

Segment – Accounting Process Part 1

THE BALANCE SHEET

Chapter Summary

LO 2-1 Identify financial effects of common business activities that affect the balance sheet.

- Financing activities involve debt transactions with lenders (e.g., Notes Payable) or equity transactions with investors (e.g., Common Stock)
- Investing activities involve buying and selling long-term assets (e.g., Buildings, Equipment).
- Operating activities involve day-to-day transactions with suppliers, employees, and customers, and typically affect current assets and current liabilities.

LO 2-2 Apply transaction analysis to accounting transactions.

- Transactions include external exchanges and internal events.
- Transaction analysis is based on the duality of effects and the basic accounting equation. *Duality of effects* means that every transaction affects at least two accounts.
- Transaction analysis follows a systematic approach of picturing the documented business activity; naming the exchanged asset, liability, and stockholders' equity accounts; and analyzing the financial effects on the basic accounting equation.

LO 2-3 Use journal entries and T-accounts to show how transactions affect the balance sheet.

- Debit means left and credit means right.
- Debits increase assets and decrease liabilities and stockholders' equity.
- Credits decrease assets and increase liabilities and stockholders' equity.
- Journal entries express, in debits-equal-credits form, the effects of a transaction on various asset, liability, and stockholders' equity accounts. Journal entries are used to record financial information in the accounting system, which is later summarized by accounts in the ledger (T-accounts).
- T-accounts are a simplified version of the ledger, which summarizes transaction effects for each account. T-accounts show increases on the left (debit) side for assets, which are on the left side of the accounting equation. T-accounts show increases on the right (credit) side for liabilities and stockholders' equity, which are on the right side of the accounting equation.

LO 2-4 Prepare a trial balance and a classified balance sheet.

- A trial balance checks on the equality of debit and credit balances.
- A *classified balance sheet* separately classifies assets as current if they will be used up or turned into cash within one year. Liabilities are classified as current if they will be paid, settled, or fulfilled within one year.

LO 2-5 Interpret the balance sheet using the current ratio and an understanding of related concepts.

- The current ratio divides current assets by current liabilities to determine the extent to which current assets are likely to be sufficient for paying current liabilities.

- Because accounting is transaction-based, the balance sheet does not necessarily represent the current value of a business. Some assets are not recorded because they do not arise from transactions.
- The amounts recorded for assets and liabilities may not represent current values because under the cost principle they generally are recorded at cost, using the exchange amounts established at the time of the initial transaction.

Accounting Decision Tools

Current Ratio = Current Assets ÷ Current Liabilities

- It tells you whether current assets are sufficient to pay current liabilities.

Chapter Outline

I. Understand the Business

LO 2-1 Identify financial effects of common business activities that affect the balance sheet.

A. Building a Balance Sheet

1. Asset—Resources presently owned by a business that generate future economic benefits.
2. Liabilities—Amounts presently owed by a business
3. Stockholders' equity—Amount invested and reinvested in a company by its stockholders.
4. Key activity for any start-up company is to obtain financing.
 - a. Equity financing—Money obtained through owners' contributions and reinvestments of profit; business is not legally obligated to repay.
 - b. Debt financing—Money obtained through loans; business is legally obligated to repay.
5. After obtaining initial financing, company will start investing in assets that will be used when business opens.
6. Features important for understanding how accounting works; a company always:
 - a. Documents its activities.
 - b. Receives something and gives something (basic feature of all business activities).
 - c. Determines a dollar amount for each exchange based on value of items given and exchanged.
 - i. Exchange is either to earn a profit immediately or obtain resources that will allow it to earn a profit later.
 - ii. Any exchange that affects company's assets, liabilities, or stockholders' equity must be captured in and reported by the accounting system.
 - iii. A dollar amount is determined for each exchange based on the value (cost) of items given and received.
 - iv. Cost principle—At the time of a transaction, assets and liabilities should be recorded at their original cost to the company.

7. Accounting for business activities:

- a. Picture the documented activity.
- b. Name what's exchanged
- c. Analyze the financial affects—Building on the last step, show how the costs cause elements of the accounting equation to increase and/or decrease.

B. Transactions and Other Activities

1. Transaction—An event or activity that has a direct and measurable financial effect on the assets, liabilities, or stockholders' equity of a business.
2. Transactions include two types of events:
 - a. External exchanges—Exchanges involving assets, liabilities, and/or stockholders' equity that you can see between the company and someone else.
 - b. Internal events—Events that do not involve exchanges with others outside the business, but rather occur within the company itself.
3. Exchange of only promises is not an accounting transaction.
 - a. Documents are created to indicate activities occurred.
 - b. Later, when promises result in actually receiving or giving an asset or services, they will become transactions captured by the accounting system.

