

CHAPTER 2

Basic Financial Statements

After studying this chapter, you should be able to:

Learning Objectives

- LO2-1** Explain the nature and general purposes of financial statements.
- LO2-2** Explain certain accounting principles that are important for an understanding of financial statements and how professional judgment by accountants may affect the application of those principles.
- LO2-3** Demonstrate how certain business transactions affect the elements of the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$.
- LO2-4** Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.
- LO2-5** Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.
- LO2-6** Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.
- LO2-7** Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.
- LO2-8** Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.
- LO2-9** Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

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AMAZON

Amazon opened its doors on the World Wide Web in 1995 with the goal of being “the Earth’s most customer-centric company.” Amazon sells both merchandise it has purchased from vendors for resale and merchandise offered by third-party sellers, and it also manufactures and sells electronic devices. Amazon focuses on providing customers with selection, price, and convenience. Amazon began its operations by selling books, but it now sells millions of unique products from a variety of product categories. Although Amazon has been very successful since its inception, it faces intense

competition from both digital and bricks-and-mortar retailers.

Technology-based companies like Amazon must continuously innovate to stay ahead of the competition. Amazon states that it follows four principles: “customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking.”¹ Amazon was willing to forego operating at a profit in its early years to build its brand name and to obtain market share and, as a result, did not report a quarterly profit until 2001.²

(continued)

¹ AMZN-2014.12.31-10K. United States Securities and Exchange Commission, 16 Jan. 2015. <https://www.sec.gov/Archives/edgar/data/1018724/000101872415000006/amzn-20141231x10k.htm>

² Ibid.

Modern-day historians agree that we have moved from the industrial age to the information age. Companies like Amazon, Facebook, Intel, and Google are major players in this transformation of business. Information-age companies rely more heavily on intellectual capital, research and development, and other intangibles that were less important for companies whose focus was heavy manufacturing or, even earlier in our history, primarily agriculture. ■

If you were a person with considerable wealth who wanted to invest in a forward-looking company in today's information age, how would you know whether Amazon or any other company is a wise investment? What information would you seek out to help you decide where to place your investment dollars? A primary source of financial information is a company's financial statements. These statements, which are prepared at least once a year and in many cases more frequently, provide insight into the current financial status of the company and how successful the company has been in meeting its financial goals. In this chapter, you are introduced to the three primary financial statements—the statement of financial position (often referred to as the balance sheet), the income statement, and the statement of cash flows. Combined with information presented in notes and other accompanying presentations, these financial statements provide for investors, creditors, and other interested parties a wealth of useful information. In fact, financial information is what this entire textbook is about, and in this chapter you receive your initial introduction to how financial statements come about and how they may be used to better understand a company.

Introduction to Financial Statements

In Chapter 1, we learned that investors and creditors are particularly interested in cash flows that they expect to receive in the future. Creditors, for example, are interested in the ability of an enterprise, to which they have made loans or sold merchandise on credit, to meet its payment obligations, which may include payment of interest. Similarly, investors are interested in the market value of their stock holdings, as well as dividends that the enterprise will pay to them while they own the stock.

One of the primary ways investors and creditors assess the probability that an enterprise will be able to make future cash payments is to study, analyze, and understand the enterprise's financial statements. As discussed in Chapter 1, a **financial statement** is simply a declaration of what is believed to be true about an enterprise, communicated in terms of a monetary unit, such as the dollar. When accountants prepare financial statements, they are describing in financial terms certain attributes of the enterprise that they believe fairly represent its financial activities.

In this chapter, we introduce three primary financial statements:

- Statement of financial position (often referred to as the balance sheet)
- Income statement
- Statement of cash flows

In introducing these statements, we use the form of business ownership referred to as a *corporation*. The corporation is a unique form of organization that allows many owners to combine their resources into a business enterprise that is larger than would be possible based on the financial resources of a single owner or a small number of owners. While businesses of any size may be organized as corporations, most large businesses are corporations because of their need for a large amount of capital that the corporate form of business organization makes possible. Later in this chapter we introduce two other forms of business organization—the sole proprietorship and the partnership—which are alternatives to the corporate form for some business enterprises.

