BALANCE SHEET

5.1 CHARACTERISTICS OF THE BALANCE SHEET:

A financial statement that summarizes a company's assets, liabilities and shareholders' equity at a specific point in time. These three balance sheet segments give investors an idea as to what the company owns and owes, as well as the amount invested by the shareholders.

The balance sheet must follow the following formula:

Assets = Liabilities + Shareholders' Equity

It's called a balance sheet because the two sides balance out. This makes sense: a company has to pay for all the things it has (assets) by either borrowing money (liabilities) or getting it from shareholders (shareholders' equity).

Each of the three segments of the balance sheet will have many accounts within it that document the value of each. Accounts such as cash, inventory and property are on the asset side of the balance sheet, while on the liability side there are accounts such as accounts payable or long-term debt. The exact accounts on a balance sheet will differ by company and by industry, as there is no one set template that accurately accommodates for the differences between different types of businesses.

The accounting **balance sheet** is one of the major financial statements used by accountants and business owners. (The other major financial statements are the **income statement**, **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, 2012 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.

In **Part 1** we will explain the components of the balance sheet and in **Part 2** we will present a sample balance sheet. We will begin our explanation of the accounting balance sheet with its major components, elements, or major categories:

- **Assets**
- **Liabilities**
- **Owner's (Stockholders') Equity**

Assets

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:

- **Cash**
- **Petty Cash**
- **Temporary Investments**
- **Accounts Receivable**
- **Inventory**
- **Supplies**
- **Prepaid Insurance**
- **Land**
- **Land Improvements**
- **Buildings**
- **Equipment**
- **Goodwill**
- **Bond Issue Costs**

- Etc.

Usually asset accounts will have *debit* balances.
Contra assets are asset accounts with *credit* balances. (A credit balance in an asset account is contrary—or contra—to an asset account's usual debit balance.)
Examples of contra asset accounts include:

- **Allowance for Doubtful Accounts**
- **Accumulated Depreciation-Land Improvements**
- **Accumulated Depreciation-Buildings**
- **Accumulated Depreciation-Equipment**
- **Accumulated Depletion**
- Etc.

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:

- **Current Assets**
- **Investments**
- **Property, Plant, and Equipment**
- **Intangible Assets**
- **Other Assets**

Effect of Cost Principle and Monetary Unit Assumption

The amounts reported in the asset accounts and on the balance sheet reflect actual costs recorded at the time of a transaction. For example, let's say a company acquires 40 acres of land in the year 1950 at a cost of $20,000. Then, in 1990, it pays $400,000 for an adjacent 40-acre parcel. The company's **Land** account will show a balance of $420,000 ($20,000 for the first parcel plus $400,000 for the second parcel.). This account balance of $420,000 will appear on today's balance sheet even though these parcels of land have appreciated to a current market value of $3,000,000.

There are two guidelines that oblige the accountant to report $420,000 on the balance sheet rather than the current market value of $3,000,000: (1) the **cost principle** directs the accountant to report the company's assets at their original historical cost, and (2) the **monetary unit assumption** directs the accountant to presume the U.S. dollar is stable over time—it is not affected by inflation or deflation. In effect, the accountant is assuming that a 1950 dollar, a 1990 dollar, and a 2013 dollar all have the same purchasing power.

The cost principle and monetary unit assumption may also mean that some very valuable resources will not be reported on the balance sheet. A company's team of brilliant scientists will not be listed as an asset on the company's balance sheet, because (a) the company did not purchase the team in a transaction (cost principle) and (b) it's impossible for accountants to know how to put a dollar value on the team (monetary unit assumption).

Coca-Cola's logo, Nike's logo, and the trade names for most consumer products companies are likely to be their most valuable assets. If those names and logos were developed internally, it is reasonable that they will not appear on the company balance sheet. If, however, a company should *purchase* a product name and logo from another company, that cost will appear as an asset on the balance sheet of the acquiring company.

Remember, accounting principles and guidelines place some limitations on what is reported as an asset on the company's balance sheet.

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.

Effect of Matching Principle

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.

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. (For a further discussion on deferred revenues/prepayments see the **Explanation of Adjusting Entries**.)
Examples of liability accounts reported on a company's balance sheet include:

- **Notes Payable**
- **Accounts Payable**
- **Salaries Payable**
- **Wages Payable**
- **Interest Payable**
- **Other Accrued Expenses Payable**
- **Income Taxes Payable**
- **Customer Deposits**
- **Warranty Liability**
- **Lawsuits Payable**
- **Unearned Revenues**
- **Bonds Payable**
- Etc.

