FINANCE AT A GLANCE

How transactions affect the balance sheet — Lesson 02

In Lesson 1, we showed the meaning of the equation:

ASSETS = LIABILITIES + SHAREHOLDER's EQUITY

In this lesson, we shall explain how transactions are recorded and how they affect the balance sheet. First let us recall that:

the **Assets** are made of:
- Cash
- Inventories
- Equipment

the **Liabilities** are made up of:
- Credit given by suppliers (which we shall call Accounts Payable)
- Funds borrowed from banks (which we shall call Long-term Debt)

the **Shareholder's Equity** is made up of
- Funds from business owners (which we shall call Capital stock)

For the purpose of illustration, let us assign values to the Company's balance sheet on Day 1 of its operation.

	As of Day 1
ASSETS	
Cash	5,000
Inventories	10,000
Equipment	15,000

Total Assets	30,000
LIABILITIES AND SHAREHOLDERS' EQUITY	
Accounts payable	4,000
Long-term debt	6,000
Capital stock	20,000

Total Liabilities and Shareholders' Equity	30,000

On Day 2, the Company used $1,000 to buy more equipment worth $1,000. The effect on the balance sheet of this transaction is a decrease of $ 1,000 from the Cash (the amount used in the equipment purchase), and an increase in Equipment of $ 1,000 (the value of the equipment purchased). We show these changes as adjustments to the balance sheet as of Day 1 to get the balance sheet as of Day 2.

	As of Day 1	Adjustments	**As of Day 2**
ASSETS			
Cash	5,000	minus 1,000	4,000
Inventories	10,000		10,000
Equipment	15,000	plus 1,000	16,000
	---------------		---------------
Total Assets	30,000		30,000
LIABILITIES AND SHAREHOLDERS' EQUITY			
Accounts payable	4,000		4,000
Long-term debt	6,000		6,000
Capital stock	20,000		20,000
	---------------		---------------
Total Liabilities and Shareholders' Equity	30,000		30,000

We see that as of Day 2, after the equipment purchase using cash, the Total Assets equals the Total Liabilities and Shareholder's Equity.

On Day 3, the Company purchased additional inventories worth $ 500 on credit. The effect of the balance sheet of this transaction is an increase of $500 in Inventories, and an increase of $500 in Accounts payable (the credit given by the suppliers). We show these adjustments on the balance as of Day 2 to get the balance sheet as of Day 3.

	As of Day 2	Adjustments	**As of Day 3**
ASSETS			
Cash	4,000		4,000
Inventories	10,000	plus 500	10,500
Equipment	16,000		16,000
	---------------		---------------
Total Assets	30,000		30,500
LIABILITIES AND SHAREHOLDERS' EQUITY			
Accounts payable	4,000	plus 500	4,500
Long-term debt	6,000		6,000
Capital stock	20,000		20,000
	---------------		---------------
Total Liabilities and Shareholders' Equity	30,000		30,500

We see that as of Day 3, the Total Assets (again) equals the Total Liabilities and Shareholder's Equity.
The examples above show us that although transactions affect the values of certain items in the balance sheet, the fact that

ASSETS = LIABILITIES + SHAREHOLDER's EQUITY

always remains true, as of any given point in time.

In the next issues of FINANCE AT A GLANCE, we shall see how other types of transactions affect the balance sheet.

Info Solutions International