4. How Transactions Impact the Accounting Equation

The preceding balance sheet for Edelweiss was static. This means that it represented the financial condition at the noted date. But, each passing transaction or event brings about a change in the overall financial condition. Business activity will impact various asset, liability, and/or equity accounts; but, they will not disturb the equality of the accounting equation. So, how does this happen? To reveal the answer to this question, let's look at four specific transactions for Edelweiss Corporation. You will see how each transaction impacts the individual asset, liability, and equity accounts, without upsetting the basic equality of the overall balance sheet.

4.1 Edelweiss Collects 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 as follows:

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	+ $0	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	+ $0	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	+ $0	Total stockholders' equity		720,000
Total liabilities and equity		$895,000		Total liabilities and equity		$895,000

The illustration plainly shows 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. Thus, assets still equal liabilities plus equity.

4.2 Edelweiss Buys Equipment With Loan Proceeds

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 as follows.

	EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)			EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)	
Assets					
Cash		$ 35,000			$ 35,000
Accounts receivable		40,000			40,000
Inventories		35,000			35,000
Land		125,000			125,000
Building		400,000			400,000
Equipment		250,000	+ $30,000		280,000
Other assets		10,000			10,000
Total assets		$895,000	+ $30,000		$925,000
Liabilities					
Accounts payable	$ 50,000			$ 50,000	
Loans payable	125,000		+ $30,000	155,000	
Total liabilities		$175,000	+ $30,000		$205,000
Stockholders' equity					
Capital stock	$120,000			$120,000	
Retained earnings	600,000			600,000	
Total stockholders' equity		720,000	+ $0		720,000
Total liabilities and equity		$895,000	+ $30,000		$925,000

This 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, but assets still equal liabilities plus equity.

4.3 Edelweiss Provides Services to a Costumer on Account

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! You already know that retained earnings is the income of the business that has not been distributed to the owners of the business. When Edelweiss Corporation earned $5,000 (which they will collect later) by providing a service to a customer, it can be said that they generated revenue of $5,000. Revenue is the enhancement to assets resulting from providing goods or services to customers. Revenue will bring about an increase to income, and income is added to retained earnings. Can you follow that?

As you examine the balance sheet on the top of the next page, notice that accounts receivable and retained earnings went up by $5,000 each, indicating that the business has more assets and more retained earnings. And, guess what: assets still equal liabilities plus equity.

4.4 Edelweiss Pays Expenses With Cash

It would be nice if you could run a business without incurring any expenses. However, such is not the case. Expenses are the outflows and obligations that arise from producing goods and services. Imagine that Edelweiss paid $3,000 for expenses. The lower set of balance sheets on the following page shows this impact.

4.5 Generalizing About the Impact of Transactions

There are countless types of transactions that can occur, and each and every transaction can be described in terms of its impact on assets, liabilities, and equity. What is important to know is that no transaction will upset the fundamental accounting equation of assets = liabilities + owners' equity.

Services to a customer on account:

EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)				EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)	
Assets					
Cash		$ 35,000			$ 35,000
Accounts receivable		40,000	+ $5,000		45,000
Inventories		35,000			35,000
Land		125,000			125,000
Building		400,000			400,000
Equipment		280,000			280,000
Other assets		10,000			10,000
Total assets		$925,000	+ $5,000		$930,000
Liabilities					
Accounts payable	$ 50,000			$ 50,000	
Loans payable	155,000			155,000	
Total liabilities		$205,000	+ $0		$205,000
Stockholders' equity					
Capital stock	$120,000			$120,000	
Retained earnings	600,000		+ $5,000	605,000	
Total stockholders' equity		720,000	+ $5,000		725,000
Total liabilities and equity		$925,000	+ $5,000		$930,000

Pays expenses:

EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (before indicated transaction)				EDELWEISS CORPORATION Balance Sheet December 31, 20X3 (after indicated transaction)	
Assets					
Cash		$ 35,000	- $3,000		$ 32,000
Accounts receivable		45,000			45,000
Inventories		35,000			35,000
Land		125,000			125,000
Building		400,000			400,000
Equipment		280,000			280,000
Other assets		10,000			10,000
Total assets		$930,000	- $3,000		$927,000
Liabilities					
Accounts payable	$ 50,000			$ 50,000	
Loans payable	155,000			155,000	
Total liabilities		$205,000	+ $0		$205,000
Stockholders' equity					
Capital stock	$120,000			$120,000	
Retained earnings	605,000		- $3,000	602,000	
Total stockholders' equity		725,000	- $3,000		722,000
Total liabilities and equity		$930,000	- $3,000		$927,000

4.6 Distinguishing Between Revenue and Income

In day-to-day conversation, some terms can often be used casually and without a great deal of precision. Words may be treated as synonymous, when in fact they are not. Such is the case for the words “income” and “revenue.” Each term has a very precise meaning, and you should accustom yourself to the correct usage. It has already been pointed out that revenues are enhancements resulting from providing goods and services to customers. Conversely, expenses can generally be regarded as costs of doing business. This gives rise to another “accounting equation”:

$$\text{Revenues} - \text{Expenses} = \text{Income}$$

Revenue is the “top line” amount corresponding to the total benefits generated from business activity. Income is the “bottom line” amount that results after deducting the expenses from revenue. In some countries, revenue is also referred to as “turnover.”