# Fundamentals of Accounting-Part 3

# Introduction to Balance Sheet

- The accounting balance sheet is one of the five major financial statements used by accountants and business owners. (The other major financial statements are the income statement, statement of comprehensive income, statement of cash flows, and statement of stockholders' equity) The balance sheet is also referred to as the statement of financial position.
- The balance sheet presents a company's financial position at the end of a specified date. Some describe the balance sheet as a "snapshot" of the company's financial position at a point (a moment or an instant) in time. For example, the amounts reported on a balance sheet dated December 31, 2019 reflect that instant when all the transactions through December 31 have been recorded.
- Because the balance sheet informs the reader of a company's financial position as of one moment in time, it allows someone—like a creditor—to see what a company owns as well as what it owes to other parties as of the date indicated in the heading. This is valuable information to the banker who wants to determine whether or not a company qualifies for additional credit or loans. Others who would be interested in the balance sheet include current investors, potential investors, company management, suppliers, some customers, competitors, government agencies, and labor unions.
- We will begin our explanation of the accounting balance sheet with its major components, elements, or major categories:

1. Assets
2. Liabilities
3. Owner's (Stockholders') Equity

# Balance sheet-Asset

- Assets are things that the company owns. They are the resources of the company that have been acquired through transactions, and have future economic value that can be measured and expressed in dollars. Assets also include costs paid in advance that have not yet expired, such as prepaid advertising, prepaid insurance, prepaid legal fees, and prepaid rent. Examples of asset accounts that are reported on a company's balance sheet include:

1. Cash
2. Petty Cash
3. Temporary Investments
4. Accounts Receivable
5. Inventory
6. Supplies
7. Prepaid Insurance
8. Land
9. Land Improvements
10. Buildings
11. Equipment
12. Goodwill

- Usually asset accounts will have *debit* balances.

# Classifications Of Assets On The Balance Sheet

- Accountants usually prepare classified balance sheets. "Classified" means that the balance sheet accounts are presented in distinct groupings, categories, or classifications. The asset classifications and their order of appearance on the balance sheet are:

1. Current asset-Cash and other resources that are expected to turn to cash or to be used up within one year of the balance sheet date. (If a company's operating cycle is longer than one year, an item is a current asset if it will turn to cash or be used up within the operating cycle.) Current assets are presented in the order of liquidity, i.e., cash, temporary investments, accounts receivable, inventory, supplies, prepaid insurance.
2. Investment-The long term asset category of a classified balance sheet which appears immediately after the current assets. Listed in this category would be a bond sinking fund, funds held for construction, the cash surrender value of a life insurance policy owned by the company, and long term investments in stocks and bonds.
3. Property, plant and equipment- A major classification on the balance sheet. It is the second long term asset section after current assets. Included are land, buildings, leasehold improvements, equipment, furniture, fixtures, delivery trucks, automobiles, etc. that are owned by the company.
4. Some examples of intangible assets include copyrights, patents, goodwill, trade names, trademarks, mail lists, etc. These assets will be reported at cost (or lower) on the balance sheet after property, plant and equipment. Trade names and trademarks that were developed by a company (as opposed to buying them from another company at a significant cost) may not appear on the balance sheet, even though they might be a company's most valuable asset.

# Classifications Of Assets On The Balance Sheet

**Example Company**
**Balance Sheet**
**December 31, 2019**

| ASSETS | LIABILITIES & OWNER'S EQUITY |
|---|---|
| Current assets | Current Liabilities |
| Investments | Long-term liabilities |
| Property, plant, and equipment | Total liabilities |
| Intangible assets | |
| Other assets | Owner's equity |
| Total assets | Total liabilities & owner's equity |