A Starting Point: Statement of Financial Position

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The names of the three primary financial statements describe the information you find in each. The **statement of financial position**, or **balance sheet**, is a financial statement that describes where the enterprise stands at a specific date. It is sometimes described as a snapshot of the business in financial or dollar terms (that is, what the enterprise looks like at a specific date).

As businesses operate, they engage in transactions that create revenues and incur expenses that are necessary to earn those revenues. An **income statement** is an activity statement that shows the revenues and expenses for a designated period of time. Revenues already have resulted in positive cash flows, or are expected to do so in the near future, as a result of transactions with customers. For example, a company might sell a product for \$100. This revenue transaction results in an immediate positive cash flow into the enterprise if the customer pays cash at the time of the transaction. An expected future cash flow results if it is a credit transaction in which payment is to be received later. Expenses have the opposite effect in that they result in an immediate cash flow *out* of the enterprise (if a cash transaction) or an expected future flow of cash out of the enterprise (if a credit transaction). For example, if a company incurs a certain expense of \$75 and pays it at that time, an immediate cash outflow takes place. If payment is delayed until some future date, the transaction represents an expected future cash outflow. Revenues result in **positive cash flows**—either past, present, or future—while expenses result in **negative cash flows**—either past, present, or future. *Positive* and *negative* indicate the directional impact on cash. The term *net income* (or *net loss*) is simply the difference between all of an enterprise's revenues and expenses for a designated period of time.

The **statement of cash flows** is particularly important in understanding an enterprise for purposes of investment and credit decisions. As its name implies, the statement of cash flows shows the ways cash changed during a designated period—the cash received from revenues and other transactions as well as the cash paid for certain expenses and other acquisitions during the period. While the primary focus of investors and creditors is on cash flows to themselves rather than to the enterprise, information about cash activity of the enterprise is an important signal to investors and creditors about the prospects of future cash flows to them.

LO2-1

LEARNING OBJECTIVE
Explain the nature and general purposes of financial statements.

A Starting Point: Statement of Financial Position

All three financial statements contain important information, but each includes different information. For that reason, it is important to understand all three financial statements and how they relate to each other. The way they relate is sometimes referred to as **articulation**, a term we will discuss further later in this chapter.

A logical starting point for understanding financial statements is the statement of financial position, also called the balance sheet. The purpose of this financial statement is to demonstrate where the company stands, in financial terms, at a specific point in time. As we will see later in this chapter, the other financial statements relate to the statement of financial position and show how important aspects of a company's financial position change over time. Beginning with the statement of financial position also allows us to understand certain basic accounting principles and terminologies that are important for understanding all financial statements.

Every business prepares a balance sheet at the end of the year, and many companies prepare one at the end of each month, week, or even day. It consists of a listing of the assets, the liabilities, and the owners' equity of the business. The date is important, as the financial position of a business may change quickly. Exhibit 2-1 shows the financial position of Vagabond Travel Agency at December 31, 2018.

Let us briefly describe several features of the statement of financial position, using Exhibit 2-1 as an example. First, the heading communicates three things: (1) the name of the business, (2) the name of the financial statement, and (3) the date. The body of the balance sheet consists of three distinct sections: *assets*, *liabilities*, and *owners' equity*.

Notice that cash is listed first among the assets, followed by notes receivable, accounts receivable, supplies, and any other assets that will soon be converted into cash or used up in

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LO2-1

LEARNING OBJECTIVE
Explain the nature and general purposes of financial statements.

EXHIBIT 2-1

Statement of Financial Position

A=L+LOE

A balance sheet shows financial position at a specific date

VAGABOND TRAVEL AGENCY STATEMENT OF FINANCIAL POSITION DECEMBER 31, 2018			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,500	Liabilities:	
Notes Receivable	10,000	Notes Payable	\$ 41,000
Accounts Receivable	60,500	Accounts Payable	36,000
Supplies	2,000	Salaries Payable	<u>3,000</u>
Office Equipment	15,000	Owners' equity:	
Building	90,000	Capital Stock	\$150,000
Land	<u>100,000</u>	Retained Earnings	<u>70,000</u>
Total	<u>\$300,000</u>	Total	<u>\$300,000</u>

business operations. Following these assets are the more permanent assets, such as equipment, buildings, and land.

