2.2: Define, Explain, and Provide Examples of Current and Noncurrent Assets, Current and Noncurrent Liabilities, Equity, Revenues, and Expenses

In addition to what you’ve already learned about assets and liabilities, and their potential categories, there are a couple of other points to understand about assets. Plus, given the importance of these concepts, it helps to have an additional review of the material.

To help clarify these points, we return to our coffee shop example and now think of the coffee shop’s assets—items the coffee shop owns or controls. Review the list of assets you created for the local coffee shop. Did you happen to notice many of the items on your list have one thing in common: the items will be used over a long period of time? In accounting, we classify assets based on whether or not the asset will be used or consumed within a certain period of time, generally one year. If the asset will be used or consumed in one year or less, we classify the asset as a **current asset**. If the asset will be used or consumed over more than one year, we classify the asset as a **noncurrent asset**.

Another thing you might have recognized when reviewing your list of coffee shop assets is that all of the items were something you could touch or move, each of which is known as a **tangible asset**. However, as you also learned in Describe the Income Statement, Statement of Owner’s Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate, not all assets are tangible. An asset could be an **intangible asset**, meaning the item lacks physical substance—it cannot be touched or moved. Take a moment to think about your favorite type of shoe or a popular type of farm tractor. Would you be able to recognize the maker of that shoe or the tractor by simply seeing the logo? Chances are you would. These are examples of intangible assets, trademarks to be precise. A trademark has value to the organization that created (or purchased) the trademark, and the trademark is something the organization controls—others cannot use the trademark without permission.

Similar to the accounting for assets, liabilities are classified based on the time frame in which the liabilities are expected...
to be settled. A liability that will be settled in one year or less (generally) is classified as a **current liability**, while a liability that is expected to be settled in more than one year is classified as a **noncurrent liability**.

Examples of current assets include **accounts receivable**, which is the outstanding customer debt on a credit sale; **inventory**, which is the value of products to be sold or items to be converted into sellable products; and sometimes a **notes receivable**, which is the value of amounts loaned that will be received in the future with interest, assuming that it will be paid within a year.

Examples of current liabilities include **accounts payable**, which is the value of goods or services purchased that will be paid for at a later date, and **notes payable**, which is the value of amounts borrowed (usually not inventory purchases) that will be paid in the future with interest.

Examples of noncurrent assets include notes receivable (notice notes receivable can be either current or noncurrent), land, buildings, equipment, and vehicles. An example of a noncurrent liability is notes payable (notice notes payable can be either current or noncurrent).

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**Why Does Current versus Noncurrent Matter?**

At this point, let’s take a break and explore why the distinction between current and noncurrent assets and liabilities matters. It is a good question because, on the surface, it does not seem to be important to make such a distinction. After all, assets are things owned or controlled by the organization, and liabilities are amounts owed by the organization; listing those amounts in the financial statements provides valuable information to stakeholders. But we have to dig a little deeper and remind ourselves that stakeholders are using this information to make decisions. Providing the amounts of the assets and liabilities answers the “what” question for stakeholders (that is, it tells stakeholders the value of assets), but it does not answer the “when” question for stakeholders. For example, knowing that an organization has $1,000,000 worth of assets is valuable information, but knowing that $250,000 of those assets are current and will be used or consumed within one year is more valuable to stakeholders. Likewise, it is helpful to know the company owes $750,000 worth of liabilities, but knowing that $125,000 of those liabilities will be paid within one year is even more valuable. In short, the **timing** of events is of particular interest to stakeholders.

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**THINK IT THROUGH**

**Borrowing**

When money is borrowed by an individual or family from a bank or other lending institution, the loan is considered a personal or consumer loan. Typically, payments on these types of loans begin shortly after the funds are borrowed. Student loans are a special type of consumer borrowing that has a different structure for repayment of the debt. If you are not familiar with the special repayment arrangement for student loans, do a brief internet search to find out when student loan payments are expected to begin.

Now, assume a college student has two loans—one for a car and one for a student loan. Assume the person gets the flu, misses a week of work at his campus job, and does not get paid for the absence. Which loan would the person be...
most concerned about paying? Why?

Equity and Legal Structure

Recall that equity can also be referred to as net worth—the value of the organization. The concept of equity does not change depending on the legal structure of the business (sole proprietorship, partnership, and corporation). The terminology does, however, change slightly based on the type of entity. For example, investments by owners are considered “capital” transactions for sole proprietorships and partnerships but are considered “common stock” transactions for corporations. Likewise, distributions to owners are considered “drawing” transactions for sole proprietorships and partnerships but are considered “dividend” transactions for corporations.

As another example, in sole proprietorships and partnerships, the final amount of net income or net loss for the business becomes “Owner(s), Capital.” In a corporation, net income or net loss for the business becomes retained earnings, which is the cumulative, undistributed net income or net loss, less dividends paid for the business since its inception.

