ACC250: Intro to Financial Accounting

# Ch2. The Balance Sheet

Jaeyoon Yu, Ph.D.
Central Michigan University

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# Business Activities

Three different types of business activities:

1. Financing - The raising and repayment of capital.
   - Selling stocks to shareholders
   - Borrowing money from banks
   - Paying dividends to shareholders
2. Investing - The purchase of assets that are not part of the core business.
   - Buying equipment
   - Buying land
   - Buying a new building
3. Operating - The core activities of a business that generate revenue (incl. R & E).
   - Selling products
   - Buying supplies
   - Paying employees' salaries
   - Paying rent for office space

# Business Activities - Classification exercise

- **F I O**: Choose F (Financing), I (Investing), or O (Operating).
- **NI**: O if the activity affects Net Income (through Revenue or Expense), otherwise X.

| **Business Activities** | **F I O** | **NI** |
|---|---|---|
| Two owners of the NoodleCake decided to contribute $5,000 each. | _ | _ |
| NoodleCake received $20,000 cash in exchange for its promise to repay the loan in two years. | _ | _ |
| NoodleCake purchased a logo by paying $300 cash to a designer. | _ | _ |
| NoodleCake bought $9,600 of Equipment on credit. | _ | _ |
| NoodleCake paid $1,000 cash to employees for salaries. | _ | _ |
| NoodleCake received $2,000 cash from customers for products sold. | _ | _ |

# Transactions

## Transactions

Financial activities that involve the exchange of goods, services, or money.

- All transactions affect the basic accounting equation: **A= L + SHE**.
- Two types:
  - **Operating** activities: Affect NI (mainly covered in Ch3).
  - **Financing** and **Investing** activities: Do not affect NI (covered in Ch2).
- **Acitivites but not transactions**:
  - Promising to hire employees
  - Exchange of stocks between shareholders

# A chart of accounts

A company manages its own **chart of accounts** to record transactions.
Examples of common accounts:

| Account | Class | Definition |
|---|---|---|
| Cash | _ | Money available for immediate use, including currency, coins, and balances in checking and savings accounts. |
| Supplies | _ | Items used in the course of business operations that are expected to be consumed within a short period. |
| Equipment | _ | Long-term assets such as machinery, computers, or vehicles used in business operations. |
| Logo and Trademarks | _ | Intangible assets representing the company's brand identity and legally protected symbols or names. |
| Software | _ | Computer programs and applications owned or licensed by the company for business use. |
| Accounts Payable | _ | Amounts the company owes to suppliers for goods or services purchased on credit. |
| Notes Payable | _ | Written promises to pay a specific amount of money at a future date, often with interest. |
| Common Stock | ____ | The basic ownership shares issued to investors, representing ownership in the company. |
| Retained Earnings | ____ | Cumulative net income that has been kept in the company rather than distributed to shareholders as dividends. |

# Duality of Effects

Each transaction has at least two effects on the basic accounting equation:

- **A= L + SHE**

Analyze the effects of the following transactions:

| Business Activities | A | L | SHE |
|---|---|---|---|
| 1. Two owners of the NoodleCake decided to contribute $5,000 each. | + | | + |
| 2. NoodleCake received $20,000 cash in exchange for its promise to repay the loan in two years. | − | − | |
| 3. NoodleCake purchased a logo by paying $300 cash to a designer. | − | | |
| 4. NoodleCake bought $9,600 of Equipment on credit. | − | − | |
| 5. NoodleCake paid $1,000 cash to employees for salaries. | - | | - |
| 6. NoodleCake received $2,000 cash from customers for products sold. | − | | − |

