The Balance Sheet and Financial Disclosures

THE BALANCE SHEET

USEFULNESS
In contrast to the income statement, the balance sheet is a snap shot of the enterprise at a specific point in time. It provides information that is useful in evaluating the capital structure of an enterprise and provides the basis for computing rates of return. Information contained in the balance sheet allows financial statement users to analyze the liquidity, solvency and financial flexibility of an enterprise.

LIMITATIONS
Although the balance sheet provides important information, there are significant limitations in its ability to communicate all of the information needed by financial statement users. These limitations include:

1. **Historical Cost**: Most of the information contained in the balance sheet is recorded at historical cost. Over time this information becomes less useful.
2. **Estimates**: Accountants have to make many estimates in recording transactions. These estimates can prove to be materially incorrect in future periods.
3. **Objectively determined**: In order to record a transaction or event the accountant must be able to objectively determine the item.
4. **Off-balance sheet financing**: Transactions can occur that are not recorded in the balance sheet and may obligate the enterprise in the future.

CLASSIFICATIONS
There are three elements of the balance sheet which relate back to the basic accounting equation discussed in an earlier lesson. The FASB defines these three elements as follows:

1. **Assets**: Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. **Liabilities**: Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
3. **Equity**: Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Assets are presented in the balance sheet in the order of liquidity while liabilities are generally grouped merely as short-term and long-term. In addition, assets are separated into categories based on how they are used in the business. The following is a list of the basic accounts present in the balance sheet and a brief description of what they represent.

1. **Assets**
   - **Current assets**—cash and other assets that will be converted to cash or consumed within one year or the operating cycle whichever is longer.
     - Cash: unrestricted cash and cash equivalents
     - Short-term investments: debt and equity securities that the business entity expects to sell (convert into cash) within one year or the operating cycle whichever is longer.
     - Receivables: net realizable value of trade and non-trade receivables
     - Inventories: raw materials, work in process and finished goods held for resale
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- Prepaid expenses: deferred costs that will be benefit the subsequent accounting period

- **Long-term investments**
  Investments in debt and equity securities, land held for speculation, noncurrent receivables and restricted cash. These are considered nonoperating assets as they are not used to generate current revenues.

- **Property, Plant, and Equipment**
  These are defined as tangible long-lived assets that are used in the operations of the business. These operational assets include land, buildings, equipment, furniture, and possibly natural resources.

- **Intangible Assets**
  These are defined as purchased assets without physical characteristics that contribute to the productivity of the enterprise. Intangibles include patents, copyrights, franchises and goodwill.

- **Other assets**
  These are defined as noncurrent assets that do not fit in any of the above categories.

2. **Liabilities**

- **Current liabilities**, obligations that are expected to be satisfied through the use of current assets or the creation of replacement current liabilities.
  - Payables: including accounts payable and accrued liabilities
  - Notes payable: written agreements that include the payment of interest
  - Unearned revenues: amounts received in advance of the performance of the activities that result in a sale
  - Current maturities of long-term debt: the principal portion that will be paid within one year or the operating cycle, whichever is longer.
  - Other liabilities: obligations that come due within one year or the operating cycle, whichever is longer.
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- **Long-term liabilities**, obligations that will not be satisfied within one year or the operating cycle, whichever is longer.
  - Notes payable: long-term obligations used to finance the enterprise
  - Bonds payable: long-term borrowing through a public sale of bonds
  - Long-term lease obligation: obligations resulting from capitalized lease transactions
  - Mortgages payable: obligations arising from the purchase of property
  - Pension obligations: long-term pension obligations under a defined benefit program
  - Deferred income taxes: tax obligations resulting from book to tax differences
  - Contingencies: obligations that exist for which the enterprise can make an estimate

3. **Stockholders’ Equity**
   - Invested equity
     - Capital stock: reflects the par or stated value of the stock issued by the enterprise
     - Additional paid-in capital: the excess of the selling price of the stock over the par value
   - Earned (and retained) equity
     - Retained earnings: the accumulation of undistributed earnings since the inception of the enterprise