Step 6:

Preparation of financial statements

Preparation of financial statements is the sixth step of accounting cycle that comes after the preparation of adjusted trial balance. Once the adjusted trial balance has been correctly prepared, its amounts can be directly used to prepare income statement, statement of retained earnings and balance sheet.

Income statement

Income statement is an important financial statement that summarizes the operating results of the business by matching the revenue earned and expenses incurred to earn that revenue during a particular period of time. The revenue and expense figures used for the preparation of income statement are directly taken from the adjusted trial balance. If revenue exceeds the total expenses, the income statement shows a net income for the period but if, on the other hand, the total expenses exceed the revenue, it would show a net loss. The net income (or net loss) determined by the income statement is reported in the statement of retained earnings. It is, therefore, prepared first of all other financial statements.

Income statement is known by various names such as statement of operations, earnings statement, and profit and loss statement.

Example:

The Business Consulting Company prepares adjusting entries at the end of each month. The adjusted trial balance of the company at December 31, 2015 is given below:

BUSINESS CONSULTING COMPANY.
Adjusted Trial Balance
December 31, 2015

Account Name	Debit	Credit
Cash	$ 85,550	
Accounts receivable	4,700	
Prepaid building rent	1,500	
Unexpired insurance	3,600	
Supplies	250	
Equipment	9,000	
Accumulated depreciation - equipment		$ 3,600
Notes payable		5,000
Accounts payable		1,600
Salaries payable		2,000
Income taxes payable		3,000
Unearned service revenue		4,400
Capital stock		50,000
Retained earnings		20,000
Dividends	3,000	
Service revenue earned		82,500
Salaries expense	42,500	
Supplies expense	1,950	
Rent expense	6,000	
Insurance expense	950	
Advertising expense	250	
Depreciation expense - equipment	900	
Interest expense	450	
Income taxe expense	11,500	
Totals	$ 172,100	$ 172,100

Required: Determine the net income (or net loss) of Business Consulting Company by preparing an income statement for the year ended December 31, 2015.

Solution:

BUSINESS CONSULTING COMPANY. Income Statement For the Year Ended December 31, 2015		
Revenue:		
Consulting revenue earned		$ 82,500
Expenses:		
Salaries expense	$ 42,500	
Supplies expense	1,950	
Rent expense	6,000	
Insurance expense	950	
Advertising expense	250	
Depreciation expense - equipment	900	
Interest expense	450	53,000
Income before income tax		$ 29,500
Income tax expense		11,500
Net income		$ 18,000

Importance/Advantage of income statement:

The profit is the primary objective of every business. Various parties such as management, shareholders, investors, creditors, and government agencies are interested to know the success of business operations of the company in terms of profitability. The companies periodically provide this information through preparing and publishing an audited income statement. Moreover, all publicly owned companies are legally required to prepare and publish an income statement as a part of their annual reports.

Limitations of income statement:

Income statement is of vital importance for the users of the financial statements. However, it suffers from the following limitations:

1. The accounting process is based on various assumptions and estimates. Therefore, the net income (or loss) measured by preparing an income statement is not absolutely accurate. An

example of estimates used in the accounting process is the depreciation which is computed on the basis of estimated useful life of assets such as building, plants and equipment etc.

2. The use of judgments and estimates in the accounting process enables management to use such figures that would generate desired net income or net loss figure for the period.
3. A manipulation in net income is possible by using a particular inventory valuation method such as FIFO method, LIFO method and average costing method. The company may use such method that generates the desired result.
4. While preparing income statement we take into account only those activities whose value can be objectively measured. For example, a sound customers relation policy can develop a good customer base that can certainly be beneficial for a profitable business operation but its value cannot be objectively measured unless evidenced by an actual business transaction.

Statement of retained earnings

The **statement of retained earnings** is a financial statement that summarizes the changes in the amount of *retained earnings* during a particular period of time.

Retained earnings is the portion of net income that a company does not distribute among its shareholders but retains in the business for various purposes such as growth of business in future and meeting the debt obligations etc. It increases when company earns net income and decreases when company incurs net loss or declares dividends during the period. Retained earnings appears in the balance sheet as a component of stockholders equity.

The statement of retained earnings is prepared after the preparation of income statement but before the preparation of balance sheet because it is used to compute the amount of retained earnings at the end of the period to be shown in the balance sheet.

The computation of retained earnings figure at the end of the period can be shown in the form of the following formula/equation:

Retained earnings at the end = Retained earnings at the beginning + Net income – Dividends

Format of the statement of retained earnings

A simple format of statement of retained earnings is given below:

COMPANY NAME STATEMENT OF RETAINED EARNINGS For the Year Ended December 31, 2015	
Retained earnings at the beginning of the period	$ XXXX
Add: net income (or less: net loss)	XXXX
Less: dividends	XXXX
Retained earnings at the end of the period	$ XXXX

Notice that the statement of retained earnings starts with the beginning balance of retained earnings. The net income is added and the net loss is subtracted; any dividends declared during the period (whether paid or not) is also subtracted in the statement of retained earnings. The resulting figure is the retained earnings at the end of the period that appears in the stockholders' equity section of the balance sheet at the end of the period.

