

ALE.1

Assets and Liabilities and Accumulated Depreciation

The income and expense of an operation are reported for a period of time, usually a month, quarter, or year. At the end of the accounting year, income and expenses return to zero. So when you talk about income and expense, or net income, you are never talking about totals over the life of the business, you are always talking about a specific accounting period.

The things a business owns, and the amounts it owes, are different. Those are cumulative over the life of a business. You may own a tractor for many years, and you may owe a loan for many years. These items do not zero out at the end of the year, they are part of the business' financial statements as long as the assets are owned or the debts are owed. They are called assets and liabilities and they are presented on a financial statement called a balance sheet. The balance sheet is the companion to the income statement. Together, the two reports paint a complete picture of your business.

Assets

Assets are used in the business and benefit it. They are usually presented in order of liquidity with cash presented first because it is already liquid, followed by amounts that could be converted to cash in the immediate future and then later by amounts that could be converted into cash, but not quickly, and not without being replaced or limiting the businesses ability to continue.

There are a few different types of assets:

1. Cash;
2. Amounts owed to the business including accounts receivable and notes receivable. Accounts receivable are amounts owed to you for normal business sales. Notes receivable are amounts owned for transactions other than regular sales, such for sales of equipment or loans made to employees.
3. Property used in the business, and expected to benefit the business beyond the current accounting period.
 - a. Supplies, materials, and inventory on hand at the end of the year are property expected to be used or sold in the coming accounting period. They are expensed when used or sold.

- i. Inventory accounting is an advanced and specialized topic.
 - ii. Financial accounting (producing formal financial statements signed by CPAs) requires specific methods for verifying physical amounts and calculating cost per unit.
 - iii. Managerial accounting (keeping track of what is on hand, stages of production, and rates of sale) requires significant internal capacity and detailed procedures.
 - iv. For tax accounting there are special, simplified methods available to businesses with less than 25M in gross receipts. See AT.3 Special Tax Requirements For Inventory On-hand at Year-end
- b. Depreciable Assets are land improvements, buildings, and equipment with an ascertained useful life. They are depreciated over their estimated useful life, or over the IRS allowable life.
 - c. Land has no ascertainable useful life, so it may not be depreciated.
 - d. Intangible assets are things like copyrights, patents, trademarks, mining and mineral rights. Intangible assets are amortized over their legal life or allowable IRS tax life. Amortization is the exact same thing as depreciation, but it is the word used for intangible assets.

Liabilities

Liabilities are amounts owed by the business, if the obligation to pay is certain, and the amount owed is known or can be reasonably estimated. This means that a liability is not shown on the records of a business if it is not a certain legal fact that the sum is owed, or if the amount owed cannot be reasonably estimated.

Liabilities include:

1. Accounts Payable - amounts owed in the ordinary course of business, usually for supplies and services
2. Credit cards payable, sales tax payable, payroll taxes payable
3. Short Term Note Payable and Current Portion of Notes Payable
4. Long Term Note Payable and Long Term Portion of Notes Payable

Liabilities are usually listed in order of when they come due.

Accumulated Depreciation

Assets are always recorded at their historic cost. The market value of an asset may go up or down, but that change is never recorded on the books of the business until the asset is sold.

In accounting, physical assets are expected to decline in value over their estimated life, even though we know they may in fact go up in market value. The accounting estimate of the decrease in value is called depreciation. Depreciation is recorded as an expense each year, until the total amount of depreciation that has been recorded equals the historic cost, or purchase price of the asset. When depreciation is recorded as an expense, the offsetting entry is not to the asset account - because assets are always shown at historic cost. Instead the offsetting entry is to an account called Accumulated Depreciation. When you look at a balance sheet you will see physical assets listed at their historic cost, and immediately below you will see a separate number for Accumulated Depreciation, and that number will be a negative.

The formal rules for assets and liabilities are part of what are called Generally Accepted Accounting Principles, or GAAP. When you are required to have financial statements prepared by a Certified Public Accountant, they are required to use GAAP to verify that the assets and liabilities reported on the balance sheet are presented and valued according to GAAP.

For businesses that are not required to have CPA-prepared financial statements it is common to keep their books on what is called a "modified-GAAP" basis, combining GAAP methods for most accounts with simplified tax methods. The FarmLink Model Chart of Accounts and Bookkeeping Learning Center are designed for you to use modified GAAP when possible, and to be able to easily adjust to full GAAP if needed.