The essence of these transactions remains the same: organizations become more valuable when owners make investments in the business and the businesses earn a profit (net income), and organizations become less valuable when owners receive distributions (dividends) from the organization and the businesses incur a loss (net loss). Because accountants are providing information to stakeholders, it is important for accountants to fully understand the specific terminology associated with the various legal structures of organizations.

The Accounting Equation

Recall the simple example of a home loan discussed in Describe the Income Statement, Statement of Owner’s Equity, Balance Sheet, and Statement of Cash Flows, and How They Interrelate. In that example, we assumed a family purchased a home valued at $200,000 and made a down payment of $25,000 while financing the remaining balance with a $175,000 bank loan. This example demonstrates one of the most important concepts in the study of accounting: the accounting equation, which is:

\[
\text{Assets} = \text{Liabilities} + \text{Owner's Equity}
\]

In our example, the accounting equation would look like this:

\[
$200,000 = $175,000 + $25,000
\]

As you continue your accounting studies and you consider the different major types of business entities available (sole proprietorships, partnerships, and corporations), there is another important concept for you to remember. This concept is that no matter which of the entity options that you choose, the accounting process for all of them will be predicated on the accounting equation.

It may be helpful to think of the accounting equation from a “sources and claims” perspective. Under this approach, the assets (items owned by the organization) were obtained by incurring liabilities or were provided by owners. Stated differently, every asset has a claim against it—by creditors and/or owners.
YOUR TURN

The Accounting Equation

On a sheet of paper, use three columns to create your own accounting equation. In the first column, list all of the things you own (assets). In the second column, list any amounts owed (liabilities). In the third column, using the accounting equation, calculate, you guessed it, the net amount of the asset (equity). When finished, total the columns to determine your net worth. Hint: do not forget to subtract the liability from the value of the asset.

Here is something else to consider: is it possible to have negative equity? It sure is . . . ask any college student who has taken out loans. At first glance there is no asset directly associated with the amount of the loan. But is that, in fact, the case? You might ask yourself why make an investment in a college education—what is the benefit (asset) to going to college? The answer lies in the difference in lifetime earnings with a college degree versus without a college degree. This is influenced by many things, including the supply and demand of jobs and employees. It is also influenced by the earnings for the type of college degree pursued. (Where do you think accounting ranks?)

Solution

Answers will vary but may include vehicles, clothing, electronics (include cell phones and computer/gaming systems, and sports equipment). They may also include money owed on these assets, most likely vehicles and perhaps cell phones. In the case of a student loan, there may be a liability with no corresponding asset (yet). Responses should be able to evaluate the benefit of investing in college is the wage differential between earnings with and without a college degree.

Expanding the Accounting Equation

Let’s continue our exploration of the accounting equation, focusing on the equity component, in particular. Recall that we defined equity as the net worth of an organization. It is helpful to also think of net worth as the value of the organization. Recall, too, that revenues (inflows as a result of providing goods and services) increase the value of the organization. So, every dollar of revenue an organization generates increases the overall value of the organization.

Likewise, expenses (outflows as a result of generating revenue) decrease the value of the organization. So, each dollar of expenses an organization incurs decreases the overall value of the organization. The same approach can be taken with the other elements of the financial statements:

- Gains increase the value (equity) of the organization.
- Losses decrease the value (equity) of the organization.
- Investments by owners increase the value (equity) of the organization.
- Distributions to owners decrease the value (equity) of the organization.
- Changes in assets and liabilities can either increase or decrease the value (equity) of the organization depending on the net result of the transaction.

A graphical representation of this concept is shown in Figure 2.4.
Figure 2.4 Graphical Representation of the Accounting Equation. Both assets and liabilities are categorized as current and noncurrent. Also highlighted are the various activities that affect the equity (or net worth) of the business. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

The format of this illustration is also intended to introduce you to a concept you will learn more about in your study of accounting. Notice each account subcategory (Current Assets and Noncurrent Assets, for example) has an “increase” side and a “decrease” side. These are called T-accounts and will be used to analyze transactions, which is the beginning of the accounting process. See Analyzing and Recording Transactions for a more comprehensive discussion of analyzing transactions and T-Accounts.

Not All Transactions Affect Equity

As you continue to develop your understanding of accounting, you will encounter many types of transactions involving different elements of the financial statements. The previous examples highlighted elements that change the equity of an organization. Not all transactions, however, ultimately impact equity. For example, the following do not impact the equity or net worth of the organization: 10

- Exchanges of assets for assets
- Exchanges of liabilities for liabilities
- Acquisitions of assets by incurring liabilities
- Settlements of liabilities by transferring assets

It is important to understand the inseparable connection between the elements of the financial statements and the possible impact on organizational equity (value). We explore this connection in greater detail as we return to the financial statements.

Footnotes

- 10 SFAC No. 6, p. 20.