Example

The adjusted trial balance and the income statement of Business Consulting company are given in income statement article. Using that information, we can prepare the statement of retained earnings of the company as follows:

BUSINESS CONSULTING COMPANY STATEMENT OF RETAINED EARNINGS For the Year Ended December 31, 2015	
Retained earnings at January 1, 2015	$ 20,000
Add: net income earned in 2015	18,000
Subtotal	38,000
Less: dividends declared in 2015	3,000
Retained earnings at December 31, 2015	$ 35,000

Balance sheet

Balance sheet (also known as the **statement of financial position**) is a financial statement that shows the assets, liabilities and owner's equity of a business at a particular date. The main purpose of preparing a balance sheet is to disclose the financial position of a business enterprise at a given date.

While the balance sheet can be prepared at any time, it is mostly prepared at the end of the accounting period.

Most of the information about assets, liabilities and owners equity items are obtained from the adjusted trial balance of the company. However, retained earnings, a part of owners' equity section, is provided by the statement of retained earnings.

Sections of the balance sheet

We can broadly divide a balance sheet into three sections – assets section, liabilities section and owners equity section. Each of these sections is briefly discussed below:

Assets section

In this section all the resources (i.e., assets) of the business are listed. In balance sheet, assets having similar characteristics are grouped together. The mostly adopted approach is to divide assets into current assets and non-current assets. Current assets include cash and all assets that can be converted into cash or are expected to be consumed within a short period of time – usually one year. Examples of current assets include cash, cash equivalents, accounts receivables, prepaid expenses or advance payments, short-term investments and inventories.

All assets that are not listed as current assets, are grouped as non-current assets. A common characteristic of such assets is that they continue providing benefit for a long period of time – usually more than one year. Examples of such assets include long-term investments, equipment, plant and machinery, land and buildings, and intangible assets.

When balance sheet is prepared, the current assets are listed first and non-current assets are listed later.

Liabilities section

Liabilities are obligations to parties other than owners of the business. They are grouped as current liabilities and long-term liabilities in the balance sheet. Current liabilities are the obligations that are expected to be met within a period of one year by using current assets of the business or by the provision of goods or services. All liabilities that are not current liabilities are considered long term liabilities.

Owner's equity section

Owner's equity is the obligation of the business to its owners. The term owners' equity is mostly used in the balance sheet of sole proprietorship and partnership form of business. In a company's balance sheet the term "owner's equity" is often replaced by the term "stockholders equity".

When balance sheet is prepared, the liabilities section is presented first and owners' equity section is presented later.

Format of the balance sheet

There are two formats of presenting assets, liabilities and owners' equity in the balance sheet – account format and report format. In **account format**, the balance sheet is divided into left and right sides like a T account. The assets are listed on the left hand side whereas both liabilities and owners' equity are listed on the right hand side of the balance sheet. If all the elements of the balance sheet are correctly listed, the total of asset side (i.e., left side) must be equal to the total of liabilities and owners' equity side (i.e., right side).

In **report format**, the balance sheet elements are presented vertically i.e., assets section is presented at the top and liabilities and owners equity sections are presented below the assets section. The example given below shows both the formats.

Example

Using the information from adjusted trial balance given and statement of retained earnings given , we can prepare the balance sheet of Business Consulting Company as follows:

Account format:

BUSINESS CONSULTING COMPANY
BALANCE SHEET
As at December 31, 2015

Assets		$	Liabilities & Stockholders' equity		$
Current assets:			Liabilities:		
Cash		85,550	Notes payable		5,000
Accounts receivable		4,700	Accounts payable		1,600
Prepaid building rent		1,500	Salaries payable		2,000
Unexpired insurance		3,600	Income tax payable		3,000
Supplies		250	Unearned service revenue		4,400
Total current assets		95,600	Total liabilities		16,000
Non-current assets:			Stockholders' equity:		
Equipment	9,000		Capital stock	50,000	
Acc. dep. - Equipment	3,600	5,400	Retained earnings	35,000	85,000
Total assets		101,000	Total liabilities & stockholders' equity		101,000

Report format:

BUSINESS CONSULTING COMPANY
BALANCE SHEET
As at December 31, 2015

Assets		
Current assets:		
Cash		85,550
Accounts receivable		4,700
Prepaid building rent		1,500
Unexpired insurance		3,600
Supplies		250
Total current assets		95,600
Non-current assets:		
Equipment	9,000	
Acc. dep. - Equipment	3,600	5,400
Total assets		101,000
Liabilities & Stockholders' equity		
Liabilities		
Notes payable		5,000
Accounts payable		1,600
Salaries payable		2,000
Income tax payable		3,000
Unearned service revenue		4,400
Total liabilities		16,000
Stockholders' equity:		
Capital stock		50,000
Retained earnings		35,000
Total stockholders' equity		85,000
Total liabilities and stockholders' equity		101,000

Usefulness of balance sheet

As described at the start of this article, balance sheet is prepared to disclose the financial position of the company at a particular point in time. This information is of great importance for all concerned parties. For example, investors and creditors use it to evaluate the capital structure, liquidity and solvency position of the business. On the basis of such evaluation, they anticipate the future performance of the company in terms of profitability and cash flows and make much important economic decisions.

Limitations of balance sheet

1. Many items have great financial value and may be important for the users of financial statements in making reliable decisions but are not reported in the balance sheet because they cannot be objectively measured. Examples of such items include the skill and knowledge of an IT company, a sound customer base and high reputation etc.
2. The current fair value of various assets and liabilities may be important for some decision makers but the balance sheet does not disclose it because assets and liabilities are mostly reported at their historical costs.
3. The value of some items is reported in the balance sheet on the basis of judgments and estimates. For example the depreciation is usually calculated on the basis of estimated life of the assets. The book value reported in the balance sheet is therefore also an estimated value. Another example is the accounts receivable that are reported at their estimated net realizable value.