Moving to the right side of the balance sheet, liabilities are shown before owners' equity. Each major type of liability (such as notes payable, accounts payable, and salaries payable) is listed separately, followed by a figure for total liabilities.

Owners' equity is separated into two parts—capital stock and retained earnings. Capital stock represents the amount that owners originally paid into the company to become owners. It consists of individual shares and each owner has a set number of shares. Notice in this illustration that capital stock totals \$150,000. This means that the assigned value of the shares held by owners, multiplied by the number of shares, equals \$150,000. For example, assuming an assigned value of \$10 per share, there would be 15,000 shares ($\$10 \times 15,000 = \$150,000$). Alternatively, the assigned value might be \$5 per share, in which case there would be 30,000 shares ($\$5 \times 30,000 = \$150,000$). The retained earnings component of owners' equity is the accumulated earnings of previous years that remain within the enterprise. Retained earnings is considered part of the equity of the owners and serves to enhance their investment in the business.

Finally, notice that the amount of total assets (\$300,000) is equal to the total amount of liabilities and owners' equity (also \$300,000). This relationship *always exists*—in fact, the *equality of these totals* is why this financial statement is frequently called a *balance sheet*.

The Concept of the Business Entity Generally accepted accounting principles require that financial statements describe the activities of a specific economic entity. This concept is called the *entity principle*.

A **business entity** is an economic unit that engages in identifiable business activities. For accounting purposes, the business entity is regarded as separate from the personal activities of its owners. For example, Vagabond is a business organization operating as a travel agency. Its owners may have personal bank accounts, homes, cars, and even other businesses. These items are not involved in the operation of the travel agency and do not appear in Vagabond's financial statements.

If the owners were to commingle their personal activities with the transactions of the business, the resulting financial statements would fail to describe clearly the financial activities of the business organization. Distinguishing business from personal activities of the owners may require judgment by the accountant.

ASSETS

Assets are economic resources that are owned by a business and are expected to benefit future operations. In most cases, the benefit to future operations comes in the form of positive future cash flows. The positive future cash flows may come directly as the asset is converted into

cash (collection of a receivable) or indirectly as the asset is used in operating the business to create other assets that result in positive future cash flows (buildings and land used to manufacture a product for sale). Assets may have definite physical characteristics such as buildings, machinery, or an inventory of merchandise. On the other hand, some assets exist not in physical or tangible form, but in the form of valuable legal claims or rights; examples are amounts due from customers, investments in government bonds, and patent rights held by the company.

One of the most basic and at the same time most controversial problems in accounting is determining the correct dollar amount for the various assets of a business. At present, generally accepted accounting principles call for the valuation of some assets in a balance sheet at cost, rather than at their current value. The specific accounting principles supporting cost as the basis for asset valuation are discussed in the sections that follow.

The Cost Principle Assets such as land, buildings, merchandise, and equipment are typical of the many economic resources that are required in producing revenue for the business. The prevailing accounting view is that such assets should be presented in the statement of financial position at their cost. When we say that an asset is shown at its *historical cost*, we mean the original amount the business entity paid to acquire the asset. This amount may be different from what it would cost to purchase the same asset today or the amount that would be received if the asset were sold today.

For example, let us assume that a business buys a tract of land for use as a building site, paying \$100,000 in cash. The amount to be entered in the accounting records for the asset is the cost of \$100,000. If we assume a booming real estate market, a fair estimate of the market value of the land 10 years later might be \$250,000. Although the market price or economic value of the land has risen greatly, the amount shown in the company's accounting records and in its balance sheet would continue unchanged at the cost of \$100,000. This policy of accounting for many assets at their cost is often referred to as the **cost principle** of accounting.

