ACCOUNTING PRINCIPLES

and the

BALANCE SHEET

by

Dr. J. Herbert Smith/ACOA Chair
Technology Management and Entrepreneurship
Faculty of Engineering
University of New Brunswick

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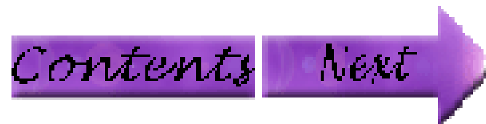

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Summary

LEARNING OBJECTIVES

In this module you will learn:

- the general guidelines, principles, and practices that are used by accountants in the preparation of financial statements.
- the meaning of financial terms that are commonly used in business.
- the structure and content of the financial statement known as the Balance Sheet
- how to analyze and interpret this financial statements and assess the financial performance of a business.

When you have successfully completed this module, you will be able to:

- correctly apply commonly used financial terms
- identify and apply accounting principles/practices as they relate to the Balance Sheet
- correctly interpret the financial results of a company as stated on the Balance Sheet
- identify the typical structure and content of the Balance Sheet

Accounting Principles and the Balance Sheet

Understanding Financial Statements

Accounting is the information system that measures business financial activities, processes that information into reports and communicates the results to decision makers. For this reason, it is called the "language of business".

Accounting provides organized and summarized information about economic activities to decision makers through financial statements.

Financial Statements are the documents that report on a business in monetary amounts. They are a key product of an accounting system, that help make informed business decisions.

Financial statements, the output of the accounting process, are the result of the accountant's ability to analyze, record, quantify, accumulate, summarize, classify, report, and interpret economic events and their financial effect on an organization.

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Audio Transcript

Audio Transcript

Accounting through financial statements performs a score keeping function for a business. It answers questions such as:

- What is the financial picture of the company on any given day? and,
- how well did it do from a financial perspective during a given period?

Accounting Principles/Practices

The guidelines that govern how accountants measure, process and communicate financial information fall under the GAAP, which stands for Generally Accepted Accounting Principles. Accounting principles draw their authority from their acceptance in the business community rather than from their ability to explain physical phenomena. Thus they are really generally accepted by those people and organizations who need guidelines in accounting for their financial undertakings.

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The ten accounting principles that are summarized in this segment of the courseware guide accountants in recording financial transactions and preparing financial statements, but since accountants may vary in their methods and approach, caution must be exercised in the analysis and interpretation of financial statements.

The principles/practices presented in this segment of the course are adopted by professional associations that govern the accounting profession (e.g.. the Canadian Institute of Chartered Accountants,). You may encounter different labels to describe these principles/practices

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The first thing to understand is that although accountants follow certain guidelines, they have considerable latitude in how they prepare financial statements for a particular company. Of course all businesses are different and accounts have to tailor the financial statement to the needs of the business. So it is important to point out that there is not a standard format or approach, there is a general format or approach but accountants do vary in the way they present and record financial transactions within businesses.

Accounting Principles/Practices

1) Dual Aspect Concept

This concept sets up for us the basic accounting equation from which financial statements are derived.

The Accounting Equation states that "total assets = total liabilities and equities"

Assets are what the company owns, Liabilities are what the company owes against those assets. The difference is the so called Equity in the company, or the net worth of the company. You have what you own (your assets), you have what you owe (your liabilities), and the difference is the owners equity or the owners investment in the assets.

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Think about it in terms of a home. Suppose you owned a home worth $100,000, and lets say you put a mortgage on it of $75,000. What you own is an asset called a home for $100,000 and what you owe is a mortgage for $ 75,000, the liability. The net worth or equity in that home is $25,000.

Accounting Principles/Practices

2) Money Measurement Concept

"Financial statements show only transactions that can be expressed in monetary terms"

A new manager might improve employee morale and the improved morale might improve the performance of the business, but unlike the purchase of a new asset for example, the improved morale cannot be accurately expressed in monetary terms and therefore will not be recorded in the financial statements.

The key thing is that accountants only record and measure financial transactions, even though there are many other things that are happening in a company that are important

Accounting Principles/Practices

3) Entity Concept

"Accounts are kept for the business entity as distinguished from the person(s) that own it"

If the owner of the business receives a salary and/or dividends from the business, you will see these transactions on the financial statements of the company. However, if the owner uses the funds received from the company to buy stock in another company, this will not be disclosed because it has no affect on the financial status of the business entity.

