

Chapter 2

Balance Sheet Concepts: Assets, Liabilities, and Stockholders' Equities



Basic Terms

- **Comparability** - ability to compare information of different companies.
- **Consistency** - companies must use the same accounting principles and methods from year to year.



Concepts in Accounting

Time Period – A business can be divided into artificial time periods. The most commonly used time periods for public corporations is quarterly and annually.

Going Concern - A company is expected to carry out its operations into the foreseeable future.



Basic Terms

- **Relevance** - information makes a difference in decisions.
- **Reliability** - information must be free of error and bias.



Concepts in Accounting

Monetary Unit – Money (US \$) is the unit used to measure economic activity.

Economic Entity – This concept provides a context or “point of view” for the economic events (i.e., transactions) captured by the financial statements. In short, it answers the questions, “Whose asset is it?”, “Whose liability is it?”



Concepts in Accounting

Cost Principle – Assets acquired are recorded at cost.

Full Disclosure Principle – Information that would effect an investor or creditors view of the company should be disclosed.



Constraints in Accounting

Permits companies to modify GAAP without hurting the usefulness of information

- **Materiality** - if item doesn't make a difference, GAAP doesn't have to be followed
- **Conservatism** - in "gray" areas choose guide which does not overstate assets or income



A Classified Balance Sheet...

Generally contains the following standard classifications:

- Current Assets
- Long-Term Investments
- Property, Plant, and Equipment
- Other Assets
- Current Liabilities
- Long-Term Liabilities
- Stockholders' Equity



Assets

The probable future economic benefit an entity obtains by entering into a transaction



Current Assets

Assets that are expected to be converted to cash or used in the business within a short period of time, usually one year. Current assets are listed in order of liquidity.

- Examples:
 - Cash
 - Short-term investments
 - Receivables
 - Inventories
 - Prepaid expenses



Definition of Specific Assets

Cash - Money in the form of cash or bank deposits (e.g., checking and/or money market account).

Short-term investments - An entity's investment in another entity's stock or debt (i.e., bonds). Sometimes referred to as "Marketable Securities". These assets yield a higher return (dividends, appreciation or interest) than is available through checking and money market accounts.



Definition of Specific Assets

Inventories - The goods an entity has on hand is referred to as a **finished good**. The material that it needs to make the goods is referred to as **raw materials**. The raw material in process of being completed (i.e., finished) is referred to as **work in process**.



Definition of Specific Assets

Prepaid expenses – The amounts an entity has already paid for services/goods to be delivered in the future (e.g., car insurance).



Definition of Specific Assets

Accounts Receivable - The amounts due from customers for goods they purchased on credit. Because all customers do not pay their bills, the balance is reduced by an “allowance” (an estimate of what will not be collected).

Example - OshKosh December 29, 2001:

Total Accounts receivable	\$ 32,542
Less: Allowance	<u>(7,075)</u>
Net accounts receivable	\$ 25,467



Non-Current Assets

Assets that are expected to benefit the business over a long period of time. Non-current assets are usually listed in order of importance to the entity.

- Examples:
 - Property plant and equipment
 - Long-term investments
 - Other assets



Definition of Specific Assets

Property, Plant, and Equipment - The land, buildings, equipment, furniture and fixtures that are used in operating the business.



Liabilities

Liabilities – The probable future sacrifice of economic benefits arising from an entity's obligations to transfer assets or provide services as a result of a past transaction or event.



Current Liabilities

Liabilities that are expected to be paid by the business within a short period of time, usually one year. Current liabilities are listed in order of liquidity.

Examples:

- accounts payable
- accrued liabilities
- short-term borrowings
- dividend payable
- unearned revenue



Definition of Specific Liabilities

Accounts payable – The amount an entity owes to suppliers for goods previously delivered. Sometimes referred to as “trade payables” or “trade accounts payable”.



Definition of Specific Liabilities

Accrued liabilities - The amounts an entity owes for taxes, rent, wages, etc. More detail is offered in the Notes to the Financial Statements.

Example: OshKosh - Exhibit 2.2 (Note 5)

A summary of 12/29/01 accrued liabilities follows:

Compensation	\$ 7,181
Workers' compensation	8,900
Income taxes	5,182
Other	<u>17,140</u>
Total	\$38,403



Definition of Specific Liabilities

Short-term borrowings – Monetary amounts due within one year for repayment of bank loans, notes payable and other commercial paper.

Dividends payable – The amount owed by a corporation to its shareholders when dividends declared by the board of directors have not yet been paid.



Definition of Specific Liabilities

Unearned revenues – The monetary amounts received by an entity that accepts up-front payments of cash in exchange for future delivery of its products.

