A FURTHER LOOK AT FINANCIAL STATEMENTS

LO 1: Identify the sections of a classified balance sheet.

- Describes a company's financial position (types and amounts of assets, liabilities, and equity) at a **point in time**.

- Example: A balance sheet would be prepared "As of December 31, 20XX" because it gives a snapshot of the company's financial position as of that date.

- **Basic Accounting Equation**: **ASSETS = LIABILITIES + STOCKHOLDERS'EQUITY**

Assets	Liabilities and Stockholders' Equity
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Property, plant, and equipment	Stockholders' equity
Intangible assets	

FRANKLIN CORPORATION
Balance Sheet
October 31, 2017

Assets

Current assets			
Cash		$ 6,600	
Debt investments		2,000	
Accounts receivable		7,000	
Notes receivable		1,000	
Inventory		3,000	
Supplies		2,100	
Prepaid insurance		400	
Total current assets			$22,100
Long-term investments			
Stock investments		5,200	
Investment in real estate		2,000	7,200
Property, plant, and equipment			
Land		10,000	
Equipment	$24,000		
Less: Accumulated depreciation—equipment	5,000	19,000	29,000
Intangible assets			
Patents			3,100
Total assets			$61,400

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable	$11,000	
Accounts payable	2,100	
Unearned sales revenue	900	
Salaries and wages payable	1,600	
Interest payable	450	
Total current liabilities		$16,050
Long-term liabilities		
Mortgage payable	10,000	
Notes payable	1,300	
Total long-term liabilities		11,300
Total liabilities		27,350
Stockholders' equity		
Common stock	14,000	
Retained earnings	20,050	
Total stockholders' equity		34,050
Total liabilities and stockholders' equity		$61,400

*****Notice that Assets = Liabilities + Stockholders' Equity. Everything is balanced.**

ACCOUNT CLASSIFICATION	EXAMPLES	DEFINITION
Current Assets	1. Cash 2. Accounts Receivable 3. Inventory 4. Prepaids 5. Supplies 6. Investments (short-term).	"Cash and other resources that are expected to be sold, collected, or used **WITHIN one year or company's operating cycle**, whichever is longer." Companies list current asset accounts in the order they expect to convert them into cash.
Long-Term Investments	1. Investments in stocks and bonds of other corporations that are held for more than one year. 2. Long-term assets such as land or buildings that a company is not currently using in its operating activities. 3. Long-term notes receivable.	"Notes receivable and investments in stocks and bonds that the company intends to hold onto for **MORE THAN** the longer of one year or operating cycle." Also, they **ARE NOT** used in the company's operating activities.
Plant Assets (Property, Plant, and Equipment)	1.Equipment 2. Machinery 3. Buildings 4. Land 5. Delivery Vehicles 6. Furniture.	"Tangible assets that are both long-lived and used in operating the business." All plant assets (EXCLUDING Land) depreciate over their useful lives. • **Depreciation**: allocating the cost of assets to a number of years. • **Accumulated Depreciation**: total amount of depreciation expensed thus far in the asset's life.
Intangible Assets	1. Trademarks 2. Patents 3. Copyrights 4. Franchises 5. Goodwill	"Long-term resources that lack a physical form (not touchable) and benefit business operations."
Current Liabilities	1. Accounts Payable 2. Salaries and Wages Payable 3. Income Taxes Payable 4. Interest Payable 5. Notes Payable (1 year or less). 6. Current maturities of long-term obligations	"Obligations due to be paid or settled **WITHIN one year or the operating cycle**, whichever is longer."
Long-Term Liabilities	1. Bonds Payable 2. Notes Payable (more than 1 year) 3. Mortgage Payable. 4. Lease Liabilities 5. Pension Liabilities	"Obligations **NOT DUE within one year or the operating cycle**, whichever is longer."
Equity	1. Common stock 2. Preferred Stock 3. Paid-in Capital 4. Retained Earnings (income retained for use in the business)	"The owner's claim on assets."

LO 2: Use ratios to evaluate a company's profitability, liquidity, and solvency.

- **Ratio analysis:** expresses the relationship among selected items of financial statement data.
    - A **ratio** expresses the mathematical relationship between one quantity and another.

FINANCIAL RATIO CLASSIFICATIONS

1. Profitability Ratios
2. Liquidity Ratios
3. Solvency Ratios

1. Profitability Ratios

"Measure the income or operating success of a company for a given period of time."

- **Earnings per share (EPS)** measures the net income earned on each share of common stock.

