

CLASSIFIED BALANCE SHEET, RATIO ANALYSIS AND ACCOUNTING PRINCIPLES

Key Terms and Concepts to Know

Accounting Principles:

- GAAP: Generally Accepted Accounting Principles
- Assumptions in Financial Reporting: Monetary Unit, Business or Economic Entity, Periodicity, Going Concern
- Principles in Financial Reporting: Historical Cost, Full Disclosure, Fair Value
- Other accounting principles: Revenue Recognition, Expense Recognition, Objectivity

Classified Balance Sheet:

- A classified balance sheet replaces the simple listing of all the accounts that comprise a balance sheet with a listing of these accounts that have been grouped or classified into subcategories based on similar characteristics.
- The groupings make the balance sheet more readable and useful information can be extracted more readily than would be the case if an overwhelming number of line items were presented.

Key Topics to Know

Accounting Standards, Assumptions and Principles

- Standards
 - Authoritative accounting standards are known as Generally Accepted Accounting Principles – GAAP
 - GAAP is overseen by the Securities and Exchange Commission – SEC
 - The Financial Accounting Standards Board – FASB is the primary standard setter in the US
 - The International Accounting Standards Board – IASB issues standards called IFRS which have been adopted in many countries
- Financial statements must be useful to investors and must have two qualities: relevance [to business decision-making] and faithful representation [of business activities]
 - Relevance means that the information will help to predict future results or will confirm or correct prior expectations of results. Relevant information is, by definition, material, meaning that it is likely to influence a financial decision.
 - Faithful representation means that financial information must be complete, neutral or unbiased and free from error
- Financial information must have these additional qualities:
 - Comparability – different companies using the same accounting principles
 - Consistency – a company using the same accounting principles and methods from year to year
 - Verifiability – independent parties using the same accounting principles and methods will achieve the same results
 - Timeliness – financial information must be available to decision-makers before it loses the ability to influence financial decisions
 - Understandability – presented in a clear, concise manner
- Assumptions underlying accounting standards are:
 - Monetary Unit – only those things that can be expressed in monetary units are included in the financial statements
 - Business (Economic) Entity - only the transactions of the business entity are included in the financial statements
 - Periodicity – the life of the business will be divided into arbitrary segments such as fiscal years to facilitate financial reporting
 - Going Concern – the business will continue to operate in a consistent manner for the foreseeable future

- Principles in Financial reporting are:
 - Historic cost – assets are recorded at their acquisition cost at time of purchase and during the time the asset is owned
 - Fair Value – assets and liabilities that are actively traded should be recorded at the price to sell the asset or settle the liability
 - Full Disclosure – businesses are required to disclose all material events and circumstances; that is, all that would or could influence financial decisions

Classified Balance Sheet

- The classified groups accounts based on certain common characteristics:
 - Time
 - Current means within one year or operating cycle, whichever is longer
 - Long-term means more than one year
 - Physical substance
 - Assets, such as long-term investments, do not have physical substance and represent the right or claim to receive cash at a future date
 - Assets, such as property, plant and equipment, have physical substance
 - Assets, such as patents or copyrights, do not have physical substance and represent the economic rights to an activity or work product
- Standard groupings are:
 - Current assets
 - Long-term investments
 - Property, plant and equipment
 - Intangible assets
 - Current liabilities
 - Long-term liabilities
 - Stockholders' equity

Current Assets

- Expected to be consumed, spent or converted into cash within an operating cycle, i.e., one year
- Includes cash, marketable securities, accounts receivable, inventory and prepaid expenses.
- Current assets are listed in the order in which they will be converted into cash
- Changes in account balances typically result from operating activities

Long-Term Investments

- Expected to be held (owned) more than one year
- Includes long-term accounts or notes receivable from another company, investments in stock or bonds of another company and other long-term assets not used in production activities
- Transactions are infrequent and typically do not result from operating activities

Property, Plant and Equipment

- Expected to be held (owned) more than one year
- Includes land, buildings, equipment and furniture and fixtures used in production
- Other than land, these assets are depreciated; that is, a portion of their cost is systematically charged to expense each year.
- Transactions are infrequent and typically do not result from operating activities