II. Study the Accounting Methods

LO 2-2 Apply transaction analysis to accounting transactions.

A. Step 1—Analyze Transactions

1. A systematic accounting process is used to capture and report the financial effects of a company's activities.
 - a. Process is called the accounting cycle; repeats itself over and over.
 - b. Steps include: analyze, record, summarize, prepare trial balance, and report financial statements.
2. Once a transaction is identified, it must be analyzed carefully to determine its financial effects; two simple ideas are used when analyzing transactions:
 - a. Duality of effects—Every transaction has at least two effects on the basic accounting equation.
 - b. The dollar amount for assets must always equal that for liabilities plus stockholders' equity for every accounting transaction. $A = L + SE$.
 - c. As part of transaction analysis, name (or account title) is given to each item exchanged.
 - d. Chart of accounts—A summary of all account names (and corresponding account numbers) used to record financial results in the accounting system.
 - i. Ensures account titles are used consistently.

- ii. Tailored to each company's business.
- iii. Many account titles are common across all companies; others may be used only by a particular company.

3. SonicGateway's Business Activities

(a) Issue Stock to Owners—Scott incorporates SonicGateway and the company issues common stock to Scott and Angus as evidence of their contribution of \$10,000 cash, which is deposited in the company's bank account.

- Name:

SonicGateway has received \$10,000 cash. SonicGateway issues \$10,000 of common stock.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Cash (A) +10,000 = Common Stock (SE) +10,000

(b) Invest in Equipment—SonicGateway pays \$300 cash for the company's logo.

- Name:

SonicGateway has received a logo costing \$300. SonicGateway gave \$300 cash.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Cash (A) -300 + Logo/Trademarks (A) +300 = 0

(c) Obtain Loan from Bank—SonicGateway borrows \$20,000 from a bank, depositing those funds in its bank account and signing a formal agreement to repay the loan in two years (on September 1, 2017).

- Name:

SonicGateway has received \$20,000 cash. SonicGateway gave a note, payable to the bank for \$20,000.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Cash (A) +20,000 = Note Payable (L) +20,000

(d) Invest in Equipment—SonicGateway purchases and receives \$9,600 in computers, printers, and desks, signing a purchase order to indicate its promise to pay \$9,600 at the end of the month.

- Name:

SonicGateway has received \$9,600 of equipment. SonicGateway gave a promise to pay \$9,600 on account.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Equipment (A) +9,600 = Accounts Payable +9,600

(e) Pay Supplier—SonicGateway pays \$5,000 of its promise to the equipment supplier in (d).

- Name:

SonicGateway has received back its \$5,000 promise to pay on account. SonicGateway gave \$5,000 cash.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Cash –5,000 = Accounts Payable –5,000

(f) Order Software for App—SonicGateway signs a contract with a programmer for program code for the Static Charge game app for \$9,000. No code has been received yet.

- Name:

An exchange of only promises is not a transaction. This does not affect the accounting equation.

- Analyze:

Assets = Liabilities + Stockholders' Equity

No change = No change

(g) Receive Software—SonicGateway receives the \$9,000 of app game code ordered in (f); pays \$4,000 cash, and promises to pay the remaining \$5,000 next month.

- Name:

SonicGateway has received software costing \$9,000. SonicGateway gave \$4,000 cash and a promise to pay \$5,000 on account.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Cash (A) –4,000 + Software (A) +9,000 = Accounts Payable (L) +5,000

(h) Receive Supplies—SonicGateway receives supplies costing \$600 on account.

- Name:

SonicGateway has received supplies costing \$600. SonicGateway gave a promise to pay \$600 on account.

- Analyze:

Assets = Liabilities + Stockholders' Equity

Supplies (A) +600 = Accounts Payable (L) +600

B. Steps 2 and 3: Record and Summarize

1. One method for recording and summarizing the financial effects of accounting transactions is to prepare a spreadsheet.
 - a. By summing each spreadsheet column, the new balances can be computed at the end of the month and reported on a balance sheet.
 - b. This method is impractical for most large organizations.
2. Most companies use computerized accounting systems, which can handle a large number of transactions.
 - a. These systems follow the accounting cycle, which is repeated month-after-month and year-after-year.
 - b. Three-step analyze-record-summarize process is applied to daily transactions, as well as adjustments at the end of each month, before preparing a trial balance and financial statements; same three steps are part of the closing processes that occurs at the end of each year.
3. Transactions are analyzed, and their financial effects are entered into journals each day they occur. Later, these journal entries are summarized in ledger accounts that keep track of the financial effects on each account.
 - a. Journal—Used to record the effects of each day's transactions; organized by date.
 - b. Ledger—Used to summarize the effects of journal entries on each account; organized by account.

