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BUS 103

# Chapter 16: Balance Sheet and Income Statement

## Background

When we start a business, we will hire an accountant to keep track of our money, how much we have and how much we owe to others. She will separate her records into categories called "accounts." An "account" is a virtual container for a number of dollars for a specific purpose. As the business does business, some accounts increase, while others decrease.

One account may remember much we owe the bank on a loan, another account may remember how much rent we've paid in advance for something (like insurance), and a third account may remember how much we've spent so far this year on office supplies (computer paper, printer ink, paper clips).

## Categories of Accounts

Your accountant will gather the accounts into 5 major categories, according to their function:

1. **Asset** accounts show the original cost to us of the resources we <u>own</u>.
2. **Liability** accounts show how much money we <u>owe</u> to other people.
3. The **Owner's Equity** account shows how much the business is worth to us. This is the amount of money we have invested into our business so far. This is equal to the amount of money we would have left if we closed the business, and sold all its assets to pay off all its liabilities.
4. If our business is <u>not incorporated</u>, this account is simply called **Equity**.
5. If our business <u>is incorporated</u>, Owner's Equity is separated into two accounts:
    a. **Common Stock**, which is the amount of money stockholders have invested in the company by buying shares of stock.
    b. **Retained Earnings**, which is the amount of Net Income that has collect (piled up) over the years since the company began. ("Retained" means "kept within the company, rather than given back to stockholders in the form of Dividends.")
6. **Revenue** accounts show the money our business has earned doing its business, so far this year.
7. **Expense** accounts show the money we have spent so far this year in order to earn Revenue.

## Financial Statements

Once a year (or perhaps at other times), your accountant creates reports for you, to show the status of your business. This chapter covers two such reports:

1. The **Balance Sheet** shows how much money (or debt) is in each of your accounts at an instant in time (usually the last day of the year).
2. The **Income Statement** shows how much Revenue you've earned and Expenses you've "incurred" (paid or must soon pay) during a period of time (usually one year). From these it computes your **Net Income**.

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## The Account Names:

| category | account name | how this account is used |
|---|---|---|
| current **Asset** (will be used within one year) | Cash | Actual cash plus contents of all bank accounts. |
| | Accts. Receivable | How much money other people owe us. "Receivable" means "we will receive in the future." (We learned the idea of "selling on account" in Chapter 7, "Invoice Terms.") |
| | Ending Inventory | The cost of the merchandise we own at the end of the accounting period (usually a year), which we plan to sell in the next period. |
| | Office Supplies | The cost to us of our supplies we will soon use. |
| | Prepaid Insurance | Money we have given to our insurance company for them to use to insure us in the future. |
| | Prepaid Rent | Money we gave to our landlord on deposit ("up front), in advance of when our rent is due. |
| long-term **Asset** (will last longer than one year) | Automobiles (net) | The current value of the automobiles we own. ("Net" means "excluding accumulated depreciation" of Chapter 17.) |
| | Building (net) | The current value of our office building. |
| | Equipment (net) | The current value of the equipment we own, which we use in earning revenue. |
| | Land | The value of the land on which our building sits. |
| current **Liability** (we will pay within one year) | Accounts Payable | How much money we owe to others for purchases we have made. "Payable" means "we will pay in the future." (We learned the idea of "selling on account" in Chapter 7, "Invoice Terms.") |
| | Salaries Payable | How much wages and salaries we owe to our employees. "Payable" means "we will pay in the future." (This account increases every day our employees work, until we pay them on payday.) |
| | Short-Term Note Payable | How much we owe on "promisory notes" (Chapter 11), which we'll pay back within a year. |
| long-term **Liability** (we will pay over years) | Long-Term Mortgage | How much we owe on the mortgage for our building. ("Long-term" because the mortgage will be repaid over several years.) |
| **Equity** | Equity | For a non-corporation, how much the business is worth to the one owner, or to the several partners who jointly own the business. |
| | Common Stock | For a corporation, the amount of money stockholders (owners) have invested in the company by buying shares of stock. |
| | Retained Earnings | For a corporation, the amount of Net Income that we have collected (piled up) over the years since the company began. |
| **Revenue** | Sales Revenue | Money that customers paid our business this year when we sold them our merchandise. |

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| | | |
|---|---|---|
| **Expense** | Administrative Expenses | Miscellaneous expenses of running the business. |
| | Depreciation Expense: Automobile | The amount of value our automobiles have lost this year (through Depreciation, Ch. 17). |
| | Depreciation Expense: Building | The amount of value our office building has lost this year (through Depreciation, Ch. 17). |
| | Depreciation Expense: Equipment | The amount of value our equipment has lost this year (hrough Depreciation, Ch. 17). |
| | Interest Expense | How much we paid this year in interest on promisory notes and mortgages. |
| | Rent Expense | The expense of renting our office so far this year. |
| | Salary Expense | The salaries we've paid employees so far this year. |
| | Selling Expenses | How much we paid this year in acitivities needed to sell our merchandise. |
| | Telephone Expense | How much we paid this year in telephone bills. |
| | Utilities Expense | How much we paid this year on utilities (water, electricity, cable TV) |
| **Other** | Purchases | The cost of our purchases of merchandise, that we intend to sell to customers, to earn our Sales Revenue. |
| | Beginning Inventory | The cost of the merchandise we own at the beginning of the accounting period (usually a year), which we intend to sell. |