Intangible Assets

- Expected to be held (owned) more than one year
- Do not have physical existence; represent rights to economic benefits for a number of year
- Includes patents, copyrights, trademarks and goodwill
- These assets are amortized; that is, a portion of their cost is systematically charged to expense each year.
- Transactions are infrequent and typically do not result from operating activities

Current Liabilities

- Expected to be paid with cash within an operating cycle, i.e., one year
- Includes accounts payable, short-term notes payable, wages and salaries payable, income taxes payable, dividends payable, accrued expenses, unearned revenue and current maturities (within the next 12 months) of long-term liabilities
- Current assets are listed in the order in which they will be consume cash
- Changes in account balances typically result from operating activities

Long-Term Liabilities

- Expected to be paid in more than one year
- Includes long-term accounts or notes payable, mortgages payable, bonds payable, lease liabilities and pension liabilities
- Transactions are infrequent and typically do not result from operating activities

Stockholders' Equity

- Claims of the owners of the business to net assets.
- Includes preferred stock, common stock, additional paid-in capital, retained earnings and certain other items.
- Retained earnings consist of the cumulative earnings of the company since inception less shareholder dividends since the inception of the company.
- Transactions are infrequent and typically do not result from operating activities

Example #1

The following table shows financial data for P Company as of June 30.

Accounts receivable	\$419,200
Accounts payable	229,100
Accrued expenses	120,100
Inventory	58,400
Common stock	662,100
Other assets	69,400
Bonds payable	268,900
Cash	732,600
Equipment	158,500
Accumulated depreciation	(40,000)
Retained earnings	117,900

Required: Prepare a balance sheet and a classified balance sheet.

Solution #1

a)

Balance Sheet

<u>Assets</u>		
Cash		\$732,600
Accounts receivable		419,200
Inventory		58,400
Equipment	\$158,500	
Less: Accumulated depreciation	40,000	
Net equipment		118,500
Other assets		69,400
Total Assets		<u>\$1,398,100</u>
<u>Liabilities and Stockholders equity</u>		
Liabilities		
Accounts payable		\$229,100
Accrued expenses		120,100
Bonds payable		268,900
Total liabilities		<u>618,100</u>
Stockholders' Equity		
Common stock		\$662,100
Retained earnings		117,900
Total Stockholders' Equity		<u>780,000</u>
Total Liabilities and Stockholders' Equity		<u>\$1,398,100</u>

b)

Classified Balance SheetAssets

Current Assets		
Cash	\$732,600	
Accounts receivable	419,200	
Inventory	58,400	
Total Current Assets		\$1,210,200
Equipment	\$158,500	
Less: Accumulated depreciation	40,000	
Net equipment		118,500
Other assets		69,400
Total Assets		<u>\$1,398,100</u>

Liabilities and Stockholders Equity

Current Liabilities		
Accounts payable	\$229,100	
Accrued expenses	120,100	
Total Current Liabilities		\$349,200
Long-term Liabilities		
Bonds payable	268,900	
Total long-term liabilities		268,900
Total liabilities		618,100
<u>Stockholders' Equity</u>		
Common stock	\$662,100	
Retained earnings	117,900	
Total Stockholders' Equity		780,000
Total Liabilities and Stockholders' Equity		<u>\$1,398,100</u>

Ratio Analysis

- Earnings per Share
 - EPS is net income less preferred stock dividends divided by shares of common stock outstanding
 - Very common measure of a company's profitability for shareholders
- Liquidity Ratios
 - Measure the ability to pay current obligations as they come due within the next year
 - Working Capital is the excess of current assets over current liabilities
 - Current Ratio is current assets divided by current liabilities
 - These two measures do not consider the quality or composition of the current assets
- Solvency Ratios
 - Measure the ability to pay all obligations as they come due; the company's ability to survive
 - Debt to Assets Ratio is total liabilities divided by total assets
- Free cash Flow
 - Cash flow from operating activities does not include certain other cash expenditures necessary to a business' survival: capital expenditures in new property, plant and equipment to maintain current operations and dividends paid to shareholders.
 - Free cash flow is the cash flow from operating activities less operating asset reinvestments and dividends paid

Practice Problems

Practice Problem #1

The calendar year-end adjusted trial balance for B Company, Inc. follows:

Cash	\$112,000	
Accounts receivable	27,000	
Prepaid rent	15,000	
Office supplies	12,300	
Office equipment	38,000	
Accumulated depreciation— Equipment		\$3,200
Building	288,000	
Accumulated depreciation—Building		42,000
Land	700,000	
Accounts payable		25,800
Salaries payable		14,500
Interest payable		2,500
Long-term note payable		72,000
Common stock		1,000
Retained earnings		909,000
Dividends	200,500	
Service fees earned		430,800
Salaries expense	90,000	
Insurance expense	5,200	
Rent expense	5,000	
Depreciation expense—Equipment	800	
Depreciation expense—Building	7,000	
Totals	\$1,500,800	\$1,500,800

- Required:
- a) Determine net income for the year
 - b) Prepare a classified year-end balance sheet. (Note: A \$9,000 installment on the long-term note payable is due within one year.)

Practice Problem #2

C Company supplied the following information as of December 31:

	<u>Dr.</u>	<u>Cr.</u>
Cash	\$11,275	
Accounts Receivable	1,750	
Office Supplies	800	
Prepaid Insurance	3,400	
Scoring Equipment	130,000	
Accumulated depreciation—Scoring equipment		\$21,700
Salaries payable		200
Common stock		1,000
Retained earnings		49,000
Dividends	46,425	
Bowling revenue		137,675
Depreciation expense—Scoring equipment	10,825	
Salaries expense	1,800	
Insurance expense	200	
Rent expense	1,600	
Office supplies expense	400	
Repairs expense	350	
Telephone expense	750	
Totals	<u>\$209,575</u>	<u>\$209,575</u>

Required: Prepare an income statement, retained earnings statement and a classified balance sheet as of December 31.

Practice Problem #3

G Company has total assets of \$425 million and total liabilities are \$110 million. Its current assets are \$110 million and current liabilities are \$20 million. Its equity was \$200 million at the beginning of the year and \$315 million at the end of the year. The average shares of common stock outstanding during the year were 414 million. No dividends were paid during the year.

- Required:
- a) Calculate the current ratio at the end of the year
 - b) Calculate working capital at the end of the year.
 - c) Calculate the debt to assets ratio at the end of the year.
 - d) Calculate earnings per share

True / False Questions

1. A classified balance sheet organizes assets and liabilities into important subgroups that provide more information to decision makers.
True False
2. Current assets and current liabilities are expected to be used up or come due within one year or the company's operating cycle whichever is shorter.
True False
3. Intangible assets are long-term resources that benefit business operations that usually lack physical form and have uncertain benefits.
True False
4. Assets are often classified into current assets, long-term investments, plant assets, tangible assets and intangible assets
True False
5. Intangible assets are assets that are long-term, have physical form, and are used to produce or sell products and services.
True False
6. Current liabilities include accounts receivable, unearned revenues, and salaries payable.
True False
7. Cash and office supplies are both classified as current assets.
True False
8. Plant assets are usually listed in order from most liquid to least liquid.
True False
9. The accounting model for the balance sheet is: $\text{Assets} + \text{Liabilities} = \text{Stockholders' Equity}$.
True False
10. The current ratio is used to help assess a company's ability to pay its debts.
True False

11. The idea that a business will continue to operate instead of being closed or sold underlies the going-concern assumption.

True False

12. Earnings per Share is the amount of income earned per share of a company's outstanding (weighted-average) common stock without regard to dividends.

True False

13. F Company's current ratio is 1.3. The industry average for the current ratio is 1.2. This indicates that Flo's can cover its short-term liabilities with its short-term assets.

True False

14. For the three companies listed below, the one with the strongest liquidity position is Company 3.

	Current Assets	Current Liabilities
Company 1	\$55,000	\$30,000
Company 2	\$141,500	\$85,000
Company 3	\$45,000	\$59,000

True False

15. The debt ratio is used to assess the risk associated with a company's use of its liabilities.

True False

Multiple Choice Questions

1. A classified balance sheet:
 - a) Measures a company's ability to pay its bills on time
 - b) Organizes assets and liabilities into important subgroups that provide more information
 - c) Broadly groups items into assets, liabilities and equity
 - d) Reports operating, investing, and financing activities