Exceptions to the cost principle are found in some of the most liquid assets (that is, assets that are expected to soon become cash). Amounts receivable from customers are generally included in the balance sheet at their *net realizable value*, which is an amount that approximates the cash that is expected to be received when the receivable is collected. Similarly, certain investments in other enterprises are included in the balance sheet at their current market value if management's plan includes conversion into cash in the near future.

In reading a balance sheet, it is important to keep in mind that the dollar amounts listed for many assets do not indicate the prices at which the assets could be sold or the prices at which they could be replaced. A frequently misunderstood feature of a balance sheet is that it does not show how much the business currently is worth, although it contains valuable information in being able to calculate such a value.

The Going-Concern Assumption Why don't accountants change the recorded amounts of assets to correspond with changing market prices for these properties? One reason is that assets like land and buildings are being used to house the business and were acquired for use and not for resale; in fact, these assets usually could not be sold without disrupting the business. The balance sheet of a business is prepared on the assumption that the business is a continuing enterprise, or a **going concern**. Consequently, the present estimated prices at which assets like land and buildings could be sold are of less importance than if these properties were intended for sale. These are frequently among the largest dollar amounts of a company's assets. Determining that an enterprise is a going concern may require judgment by the accountant.

The Objectivity Principle Another reason for using cost rather than current market values in accounting for many assets is the need for a definite, factual basis for valuation. The cost of land, buildings, and many other assets that have been purchased can be definitely determined. Accountants use the term *objective* to describe asset valuations that are factual and can be verified by independent experts. For example, if land is shown on the balance sheet at cost, a CPA who performed an audit of the business would be able to find objective evidence that the land was actually measured at the cost incurred in acquiring it. On the other

hand, estimated market values for assets such as buildings and specialized machinery are not factual and objective. Market values are constantly changing, and estimates of the prices at which assets could be sold are largely a matter of judgment.



YOUR TURN

You as a Home Owner

First, assume you have owned your home for 10 years and need to report the value of your home to the city assessor for real estate tax assessment purposes. What information would you provide? Second, assume you are planning to sell your home. What type of information would you provide to potential buyers? What ethical issues arise in these two situations that the objectivity principle helps address?

(See our comments in Connect.)

At the time an asset is acquired, the cost and market value are usually the same. With the passage of time, however, the current market value of assets is likely to differ considerably from its historical cost. As you will learn, for some assets we adjust the amount in the balance sheet as the value changes. For other assets, we retain historical cost as the basis of the asset in the balance sheet.

The Stable-Dollar Assumption A limitation of measuring assets at historical cost is that the value of the monetary unit or dollar is not always stable. **Inflation** is a term used to describe the situation where the value of the monetary unit decreases, meaning that it will purchase less than it did previously. **Deflation**, on the other hand, is the opposite situation in which the value of the monetary unit increases, meaning that it will purchase more than it did previously. Typically, countries like the United States have experienced modest inflation rather than deflation. When inflation becomes severe, historical cost amounts for assets lose their relevance as a basis for making business decisions.

Accountants in the United States prepare financial statements under an assumption that the dollar is a stable unit of measurement, as is the gallon, the acre, or the mile. The cost principle and the **stable-dollar assumption** work well in periods of stable prices but are less satisfactory under conditions of rapid inflation. For example, if a company bought land 20 years ago for \$100,000 and purchased a second similar tract of land today for \$500,000, the total cost of land shown by the accounting records would be \$600,000 following the historical cost principle. This treatment ignores the fact that dollars spent 20 years ago had greater purchasing power than today's dollar. Thus the \$600,000 total for the cost of land is a mixture of two "sizes" of dollars with different purchasing power.

After much research into this problem, at one time the FASB required on a trial basis that large corporations annually disclose financial data adjusted for the effects of inflation. At the present time, this disclosure is optional, but inflation-adjusted financial statements are rarely, if ever, provided in publicly available financial reports in the United States.



INTERNATIONAL CASE IN POINT

Many countries experience prolonged and serious inflation. Inflation can undermine the stable-currency assumption. Accounting rules have been designed in some foreign countries to address the impact of inflation on a company's financial position. For example, Mexican corporate law requires Mexican companies to adjust their balance sheets to current purchasing power by using indexes provided by the government. Because inflation is significant, the indexes are used to devalue the Mexican currency (pesos) to provide a more transparent representation of the company's financial condition.

