TSC | WILLIAM D. LAW, JR. LEARNING COMMONS

# Chapter 2 Study Guide: The Balance Sheet

## 1. Overview of the Balance Sheet

- **Definition**: The **Balance Sheet** is a financial statement that provides a snapshot of a company's financial position at a specific point in time. It lists the company's assets, liabilities, and equity.
- **Purpose**: The balance sheet helps stakeholders understand the company's financial health and how it finances its assets—through debt or equity.
- **Basic Accounting Equation**:
    - **Assets = Liabilities + Equity**
    - This equation must always be in balance, meaning the total value of the company's assets equals the total of liabilities and equity.

## 2. Components of the Balance Sheet

- **Assets**: Economic resources owned by the company, expected to provide future benefits.
    - **Current Assets**: Assets expected to be converted into cash or used up within one year (e.g., cash, accounts receivable, inventory).
    - **Non-current Assets**: Long-term assets that are expected to provide benefits over a period longer than one year (e.g., property, equipment, intangible assets like patents).
- **Liabilities**: Obligations that the company owes to external parties.
    - **Current Liabilities**: Debts or obligations due within one year (e.g., accounts payable, short-term loans).
    - **Non-current Liabilities**: Debts or obligations due after more than one year (e.g., long-term debt, bonds payable).
- **Equity**: The owners' claim on the business after all liabilities have been paid. It is the residual interest in the assets of the entity after deducting liabilities.
    - **Common Stock**: The value of shares issued to investors.
    - **Retained Earnings**: The accumulated net income of the business that has not been distributed to shareholders as dividends.

## 3. The Classification of Assets and Liabilities

- Assets and liabilities are classified into **current** and **non-current** based on their liquidity and maturity.
    - **Current assets** include cash, accounts receivable, and inventory.
    - **Current liabilities** include accounts payable, short-term debt, and wages payable.
    - **Non-current assets** include property, plant, and equipment (PPE), long-term investments, and intangible assets.
    - **Non-current liabilities** include long-term loans, bonds payable, and pension obligations.

## 4. Preparing a Balance Sheet

- **Balance Sheet Format**:
  - **Assets** on the left side or top, divided into current and non-current.
  - **Liabilities and Equity** on the right side or bottom, divided into current liabilities, non-current liabilities, and equity.

  Example format:

  - **Assets**
    - Current Assets
    - Non-Current Assets
  - **Liabilities**
    - Current Liabilities
    - Non-Current Liabilities
  - **Equity**
    - Common Stock
    - Retained Earnings

## 5. Importance of the Balance Sheet in Financial Analysis

- The balance sheet is used to assess a company's:
  - **Liquidity**: Ability to meet short-term obligations.
  - **Solvency**: Ability to meet long-term obligations and sustain operations.
  - **Capital Structure**: The mix of debt and equity financing.

## 6. Key Terms to Know

- **Assets**
- **Liabilities**
- **Equity**
- **Current Assets**
- **Non-current Assets**
- **Current Liabilities**
- **Non-current Liabilities**
- **Retained Earnings**
- **Common Stock**
- **Liquidity**
- **Solvency**
- **Capital Structure**

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## Practice Questions for Chapter 2: The Balance Sheet

# 1. Identifying Components of the Balance Sheet

## Problem 1.1: Classifying Assets and Liabilities

Classify each of the following as a **Current Asset**, **Non-current Asset**, **Current Liability**, or **Non-current Liability**:

- Cash
- Accounts Payable
- Inventory
- Equipment
- Long-term Debt
- Accounts Receivable
- Buildings
- Notes Payable (due in 6 months)
- Patents

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# 2. Basic Balance Sheet Calculation

## Problem 2.1: Preparing a Balance Sheet

XYZ Corporation has the following financial information as of December 31, 2024:

- Cash: $15,000
- Accounts Receivable: $8,000
- Inventory: $5,000
- Equipment: $20,000
- Accounts Payable: $7,000
- Notes Payable (due in 1 year): $5,000
- Long-term Debt: $10,000
- Common Stock: $8,000
- Retained Earnings: $18,000

Prepare a balance sheet for XYZ Corporation.