Ex: An Earnings per Share (EPS) of \$1.64 means that each share of common stock earned \$1.64.

$$\text{Earnings per Share} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Weighted-Average Common Shares Outstanding}}$$

2. Liquidity Ratios

"Measure short-term ability of the company to pay obligations expected to become due within next year or operating cycle and to meet unexpected cash needs."

- **Working Capital** measures the difference between the amounts of current assets and current liabilities.

$$\textbf{Working Capital} = \textbf{Current Assets} - \textbf{Current Liabilities}$$

- **Current Ratio** measures how much of current assets a company has for every dollar of current liabilities.

- Usually, a current ratio above 1 is a good sign for a company because they have a greater ability to pay current liabilities from current assets.

Ex: 2.6 means a company has \$2.60 of current assets for every \$1 of current liabilities.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

3. Solvency Ratios

"Measure the ability of the company to survive over a long period of time by examining its ability to pay interest as it comes due and to repay the balance of a debt due at its maturity."

- **Debt to Assets Ratio** measures the percentage of total financing provided by creditors rather than stockholders.

Ex: A ratio of 80% indicates that every dollar of assets was financed by 80 cents of debt.

$$\text{Debt to Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

LO 3: Discuss financial reporting concepts.

Standard-Setting Environment

1. <u>GAAP</u>: (Generally Accepted Accounting Principles) rules and concepts that govern financial accounting. It attempts to make information RELEVANT, RELIABLE, and COMPARABLE.

Standard-setting bodies that determine these guidelines:

- **SEC (Securities and Exchange Commission):** oversees the U.S. financial markets and accounting standard-setting bodies.
- **FASB (Financial Accounting Standards Board):** The primary accounting standard-setting body in the United States.
- **IASB (International Accounting Standards Board):** The primary accounting standard-setting body for countries outside the united States that use International Financial Reporting Standards (IFRS).
- **PCAOB (Public Company Accounting Oversight Board)**: Determine the auditing standards and review performance of auditing firms.

2. **<u>Characteristics of Financial Information</u>**: Financial information needs to be **USEFUL** to investors and creditors for making decisions about providing capital. **Useful information possesses two important qualities…**

1. **RELEVANCE:** Has the potential to impact decision making. Information is relevant if it has…
    - **Predictive Value:** helps provide accurate expectations about the future.
    - **Confirmatory Value:** confirms or corrects prior expectations.
    - **Materiality:** when its size makes it likely to influence the decision of an investor or creditor.

2. **FAITHFUL REPRESENTATION**: The information accurately reflects an entity's economic activity or condition. To provide a faithful representation, information must be…
    - **Complete:** nothing important has been omitted.
    - **Neutral:** is not biased toward one position or another.
    - **Free from Error:** no errors or omissions in amounts and process used to report amounts.

- **Enhancing qualities** of useful information include:
    1. **Comparability:** results when different companies use the same accounting principles.
    2. **Verifiability:** independent observers would reach similar conclusions.
    3. **Understandability:** comprehensible by a user with a reasonable understanding of the business. (material is presented in a clear and concise manner)
    4. **Timeliness:** recent enough to make a difference.
    5. **Consistency:** a company uses the same accounting principles and methods from year to year.

3. **Assumptions in Financial Reporting**:
   1. ***GOING-CONCERN ASSUMPTION:*** anticipates that a business entity will continue to operate indefinitely instead of being closed or sold.
   2. ***MONETARY UNIT ASSUMPTION:*** stable monetary unit of measure used in U.S. financial statements such as the U.S. dollar.
   3. ***PERIODICITY ASSUMPTION:*** life of a company can be divided into time periods, such as months and years, which can be useful in generating reports.
   4. ***ECONOMIC ENTITY ASSUMPTION:*** business is accounted for separately from other business entities, including its owner.

4. **Accounting Principles:**
   1. ***MEASUREMENT PRINCIPAL (COST PRINCIPAL AND FAIR VALUE PRINCIPLE)***
      - ***Historical Cost Principle**:* *A*ccounting information is based on actual cost. Cost is measured on a cash or equal to cash basis. (Ex: Bob bought equipment for $15,000 so the equipment should be valued at $15,000). **In generally, most assets have to be valued using the historical cost principle.**

      - ***Fair Value Principle**:* Indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). **Only in situations where assets are actively traded, such as investment securities, is the fair value principle applied.**

   2. ***FULL DISCLOSURE PRINCIPAL:*** a company must report ALL the details behind the financial statements that influence users' decisions.

5. **Accounting Constraints**:
   1. ***COST CONSTRAINT:*** only information with benefits of disclosure greater than the costs of providing it need to be disclosed.