# Effect of Conservatism

- While the cost principle and monetary unit assumption generally prevent assets from being reported on the balance sheet at an amount greater than cost, conservatism will result in some assets being reported at less than cost. For example, assume the cost of a company's inventory was $30,000, but now the current cost of the same items in inventory has dropped to $27,000. The conservatism guideline instructs the company to report Inventory on its balance sheet at $27,000. The $3,000 difference is reported immediately as a loss on the company's income statement.
- The matching principle will also cause certain assets to be reported on the accounting balance sheet at less than cost. For example, if a company has Accounts Receivable of $50,000 but anticipates that it will collect only $48,500 due to some customers' financial problems, the company will report a credit balance of $1,500 in the contra asset account Allowance for Doubtful Accounts. The combination of the asset Accounts Receivable with a debit balance of $50,000 and the contra asset Allowance for Doubtful Accounts with a credit balance will mean that the balance sheet will report the net amount of $48,500. The income statement will report the $1,500 adjustment as Bad Debts Expense
- The matching principle also requires that the cost of buildings and equipment be depreciated over their useful lives. This means that over time the cost of these assets will be moved from the balance sheet to Depreciation Expense on the income statement. As time goes on, the amounts reported on the balance sheet for these long-term assets will be reduced. The long term asset land is an exception, it is not depreciated.

# Liabilities

Liabilities are obligations of the company; they are amounts owed to creditors for a past transaction and they usually have the word "payable" in their account title. Along with owner's equity, liabilities can be thought of as a source of the company's assets. They can also be thought of as a claim against a company's assets. For example, a company's balance sheet reports assets of $100,000 and Accounts Payable of $40,000 and owner's equity of $60,000. The source of the company's assets are creditors/suppliers for $40,000 and the owners for $60,000. The creditors/suppliers have a claim against the company's assets and the owner can claim what remains after the Accounts Payable have been paid.

Liabilities also include amounts received in advance for future services. Since the amount received (recorded as the asset Cash) has not yet been earned, the company defers the reporting of revenues and instead reports a liability such as Unearned Revenues or Customer Deposits.

# Liabilities

Notes Payable-The amount of principal due on a formal written promise to pay. Loans from banks are included in this account.

Accounts Payable-This current liability account will show the amount a company owes for items or services purchased on credit and for which there was not a promissory note.

Salaries Payable

Wages Payable

Interest Payable

Other Accrued Expenses Payable

Income Taxes Payable

Customer Deposits

Warranty Liability

Lawsuits Payable

Unearned Revenues

Bonds Payable

# Liability

Income Taxes Payable

Customer Deposits-A liability account on the books of a company receiving cash in advance of delivering goods or services to the customer.

Lawsuits Payable

Unearned Revenues-A liability account that reports amounts received in advance of providing goods or services.

Bonds Payable: Shares and bonds are both types of investment securities, but they have very different characteristics and behave very differently. Simply put, when an investor buys shares they are buying part of a company; when they buy bonds, they are lending money to a company.

# Owner’s equity-Shares, Bonds

- Shares- A share is a stake in the ownership of a company. When a company issues shares they are selling a certain amount of ownership in their company. An investor who buys the shares has a claim to the company’s earnings and assets. Some companies pay out a percentage of profits to investors in the form of dividends. However, companies are not obliged to pay dividends and they are not certain. Over time dividends can be increased, decreased or not declared at all.
- Consider an example; your new project/business is successful and so, you want to expand it. Now, you sell half of your company to your brother for Tk. 50,000. You put this transaction in writing – ‘my new company will issue 100 shares of stock. My brother will buy 50 shares for Tk. 50,000.' Thus, your brother has just bought 50% of the shares of stock of your company. He is now a shareholder. Suppose your brother immediately needs Tk. 50,000. He can sell the share in the secondary market and get the money. This may be more or less than lk;oi908 50,000. For this reason, it is considered a riskier instrument.
- Shares are thus, a certificate of ownership of a corporation. Thus, as a stockholder, you share a portion of the profit the company may make. As the company keeps doing better, your stocks will increase in value.
- Shares are perpetual investments – from when a company first issues shares it continues to evolve, and its share price continues to fluctuate. It takes an event such as bankruptcy or a takeover to cause the share life-cycle to end.

# Owner's equity-Shares, Bonds

1. Primary Market:

- This where a company gets registered to issue a certain amount of shares and raise money. This is also called getting listed in a stock exchange.
- A company enters primary markets to raise capital. If the company is selling shares for the first time, it is called an Initial Public Offering (IPO). The company thus becomes public.

