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Module 4 Assets, Liabilities, and Balance Sheet

PAD 501

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Overview

- Required Reading: Chapters 9 and skim 7
  - Read Chapter 9 first, then quickly skim Chapter 7, such as receivables and payables.
- Understand the definitions of these concepts:
  - Generally accepted accounting principles
  - Fundamental equation of accounting
  - Assets and common asset items: cash, receivables, investments, long-term assets, etc.
  - Liabilities and common liability items: account payable, payroll payable, note payable, etc.
- Understand these skills:
  - How to record transactions in balance sheet
  - How to generate basic balance sheet for an organization

The Financial Statements

- Statement of Financial Position (Balance Sheet): a snapshot of the resources (assets), obligations (liabilities), and worth of an organization (net assets) at a specific point in time.
- Activity Statement (Operating or Income Statement): measures the cumulative resource inflows (revenues) and outflows (expenses) for an organization over some specified period of time. It is the reporting equivalent of an operating budget.
- Cash Flow Statement: measures the cumulative cash inflows and outflows for an organization over some specified period of time. It is the reporting equivalent of a cash budget.

Why we need three statements?

- Each statement tells a story of the organization's financial activities.
- The balance sheet shows what the organization owns and owes — its assets and liabilities.
- The activity statement shows how much the organization earned and spent — its revenues and expenses.
- The cash flow statement shows the actual movement of cash in and out of the organization.

- Missing either one of the statements makes the story incomplete.

A note on terminology

- Balance sheet can be called different names, including:
  - Statement of Financial Position
  - Statement of Net Position (used by governments and public organizations)
  - Statement of Assets, Liabilities, and Net Assets (used by nonprofits)
- Activity statement can be called different names, including:
  - Statement of Revenues, Expenses, and Changes in Net Position (for governments)
  - Statement of Activities (for nonprofits)
  - Income Statement or Profit and Loss Statement (for businesses)
- Net assets can be called different names, including
  - Fund Balance (in governmental accounting)
  - Net Position (in public organizations)
  - Owner's Equity or Shareholders' Equity (in businesses)

GAAP

- Generally Accepted Accounting Principles, or GAAP, are the standard rules and guidelines used to prepare financial statements. They ensure that financial information is consistent, comparable, and transparent across different organizations.

- FASB, the Financial Accounting Standards Board, sets GAAP for private and nonprofit organizations.

- GASB, the Governmental Accounting Standards Board, sets GAAP for state and local governments.

General rules with GAAP

- Entity Concept requires that you define the organizational component for which you are trying to account.
- Money Denominator Convention requires that all items included on the financial statements be measurable in dollar terms.
- Objective Evidence (objectivity or reliability principle) and the Cost Convention (cost principle) require that values be based on an objective valuation of resources. When there is a dispute over value, cost is used.

More General rules with GAAP

- Conservatism says that you should anticipate losses but not gains.
- Going Concern Concept assumes that the organization will continue in operation. Bankruptcy values may be lower.
- Materiality says that reporting only needs to contain the level of detail and accuracy necessary for decision making. Financial reports do not need to be exactly accurate.
- Accrual Concept states that revenues are recorded when the organization has earned them and expenses are recorded when resources are used to generate revenues.

Fundamental accounting equation

- Assets (-500) = Liabilities (-400) + Net Assets (-100)

- Assets: what the organization owns. Example: your house worth $300,000
- Liabilities: what the organization owes out entities and must pay back. Example: your house mortgage outstanding debt is $200,000
- Net Assets: what the organization actual have. In the above example, 300,000 – 200, 000 = 100,000 is your net assets. That is, after paying off all your debt, how much you still have.

- Note that the equation can also be written as Net assets = Assets – liabilities

Statement of Financial Position (The Balance Sheet)

- Balance sheet reports
  - What an organization owns (Assets)
  - What it owes to outsiders (Liabilities), and
  - The portion of the organization's assets owned by its owners. Called
    - Owner's Equity, Partners' Equity, Net Worth, or
    - Stockholders' Equity (for-profit organizations)
    - Net Assets or Fund Balance (not-for-profit and governments).
- ...at a specific point in time. For example, at the end of the organization's Fiscal Year.

Assets

- Assets on the balance sheet are divided into
  - Current or short-term (those that are cash or are expected to become cash or will be used up within twelve months) and
  - Long-term (those that will not).

- Short-Term or Current Assets are listed in order of declining liquidity (i.e. how soon the asset can turn into cash) and normally include:
  - Cash: including cash, checking and saving accounts
  - Marketable securities: stocks, bonds that the organization holds (not the stocks or bonds the organization issues)
  - Accounts receivable: the bills that the organization has issued but not collected yet.
  - Inventory: supplies or goods the organization has purchased.
  - Prepaid expenses (long-term prepaid expenses are called Deferred Charges).

PAUSE…

- Think about what are the common asset items.
- Go back to the previous slide if necessary

Long-Term Assets

Long-Term Assets are generally divided into three categories:

- Fixed Assets, which include:
  - Property (land) usually recorded at cost,
  - Plant (buildings) recorded at cost and reported at net book value, and
  - Equipment (including furniture) recorded at cost and reported at net book value.
- Investments: long-term investment
- Intangibles: including goodwill, patents, trademarks, or copyrights.

Pause again

- What are long-term assets?
- Which long-term assets you should consider depreciation?

Liabilities

- Liabilities are categorized as short term and long term depending on when they are due for payment.

- Short-term liabilities generally consist of:
  - Specific “payables” which are typically due within a short period of time
    - wages or salary payable,
    - accounts payable,
    - short-term notes payable—that is, short-term loans, and
    - that portion of long-term debt which is due during the coming year.

Long-Term Liabilities

- Long-Term Liabilities are recorded at the Present Value of the required future payments. They include:

- Long-Term Debt,
  - Capital Leases
  - Long-Term Unsecured Loans
  - Long-Term Notes Payable
  - Mortgages
  - Bonds Payable

- Pension Liabilities

Net Asset Categories

- The net worth of an organization represents the sum of the organization's earnings from inception plus any paid-in capital (in for-profits) less any payments that have been made to the organization's owners.

- In not-for-profit organizations, net worth is called "Net Assets" and is broken down into three categories.
  - Unrestricted Net Assets, which have not been restricted by donors (also cumulative profits appear here).
  - Temporarily Restricted Net Assets, the use of which has been restricted by donors.
  - Permanently Restricted Net Assets, which are restricted in perpetuity.