2. Two common subgroups for liabilities on a classified balance sheet are:
 - a) Current liabilities and intangible liabilities
 - b) General liabilities and specific liabilities
 - c) Intangible liabilities and long-term liabilities
 - d) Current liabilities and long-term liabilities

3. Which of the following is classified as current assets?
 - a) Office equipment
 - b) Patents
 - c) Unearned revenue
 - d) Office supplies

4. Which of the following statements about a company's operating cycle is *not* true:
 - a) Non-current items are those expected to come due within one year or the company's operating cycle
 - b) The operating cycle is the time span from when cash is used to acquire goods and services until cash is received from the sale of goods and services.
 - c) The length of a company's operating cycle depends on its activities
 - d) Most operating cycles are less than one year

5. The accounting concept that requires every business to be accounted for separately from other business entities, including its owner or owners is known as the:
 - a) Time-period assumption
 - b) Business entity assumption
 - c) Going-concern assumption
 - d) Revenue recognition principle

6. Use the information in the adjusted trial balance presented below to calculate current assets for T Company.:

<u>Account Title</u>	<u>Dr.</u>	<u>Cr.</u>
Cash	23,000	
Accounts receivable	16,000	
Prepaid insurance	6,600	
Equipment	100,000	
Accumulated Depreciation— Equipment		50,000
Land	95,000	
Accounts payable		17,000
Interest payable		2,400
Unearned revenue		5,000
Long-term notes payable		30,000
Common stock		1,000
Retained Earnings		
Totals	240	240,600

- a) \$21,200
 b) \$45,600
 c) \$24,400
 d) \$95,600
7. The rule that requires financial statements to reflect the assumption that the business will continue operating instead of being closed or sold, unless evidence shows that it will not continue, is the:
- a) Business entity assumption
 b) Objectivity principle
 c) Going-concern assumption
 d) Monetary unit assumption
8. To include the personal assets and transactions of a business's stockholders in the records and reports of the business would be in conflict with the
- a) Business entity assumption
 b) Objectivity principle
 c) Going-concern assumption
 d) Monetary unit assumption

9. The accounting principle that requires accounting information to be based on actual cost and requires assets and services to be recorded initially at the cash or cash-equivalent amount given in exchange, is the:
- Accounting equation
 - Cost principle
 - Going-concern assumption
 - Business entity assumption
10. The S Company acquired a building for \$500,000. The building was appraised at a value of \$575,000. The seller had paid \$300,000 for the building 6 years ago. Which accounting principle would require Superior to record the building on its records at \$500,000?
- Business entity assumption
 - Objectivity principle
 - Going-concern assumption
 - Cost principle
11. The amount of income earned per share of a company's outstanding common stock is known as:
- Restricted retained earnings per share
 - Book value per share
 - Earnings per share
 - Dividends per share
12. R Company had net income of \$67,000. The company had 9,000 weighted average common shares outstanding throughout the year. The basic earnings per share equals
- \$0.13
 - \$1.00
 - \$14.89
 - \$7.44
13. M Company had net income of \$132,000. The weighted-average common shares outstanding were 80,000. The company declared a \$27,000 dividend on its noncumulative, nonparticipating preferred stock. There were no other stock transactions. The company's earnings per share is:
- \$1.65
 - \$1.99
 - \$1.31
 - \$0.34

The next 2 questions refer to the following information.
The December 31, post-closing trial balance for S Company is presented below:

	<u>Debits</u>	<u>Credits</u>
Cash	\$18,500	
Long-term Investments	55,000	
Accounts receivable	26,500	
Prepaid Insurance	4,500	
Supplies	100,000	
Land	45,000	
Building	277,500	
Accumulated Depreciation		\$80,000
Accounts Payable		37,500
Notes Payable due in 6 months		65,000
Interest Payable		10,000
Notes payable due in 15 months		120,000
Common stock		150,000
Retained Earnings		<u>64,500</u>
	\$527,000	\$527,000

14. Total current assets are:

- a) \$204,500
- b) \$322,500
- c) \$222,500
- d) \$149,500

15. Total long-term liabilities are:

- a) \$527,000
- b) \$312,500
- c) \$120,000
- d) \$47,000

Solutions to Practice Problems

Practice Problem #1

a)