LIABILITIES

Liabilities are financial obligations or debts. They represent negative future cash flows for the enterprise. The person or organization to whom the debt is owed is called a **creditor**.

All businesses have liabilities; even the largest and most successful companies often purchase merchandise, supplies, and services "on account." The liabilities arising from such purchases are called *accounts payable*. Many businesses borrow money to finance expansion or the purchase of high-cost assets and pay for them over time. When obtaining a loan, the borrower usually must sign a formal note payable. A *note payable* is a written promise to repay the amount owed by a particular date and usually calls for the payment of interest as well.

Accounts payable, in contrast to notes payable, involve no written promises and generally do not call for interest payments. In essence, a note payable is a more formal arrangement than an account payable, but they are similar in that both require the company to make payment in the future.

Liabilities are usually listed in the order in which they are expected to be repaid.³ Liabilities that are similar may be combined to avoid unnecessary detail in the financial statement. For example, if a company had several expenses payable at the end of the year (for example, wages, interest, taxes), it might combine these into a single line called *accrued expenses*. The word *accrued* is an accounting term communicating that the payment of certain expenses has been delayed or deferred.

Liabilities represent claims against the borrower's assets. As we shall see, the owners of a business also have claims on the company's assets. But in the eyes of the law, creditors' claims take priority over those of the owners. This means that creditors are entitled to be paid in full, even if such payment would exhaust the assets of the business and leave nothing for its owners.

OWNERS' EQUITY

Owners' equity represents the owners' claims on the assets of the business. Because liabilities or creditors' claims have legal priority over those of the owners, owners' equity is a residual amount. If you are the owner of a business, you are entitled to assets that are left after the claims of creditors have been satisfied in full. Therefore, owners' equity is always equal to total assets minus total liabilities. For example, using the data from the illustrated balance sheet of Vagabond Travel Agency (Exhibit 2-1):

Vagabond has total assets of	\$360,000
And total liabilities of	(96,000)
Therefore, the owners' equity must be	<u>\$264,000</u>

Owners' equity does *not* represent a specific claim to cash or any other particular asset. Rather, it is the owners' overall financial interest in the entire company.

Increases in Owners' Equity The owners' equity in a business comes from two primary sources:

1. *Investments of cash or other assets* by owners.
2. *Earnings* from profitable operation of the business.

Decreases in Owners' Equity Decreases in owners' equity also are caused in two ways:

1. *Payments of cash or transfers of other assets* to owners.
2. *Losses* from unprofitable operation of the business.

Accounting for payments to owners and net losses are addressed in later chapters.

³ Short-term liabilities generally are those due within one year. Long-term liabilities are shown separately in the balance sheet, after the listing of all short-term liabilities. Long-term liabilities are addressed in Chapter 10.

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LO2-3

LEARNING OBJECTIVE

Demonstrate how certain business transactions affect the elements of the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity.}$$

A-1, LOE

The accounting equation**THE ACCOUNTING EQUATION**

A fundamental characteristic of every statement of financial position is that the total for assets always equals the total of liabilities plus owners' equity. This agreement or balance of total assets with the total of liabilities and owners' equity is the reason for calling this financial statement a *balance sheet*. But why do total assets equal the total of liabilities and owners' equity?

The dollar totals on the two sides of the balance sheet are always equal because they represent two views of the same business. The listing of assets shows us what things the business owns; the listing of liabilities and owners' equity tells us who supplied these resources to the business and how much each group supplied. Everything that a business owns has been supplied to it either by creditors or by the owners. Therefore, the total claims of the creditors plus the claims of the owners always equal the total assets of the business.

The equality of the assets on the one hand and the claims of the creditors and the owners on the other hand is expressed in the following **accounting equation**:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Owners' Equity} \\ \$360,000 &= \$96,000 + \$264,000 \end{aligned}$$

The amounts listed in the equation were taken from the balance sheet illustrated in Exhibit 2-1. The balance sheet is simply a detailed statement of this equation. To illustrate this relationship, compare the balance sheet of Vagabond Travel Agency with the given accounting equation.