# Debit/Credit Framework: 1. What are Debit and Credit?

**Debit(DR): Left** **Credit (CR): Right**

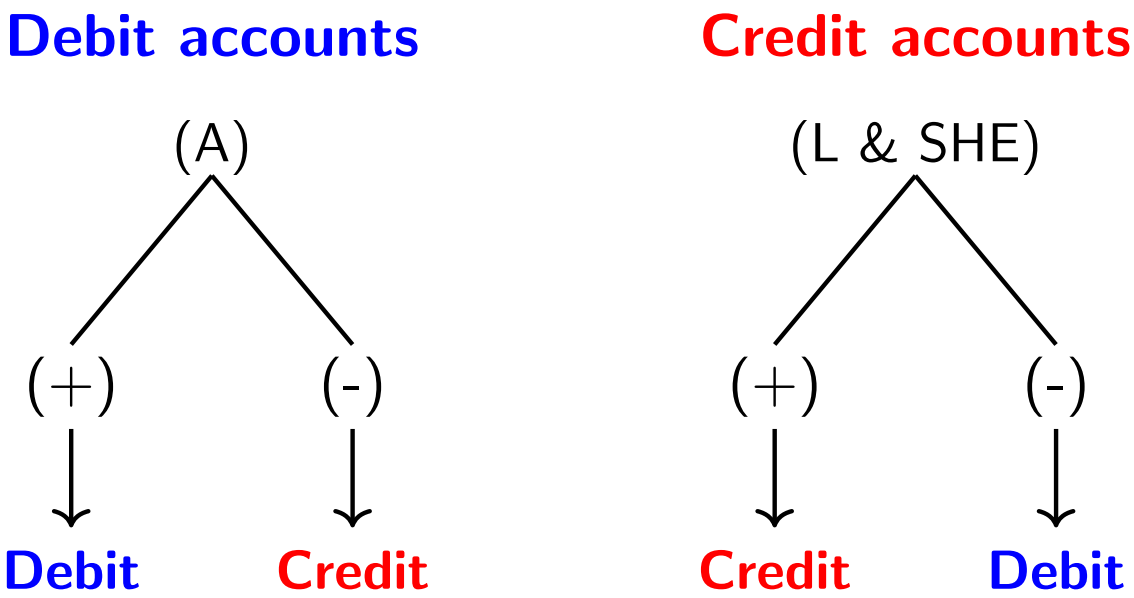
# Debit/Credit Framework: 2. What are Debit and Credit Accounts?

$$A = L + \mathbf{SHE}$$

Those on
the **left-hand** side:
**Debit Accounts**

Those on
the **right-hand** side:
**Credit Accounts**

# Debit/Credit Framework: 3. Where to record?




- When **Debit** accounts increase: **Debit**.
- When **Debit** accounts decrease: **Credit**.
- When **Credit** accounts increase: **Credit**.
- When **Credit** accounts decrease: **Debit**.

# Debit/Credit Framework

| | A | L | SHE |
|---|---|---|---|
| **Debit / Credit account** | **Debit acc.** | **Credit acc.** | **Credit acc.** |
| **Increase** | **D (L)** | **C (R)** | **C (R)** |
| **Decrease** | **C (R)** | **D (L)** | **D (L)** |