Service fees earned		\$430,800
Salaries expense	90,000	
Insurance expense	5,200	
Rent expense	5,000	
Depreciation expense—Equipment	800	
Depreciation expense—Building	7,000	
Total expenses		<u>108,000</u>
Net Income		<u>\$ 322,800</u>

b)

**B Company
Balance Sheet
December 31**

Assets**Current Assets:**

Cash	\$112,000	
Accounts receivable	27,000	
Prepaid rent	15,000	
Office supplies	12,300	
Total current assets		\$166,300

Property, Plant and Equipment:

Office equipment	38,000	
Less accumulated depreciation	3,200	34,800
Building	288,000	
Less accumulated depreciation	42,000	246,000
Land		700,000
Total plant assets		980,800
Total assets		\$1,147,100

Liabilities**Current Liabilities:**

Accounts payable	\$25,800	
Salaries payable	14,500	
Interest payable	2,500	
Current installment of long-term note	9,000	
Total current liabilities		\$51,800

Long-term Liabilities:

Notes payable	63,000	
Total liabilities		114,800

Equity

Common stock		1,000
Retained earnings		1,031,300
Total liabilities and equity		\$1,147,100

Practice Problem #2

C Company
Income Statement
For Year Ended June 30

Bowling Revenue		\$137,675
Expenses:		
Depreciation expense—Scoring equipment	\$10,825	
Salaries expense	1,800	
Insurance expense	200	
Rent expense	1,600	
Office supplies expense	400	
Repairs expense	350	
Telephone expense	750	
Total expenses	15,925	
Net Income		\$121,750

C Company
Statement of Retained Earnings
For Year Ended June 30

Retained Earnings, Beginning Balance		\$49,000
Plus net income		121,750
		\$170,750
Less Dividends		(46,425)
Retained Earnings, Ending balance		\$124,325

**C Company
Balance Sheet
June 30**

Assets**Current Assets**

Cash	\$11,275	
Accounts receivable	1,750	
Office supplies	800	
Prepaid Insurance	<u>3,400</u>	
Total current assets		\$17,225

Plant Assets

Scoring Equipment	130,000	
Less: Accumulated Depreciation	<u>21,700</u>	
Total plant assets		<u>108,300</u>
Total Assets		<u><u>\$125,525</u></u>

Liabilities**Current liabilities**

Salaries payable	<u>\$200</u>	
Total current liabilities		\$200

Equity

Common stock		1,000
Retained earnings		<u>124,325</u>
Total Liabilities & Stockholders' Equity		<u><u>\$125,525</u></u>

Practice Problem #3

- a) Current ratio $\frac{110,000,000}{20,000,000} = 5.5$
- b) Working capital $110,000,000 - 20,000,000 = 90,000,000$
- c) Debt to assets ratio $\frac{110,000,000}{425,000,000} = 25.8\%$
- d) Earnings per share $\frac{115,000,000}{414,000,000} = \0.28

Solutions to True / False Problems

1. True
2. False – whichever is longer, a year or the operating cycle.
3. True
4. False – tangible assets are assets with a physical existence, not a separate classification on the balance sheet
5. False – intangible assets do not have physical existence and are the rights to an economic benefit
6. False – accounts receivable are a current asset
7. True
8. True
9. True
10. False - the accounting model for the balance sheet is: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
11. False – Current ratio measure ability to pay debts in the near future
12. True
13. False – Monetary unit assumption states that only items that can be expressed in monetary units will be included in the financial statements
14. False – corporations, sole proprietorships and partnerships are the three forms of ownership.
15. False – preferred stock dividends must be deducted from net income in the numerator
16. True
17. False – Company 1 as it has the highest current ratio
18. False – the ratio is total liabilities / total assets
19. False – the ratio is $\$105 \text{ million} / \$350 \text{ million} = 30\%$
20. True

Solutions to Multiple Choice Questions

- | | |
|-----|---|
| 1. | B |
| 2. | D |
| 3. | D |
| 4. | A |
| 5. | B |
| 6. | B |
| 7. | C |
| 8. | A |
| 9. | B |
| 10. | D |
| 11. | C |
| 12. | D |
| 13. | C |
| 14. | D |
| 15. | C |