Every business transaction, no matter how simple or how complex, can be expressed in terms of its effect on the accounting equation. A thorough understanding of the equation and some practice in using it are essential to the student of accounting.

Regardless of whether a business grows or contracts, the equality between the assets and the claims on the assets is always maintained. Any increase in the amount of total assets is necessarily accompanied by an equal increase on the other side of the equation—that is, by an increase in either the liabilities or the owners' equity. Any decrease in total assets is necessarily accompanied by a corresponding decrease in liabilities or owners' equity. The continuing equality of the two sides of the accounting equation can best be illustrated by taking a new business as an example and observing the effects of various transactions.

**THE EFFECTS OF BUSINESS TRANSACTIONS:
AN ILLUSTRATION**

How does a statement of financial position come about? What has occurred in the past for it to exist at any point in time? The statement of financial position is a picture of the results of past business transactions that has been captured by the company's information system and organized into a concise financial description of where the company stands at a point in time. The specific items and dollar amounts are the direct results of the transactions in which the company has engaged. The balance sheets of two separate companies would almost always be different due to the unique nature, timing, and dollar amounts of each company's business transactions.

To illustrate how a balance sheet comes about, and later to show how the income statement and statement of cash flows relate to the balance sheet, we use an example of a small auto repair business, Overnight Auto Service.

The Business Entity Assume that Michael McBryan, an experienced auto mechanic, opens his own automotive repair business, Overnight Auto Service. A distinctive feature of Overnight's operations is that all repair work is done at night. This strategy offers customers the convenience of dropping off their cars in the evening and picking them up the following morning.

Operating at night also enables Overnight to minimize labor costs. Instead of hiring full-time employees, Overnight offers part-time work to mechanics who already have day jobs at major automobile dealerships. This eliminates the need for costly employee training programs and for such payroll fringe benefits as group health insurance and employees' pension plans, benefits usually associated with full-time employment.



Overnight's Accounting Policies McBryan has taken several courses in accounting and maintains Overnight's accounting records himself. He knows that small businesses such as his are not required to prepare formal financial statements, but he prepares them anyway. He believes they will be useful to him in running the business. In addition, if Overnight is successful, McBryan plans to open more locations. He anticipates needing to raise substantial amounts of capital from investors and creditors. He believes that the financial history provided by a series of monthly financial statements will be helpful in obtaining investment capital.

The Company's First Transaction McBryan officially started Overnight on January 20, 2018. On that day, he received a charter from the state to begin a small, closely held corporation whose owners consisted of himself and several family members. Capital stock issued to these investors included 8,000 shares at \$10 per share. McBryan opened a bank account in the name of Overnight Auto Service, into which he deposited the \$80,000 received from the issuance of the capital stock.

This transaction provided Overnight with its first asset—Cash—and also created the initial owners' equity in the business entity. See the balance sheet showing the company's financial position after this initial transaction in Exhibit 2-2.

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 20, 2018**

EXHIBIT 2-2
Balance Sheet, Jan. 20

Assets		Owners' Equity	
Cash	<u>\$80,000</u>	Capital Stock	<u>\$80,000</u>

Beginning balance sheet of a new business

Overnight's next two transactions involved the acquisition of a suitable site for its business operations.

Purchase of an Asset for Cash Representing the business, McBryan negotiated with both the City of Santa Teresa and the Metropolitan Transit Authority (MTA) to purchase an abandoned bus garage. (The MTA owned the garage, but the city owned the land.)

On January 21, Overnight purchased the land from the city for \$52,000 cash. This transaction had two immediate effects on the company's financial position: first, Overnight's cash was reduced by \$52,000; and second, the company acquired a new asset—Land. We show the company's financial position after this transaction in Exhibit 2-3.

