year or the operating cycle whichever is longer. Current assets include cash, accounts receivable, interest receivable, supplies, inventory, and other prepaid expenses.
- **Long Term Investments:** Investments that do not come due for more than a year are reported in this section. Long term investments would include notes receivable or investments in bonds or stocks.
- **Plant Assets:** Plant assets (also called Property, Plant, and Equipment or Fixed Assets) refer to property that is tangible (can be seen and touched) and is used in the business to generate revenue. Plant assets include depreciable assets and land used in the business. The plant asset is recorded with its accumulated depreciation (if any) subtracted below it to get the asset's book value.
- **Intangible Assets:** Intangible assets are items that have a financial value but do not have a physical form. These would be things like trademarks, patents, and copyrights.
- **Current Liabilities:** Like current assets, these are liabilities that are due to be paid within a year or the operating cycle whichever is longer. Current liabilities include accounts payable, salaries payable, taxes payable, unearned revenue, etc.
- **Long Term Liabilities:** Liabilities due more than a year from now would be reported here. These would include notes payable, mortgage payable, bonds payable, etc.

The Equity section of a classified balance sheet does not change. Using the information for MicroTrain, the financial statements would be:

MicroTrain Company
Income Statement

For Year Ended December 31		
<i>Revenues:</i>		
Service Revenue	\$ 36,500	
Interest Revenue	<u>600</u>	
Total Revenues		\$ 37,100
<i>Expenses:</i>		
Salaries Expense	18,360	
Rent Expense	1,200	
Utilities Expense	500	
Insurance Expense	200	
Supplies Expense	7,000	
Depreciation Expense	<u>750</u>	
Total Expenses		<u>28,010</u>
Net Income (37,100 – 28,010)		\$ 9,090

The net income gets carried over to the statement of retained earnings. We will also use the retained earnings balance from the adjusted trial balance as the beginning balance. There are no dividends listed on the adjusted trial balance so MicroTrain did not pay dividends.

MicroTrain Company		
Statement of Retained Earnings		
For Year Ended December 31		
Beginning Retained Earnings	\$ 6,100	<i>from the adjusted trial balance</i>
Net Income	<u>9,090</u>	<i>from the income statement</i>
	\$ 15,190	
Dividends	<u>– 0</u>	<i>No dividends paid this year</i>
Ending Retained Earnings	\$ 15,190	<i>goes to the balance sheet</i>

The calculated ending balance will be reported as the Retained Earnings amount on the balance sheet. We are doing the Classified Balance Sheet showing the subgroups for assets and liabilities in report form.

MicroTrain Company		
Classified Balance Sheet		
December 31		
Assets		
<i>Current Assets</i>		
Cash	\$ 10,000	
Accounts Receivable	25,000	
Interest Receivable	600	

Supplies	1,500	
Prepaid Insurance	<u>2,200</u>	
<i>Total Current Assets</i>		\$ 39,300
<i>Plant Assets</i>		
Trucks	40,000	
Less: Accum. Depreciation – Trucks	<u>(750)</u>	
<i>Total Plant Assets</i>		<u>39,250</u>
TOTAL ASSETS		\$ 78,550
Liabilities and Equity		
<i>Current Liabilities</i>		
Accounts Payable	25,000	
Unearned Revenue	3,000	
Salaries Payable	<u>360</u>	
<i>Total Current Liabilities</i>		28,360
<i>Equity</i>		
Common Stock	35,000	
Retained Earnings	<u>15,190</u>	
<i>Total Equity</i>		<u>50,190</u>
TOTAL LIABILITIES AND EQUITY		\$ 78,550

Notice how accumulated depreciation, a contra-account, reduces the asset account it is related to in the plant asset section. Remember, the balance sheet proves the accounting equation (ASSETS = LIABILITIES + EQUITY) and must always be in balance. Why do we need these groupings? It makes it easier for investors to quickly calculate ratios, for example, the **current ratio**.

The current ratio measures how much in assets the company has available now to pay liabilities due in the next year. The current ratio uses current assets and current liabilities:

Current Ratio =	<u>Current Assets</u>
	Current Liabilities

We can calculate MicroTrain's current ratio as follows:

<u>Current Assets</u> =	<u>39,300</u> =	1.39
Current Liabilities	28,360	

The current ratio has been rounded to 2-decimal places to get a current ratio of 1.39 or 1.39 to 1. This means MicroTrain has approximately \$1.39 in current assets available to pay every \$1 of current liabilities. Investors like to see a ratio of between 1.5 and 2 so MicroTrain's current ratio is a little low but still good since we have more assets than liabilities.

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