

PART FOUR

FINANCING ASSETS

Note: This Overview, while written for the beginning student, will prove more valuable with a second reading upon the completion of Part IV.

Assets may be financed with either debt or equity (ownership) capital. Types of **debt financing** include Current Liabilities and Long-Term Liabilities. Types of **equity financing** include sole proprietorships, partnerships, and corporations. Together, the amount of debt and equity financing will determine the amount of assets available to operate a business.

CURRENT LIABILITIES

Liabilities are legal obligations which require the future payment of assets or services and are categorized as either Current or Long-Term. Current Liabilities are those due within a year or within the operating cycle, whichever is longer. Liabilities must be recorded when incurred. Whenever a future event will result in a probable liability which is measurable, a **contingent liability** must be recorded, (example, Coupon and Warranty Liability) otherwise a footnote disclosure is

appropriate. Examples of Current Liabilities include the current portion of notes payable, accounts payable, taxes payable, salaries payable, interest payable, and unearned revenue. Creditors like to see substantial **working capital** (Current Assets minus Current Liabilities) as signified by a high **current ratio** (Current Assets divided by Current Liabilities). While what constitutes an acceptable current ratio varies from industry to industry, 2:1 is often given as the norm.

LONG-TERM LIABILITIES

Long-term liabilities consist of notes payable and bonds payable. **Notes payable** are more formal than accounts payable in that a legal document is signed stating the interest rate, payment dates, and required collateral.

Bonds are debt securities sold in denominations of \$1,000 or more, paying a specific interest rate for a specific time period. Both will be explored in Part VI of **Quick Notes**.

PARTNERSHIPS

A partnership is a voluntary association between two or more individuals. It exists to operate a profitable business. As **mutual agents**, partners are responsible for each other's partnership business activities. All except limited partners have **unlimited liability** for partnership debts. This means their personal assets can

be used to pay partnership debts. Partnerships have a **limited life** and are dissolved upon the withdrawal, bankruptcy, incapacity, retirement, or death of an existing partner. A new partnership may then be formed.

CORPORATIONS

A corporation is a legal entity in the eyes of the law. State approval of the Articles of Incorporation, which defines the rights and duties of stockholders, members of the board of directors, and management, is required to operate a corporation. Key advantages include **limited liability** (stockholder losses are generally

limited to their investment), ease of capital accumulation, ease of ownership transferability, no mutual agency, and a long life. Disadvantages include strong government regulation, double taxation, as both income and dividends are taxed, and separation of ownership and management.

A corporation raises capital by selling ownership shares called stocks to investors. Stocks almost always sell at a price above the amount listed on the certificate which is called either par or stated value. Any excess received is called Paid in Capital in Excess of Par (Stated Value). The total received is called Contributed Capital. Common Stocks, which carry a voting right

and receive dividends only after other stockholders have received dividends, represent the primary ownership in a corporation. Preferred stockholders do not have a voting right, are preferred in reference to dividends, and are in actuality similar in nature to corporate bondholders (owners of fixed long-term obligations of the corporation.)

Income generated by a corporation is either paid out in dividends or stored for future allocation in an account called Retained Earnings. This account is also charged

for prior period adjustments, the reissue of treasury stock below cost, and for appropriations related to specific future needs.