Accounting Principles/Practices

4) Going Concern Concept

"Accountants assume that the business will continue indefinitely"

Without this assumption it would not be reasonable to spread (amortize) the cost of an asset over the period of its economic life. If the business is not going to continue all costs would have to be accounted for immediately as soon as they are acquired

Accounting Principles/Practices

5) Cost Concept

"Assets are recorded at the price paid to acquire them"

It is absolutely critical to be constantly aware of this accounting principle. When you look at a balance sheet you are seeing assets valued at their original cost less accumulated depreciation. The "fair market value" of the assets might be significantly higher. For example if you bought land twenty years ago for $20,000 and that land is today worth $300,000, the balance sheet would show $20,000 as the value of that asset.

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If you were to enter into negotiations to buy a company, you should know that you may end up paying more or less than what is recorded as the value of the assets on the balance sheet. You never accept a financial statement at face value, you always have to dig deeper and find out what the true value of the assets is.

Accounting Principles/Practices

6) Realization Concept

"Revenues are recognized when goods and services are delivered and in an amount that is reasonably certain to be realized"

There are two important dimensions to this principle, i.e. when revenue is recognized, and whether it is certain that all revenue will eventually be collected.

If the accountant believes that based on past experience only 90% of revenues will be collected, then the accountant will create an "allowance for doubtful accounts".

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For example, if you were to pay in advance for an airline ticket when you make your reservation, the airline will not claim the revenue until they deliver the service i.e. when you take your trip, even though they have your cash perhaps months before your trip.

Accounting Principles/Practices

7) Matching Concept

"Expenses incurred in earning revenues are matched against the revenues"

Whatever revenues your company earns during a certain period, you match the appropriate expenses that you incurred in earning those revenues during the same period

This principle ensures that the profit contribution of a particular sale is accurately measured. What expenses should be attributed to the products/services sold in this sale?

Accounting Principles/Practices

8) Conservatism Concept

"Accountants are conservative in recording transactions".

This principle has probably contributed most to the stereotypical image of the professional accountant. They always tend to take the pessimistic view in recording transactions because they are obligated to protect the reader of financial statements from concluding that the financial status of a company is brighter than it really is.

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Even though the cost concept requires Accountants to record assets at historical cost to acquire them, if for some reason the "fair market value" were to plunge below the acquisition cost, then the accountant will write down the value of the asset to this new lower "fair market value".

Accounting Principles/Practices

9) Consistency Concept

"For a given type of transaction, the same method is used from one period to another"

Accountants have considerable latitude within "generally accepted accounting practices" in terms of the methods they use to record financial transactions. It is important therefore that they use the same method from one accounting period to another, otherwise the reader of the statements will be looking at "apples and oranges". Accountants can change accounting methods from time to time when there is good justification for a change. However if they do change methods, the change must be highlighted in the financial statements.

Accounting Principles/Practices

10) Materiality Concept

"Accountants disclose non-trivial transactions"

All financial transactions must be recorded but many are too trivial to be highlighted separately. An accountant will disclose any "material" adverse change in a business.

The Balance Sheet - Overview

Balance Sheet - Company ABC **September 17, 2001**	
Assets	**Liabilities and Equity**
Current Assets	Current Liabilities
Long Term Assets	Long term Debt and Equity

The Balance Sheet is a statement of financial position/condition of a company at a point-in-time. It is divided into four quadrants. The left side represents assets, the right side represents liabilites and equity. The upper part represents short term (within a year) assets/liabilities and the bottom part represents long term (beyond one year) assets or debt/equity.

The Balance Sheet - Overview

Balance Sheet - Company ABC September 17, 2001	
Assets	**Liabilities and Equity**
Current Assets	Current Liabilities
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The Balance sheet is a "snapshot" of the company's financial information on a given day, not over a period of time. It might look very different the day after the date indicated on the balance sheet if some significant transactions take place. Always check the balance sheet date first before looking at the numbers.

The Balance Sheet - Current Assets

Balance Sheet Company ABC September 17, 2001	
Assets Current Assests **Cash** **Accounts Receivable** **Inventory** **Prepaid Expenses** **Marketable Securities** Long Term Assets	**Liabilities and Equity** Current Liabilities Long Term Debt & Equity

Current Asset Accounts:
Cash, accounts receivable, inventory, prepaid expenses and marketable securities are typical "accounts" that you will find on many balance sheets in the current asset quadrant.

The labels that accountants use to categorize various kinds of financial transactions in a business are known as "accounts". A listing of all of the accounts used in the financial statements of a business is known as the "chart of accounts".

The Balance Sheet - Overview

Balance Sheet - Company ABC September 17, 2001	
Assets	**Liabilities and Equity**
Current Assets	Current Liabilities
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In the remainder of the module we will examine each quadrant of the balance sheet in greater depth, beginning with the current assets quadrant.

