Accounting (Basics) - Lecture 2

ASSETS AND EQUITIES, THEIR STRUCTURE AND DEFINITION, ASSETS AND EQUITIES CLASSES, THEIR MUTUAL RELATIONS. BALANCE SHEET SYSTEM, IMPACT OF ECONOMIC TRANSACTIONS ON THE BALANCE SHEET.

Content

- Assets and equities, structure, definition, classes
- Relations of assets and equities
- Balance sheet system
- Impact of economic transactions on the balance sheet

The balance sheet

Assets **Equities**

Assets	**Equities**
1. Fixed assets - intangible assets - tangible assets - long-term financial assets **2. Current assets** - inventories - long – term receivables - short – term receivables - short – term financial assets	**1. Owner's equity** - common stocks - capital funds - funds created by net profit - economic results **2. Liabilities** - Reserves (provisions) - long – term debts (liabilities) - short - term debts (liabilities) - bank credits (loans)
Σ Assets	**Σ Equities**

Components of the balance sheet

- Assets
  - Fixed assets
  - Current assets

- Equities
  - Owner's equity
  - Liabilities

Fixed assets

- **Intangible assets –** assets of an intangible nature with a term of usage longer than 1 year with a value exceeding a limit chosen by an enterprise in according with so called “common traditions”.
- As the “common traditions” the amount of 60 000 CZK is usually respected.
- But this amount is not obligatory given.
- Assets of an intangible nature with a term of usage longer than 1 year with a value which do not come to a limit chosen by an enterprise are charged as costs immediately in the moment of their acquirement.
- As examples of intangible assets can be mentioned - valuable rights, licenses, software, know – how, goodwill, etc.

Fixed assets

- **Tangible assets** - assets of a tangible nature with a term of usage longer than 1 year with a value exceeding a limit chosen by an enterprise in according with so called “common traditions” and some other assets of the tangible nature (especially buildings and parcels) regardless to their value.
- As the “common traditions” the amount of 40 000 CZK is usually respected in this case.
- Again - from the accounting point of view this amount is not obligatory given.
- But from the tax point of view the amount of 40 000 CZK is obligatory determined by the law of income taxes.
- As examples of tangible assets – buildings, parcels, cars, hardware, equipment, machinery, etc. can be mentioned.

Fixed assets

- **Long-term financial assets** – assets of a financial nature with a term of payment longer than 1 year regardless to their value.
- As examples of long-term assets - long-term investment, capital shares, long-term bills of exchange, etc. can be mentioned.

Fixed assets

- Especially the intangible and tangible assets cannot be consumed during one year.
- Their consumption is usually gradual.
- But as time passes, many fixed assets, such as buildings, computers, cars, software, etc. lose their capacity to provide useful services.
- This decrease in usefulness is a business cost called **depreciation.**

Fixed assets

- The adjusting entry to record depreciation must recognize the cost (expense) as well as the decrease in the fixed assets.
- But in practical charging the value of fixed assets is not reduced directly on asset account.
- In addition, it is common practice to show on the balance sheet both original value of fixed assets and the amount of depreciation accumulated since the acquisition.

Fixed assets

- Accordingly, the acquisition costs of fixed assets are recorded as debits to the appropriate asset accounts, and the decreases in usefulness are recorded as credits to the related **accumulated depreciation accounts.**
- The latter are called **contra accounts** because they are offset against the fixed asset accounts.
- The unexpired or remaining acquisition cost of a fixed asset (net booking value) is the debit balance on asset account minus the credit balance on the related accumulated depreciation account.

Fixed assets

- **The amortized value (net booking value) = Acquisition costs – Accumulated depreciation**
- Not all fixed assets can be depreciated.
- Especially lands and artistic collections are not depreciated in the Czech Republic.
- These fixed assets are recorded on accounts in acquisition costs until the time of their sale or other reason for their removing from accounting evidence (damage, steal, donation, etc.).
- These assets are called non-depreciated assets.

Current assets

- **Inventories** – merchandise (goods) held for sale in the normal course of business and materials in the process of production or held for such use.

Current assets

- **Receivables –** include all money claims against people, organizations, or other debtors.
- Receivables are acquired by a business enterprise in various kinds of transactions, the most common being the sale of merchandise or services on a credit basis.
- The receivables can be divided into 2 parts – **long-term receivables** with term of payment longer than 1 year and **short-term receivables** with term of payment shorter than 1 year.

Current assets

- **Short-term financial assets -** assets of a financial nature with a term of payment shorter than 1 year.
- As an example of short-term financial assets can be mentioned securities held for trade, stamps, deposits on bank accounts, cash, etc.