(continued on next page)

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## Location of Accounts on the Financial Statements

| category | account name | which financial statement it's on |
|---|---|---|
| current **Asset** | Ending Inventory | Both |
| | Accts. Receivable | Balance Sheet |
| | Cash | |
| | Office Supplies | |
| | Prepaid Insurance | |
| | Prepaid Rent | |
| long-term **Asset** | Automobiles (net) | |
| | Building (net) | |
| | Equipment (net) | |
| | Land | |
| current **Liability** | Accounts Payable | |
| | Salaries Payable | |
| | Short-Term Note Payable | |
| long-term **Liability** | Long-Term Mortgage | |
| **Equity** | Equity | |
| | Common Stock | |
| | Retained Earnings | |
| **Revenue** | Sales Revenue | Income Statement |
| **Expense** | Administrative Expenses | |
| | Depreciation Expense: Automobile | |
| | Depreciation Expense: Building | |
| | Depreciation Expense: Equipment | |
| | Interest Expense | |
| | Rent Expense | |
| | Salary Expense | |
| | Selling Expenses | |
| | Telephone Expense | |
| | Utilities Expense | |
| **Other** | Purchases | |
| | Beginning Inventory | |

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## The Basic Accounting Equation

As we said above, **Assets** are the cash and other resources the business owns, **Liabilities** are how much of those Assets the business owes to other people, and **Owner's Equity** is the amount of money the owner would have left if we used the **Assets** to pay off all the **Liabilities**. Those words mean the same as the following formula:

**Assets = Liabilities + Owner's Equity**

No matter how much individual accounts increase and decrease during the year, or the life of the business, this equation remains true. Whenever one account changes, another account changes such that this equation remains true.

Another way of explaining why this equation is always true is: "If we sell all our Assets, we'll need to pay off all our debts (Liabilities). Then we'll have something left for our back pocket (Equity)." (Daniel Wrentmore, J.D., M.B.A.)

## Example Balance Sheet

Problem 1 (not incorporated)
Balance Sheet
snapshot at Dec. 31, 2008

| | | | | |
|---|---|---|---|---|
| Assets | | | Liabilities | |
| Current Assets | | | Current Liabilities | |
| Cash | $7,000 | | Accounts Payable | $19,000 |
| Accounts Receivable | $5,000 | | Salaries Payable | $13,000 |
| Ending Inventory | $27,000 | | Short Term Note Payable | $3,000 |
| Prepaid Insurance | $9,000 | | Long-Term Liabilities | |
| Prepaid Rent | $3,000 | | Long Term Mortgage | + $291,000 |
| Long-term assets: | | | Total Liabilities | $326,000 |
| Building (net) | $500,000 | | | |
| Land | + $100,000 | | Owners' Equity | |
| | | | Equity | + $325,000 |
| | | | | |
| Total Assets | $651,000 | | Total Liabilities + Equity | $651,000 |
| | | | | |

Single underlines indicate addition of the numbers above it.
A double underline indiates a final result.

The "Total Assets" will always equal the "Total Liabilities + Equity".

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## Example Income Statement

| Problem 1 (not incorporated)<br>Income Statement<br>for the year Jan. 1, 2008 to Dec. 31, 2008 | | |
|---|---|---|
| Sales Revenue | | $286,000 |
| **C**ost **o**f **G**oods **S**old: | | |
| Beginning Inventory (of merchandise) | $21,000 | |
| Add: Purchases (of merchandise) | + $50,000 | |
| **C**ost **o**f **G**oods **A**vailable for **S**ale | $71,000 | |
| Less: Ending Inventory (of merchandise) | - $27,000 | |
| **C**ost **o**f **G**oods **S**old | $44,000 | |
| Gross Profit | | $242,000 |
| | | |
| Less: Expenses | | |
| Depreciation Expense: Building | $25,000 | |
| Interest Expense | $5,000 | |
| Salary Expense | $38,000 | |
| Telephone Expense | $8,000 | |
| Utilities Expense | + $8,000 | |
| Total Expenses | | - $84,000 |
| | | |
| Net Income (=Gross Profit - Total Expenses) | | $158,000 |
| | | |

COGAS = "Cost of Goods Available for Sale"
= "Beginning Inventory" - "Purchases"
COGS = "Cost of Goods Sold" = "COAGS - "Ending Inventory"
"Gross Profit" = "Sales Revenue" - COGS
"Net Income" = "Gross Profit" - "Total Expenses"

The left-hand column is for subtotalling; the right-hand column is for totals.

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