How Transactions Impact the Accounting Equation

The preceding balance sheet for Edelweiss represented the financial condition at the noted date. But, each new transaction brings about a change in financial condition. Business activity will impact various asset, liability, and/or equity accounts without disturbing the equality of the accounting equation. How does this happen? To reveal the answer to this question, look at four specific cases for Edelweiss. See how each impacts the balance sheet without upsetting the basic equality.

MyExceLab (http://www.myexcelab.com/Chapter1/Pay%20an%20account%20payable.xl

Case A: Collect An Account Receivable

If Edelweiss Corporation collected $10,000 from a customer on an existing account receivable (i.e., not a new sale, just the collection of an amount that is due from some previous transaction), then the balance sheet would be revised to show that cash (an asset) increased from $25,000 to $35,000, and accounts receivable (an asset) decreased from $50,000 to $40,000. As a result total assets did not change, and liabilities and equity accounts were unaffected, as shown in the following illustration.

EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)				EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)		
Assets				**Assets**		
Cash		$ 25,000	+$10,000	Cash		$ 35,000
Accounts receivable		50,000	-$10,000	Accounts receivable		40,000
Inventories		35,000		Inventories		35,000
Land		125,000		Land		125,000
Building		400,000		Building		400,000
Equipment		250,000		Equipment		250,000
Other assets		10,000		Other assets		10,000
Total assets		$895,000		Total assets		$895,000
Liabilities				**Liabilities**		
Accounts payable	$ 50,000			Accounts payable	$ 50,000	
Loans payable	125,000			Loans payable	125,000	
Total liabilities		$175,000		Total liabilities		$175,000
Stockholders' equity				**Stockholders' equity**		
Capital stock	$120,000			Capital stock	$120,000	
Retained earnings	600,000			Retained earnings	600,000	
Total stockholders' equity		720,000		Total stockholders' equity		720,000
Total liabilities and equity		$895,000		Total liabilities and equity		$895,000

Case B: Buy Equipment via Loan

MyExceLab (http://www.myexcelab.com/Chapter1/Buy%20inventory%20with%20cash.xlsx)

If Edelweiss Corporation purchased $30,000 of equipment, agreeing to pay for it later (i.e. taking out a loan), then the balance sheet would be further revised. The Case B illustration shows that equipment (an asset) increased from $250,000 to $280,000, and loans payable (a liability) increased from $125,000 to $155,000. As a result, both total assets and total liabilities increased by $30,000.

EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)				EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)		
Assets				**Assets**		
Cash		$ 35,000		Cash		$ 35,000
Accounts receivable		40,000		Accounts receivable		40,000
Inventories		35,000		Inventories		35,000
Land		125,000		Land		125,000
Building		400,000		Building		400,000
Equipment		250,000	+$30,000	Equipment		280,000
Other assets		10,000		Other assets		10,000
Total assets		$895,000		Total assets		$925,000
Liabilities				**Liabilities**		
Accounts payable	$ 50,000			Accounts payable	$ 50,000	
Loans payable	125,000		+$30,000	Loans payable	155,000	
Total liabilities		$175,000		Total liabilities		$205,000
Stockholders' equity				**Stockholders' equity**		
Capital stock	$120,000			Capital stock	$120,000	
Retained earnings	600,000			Retained earnings	600,000	
Total stockholders' equity		720,000		Total stockholders' equity		720,000
Total liabilities and equity		$895,000		Total liabilities and equity		$925,000

Case C: Provide Services On Account

IyExceLab (http://www.myexcelab.com/Chapter1/Provide%20services%20for%20cash.xlsx)

What would happen if Edelweiss Corporation did some work for a customer in exchange for the customer's promise to pay $5,000? This requires further explanation; try to follow this logic closely! Retained earnings is the income of the business that has not been distributed to the owners of the business. When Edelweiss Corporation provided a service to a customer, it can be said that it generated revenue of $5,000. **Revenue** is the enhancement resulting from providing goods or services to customers. Revenue will contribute to income, and income is added to retained earnings. Examine the resulting balance sheet for Case C and notice that accounts receivable and retained earnings went up by $5,000 each, indicating that the business has more assets and more retained earnings. Note that assets still equal liabilities plus equity.

EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)				EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)		
Assets				**Assets**		
Cash		$ 35,000		Cash		$ 35,000
Accounts receivable		40,000	+$5,000	Accounts receivable		45,000
Inventories		35,000		Inventories		35,000
Land		125,000		Land		125,000
Building		400,000		Building		400,000
Equipment		280,000		Equipment		280,000
Other assets		10,000		Other assets		10,000
Total assets		$925,000		Total assets		$930,000
Liabilities				**Liabilities**		
Accounts payable	$ 50,000			Accounts payable	$ 50,000	
Loans payable	155,000			Loans payable	155,000	
Total liabilities		$205,000		Total liabilities		$205,000
Stockholders' equity				**Stockholders' equity**		
Capital stock	$120,000			Capital stock	$120,000	
Retained earnings	600,000		+$5,000	Retained earnings	605,000	
Total stockholders' equity		720,000		Total stockholders' equity		725,000
Total liabilities and equity		$925,000		Total liabilities and equity		$930,000

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Case D: Pay Expenses

ExceLab (http://www.myexcelab.com/Chapter1/Incur%20expenses%20on%20account.xlsx)

Expenses are the outflows and obligations that arise from producing goods and services. Imagine that Edelweiss paid $3,000 for expenses. This transaction reduces cash and income (i.e., retained earnings), as shown in the Case D illustration.

EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)				EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)		
Assets				**Assets**		
Cash		$ 35,000	-$3,000	Cash		$ 32,000
Accounts receivable		45,000		Accounts receivable		45,000
Inventories		35,000		Inventories		35,000
Land		125,000		Land		125,000
Building		400,000		Building		400,000
Equipment		280,000		Equipment		280,000
Other assets		10,000		Other assets		10,000
Total assets		$930,000		Total assets		$927,000
Liabilities				**Liabilities**		
Accounts payable	$ 50,000			Accounts payable	$ 50,000	
Loans payable	155,000			Loans payable	155,000	
Total liabilities		$205,000		Total liabilities		$205,000
Stockholders' equity				**Stockholders' equity**		
Capital stock	$120,000			Capital stock	$120,000	
Retained earnings	605,000		-$3,000	Retained earnings	602,000	
Total stockholders' equity		725,000		Total stockholders' equity		722,000
Total liabilities and equity		$930,000		Total liabilities and equity		$927,000

In General

xcelab.com/Chapter1/Transactions%20impacting%20more%20than%20two%20items.xlsx)

In the life of any business entity, there are countless transactions. Each can be described by its impact on assets, liabilities, and equity. Note that no properly recorded transaction will upset the balance of the accounting equation.

Terms

In day-to-day conversation, some terms are used casually and without precision. Words may incorrectly be regarded as synonymous. Such is the case for the words “income” and “revenue.” Each term, however, has a very precise meaning. Revenues are enhancements resulting from providing goods and services to customers. Conversely, expenses can generally be regarded as the costs of doing business. This gives rise to another accounting equation:

Revenues – Expenses = Income

Revenue is the “top line” amount corresponding to the total benefits generated from all business activity. Income is the “bottom line” amount that results after deducting expenses from revenue. In some countries, revenue is also referred to as “turnover.” As you will see, revenue is summarized first in the company’s income statement.

Did you learn?
Demonstrate how specific transactions impact the balance sheet without impacting the overall equality.
Distinguish between the terms revenue and net income.

Previous (//www.principlesofaccounting.com/chapter-1/accounting-equation/)

Next (//www.principlesofaccounting.com/chapter-1/financial-statements/)