Owner's equity

- **Common stocks –** is a number of shares (in face values) issued by an enterprise.
- **Capital funds** – the funds created from other resources than a net profit is (grants, gifts, etc.)
- **Funds created from net profit** – the funds created from net profit. The net profit is a profit after taxes.

Owner's equity

- **Economic results (earnings)** – economic results of an enterprise achieved by business activities.
- The economic results can be divided into 2 parts – economic results achieved in previous accounting periods and economic result achieved in present accounting period.

Owner's equity

- The economic result achieved in present accounting period is primarily calculated in the second basic financial statement – The Profit and Loss Statement (International Accounting Standards use the term The Income Statement).

Owner's equity

- Owner's equity is the residual claim of the owner or owners against the assets of the business after the total liabilities are deducted.
- Other commonly used terms for owner's equity are stockholders' equity, shareholders' equity, shareholders' investment, and net worth (or capital in referring to a sole proprietorship or partnership).

Liabilities

- **Reserves (provisions)** – represent the liabilities created due to covering potential business risks (losses).
- Reserves (provisions) are also created due to covering future debts to creditors.
- The creation of reserves (provisions) is charged as a cost (expense), the usage of reserves (provisions) is charged as a revenue or decrease of costs (expenses).

Liabilities

- **Debts** – debts owed by an enterprise to its creditors.
- Money claims against a firm may originate in many ways, such as purchases of merchandise or services on account, purchases of equipment and marketable securities on a credit basis, etc.

Liabilities

- At any particular moment, an enterprise may also owe its employees for wages or salaries accrued, other creditors for interest accrued on notes, governmental agencies for taxes, etc.
- The debts can be divided into two basic groups – current (short-term) debts and long-term debts.

Liabilities

- The current debts are debts that will due within a short time (one year or less) an that should be paid out of current assets.
- The most common debts in this group are so-called notes payable and accounts payable, which are exactly like their receivable counterparts except that the debtor-creditor relationship is reversed.
- Long-term debts will not be due for a comparatively long time (more than one year).

Liabilities

- **Bank credits (loans)**– debts owed by an enterprise to the banks.

- The concrete structure of assets and equities is very important because of impact on business effectiveness.
- The fixed assets are usually worse convertible into cash than current assets.

Liabilities

- The fixed assets burden more the financial sources of the business entity.
- On the other hand some kinds of assets recorded in the balance sheet as current assets can influence the financial sources more than fixed assets in fact (for example unassailable receivables).
- The management of the enterprise should carefully manage the structure of the assets with the objective to assure the profit-making nature as well as the liquid position of the enterprise.

Liabilities

- The same situation is in case of equities.
- The long-term equities (owner's equity, reserves (provisions) and long-term debts) are usually more expensive than current equities (current liabilities).
- On the other hand the current liabilities are more risky because of relatively short term of payment.
- Again here, the management of the business entity must carefully manage the structure of equities with the same objectives as in case of assets.

Transactions and the accounting equation

- All business transactions, from the simplest to the most complex, can be stated in terms of the resulting change in the four basic elements of the accounting equation.
- In all cases, the recording of the effects of transactions on the elements of the accounting equation must be such that the equality of the equation is maintained.

Transactions and the accounting equation

- For example, if a business organizes as a corporation by selling shares of ownership interests, generally referred to as capital stock, for 50,000 CZK, the asset cash will increase by 50,000 CZK and the owner's equity will increase by 50,000 CZK. The effect of this transaction on the accounting equation is as follows:

Transactions and the accounting equation

- **Assets = Liabilities + Owner's Equity**
- **Cash + 50 000 CZK**
  Capital Stock + 50 000 CZK

- **Summary:**
- There are four types of economic transactions in double-entry accounting system according to their impact on assets and equities:

Transactions and the accounting equation

- **Transactions that increase both assets and equities (A+E+).** An example of this transaction can be a purchase of goods paid by bank credit. This type of transaction increases the balance sheet amount.

- **Transactions that decrease both assets and equities (A-E-).** An example of this transaction can be a payment of credit by cash. This type of transaction decreases the balance sheet amount.

Transactions and the accounting equation

- **Transactions that increase some asset item and decrease another asset item (A+A-).** An example of this transaction can be a purchase of goods paid by cash. This type of transaction does not change the balance sheet amount.
- **Transactions that increase some equity item and decrease another equity item (E+E-).** An example of this transaction can be a payment of trade liabilities by bank credit. This type of transaction does not change the balance sheet amount.

Transactions and the accounting equation

- The transactions completed by an enterprise during a specific period may number into the thousands and may cause increases and decreases in many different asset, liability, and owner's equity items.
- To provide timely reports on the effects of these transactions, accountants must record them in a systematic manner.