2. Secondary Market:

- Once new securities have been sold in the primary market, these shares are traded in the secondary market. This is to offer a chance for investors to exit an investment and sell the shares. Secondary market transactions are referred to trades where one investor buys shares from another investor at the prevailing market price or at whatever price the two parties agree upon.
- Normally, investors conduct such transactions using an intermediary such as a broker who facilitates the process.
- Common vs. Preferred Stock
- The two main types of stock are common and preferred. Shareholders with preferred stock will receive payouts and dividends before those who own common stock in that company - basically, those with preferred stock have a higher claim on the company's first asset payouts, leaving common stock holders with no guarantee of payment.
- Those who own common stock in a company typically have voting rights in shareholder's meetings and may even receive dividends, while preferred stock owners do receive dividends but don't always receive voting rights. Preferred stock owners also typically have priority if a company goes bankrupt

# Owner’s equity-Shares, Bonds

- While stocks are a stake of ownership in a company, a bond is a debt that the company or entity enters into with the investor that pays the investor interest on that debt.
- Bonds are created when a company, government, or other entity wishes to raise money to finance a project, growth, or development and wish to use investors instead of a bank to create loans.
- Bonds are fixed-income investments, which operate off of a fixed interest rate and a fixed amount of time wherein the company, government, or other will repay the money plus the interest (the interest rate is called a coupon rate) to the creditor (at the point of maturity). For this reason, bonds are frequently called "fixed-income securities," which, as the name suggests, may be more dependable (in theory) than investing in stocks

# Owner's equity-Retained earnings, Treasury stock

- Retained Earnings (RE) are the portion of a business's profits that are not distributed as dividends to shareholders but instead are reserved for reinvestment back into the business.
- Positive profits give a lot of room to the business owner(s) or the company management to utilize the surplus money earned. Often this profit is paid out to shareholders, but it can also be re-invested back into the company for growth purposes. The money not paid to shareholders counts as retained earnings.
- Treasury stock, also known as treasury shares or reacquired stock refers to previously outstanding stock that is bought back from stockholders by the issuing company. The result is that the total number of outstanding shares on the open market decreases.

**Example Company**
**Balance Sheet**
**December 31, 2019**

## ASSETS

| | |
|---|---|
| Current assets | |
| Cash | $ 2,100 |
| Petty cash | 100 |
| Temporary investments | 10,000 |
| Accounts receivable - net | 40,500 |
| Inventory | 31,000 |
| Supplies | 3,800 |
| Prepaid insurance | 1,500 |
| Total current assets | 89,000 |
| Investments | 36,000 |
| Property, plant & equipment | |
| Land | 5,500 |
| Land improvements | 6,500 |
| Buildings | 180,000 |
| Equipment | 201,000 |
| Less: accum depreciation | (56,000) |
| Prop, plant & equip - net | 337,000 |
| Intangible assets | |
| Goodwill | 105,000 |
| Trade names | 200,000 |
| Total intangible assets | 305,000 |
| Other assets | 3,000 |
| Total assets | $ 770,000 |

## LIABILITIES

| | |
|---|---|
| Current liabilities | |
| Notes payable | $ 5,000 |
| Accounts payable | 35,900 |
| Wages payable | 8,500 |
| Interest payable | 2,900 |
| Taxes payable | 6,100 |
| Warranty liability | 1,100 |
| Unearned revenues | 1,500 |
| Total current liabilities | 61,000 |
| Long-term liabilities | |
| Notes payable | 20,000 |
| Bonds payable | 400,000 |
| Total long-term liabilities | 420,000 |
| Total liabilities | 481,000 |

## STOCKHOLDERS' EQUITY

| | |
|---|---|
| Common stock | 110,000 |
| Retained earnings | 220,000 |
| Accum other comprehensive income | 9,000 |
| Less: Treasury stock | (50,000) |
| Total stockholders' equity | 289,000 |
| Total liabilities & stockholders' equity | $ 770,000 |

The notes to the sample balance sheet have been omitted.