Example: Your advance cash payment for a three-year subscription to *Fortune Magazine* requires their sacrifice of future economic benefits (they are liable) to provide the magazine. It is termed “unearned” as it represents a service (i.e., the subscription) that has **NOT** yet been completed (i.e., delivered to your door). It will be “earned” as delivery takes place.



Long-Term Liabilities

Debts expected to be paid after one year.

Examples:

- warranties
- employee benefit plan liabilities
- leases
- bonds payable
- long-term obligations



Definition of Specific Liabilities

Warranties – The entity's obligation to replace defective merchandise within a specified time period.

Employee benefit plan liabilities – The “sacrifice” of cash that an entity must make for pensions, retirement health care and other retirement benefits.

Lease – The “sacrifice” of cash that an entity must make to secure equipment or for the use of property to conduct operations



Definition of Specific Liabilities

Bonds payable – The amount due to bond purchasers under terms of the bond issue.

Long-term borrowings – Monetary amounts for bank loans, notes payable and other commercial paper that **does not** have to be repaid within one year.



Stockholders' Equity

Stockholders' Equity – The difference between total assets and total liabilities. Stockholders' equity arises from the contributions of owners.



Definition of Stockholders' Equity Accounts

Common Stock – Shareholders' investment in the entity through acquisition of stock. Ownership of a share entitles the holder to a vote on major corporate decisions and a residual claim to the entity's assets in the event of liquidation. The amount recorded in this account represents the legal capital per share that must be retained in the business. Is usually low because some states levy a tax on the corporation based on par value.



Definition of Stockholders' Equity Accounts

Additional paid-in-capital – The amount paid by the investor for a share of stock in excess of its par value.



Definition of Stockholders' Equity Accounts

Preferred Stock – Another vehicle available to corporations for raising owner contributions. A preferred owner typically is not allowed to vote on major corporate issues. In the event of liquidation, these shareholders receive the stated value of their shares.



Definition of Stockholders' Equity Accounts

Retained Earnings - equity (net income) generated from operations less what has been returned to the shareholders in dividends. The adjective “retained” reveals that these earnings have not been distributed to shareholders in the form of dividends.



Constructing the Balance Sheet

Analyze the effect of business transactions on the basic accounting identity:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Remember: The Accounting Identity must always balance.



Transaction Analysis

Transactions can be divided into two types:

- ☞ External events
- ☞ Internal events

Only **external** transactions must be recorded in the financial statements.



Steps in the Transaction Process

1. **Analyze** each transaction
2. **Journalize** each transaction
3. **Post** each transaction to a T account. An **account** would be cash, accounts payable etc.



Transaction Analysis

Transaction Analysis determines if and how the transaction impacts the financial statements.

Types of Events

External events occur between the company and some outside party. It involves an exchange of assets, liabilities, or stockholders' equity between a company and an outside party

Internal events are economic events that occur entirely within one company. For example the act of hiring of an employee.



Steps in the Transaction Process

Analyze - determine how the transaction affects the balance sheet (i.e., increase or decrease assets, liabilities etc.).

Journal - accounting record where the transactions are recorded in chronological order.

Posting - transferring of information from the journals to the general ledger accounts (i.e., T - Accounts)



Account

An individual accounting record of increases and decreases in a specific **Asset**, **Liability**, or **Stockholders' Equity** item.

Three parts :

- 1) the **Title** of the account
- 2) a left or **Debit** side
- 3) a right or **Credit** side



T - Account

TITLE	
DEBIT	CREDIT



Total the Entries to Each Side

TITLE	
Debit	Credit
Total Debits	Total Credits

If the greater sum is on the left,
the account has a **Debit Balance**



Total the Entries to Each Side

TITLE	
Debit	Credit
Total Debits	Total Credits

If the greater sum is on the right,
the account has a **Credit Balance**



Effect of Debits/Credits on Accounts

DEBITS

Increase – Assets

Decrease – Liability and Equity Accounts

CREDITS

Decrease – Assets

Increase – Liability and Equity Accounts



Normal Balance

The term **normal balance** for an account is the side (i.e., debit or credit) that is increased.

Normal Debit Balance: Assets

Normal Credit Balance: Liabilities
Stockholders' Equity



Let's Practice

Transaction Analysis



Transaction Analysis

The basic steps in the recording process are:

- Analyze each transaction in terms of its effect on the accounts.
- Record the debit and credit effects on specific accounts for each transaction.



Recording A Transaction

On January 1, \$40,000 is invested in Rhody Corporation in exchange for common stock.

How does this affect the accounting equation?



Recording A Transaction

$$\begin{array}{ccccccc} A & = & L & + & SE \\ + & & & & + \end{array}$$

- Assets increase
- Stockholders' equity increases

What asset account and stockholders' equity account is affected?



Recording A Transaction

Cash	(debit)	\$40,000
Common Stock	(credit)	\$40,000

Note: Debits are always written first and you always indent the credit.