The Balance Sheet - Current Assets

Cash

"Cash is something of value owned by the company and since it is currently in the form of cash it meets the definition of a current asset"

You will not always find "Cash" on a company's balance sheet. Many companies, particularly during the start-up phase of the business have negative cash flow, i.e. they are spending more money than they are collecting from sales and therefore do not have any surplus cash on hand. Many companies do not have any cash "inflow" for a considerable period of time after start-up.

In this scenario the company might be funding its operations with an operating line of credit from a bank until such time it is in a positive cash flow position.

The Balance Sheet - Current Assets

Accounts Receivable

"Amounts owed to the company by customers for goods/services sold on credit"

Many businesses have arrangements with their customers that permit the customer to buy the product or service on credit. A typical scenario would involve delivery of the product/service followed by the issuance of an invoice to the customer. When the invoice is issued, the company sets up an "accounts receivable" from the customer. When the invoice is paid by the customer, the company reduces the amount showing under "accounts receivable" on the balance sheet by the amount paid.

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In some businesses, the customer pays for the product or service at the same time it is delivered. For example, a meal at a restaurant is normally paid for by the customer prior to leaving the restaurant. There are typically no "accounts receivable" in this kind of business.

The Balance Sheet - Current Assets

Inventory

- Raw Material: materials used in production process
- Work-in-Progress: goods/services in production process
- Finished Goods: production completed, goods not yet sold

For example - In manufacturing businesses, inventory is often broken down into these three groupings. If $1,000 of raw materials is taken out of the raw materials inventory and moved into the production process, the raw materials inventory is reduced by $1,000 and the work-in-progress inventory is immediately increased by $1,000. If $500 of production labour is then added during the production process to convert the raw materials to product, work-in-progress increases to $1,500. Ultimately, the production process is completed and the inventory is moved to finished goods. At this stage, work-in-progress is reduced by $1,500 and the finished goods inventory is increased by $1,500. If half of the finished goods were then sold to customers, the finished goods inventory would then be reduced by $750. The sum of the balances in raw materials, work-in-progress and finished goods as of the balance sheet date determines the total inventory balance.

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In service businesses, you might not see inventory on the balance sheet because many services are produced and consumed at the same time. However, a professional services firm (e.g. engineering, accounting, legal services) firm might have work-in-progress inventory, i.e. hours/days of work on a project that have been completed, but not yet invoiced to the client.

The Balance Sheet - Current Assets

Prepaid Expenses

"Expenses paid in advance such as insurance premiums. The unused portion of the insurance policy is something of value owned by the company."

For example - Suppose your company pays $6,000 insurance premiums on October 1 to renew your insurance coverage for one more year.

Your balance sheet on October 1 would show prepaid expenses of $6,000 because the insurance coverage is an asset, something of value owned by the company. It is a current asset because the coverage will be used up in the next twelve months.

Three months later, on January 1, 3/12ths of the value of this asset will have been used up. Therefore the value of the insurance policy will be shown on the balance sheet (under prepaid expenses) at that time as $4,500.

$6,000 less 3/12ths of $6,000 (i.e. $1,500) = $4,500.

The Balance Sheet - Current Assets

Marketable Securities

"Short term investments of the company that will be converted back to cash within one year. Companies with surplus cash invest in these securities to create interest income."

For example - Suppose your company has experienced strong cash flow. Your accountant prepares some cash flow projections that indicate that the outflow of cash for the next three months is going to be much less than the inflow. After allowing a margin for error you conclude that you have $10,000 of surplus cash that will not be needed for the next three months.

Rather than leave the cash in a checking or low interest bearing account, you decide to invest it in short term securities (e.g. government T-bills) that can be converted back to cash three months from now when the cash will be needed for operations. During the three month period your company's balance sheet will show marketable securities of $10,000 as a current asset. The investment in securities is something of value owned by the company that will be converted to cash within twelve months.

The Balance Sheet - Long Term Assets

Balance Sheet Company ABC September 17, 2001	
Assets Current Assests Long Term Assets **Property (Land)** **Plant & Equipment** **Net Fixed Assets** **Long Term Investments** **Goodwill**	**Liabilities and Equity** Current Liabilities Long Term Debt & Equity

The Balance Sheet - Long Term Assets

Property (Land)

"Land holdings of company are recorded on the balance sheet at the acquisition cost. There is no depreciation allowance on property."

The Balance Sheet - Long Term Assets

Plant and Equipment

"Buildings, machinery, vehicles, etc. are recorded at historical cost."