# Debit/Credit Framework - Examples

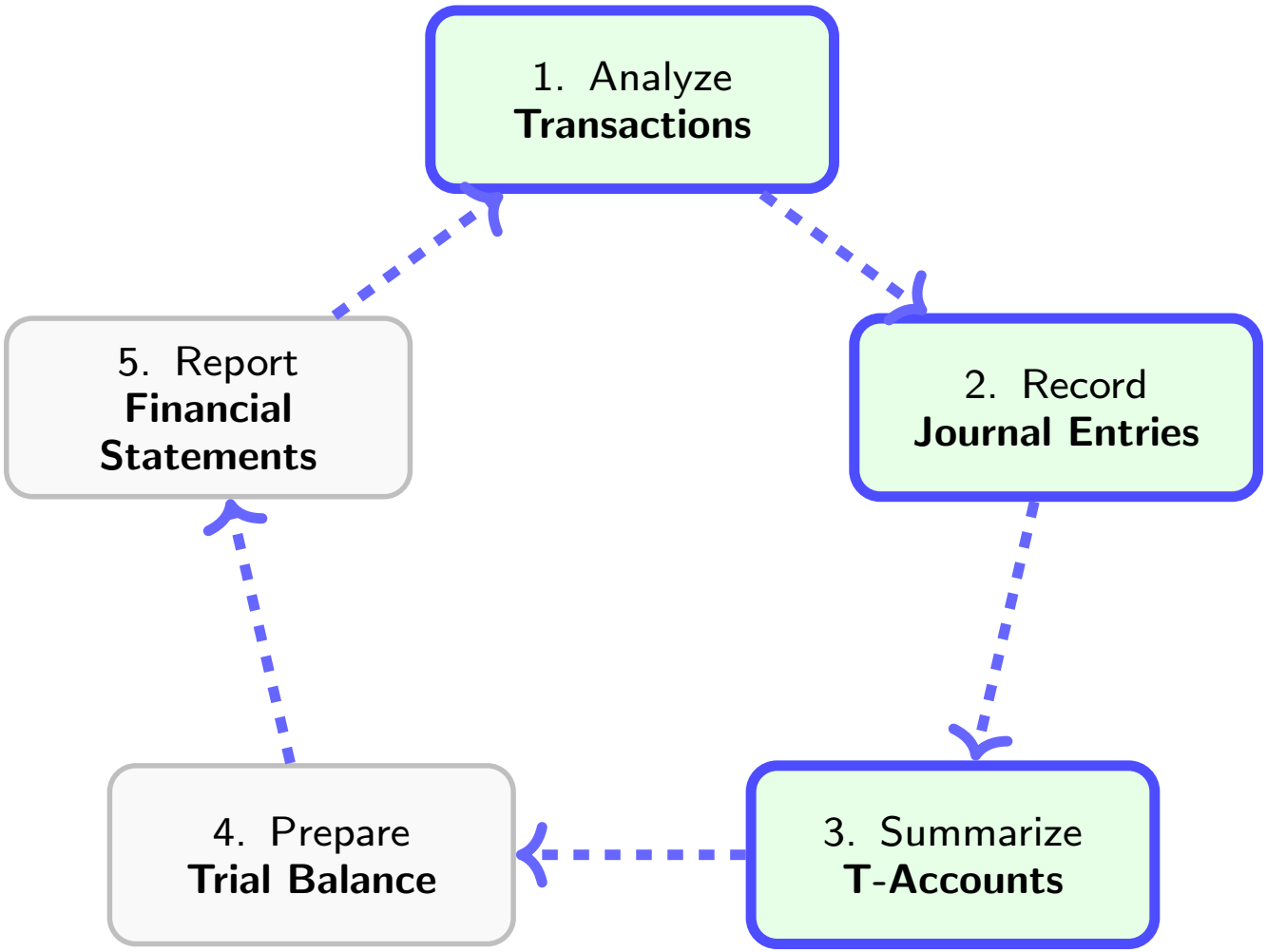
**EX.** Prepare journal entries for the following transactions under the debit/credit framework:

1. Two owners of NoodleCake each contributed $5,000.

2. Noodlecake pays $300 cash to create the company's logo.

# Accounting Cycle

A systematic accounting process is used to capture and report the financial effects of a company's transactions.




*Note: Steps 1–3 are covered in this chapter.*

# Step 1. Analyze Transactions

## Questions for Every Transaction

1. Is it a transaction?
2. Which accounts are affected?
3. How are they affected? (increase or decrease)

**Example:** You bought $500 worth of supplies and paid cash.

- **Transaction?** It affects the **basic accounting equation**, so it's a transaction.
- **What accounts?** Supplies (Asset) and Cash (Asset) are affected.
- **How affected?** Supplies increases, Cash decreases.