LO 2-3 Use journal entries and T-accounts to show how transactions affect the balance sheet.

C. The Debit/Credit Framework

1. The accounting equation ($A = L + SE$) can be thought of as a scale that tips at the equals sign; assets are put on the left side of the scale and liabilities and stockholders' equity accounts are put on the right.
2. Each individual account has two sides, with one side used for increases and the other for decreases.
3. Accounts increase on the same side as they appear in $A = L + SE$ (decreases are the opposite):
 - a. Assets increase on the left side of the account.
 - b. Liabilities increase on the right side of the account.
 - c. Stockholders' equity accounts increase on the right side of the account.
4. Debit (dr)—The left side of an account, or the act of entering an amount into the left side of an account.
5. Credit (cr)—The right side of an account, or the act of entering an amount into the right side of an account.
6. When combined with how increases and decreases are entered into accounts, the following rules emerge:

- a. Use debits for increases in assets (and for decreases in liabilities and stockholders' equity accounts).
 - b. Use credits for increases in liabilities and stockholders' equity accounts (and for decreases in assets).
- 7. Normal balance—the side on which an account increases.
 - a. Assets accounts normally have debit balances.
 - b. Liabilities and stockholders' equity accounts normally have credit balances.
- 8. In addition to requiring that $A = L + SE$, the double-entry system also requires that debits = credits.
 - a. Step 1: Analyzing Transactions—The debit/credit framework does not change this step.
 - b. Step 2: Recording Journal Entries—The financial effects of transactions are entered into a journal using a debits-equal-credits format.
- 9. Journal entries—Indicate the effects of each day's transactions in a debits-equal-credits format.
 - a. A date is included for each transaction.
 - b. Debits appear first; credits are written below the debits and are indented to the right (words and amounts).
 - c. Total debits must equal total credits.
 - d. Dollar signs are not used.
 - e. The reference column (Ref.) will be used later (in step 3) to indicate when the journal entry has been summarized in the ledger accounts.
 - f. A brief explanation of the transaction is written below the debits and credits.
 - g. The line after the description is left blank.
- D. Step 3: Summarizing in Ledger Accounts:
 - 1. After journal entries have been recorded (in step 2), their dollar amounts are copied ("posted") to each ledger account affected by the transaction so that account balances can be computed.
 - 2. The posting of journal entries to general ledger accounts is kept track of by writing the account number in the Ref. column of the journal and the journal page number in the Ref. column of the ledger.
 - 3. T-account—Simplified version of a ledger account used for summarizing the effects of journal entries.
 - a. Every account starts with a beginning balance normally on the side where increases are summarized.
 - b. Dollar signs are not needed.

c. Each amount is accompanied by a reference to the related journal entry, which makes it easy to trace back to the original transaction should errors occur.

d. To find ending account balance, express the T-account as equations:

Start with beginning balance

Add “+” side

Subtract “–” side

Equals ending balance

e. Ending balance is double underscored to distinguish it.

E. SonicGateway’s Accounting Records

(a) Issue Stock to Owners—Scott incorporates SonicGateway and the company issues common stock to Scott and Angus as evidence of their contribution of \$10,000 cash, which is deposited in the company’s bank account.

1. Analyze: Assets = Liabilities + Stockholders’ Equity

Cash (A) +10,000 = Common Stock (SE) +10,000

2. Record:

	<u>Debit</u>	<u>Credit</u>
Cash (+A)	10,000	
Common Stock (+SE)		10,000

(b) Invest in Equipment—SonicGateway pays \$300 cash for the company’s logo.

1. Analyze: Assets = Liabilities + Stockholders’ Equity

Cash (A) –300; Logo and Trademarks (A) +300 = 0

2. Record:

	<u>Debit</u>	<u>Credit</u>
Logo and Trademarks (+A)	300	
Cash (–A)		300

(c) Obtain Loan from Bank—SonicGateway borrows \$20,000 from a bank and signs a formal agreement to repay the loan in two years (on September 1, 2017).

