CHAPTER

3

Assets, Liabilities, and Net Worth

OVERVIEW

Assets, liabilities, and net worth are part of the language of finance. As such, it is important to understand both their composition and how they fit together. Short definitions appear below, followed by examples.

Assets

Assets are economic resources that have expected future benefits to the business. In other words, assets are what the organization owns and/or controls.

Liabilities

Liabilities are "outsider claims" consisting of economic obligations, or debts, payable to outsiders. Thus, liabilities are what the organization owes, and the outsiders to whom the debts are due are creditors of the business.

Net Worth

"Insider claims" are also known as owner's equity, or net worth. These are claims held by the owners of the business. An owner has a claim to the entity's assets because he or she has invested in the business. No matter what term is used, the sum of these claims reflects what the business is worth, net of liabilities—thus "net worth."

The Three-Part Equation

An accounting equation reflects a relationship among assets, liabilities, and net worth as follows: assets equal

Progress Notes

After completing this chapter, you should be able to

1. Recognize typical assets.
2. Recognize typical liabilities.
3. Understand net worth terminology.
4. See how assets, liabilities, and net worth fit together.

liabilities plus net worth. The three pieces must always balance among themselves because this is how they fit together. The equation is as follows:

$$\text{Assets} = \text{Liabilities} + \text{Net Worth}$$

WHAT ARE EXAMPLES OF ASSETS?

All of the following are typical business assets.

Examples of Assets

Cash, accounts receivable, notes receivable, and inventory are all assets. If the Great Lakes Home Health Agency (HHA) has cash in its bank account, that is an economic resource—an asset. The HHA is owed money for services rendered; these accounts receivable are also an economic resource—an asset. If certain patients have signed a formal agreement to pay the HHA, then these notes receivable are likewise economic resources—assets. All types of business receivables are assets. The Great Lakes HHA also has an inventory of medical supplies (dressings, syringes, IV tubing, etc.) that are used in its day-to-day operations. This inventory on hand is an economic resource—an asset. Land, buildings, and equipment are also assets. **Exhibit 3–1** summarizes asset examples.

Short-Term Versus Long-Term Assets

Assets are often labeled either "current" or "long-term" assets. Current is another word for "short-term." If an asset can be turned into cash within a 12-month period, it is current, or short term. If, on the other hand, an asset cannot be converted into cash within a 12-month period, it is considered long term. In our Great Lakes HHA example, accounts receivable should be collected within 1 year and thus should be current assets. Likewise, the inventory should be converted to business use within 1 year; thus, it too is considered short term.

Classification of the note receivable depends on the length of time that payment is promised. If the entire note receivable will be paid within 1 year, it is a short-term asset. Consider, however, what would happen if the note is to be paid over 3 years. A portion of the note—that amount to be paid in the coming 12 months—will be classified as short-term, or current, and the rest of the note—that amount to be paid further in the future—will be classified as long-term.

The land, building, and equipment will generally be classified as long-term because these assets will not be converted into cash in the coming 12 months. Buildings and equipment are also generally stated at a net

Exhibit 3–1 Asset Examples

Cash
Accounts receivable
Notes receivable
Inventory
Land
Buildings
Equipment

figure called book value, which reduces their historical cost by any accumulated depreciation. (The concept of depreciation is discussed in Chapter 8.)

WHAT ARE EXAMPLES OF LIABILITIES?

All of the following are typical business liabilities.

Examples of Liabilities

Accounts payable, payroll taxes due, notes payable, and mortgages payable are all liabilities. The Great Lakes HHA owes vendors for medical supplies it has purchased. The amount owed to the vendors is recognized as accounts payable. When the HHA paid its employees, it withheld payroll taxes, as required by the government. The payroll taxes withheld are due to be paid to the government and thus are also a liability. The HHA has borrowed money and signed a formal agreement and thus the amount due is a liability. The HHA also has a mortgage on its building. This mortgage is likewise a liability. In other words, debts are liabilities. **Exhibit 3–2** summarizes liability examples.

Short-Term Versus Long-Term Liabilities

Liabilities are also usually labeled as either "current" (short-term) or "long-term" liabilities. In this case, if a liability is expected to be paid within a 12-month period, it is current, or short-term. If, however, the liability cannot reasonably be expected to be paid within a 12-month period, it is considered long-term. In our Great Lakes HHA example, accounts payable and payroll taxes due should be paid within 1 year and thus should be labeled as current liabilities.

Classification of the note payable depends on the length of time that payment is promised. If the HHA is going to pay the entire note payable within 1 year, it is a short-term liability. But consider what would happen if the note is to be paid over 3 years. A portion of the note—that amount to be paid in the coming 12 months—will be classified as short-term, or current, and the rest of the note—that amount to be paid further in the future—will be classified as long-term. The mortgage will be treated slightly differently. That portion to be paid within the coming 12 months will be classified as a short-term liability, while the remaining mortgage balance will be labeled as long-term.

WHAT ARE THE DIFFERENT FORMS OF NET WORTH?

Net worth—the third part of the accounting equation—is labeled differently, depending on the type of organization. For-profit organizations will have equity accounts with which to report their net worth. (Equity is the ownership right in property or the

Exhibit 3–2 Liability Examples

Accounts payable
Payroll taxes due
Notes payable
Mortgage payable
Bonds payable

money value of property.) For example, a sole proprietorship or a partnership's net worth may simply be labeled as "Owners' Equity." A corporation, on the other hand, will generally report two types of equity accounts: "Capital Stock" and "Retained Earnings." Capital stock represents the owners' investment in the company, indicated by their purchase of stock. Retained earnings, as the name implies, represents undistributed company income that has been left in the business.

Not-for-profit organizations will generally use a different term such as "Fund Balance" to report the difference between assets and liabilities in their report. This is presumably because nonprofits should not, by definition, have equity. Governmental entities in the United States may also use the term "Fund Balance" in their reports. **Exhibit 3–3** summarizes terminology examples for net worth as just discussed.

Exhibit 3–3 Net Worth Terminology Examples

For-profit sole proprietors or partnerships:
Owners' Equity
For-profit corporations:
Capital Stock
Retained Earnings
Not-for-profit (nonprofit) companies:
Fund Balance

INFORMATION CHECKPOINT

What is needed?	A report that shows the balance sheet for your organization.
Where is it found?	Probably with your supervisor.
How is it used?	Study the balance sheet to find the assets and liabilities. Check the equity section to see whether equity is listed as net worth or as fund balance.

KEY TERMS

Assets
Equity
Fund Balance
Liabilities
Net Worth

DISCUSSION QUESTIONS

1. Do you ever work with balance sheets in your current position?
2. If so, is the balance sheet you receive for your department only or for the entire organization? Do you know why this reporting method (departmental versus entire organization) was chosen by management?

3. If you receive a copy of the balance sheet, is one distributed to you once a month, once a year, or on some other more irregular basis? What are you supposed to do with it upon receipt?
4. Do you think the balance sheet report you receive gives you useful information? How do you think it could be improved?