| A | = L | + SHE |
|---|---|---|
| | | |
| | | |

# Step 1. Analyze Transactions - Examples

1. Two owners of the NoodleCake decided to contribute $5,000 each.

| A | = L | + SHE |
|---|---|---|
| _____ | | _____ |

2. NoodleCake received $20,000 cash in exchange for its promise to repay the loan in two years.

| A | = L | + SHE |
|---|---|---|
| _____ | _____ | |

3. NoodleCake bought $9,600 of Equipment on credit.

| A | = L | + SHE |
|---|---|---|
| _____ | _____ | |

# Step 2. Record Journal Entries

**EX.** Consider the following transactions. Prepare journal entries for each:

1. Two owners of NoodleCake each contributed $5,000.

2. Noodlecake pays $300 cash to create the company's logo.

3. NoodleCake received $20,000 cash in exchange for a promise to repay the loan in 2 years.

4. Noodlecake purchases and receives $9,600 in equipment (e.g., computers), in exchange for its promise to pay $9,600 at the end of the month.

5. Noodlecake pays $5,000 to the equipment supplier in (d).

6. Noodlecake signs a contract with a programmer for program code for the Enchanted World game app for $9,000. No code has been received yet.

7. Noodlecake 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.

8. Noodlecake receives supplies costing $600 on account.

# Step 3. Summarize T-Accounts

Ledger Accounts, T-Accounts, and General Ledger

- Transactions are posted to (i.e., summarized by) (**Ledger Accounts**).
- A complete list of Ledger Accounts is called **General Ledger**.
- **T-account** is a visual representation of the (Ledger Accounts).
- We use T-accounts in this course.

**Cash**

| | |
|---|---|
| **Beg. 0** | |
| (a) _____ | ___ (b) |
| (c) _____ | _____ (e) |
| | _____ (g) |
| **End.** _____ | |

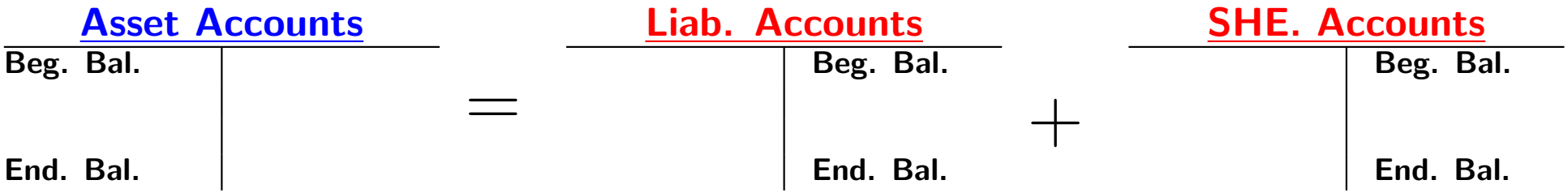
# Step 3. Summarize T-Accounts

Balances of T-accounts

- **Debit** accounts have normally **debit** balances.
- **Credit** accounts have normally **credit** balances.

How to get transactions (in journal entries) posted to T-accounts?

- Get the **beginning balance** of the T-account from the previous period.
- For each account, go through transactions that affect the account.
  - For those with **debit** values, add the **debit** value to the T-account.
  - For those with **credit** values, add the **credit** value to the T-account.
- Get the **ending balance** of the T-account.



# Step 3. Summarize T-Accounts

## ASSETS

### Cash

| | |
|---|---|
| **Beg. 0** | |
| (a) 10,000 | 300 (b) |
| (c) 20,000 | 5,000 (e) |
| | 4,000 (g) |
| **End. 20,700** | |

### Supplies

| | |
|---|---|
| **Beg. 0** | |
| (h) 600 | |
| **End. 600** | |

### Equipment

| | |
|---|---|
| **Beg. 0** | |
| (d) 9,600 | |
| **End. 9,600** | |

### Logo & Trademarks

| | |
|---|---|
| **Beg. 0** | |
| (b) 300 | |
| **End. 300** | |

### Software

| | |
|---|---|
| **Beg. 0** | |
| (g) 9,000 | |
| **End. 9,000** | |

## LIABILITIES

### Accounts Payable

| | |
|---|---|
| | **Beg. 0** |
| (e) 5,000 | 9,600 (d) |
| | 5,000 (g) |
| | 600 (h) |
| | **End. 10,200** |