1. Analyze: Assets = Liabilities + Stockholders’ Equity

Cash (A) +20,000 = Note Payable (long-term) (L) +20,000

2. Record:

	<u>Debit</u>	<u>Credit</u>
Cash (+A)	20,000	
Note Payable (long-term) (+L)		20,000

(d) Invest in Equipment—SonicGateway purchases and receives \$9,600 in computers, printers, and desks, signing a purchase order to indicate its promise to pay \$9,600 at the end of the month.

1. Analyze: Assets = Liabilities + Stockholders' Equity
Equipment (A) +9,600 = Accounts Payable +9,600

2. Record:

	<u>Debit</u>	<u>Credit</u>
Equipment (+A)	9,600	
Accounts Payable (+L)		9,600

(e) Pay Supplier—SonicGateway pays \$5,000 to the equipment supplier in (d).

1. Analyze: Assets = Liabilities + Stockholders' Equity

Cash –5,000 = Accounts Payable –5,000

2. Record:

	<u>Debit</u>	<u>Credit</u>
Accounts Payable (–L)	5,000	
Cash (–A)		5,000

(f) Order Software for App—SonicGateway signs a contract with a programmer for program code for the Static Charge game app for \$9,000. No code has been received yet.

1. Analyze: Assets = Liabilities + Stockholders' Equity

No change = No change

2. Record—No journal entry is needed.

(g) Receive Software—SonicGateway receives the \$9,000 of app game code ordered in (f); pays \$4,000 cash, and promises to pay the remaining \$5,000 next month.

1. Analyze: Assets = Liabilities + Stockholders' Equity

Cash (A) –4,000 + Software (A) +9,000 = Accounts Payable (L) +5,000

2. Record:

	Debit	Credit
Software (+A)	9,000	
Cash (−A)		4,000
Accounts Payable (+L)	5,000	

(h) Receive Supplies—SonicGateway receives supplies costing \$600 on account.

1. Analyze:

Assets = Liabilities + Stockholders' Equity

Supplies (A) +600 = Accounts Payable (L) +600

2. Record:

	Debit	Credit
Supplies (+A)	600	
Accounts Payable (+L)		600

LO 2-4 Prepare a trial balance and a classified balance sheet.

F. Preparing a Trial Balance and a Balance Sheet

1. The trial balance lists the ending balance in every T-account and then computes total debits and total credits; when the column totals are equal, a balance sheet can be prepared.

2. Classified balance sheet—A balance sheet that shows a subtotal for current assets and current liabilities.

a. Current assets—To be used up or converted into cash within 12 months of the balance sheet date.

b. Current liabilities—Debts and obligations that will be paid, settled, or fulfilled within 12 months of the balance sheet date.

c. Noncurrent (or long-term)—Assets and liabilities that do not meet the definition of current.

III. Evaluate the Results

LO 2-5 Interpret the balance sheet using the current ratio and an understanding of related concepts.

A. Assessing the Ability to Pay

1. The classified balance sheet format makes it easy to see whether current assets are sufficient to pay current liabilities.

2. The only problem with this approach is that looking at total dollar amounts can be awkward, especially if we want to compare across several companies.

3. Current Ratio

- a. Current assets divided by current liabilities.
 - b. Used to evaluate the ability to pay liabilities as they come due in the short run.
 - c. Generally speaking, a high ratio suggests good liquidity.
- B. Balance Sheet Concepts and Values
- 1. Some mistakenly believe that the balance sheet reports what a business is actually worth.
 - 2. In fact, net worth is a term that many accountants and analysts use when referring to stockholders' equity.
 - 3. The answer comes from knowing that accounting is based on recording and reporting transactions:
 - a. What is (and is not) recorded?
 - i. Only measurable exchanges are recorded.
 - ii. Items not acquired in an exchange are not listed on the balance sheet.
 - b. What amounts are assigned to recorded items?
 - i. Following the cost principle, assets and liabilities are first recorded at cost, which is their cash equivalent value on the date of the transaction; later, if an asset's value:
 - Increases—The increase is generally not recorded under GAAP
 - Falls—It is generally reported at that lower value.
 - ii. Thus, the amount reported on the balance sheet may not be the asset's current value.
- C. A Review of the Accounting Cycle
- 1. During the accounting period, transactions take place.
 - a. Picture the documented activity.
 - b. Name what's exchanged.
 - c. Analyze the financial effects.
 - d. Record a journal entry.
 - e. Summarize in T-accounts.
 - 2. At the end of accounting period:
 - a. Prepare a trial balance.
 - b. Adjust the accounts.
 - c. Prepare financial statements from the trial balance and distribute to users. (Because the company does not report any operations here, it prepares only the balance sheet.)
 - d. Close the books