Liability accounts will normally have credit balances.

Contra liabilities are liability accounts with debit balances. (A debit balance in a liability account is contrary—or contra—to a liability account's usual credit balance.) Examples of contra liability accounts include:

- **Discount on Notes Payable**
- **Discount on Bonds Payable**
- Etc.

Classifications Of Liabilities On The Balance Sheet

Liability and contra liability accounts are usually classified (put into distinct groupings, categories, or classifications) on the balance sheet. The **liability classifications** and their order of appearance on the balance sheet are:

- **Current Liabilities**
- **Long Term Liabilities**
- Etc.

Commitments

A company's commitments (such as signing a contract to obtain future services or to purchase goods) may be *legally* binding, but they are not considered a liability on the balance sheet until some services or goods have been received. Commitments (if significant in amount) should be disclosed in the notes to the balance sheet.

Form vs. Substance

The leasing of a certain asset may—on the surface—*appear* to be a rental of the asset, but in substance it may involve a binding agreement to purchase the asset and to finance it through monthly payments. Accountants must look past the *form* and focus on the *substance* of the transaction. If, in substance, a lease is an agreement to purchase an asset and to create a note payable, the accounting rules require that the asset and the liability be reported in the accounts and on the balance sheet.

Contingent Liabilities

Three examples of contingent liabilities include warranty of a company's products, the guarantee of another party's loan, and lawsuits filed against a company. Contingent liabilities are potential liabilities. Because they are dependent upon some future event occurring or not occurring, they may or may not become actual liabilities.

To illustrate this, let's assume that a company is sued for $100,000 by a former employee who claims he was wrongfully terminated. Does the company have a liability of $100,000? It depends. If the company was justified in the termination of the employee and has documentation and witnesses to support its action, this might be considered a frivolous lawsuit and there may be no liability. On the other hand, if the company was *not* justified in the termination and it is clear that the company acted improperly, the company will likely have an income statement loss and a balance sheet liability.

The accounting rules for these contingencies are as follows: If the contingent loss is *probable* **and** the *amount of the loss can be estimated*, the company needs to record a liability on its balance sheet and a loss on its income statement. If the contingent loss is *remote*, no liability or loss is recorded and there is no need to include this in the notes to the financial statements. If the contingent loss lies somewhere in between, it should be *disclosed* in the notes to the financial statements.

Current vs. Long-term Liabilities

If a company has a loan payable that requires it to make monthly payments for several years, only the *principal*due in *the next twelve months* should be reported on the balance sheet as a **current liability**. The remaining principal amount should be reported as a **long-term liability**. The interest on the loan that pertains to the future is not recorded on the balance sheet; only unpaid interest up to the date of the balance sheet is reported as a liability.

Notes to the Financial Statements

As the above discussion indicates, the notes to the financial statements can reveal important information that should not be overlooked when reading a company's balance sheet.

> **Owner's Equity**—along with liabilities—can be thought of as a source of the company's assets. Owner's equity is sometimes referred to as the **book value of the company**, because owner's equity is equal to the reported asset amounts *minus* the reported liability amounts. Owner's equity may also be referred to as the **residual** of assets minus liabilities.

"Owner's Equity" are the words used on the balance sheet when the company is a **sole proprietorship**. If the company is a corporation, the words Stockholders' Equity are used instead of Owner's Equity. An example of an owner's equity account is **Mary Smith, Capital** (where Mary Smith is the owner of the sole proprietorship). Examples of stockholders' equity accounts include:

- **Common Stock**
- **Preferred Stock**
- **Paid-in Capital in Excess of Par Value**

- **Paid-in Capital from Treasury Stock**
- **Retained Earnings**
- Etc.

Both owner's equity and stockholders' equity accounts will normally have *credit* balances.

Contra owner's equity accounts are a category of owner equity accounts with *debit* balances. (A debit balance in an owner's equity account is contrary—or contra—to an owner's equity account's usual credit balance.) An example of a contra owner's equity account is **Mary Smith, Drawing** (where Mary Smith is the owner of the sole proprietorship). An example of a contra stockholders' equity account is **Treasury Stock**