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 21, 2018**

EXHIBIT 2-3
Balance Sheet, Jan. 21

Assets		Owners' Equity	
Cash	\$28,000	Capital Stock	\$80,000
Land	<u>52,000</u>		
Total	<u>\$80,000</u>	Total	<u>\$80,000</u>

Balance sheet totals unchanged by purchase of land for cash

Purchase of an Asset and Financing Part of the Cost On January 22, Overnight purchased the old garage building from Metropolitan Transit Authority for \$36,000. Overnight made a cash down payment of \$6,000 and issued a 90-day non-interest-bearing note payable for the \$30,000 balance owed.

As a result of this transaction, Overnight had (1) \$6,000 less cash; (2) a new asset, Building, which cost \$36,000; and (3) a new liability, Notes Payable, in the amount of \$30,000. This transaction is reflected in Exhibit 2-4.

EXHIBIT 2-4

Balance Sheet, Jan. 22

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 22, 2018			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,000	Liabilities:	
Building	36,000	Notes Payable	\$ 30,000
Land	52,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$110,000</u>	Total	<u>\$110,000</u>

A=L+LOE
Totals increased equally by debt incurred in acquiring assets

Once a company has multiple assets and liabilities, the question arises as to the proper order of the items in the statement of financial position. Assets are ordinarily presented in their order of "permanence," starting with cash. Next are other assets that are close to cash (e.g., receivables from customers), followed by more permanent assets like equipment, buildings, and land, which is considered the most permanent asset. Liabilities are usually presented in the order in which they become due. We discuss the subject of "classified balance sheets" later in this text.

Purchase of an Asset on Account On January 23, Overnight purchased tools and automotive repair equipment from Snappy Tools. The purchase price was \$13,800, due within 60 days. After this purchase, Overnight's financial position is depicted in Exhibit 2-5.

EXHIBIT 2-5

Balance Sheet, Jan. 23

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 23, 2018			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,000	Liabilities:	
Tools and Equipment	13,800	Notes Payable	\$ 30,000
Building	36,000	Accounts Payable	13,800
Land	52,000	Total liabilities	\$ 43,800
		Owners' equity:	
		Capital Stock	80,000
Total	<u>\$123,800</u>	Total	<u>\$123,800</u>

A=L+LOE
Totals increased equally by debt incurred in acquiring assets

Sale of an Asset After taking delivery of the new tools and equipment, Overnight found that it had purchased more than it needed. Ace Towing, a neighboring business, offered to buy the excess items. On January 24, Overnight sold some of its new tools to Ace for \$1,800, a price equal to Overnight's cost.⁴ Ace made no down payment but agreed to pay the amount due within 45 days. This transaction reduced Overnight's tools and equipment by \$1,800 and created a new asset, Accounts Receivable, for that same amount. A balance sheet as of January 24 appears in Exhibit 2-6.

Collection of an Account Receivable On January 26, Overnight received \$600 from Ace Towing as partial settlement of its account receivable from Ace. This transaction caused an increase in Overnight's cash but a decrease of the same amount in accounts receivable. This transaction converts one asset into another of equal value; there is no change in the amount of total assets. After this transaction, Overnight's financial position is summarized in Exhibit 2-7.

⁴ Sales of assets at prices above or below cost result in gains or losses. Such transactions are discussed in later chapters.

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 24, 2018**

Assets		Liabilities & Owners' Equity	
Cash	\$ 22,000	Liabilities:	
Accounts Receivable	1,800	Notes Payable	\$ 30,000
Tools and Equipment	12,000	Accounts Payable	13,800
Building	36,000	Total liabilities	\$ 43,800
Land	52,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$123,800</u>	Total	<u>\$123,800</u>

EXHIBIT 2-6
Balance Sheet, Jan. 24

A-1-10E No change in totals by sale of assets at cost

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 26, 2018**

Assets		Liabilities & Owners' Equity	
Cash	\$ 22,600	Liabilities:	
Accounts Receivable	1,200	Notes Payable	\$ 30,000
Tools and Equipment	12,000	Accounts Payable	13,800
Building	36,000	Total liabilities	\$ 43,800
Land	52,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$123,800</u>	Total	<u>\$123,800</u>

EXHIBIT 2-7
Balance Sheet, Jan. 26

A-1-10E Totals unchanged by collection of a receivable

Payment of a Liability On January 27, Overnight made a partial payment of \$6,800 on its account payable to Snappy Tools. This transaction reduced Overnight's cash and accounts payable by the same amount, leaving total assets and the total of liabilities plus owners' equity in balance. Overnight's balance sheet at January 27 appears in Exhibit 2-8.