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# 3. Applying the Accounting Equation

## Problem 3.1: Accounting Equation Balance

On January 1, ABC Inc. had the following balances:

- Assets: $50,000

- Liabilities: $20,000
- Equity: $30,000

During the month, ABC Inc. purchased equipment for $8,000, paying with cash. How do these transactions affect the balance sheet? What is the new balance of assets, liabilities, and equity?

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## 4. Assessing Liquidity

### Problem 4.1: Liquidity Assessment

Given the following balance sheet items:

- Cash: $5,000
- Accounts Receivable: $10,000
- Inventory: $8,000
- Accounts Payable: $4,000
- Notes Payable (due in 3 months): $3,000

Is the company in a strong position to meet its short-term obligations? Calculate the **current ratio** and **quick ratio** to assess liquidity.

- **Current Ratio** = Current Assets / Current Liabilities
- **Quick Ratio** = (Current Assets - Inventory) / Current Liabilities

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## 5. Determining Capital Structure

### Problem 5.1: Capital Structure Analysis

XYZ Corp. has the following balance sheet data:

- Assets: $100,000
- Liabilities: $40,000
- Equity: $60,000

What is the company’s debt-to-equity ratio? Show your calculation and interpret the result.

- **Debt-to-Equity Ratio** = Liabilities / Equity

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## 6. Analyzing Retained Earnings

## Problem 6.1: Changes in Retained Earnings

XYZ Corp. started the year with $50,000 in retained earnings. During the year, it earned $20,000 in net income and paid out $5,000 in dividends. What is the ending balance in retained earnings at the end of the year?

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# 7. Preparing a Classified Balance Sheet

## Problem 7.1: Creating a Classified Balance Sheet

ABC Company has the following data:

- Cash: $12,000
- Inventory: $5,000
- Accounts Payable: $4,000
- Buildings: $25,000
- Equipment: $10,000
- Common Stock: $15,000
- Retained Earnings: $10,000
- Long-term Debt: $20,000

Prepare a classified balance sheet using the information provided.

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# Answers to Practice Questions

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## Problem 1.1: Classifying Assets and Liabilities

- Cash → Current Asset
- Accounts Payable → Current Liability
- Inventory → Current Asset
- Equipment → Non-current Asset
- Long-term Debt → Non-current Liability
- Accounts Receivable → Current Asset
- Buildings → Non-current Asset
- Notes Payable (due in 6 months) → Current Liability
- Patents → Non-current Asset

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## Problem 2.1: Preparing a Balance Sheet

## XYZ Corporation Balance Sheet as of December 31, 2024

- **Assets**
  - Current Assets:
    - Cash: $15,000
    - Accounts Receivable: $8,000
    - Inventory: $5,000

      **Total Current Assets**: $28,000
  - Non-current Assets:
    - Equipment: $20,000

      **Total Non-current Assets**: $20,000
  - **Total Assets**: $48,000
- **Liabilities**
  - Current Liabilities:
    - Accounts Payable: $7,000
    - Notes Payable (due in 1 year): $5,000

      **Total Current Liabilities**: $12,000
  - Non-current Liabilities:
    - Long-term Debt: $10,000

      **Total Non-current Liabilities**: $10,000
  - **Total Liabilities**: $22,000
- **Equity**
  - Common Stock: $8,000
  - Retained Earnings: $18,000
  - **Total Equity**: $26,000
- **Total Liabilities and Equity**: $48,000

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## Problem 3.1: Accounting Equation Balance

- **Assets**: $58,000
- **Liabilities**: $20,000
- **Equity**: $38,000

Explanation: The purchase of equipment for $8,000 decreases cash (an asset), but increases equipment (another asset), so total assets remain the same. No effect on liabilities or equity