All Long term Assets except Land decline in usefulness as they age. This decline is an expense to the business. Accountants systematically spread the cost of each capital asset, except land, over the years of its useful life. The term used to describe the process of allocating the cost of a long lived asset to expense over its life is depreciation or amortization.

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For each accounting period, a depreciation charge is recorded for each asset using an acceptable depreciation method. Two common methods used to determine depreciation are:

- Straight Line Method,
- Declining Balance Method.

The Balance Sheet - Long Term Assets

Straight Line Method of Depreciation

The straight line method spreads the net cost of an asset (initial investment less estimated future salvage value) evenly over the estimated life of the asset. Instead of expensing all of the cost of the asset at the time it in acquired, it is expensed over its productive life.

Original Cost (C)	$100,000
Estimated Salvage Value (S)	$10,000
Estimated Life (N)	10 years

Depreciation Charge = (C-S)/N =($100,000-$10,000)/10 =$9,000/year

The Balance Sheet - Long Term Assets

Declining Balance Method of Depreciation

In the declining balance method, instead of spreading the cost of an asset evenly over its life, the asset is expensed at a constant rate, resulting in successively declining depreciation charges each period.

Original Cost (C)	$100,000
Depreciation rate	20%

Depreciation Charge	Net Book Value	Year End
Year 1	$20,000	$80,000
Year 2	$16,000	$64,000
Year 3	$12,800	$51,200

The Balance Sheet - Long Term Assets

Net Fixed Assets

"The cumulative original cost of all plant and equipment less the accumulated depreciation charges equals net fixed assets or net book value."

When accountants prepare financial records for the company, they establish a depreciation schedule for every asset that is acquired, at the time it is acquired. Moving forward, the depreciation on each asset is accumulated. The accumulated depreciation is then subtracted from the original cost (cost basis) of the asset to give the "net book value" of the asset as of the balance sheet date. The balance sheet will show an aggregated summary of the original cost, accumulated depreciation and net book value of all the company's assets.

The Balance Sheet - Long Term Assets

Long Term Investments

"Other investments such as securities which mature beyond one year and/or investments in other companies."

If a company buys a minority interest in another company, it would be considered a long term investment. What ever is paid to acquire the shares in that other company would show up on the balance sheet as a long-term investment.

The Balance Sheet - Long Term Assets

Good Will

Recorded as a result of corporate re-structuring and/or acquisition when the fair market value of assets is determined to be greater than the net book value."

The corporate name of an acquired company may represent a significant value in an acquisition. Also, other intangible assets such as the value of patents would be recorded in this quadrant of the balance sheet.

The Balance Sheet - Current Liabilities

<table>
<tr><td colspan="2">Balance Sheet
Company ABC
September 17, 2001</td></tr>
<tr><td><u>Assets</u>

Current Assests

Long Term Assets</td><td><u>Liabilities and Equity</u>

Current Liabilities

Accounts Payable
Bank Indebtedness
Current Portion of Long Term Debt
Accrued Expenses

Long Term Debt & Equity</td></tr>
</table>

The Balance Sheet - Current Liabilities

Accounts Payable

"Amounts owed by company to suppliers for purchases on credit"

Accounts payable are in a sense, the mirror image of accounts receivable. Instead of being owed money by our customers, our company owes money to our suppliers.

The Balance Sheet - Current Liabilities

Bank Indebtedness/Short Term Debt

"Principal outstanding on short term loans/notes due within one year and/or lines of credit."

Whenever debt or loans are recorded on a balance sheet, it is the principal outstanding on the loan, or loans at that particular point in time that is being reflected.

The Balance Sheet - Current Liabilities

Current Portion of Long Term Debt

"Principal due within next year on long term debt"

Any bank debt/loan principal of any kind that the company is going to pay off in the next 12 months has to be shown as a current liability. Long term debt such as mortgages that will be paid off beyond the next 12 months will be recorded elsewhere, but typically, some portion of long term debt is being paid off in the next 12 months, so it has to be reflected as a current liability.

The Balance Sheet - Current Liabilities

Accrued Expenses

"A claim against the company which has not yet been expensed. For example if the company pays its employees in arrears bi-weekly, and the balance sheet date falls in the middle of the pay period, an accrued wage liability will be shown."

There could be other similar liabilities, for example, if you were building something complicated for a customer and you require them to pay a deposit in advance, a down payment in order for you to begin construction of this custom made device. That would be a liability until such time as you complete the project and then charge the full amount for the product. This type of liability is often referred to as "deferred revenue" because you have been paid for a portion of a product or service before you deliver it to the customer.