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 27, 2018**

Assets		Liabilities & Owners' Equity	
Cash	\$ 15,800	Liabilities:	
Accounts Receivable	1,200	Notes Payable	\$ 30,000
Tools and Equipment	12,000	Accounts Payable	7,000
Building	36,000	Total liabilities	\$ 37,000
Land	52,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$117,000</u>	Total	<u>\$117,000</u>

EXHIBIT 2-8
Balance Sheet, Jan. 27

A-1-10E Both totals decreased by paying a liability

Earning of Revenue By the last week in January, McBryan had acquired the assets Overnight needed to start operating, and he began to provide repair services for customers. Rather than recording each individual sale of repair services, he decided to accumulate them and record them at the end of the month. Sales of repair services for the last week of January were \$2,200, all of which was received in cash.

Earning of revenue represents the creation of value by Overnight. It also represents an increase in the financial interest of the owners in the company. As a result, cash is increased by \$2,200 and owners' equity is increased by the same amount. To distinguish owners' equity that is earned from that which was originally invested by the owners, the account Retained Earnings is used in the owners' equity section of the balance sheet. The balance sheet in Exhibit 2-9, as of January 31, reflects the increase in assets (cash) and owners' equity (retained earnings) from the revenue earned and received in cash during the last week of January, but before the payment of expenses (see next section).

EXHIBIT 2-9
Balance Sheet, Jan. 31

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 31, 2018			
Assets		Liabilities & Owners' Equity	
Cash	\$ 18,000	Liabilities:	
Accounts Receivable	1,200	Notes Payable	\$ 30,000
Tools and Equipment	12,000	Accounts Payable	7,000
Building	36,000	Total liabilities	\$ 37,000
Land	52,000	Owners' equity:	
		Capital Stock	\$ 80,000
		Retained Earnings	2,200
Total	<u>\$119,200</u>	Total	<u>\$119,200</u>

A-1-LOE
Revenues increase assets and owners' equity

LO2-4

LEARNING OBJECTIVE
Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.

Payment of Expenses In order to earn the \$2,200 of revenue that we have just recorded, Overnight had to pay some operating expenses, namely utilities and wages. McBryan decided to pay all operating expenses at the end of the month. For January, he owed \$200 for utilities and \$1,200 for wages to his employees, a total of \$1,400, which he paid on January 31. Paying expenses has an opposite effect from revenues on the owners' interest in the company—their investment is reduced. Of course, paying expenses also results in a decrease of cash. The January 31 balance sheet, after the payment of utilities and wages, is presented in Exhibit 2-10.

EXHIBIT 2-10
Balance Sheet, Jan. 31

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 31, 2018			
Assets		Liabilities & Owners' Equity	
Cash	\$ 16,600	Liabilities:	
Accounts Receivable	1,200	Notes Payable	\$ 30,000
Tools and Equipment	12,000	Accounts Payable	7,000
Building	36,000	Total liabilities	\$ 37,000
Land	52,000	Owners' equity:	
		Capital Stock	\$ 80,000
		Retained Earnings	800
Total	<u>\$117,800</u>	Total	<u>\$117,800</u>

A-1-LOE
Expenses reduce assets and owners' equity

Notice that the expenses of \$1,400 (\$200 for utilities and \$1,200 for wages) reduce the amount of retained earnings in the balance sheet. That balance was formerly \$2,200, representing the revenues for the last week of January. It is now \$800, representing the difference between the revenues for the last week of January and the \$1,400 of expenses that Overnight incurred during the same period of time. From this illustration we can see that revenues enhance or increase the financial interest of owners while expenses diminish or reduce the interest of owners. In a corporation, the net effect of this activity is reflected in the balance sheet as retained earnings.