### Notes Payable

| | |
|---|---|
| | **Beg. 0** |
| | 20,000 (c) |
| | **End. 20,000** |

## SHAREHOLDERS' EQUITY

### Common Stock

| | |
|---|---|
| | **Beg. 0** |
| | 10,000 (a) |
| | **End. 10,000** |

# Step 4. Prepare Trial Balance

- Take all the debits and credits from the T-Accounts
- Put them in the Trial Balance.
- Calculate the total debits and credits.
- Check if the **total debits** equal the **total credits**.
- **If it does not, there is an error in the journal entries.**

| Account Title | Debit ($) | Credit ($) |
|---|---|---|
| Cash | _____ | |
| Supplies | ____ | |
| Equipment | _____ | |
| Logo & Trademarks | ____ | |
| Software | _____ | |
| Accounts Payable | | _____ |
| Notes Payable | | _____ |
| Common Stock | | _____ |
| **Total** | _____ | _____ |

# Step 4. Prepare Trial Balance

- If the total debits do not equal the total credits, there's an error in the journal entries.
- If the total debits equal the total credits, the journal entries are **likely** correct.
- Having the same balances **does not guarantee** the journal entries are correct.

# Classified Balance Sheet

- **Assets** are grouped into **current assets** and **non-current assets**.
  - **Current assets**: those expected to be converted to cash or used up within 1 year (e.g., Cash, Supplies).
  - **Non-current assets**: those expected to provide benefits for more than 1 year (e.g., Equipment, Logo & Trademarks, Software).

- **Liabilities** are grouped into **current liabilities** and **non-current liabilities**.
  - **Current liabilities**: those expected to be paid within 1 year (e.g., Accounts Payable, Notes Payable).
  - **Non-current liabilities**: those expected to be paid more than 1 year from now (e.g., Notes Payable).

# Classified Balance Sheet

NoodleCake Studio, Inc.
Balance Sheet
As of August 31, 20XX

| | |
|---|---|
| **Assets** | |
| Current Assets | |
| Cash | $20,700 |
| Supplies | 600 |
| **Total Current Assets** | $21,300 |
| Equipment | 9,600 |
| Logo & Trademarks | 300 |
| Software | 9,000 |
| **Total Assets** | **$40,200** |
| **Liabilities and Shareholders' Equity** | |
| Current Liabilities | |
| Accounts Payable | $10,200 |
| **Total Current Liabilities** | $10,200 |
| Notes Payable | 20,000 |
| **Total Liabilities** | **$30,200** |
| Stockholders' Equity | |
| Common Stock | $10,000 |
| Retained Earnings | $0 |
| **Total Stockholders' Equity** | **$10,000** |
| **Total Liabilities and Shareholders' Equity** | **$40,200** |

# Current Ratio

## Current Ratio

A measure of a company's ability to pay its short-term obligations.
Calculated as: $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

- *Current Ratio* $> 1$: the company is able to pay its current liabilities.
- *Current Ratio* $< 1$: the company is **not** able to pay its current liabilities.

**EX.** From the previous example:

- Current assets: _____
- Current liabilities: _____
- Current Ratio: _____
- Implications: The company _____ its current liabilities (to suppliers, employees, etc.) using its current assets (e.g., Cash, Accounts Receivable).

# Cost Principle - Assets

## Cost Principle

Assets are initially recorded at their **acquisition cost**, which includes all costs necessary to acquire the asset and prepare it for its intended use.

- Asset values are initially determined by the **cost principle**.
  (i.e., how much the company paid to acquire the assets.)
- **Not** the current market value of the assets.
- Subsequently, the value is adjusted for depreciation and other factors.
  (will be covered later.)

# Cost Principle - Assets

**EX.** Think about this:

- The firm paid \$9,600 to acquire the equipment.
  - Hitorical acquisition cost: \$9,600 (following the **cost principle**).
- To buy the same one today, the firm would need to pay \$10,000.
  - Current market value: \$10,000.
- Historical acquisition cost is **not** the current market value of the asset.
- In B/S, the asset value is the **historical acquisition cost**.