The Balance Sheet - Long Term Debt and Equity

<table>
<tr><td colspan="2" align="center">Balance Sheet
Company ABC
September 17, 2001</td></tr>
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Current Liabilities

Long Term Debt & Equity

Long Term Debt
Shareholder's Equity</td></tr>
</table>

The Balance Sheet - Long Term Debt and Equity

Long Term Debt

"Principal outstanding on all forms of debt that is being re-paid beyond one year. This would include term debt, mortgages, subordinated debt, bonds etc."

If a company has long term borrowings, with time the amounts due are constantly changing as the debt is being paid down. So on each subsequent balance sheet, that liability gets less and less unless the company borrows again. In this case the new principal would be added to long term debt, less any current portion.

The Balance Sheet - Long Term Debt and Equity

Shareholder's Equity

"Shareholder's equity consists of shareholder loans, share capital and retained earnings."

The Balance Sheet - Long Term Debt and Equity

Shareholder Loans

"Shareholder loans are loans made to the company by a shareholder or shareholders. They are normally considered to be equity because they are subordinated to all debt."

Sometimes owners of a company prefer to place a portion of their investment in their company in the form of a loan to the company rather than putting it all in as share capital. The loan might be interest or non-interest bearing. This approach can make it easier for a shareholder to reduce his or her investment in the company when the company is in a position to re-pay the shareholders loan.

The Balance Sheet - Long Term Debt and Equity

Share Capital

"Share capital is capital raised by selling shares of the company either privately or in public markets. Share capital can consist of preferred shares and/or common shares."

If a company is a private company, that means it is private individuals or maybe just one individual that is providing all of the share capital in return for shares. Perhaps in the future, the company may go public and sell shares in a public stock exchange. In this case members of the public are buying shares in the company as an investment and putting share capital in.

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Preferred shareholders rank ahead of common shareholders in the event of the liquidation of a company and they may enjoy some other advantages, such as preferential treatment with respect ot distribution of dividends. However, unlike common shareholders preferred shareholders typically do not have voting rights.

The Balance Sheet - Long Term Debt and Equity

Retained Earnings

"Retained earnings are profits of the company that have been retained in the business to finance growth as opposed to paid out to shareholders as dividends."

When your company is profitable, each year you have the option of keeping all the profits in the company to help finance further growth of your business or you may say we really have enough capital to grow and think we can declare dividends and provide our shareholders with some return on their investment.

Summary

ACCOUNTING PRINCIPLES and the BALANCE SHEET

The Accounting Principles

Accountants follow certain general guidelines when preparing the financial statements of a company. However, accountants have certain latitude on how they record and present the financial data. Ten accounting principles /practices that are commonly followed are:

1. Dual Aspect Concept
2. Realization Concern
3. Money Measurement Concept
4. Matching Concern
5. Entity Concept
6. Conservatism Concept
7. Going Concern Concept
8. Consistency Concept
9. Cost Concept
10. Materiality Concept

The Balance Sheet

A balance sheet is a snapshot of the company at a given point in time. The date of the balance sheet is always recorded because the balance sheet changes over time. The balance sheet of a company could be given at the fiscal year end, end of the month, or end of the quarter. Most companies produce a balance sheet on a monthly basis for financial reporting purposes. Typically, a balance sheet is divided into four quadrants. Assets (things of value owned by the company) are recorded on the left hand side and liabilities (amounts of money owed by the company to creditors) and equities (what is left over for the owners) on the right hand side. Both sides are further divided into top and bottom. The top is current and the bottom is long term. [In the financial world current is defined as "within the next 12 months" and long term is "beyond 12 months".]

Typical Accounts of the Balance Sheet

Typical Current Assets:

Cash
Accounts Receivable
Inventory
Prepaid Expenses
Marketable Securities

Typical Long Term Assets:

Property
Plant And Equipment
Net Fixed Assets
Long Term Investments
Goodwill

Typical Current Liabilities:

Accounts Payable
Bank Indebtedness
Current Portion Long Term Debt
Accrued Expenses

Typical Long Term Debt and Equity:

Long Term Debt

Shareholder's Equity

- Shareholder loans
- Share capital
- Retained earnings

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Inventory
Prepaid Expenses
Marketable Securities

Typical Long Term Assets:

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Plant And Equipment
Net Fixed Assets
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Accounts Payable
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Current Portion Long Term Debt
Accrued Expenses

Typical Long Term Debt and Equity:

Long Term Debt

Shareholder's Equity

- Shareholder loans
- Share capital
- Retained earnings