Recording A Transaction

Also on January 1 Rhody purchases \$20,000 of equipment for cash.

How does this affect the accounting equation?



Recording A Transaction

$$\begin{array}{rclcl} A & = & L & + & SE \\ + & = & & & \\ - & & & & \end{array}$$

- Assets increase
- Assets decrease

What asset accounts are affected?



Recording A Transaction

Equipment (debit)	\$20,000
Cash (credit)	\$20,000

Note: Debits are always written first and you always indent the credit.



Recording A Transaction

On January 5 Rhody purchases inventory of \$14,000 on account.

How does this affect the accounting equation?



Recording A Transaction

$$\begin{array}{rclcl} A & = & L & + & SE \\ + & & + & & \end{array}$$

- Assets increase
- Liabilities increase

What asset account and liability account is affected?



Recording A Transaction

Inventory (debit)	\$14,000
Accounts Payable (credit)	\$14,000

Note: Debits are always written first and you always indent the credit.



Recording A Transaction

On March 6 Rhody buys \$4,000 of supplies for cash.

How does this affect the accounting equation?



Recording A Transaction

$$\begin{array}{rclcl} A & = & L & + & SE \\ + & = & & & \\ - & & & & \end{array}$$

- Assets increase
- Assets decrease

What asset accounts are affected?



Recording A Transaction

Supplies (debit)	\$4,000	
Cash (credit)		\$4,000

Note: Debits are always written first and you always indent the credit.



Recording A Transaction

On April 1 Rhody pays \$12,000 to insure its cars for the next year.

How does this affect the accounting equation?



Recording A Transaction

$$\begin{array}{rclcl} A & = & L & + & SE \\ + & & & & \\ + & & & & \end{array}$$

- Assets increases
- Assets decrease

What asset accounts are affected?



Recording A Transaction

Prepaid Insurance (debit)	\$12,000	
Cash (credit)		\$12,000

Note: Debits are always written first and you always indent the credit.



Recording A Transaction

On September 1, Rhody receives \$18,000 in advance for services to be performed in the future.

How does this affect the accounting equation?



Recording A Transaction

A = L + SE
+ +

- Assets increase
- Liabilities increase

What asset account and liability account is affected?



Recording A Transaction

Cash (debit) \$18,000
 Unearned Revenue (credit) \$18,000

Note: Debits are always written first and you always indent the credit.



Recording A Transaction

October 1, 2004, Rhody lends the Minutemen Corporation \$10,000 in the form of a note receivable. The note is due on September 30, 2005, and carries an interest rate of 9%.

How does this affect the accounting equation?



Recording A Transaction

A = L + SE
+
-

- Assets increase
- Assets decrease

What asset accounts are affected?



Recording A Transaction

Note Receivable (debit) \$10,000
 Cash (credit) \$10,000

Note: Debits are always written first and you always indent the credit.



T-Account

Remember every journal entry will be posted to the appropriate account. For example, based on the entries made, the T-Account for cash would have an ending debit balance of \$12,000 (see next slide).



T - Account

CASH	
1/1	40,000
1/1	20,000
3/6	4,000
4/1	12,000
9/1	18,000
10/1	10,000
	<u>58,000</u>
	<u>46,000</u>
Balance	12,000 (Debit)



Purpose of Trial Balance

A list of all the accounts and their balances at a given time.

It serves to prove the mathematical equality of debits and credits after posting (shouldn't be critical, assuming credible software is used).

It aids in the preparation of financial statements.



Rhody Corporation Trial Balance December 31, 2004

	Debit	Credit
Cash	\$12,000	
Note Receivable	10,000	
Supplies	4,000	
Inventory	14,000	
Prepaid Insurance	12,000	
Office Equipment	20,000	
Accounts Payable		14,000
Unearned Service Revenue		18,000
Common Stock		<u>40,000</u>
	<u>\$ 72,000</u>	<u>\$72,000</u>



Ratio Analysis

Expresses the relationship among selected items of financial statement data

Relationship can be expressed in terms of...

- ◆ percentage
- ◆ rate
- ◆ proportion



Financial Ratio Classifications

Basic Asset-Based Ratios

- Liquidity Ratios
- Solvency Ratios



Liquidity

Liquidity Ratios - measures of short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.

Examples:

- Working capital
- Current ratio



Working Capital

Measures short-term ability to pay liabilities.
Problem is you can't compare absolute dollar amounts.

$$\text{Current Assets} - \text{Current Liabilities} = \text{Working Capital}$$



Current Ratio

Measure of short-term ability to pay obligations

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$



Solvency

Solvency Ratios - measures of the ability of a company to survive over a long period of time.



Solvency Ratio

Debt to Total Assets Ratio - measures % of assets financed by creditors. Total debt includes both current and long-term liabilities.

$$\text{Total Debt to Total Assets} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

