

**CHAPTER 2**  
**A Further Look at Financial Statements**  
**Study Objectives**

1. Explain the meaning of generally accepted accounting principles and describe the basic objective of financial reporting.
2. Discuss the qualitative characteristics of accounting information.
3. Identify the two constraints in accounting.
4. Identify sections of a classified balance sheet.
5. Identify and compute ratios for analyzing a company's profitability.
6. Explain the relationship between a retained earnings statement and a statement of stockholders' equity.
7. Identify and compute ratios for analyzing a company's liquidity and solvency using a balance sheet.
8. Identify and compute ratios for analyzing a company's liquidity and solvency using a statement of cash flows.

### Study Objective 1 - Explain the Meaning of Generally Accepted Accounting Principles and Describe the Basis Objective of Financial Reporting

- ◆ The basic objective for financial reporting is to provide information useful for **decision making**.
- ◆ **Generally Accepted Accounting Principles (GAAP)** are the agreed-upon accounting rules which most U. S. companies use in preparing financial statements. GAAP are promulgated by the **Financial Accounting Standards Board**.

### Study Objective 2 - Discuss the Qualitative Characteristics of Accounting Information

In order to be useful, financial information should possess the following qualitative characteristics:

- ◆ **Relevance** - if information has the ability to make a difference in a decision scenario, it is **relevant**.
- ◆ Accounting information is also **relevant** to business decisions because it confirms or corrects prior expectations. Financial statements both help **predict** future events and confirm or correct prior expectations about the financial health of the company. In order to be **relevant** accounting information must be **timely**.
- ◆ **Reliability** - information is **reliable** if it can be depended on. To be **reliable** information must be:
  - **verifiable**--free from error and bias,
  - **faithful representative**--factual, and
  - **neutral**--cannot be selected, prepared, or presented to favor one set of users over another.
- ◆ **Comparability and Consistency**
  - **comparability**--when different firms use the same accounting principles.
  - **consistency**--when firms use the same accounting principles and methods from year to year.

### Study Objective 3 - Identify the Two Constraints in Accounting

**Constraints** allow a company to modify **generally accepted accounting principles** without reducing the usefulness of the information content. These **constraints** are:

- ◆ **Materiality** - an item is **material** if it can influence the decision of an investor or a creditor. An item is **immaterial** if inclusion has no impact on the decision.
- ◆ **Conservatism** - allows the accountant to choose the accounting method that will be the least likely to overstate assets and income. Many times items in inventory become obsolete or damaged. In this instance inventory items should be listed at market value if it is lower than cost.

### Study Objective 4 - Identify the Sections of a Classified Balance Sheet

In a **classified balance sheet** companies often group similar assets and similar liabilities together as they have similar economic characteristics. The groupings help users to determine

- (1) whether the company has enough assets to pay its debts and
- (2) the claims of short-and long-term creditors on the company's total assets.

A **classified balance sheet** generally contains the following standard classifications:

◆ **Current Assets**

- Assets that are expected to be converted to cash or used in the business within a short period of time, usually one year.
- Examples of current assets include: cash, marketable securities, receivables, inventories and prepaid expenses.
- On the balance sheet, current assets are listed in order of liquidity.

◆ **Long-Term Investments**

- Assets that can be converted into cash, but whose conversion is not expected within one year.
- Assets not intended for use within the business.
- Examples are investments of stocks and bonds of other corporations.

◆ **Property, Plant, and Equipment**

- Assets with relatively long useful lives.
- Assets used in the business.
- Examples include land, buildings, machinery, delivery equipment, and furniture and fixtures.

◆ **Intangible Assets**

- Non current assets.
- Assets which have no physical substance.
- Examples are patents, copyrights, and trademarks or trade names.

◆ **Current Liabilities**

- Obligations that are supposed to be paid within the coming year.
- Common examples are accounts payable, wages payable, bank loans payable, interest payable, taxes payable, and current maturities of long-term bank loans payable, interest payable, and current maturities of long-term obligations.

◆ **Long-Term Liabilities**

- Obligations expected to be paid after one year.
- Liabilities in this category include bonds payable, mortgages payable, long-term notes payable, lease liabilities, and obligations under employee pension plans.

◆ **Stockholders' Equity**

- **Capital Stock** - investments in the business by the stockholders.
- **Retained earnings** - earnings retained for use in the business.

**Study Objective 5 - Identify and Compute Ratios for Analyzing a Company's Profitability.**

Creditors and investors are interested in evaluating profitability. Profitability is frequently used as a test of management's effectiveness. To supplement an evaluation of the income statement, ratio analysis is used.

◆ **Profitability ratios** - measure the income or operating success of an enterprise for a given period of time.

- **Return on assets ratio**
  - overall measure of profitability
  - computed by dividing net income by average assets
  - reveals the amount of net income generated by each dollar invested
- **Profit margin ratio**

- measures the percentage of each dollar of sales that results in net income
- computed by dividing net income by net sales for the period

**Study Objective 6 - Explain the Relationship Between a Retained Earnings Statement and a Statement of Stockholders' Equity**

◆ **Retained Earnings Statement**

- Describes the events that caused changes in the retained earnings account for the period.
- Add net income and subtract dividends from beginning balance of retained earnings to arrive at ending balance of retained earnings.

◆ **Statement of Stockholders' Equity**

- Reports all changes in stockholders' equity accounts (i.e. capital stock issued or retired).

## Study Objective 7 - Identify and Compute Ratios for Analyzing a Company's Liquidity and Solvency Using a Balance Sheet

An analysis of the relationship between a company's assets and liabilities can provide users with information about the firm's liquidity and solvency.

- ◆ **Liquidity** - The ability to pay obligations as they come due.
  - **Working capital**
    - Measure of short term ability to pay obligations.
    - Excess of current assets over current liabilities.
    - Positive **working capital** indicates the likelihood for paying liabilities is favorable.
  - **Current ratio**
    - Measure of short term ability to pay obligations.
    - Computed by dividing current assets by current liabilities.
    - More dependable indicator of liquidity than working capital.
    - Does not take into account composition of current assets.

A 1.6:1 ratio means that for every \$1 in debt, the company has \$1.6 in current assets to pay the debt. Also, students need to be aware of the fact that the composition of the assets may be very important. For example if a company had most of its current assets in cash it could be more sure of its liquidity position than another company with the majority of its current assets in inventory. What happens if the company cannot sell the inventory?

- ◆ **Solvency** - The ability of the enterprise to survive over a long period of time.
  - **Debt to Total Assets Ratio**
    - Measures the percentage of assets financed by creditors.
    - The higher the percentage of debt financing, the riskier the business.
    - Computed by dividing total debt (both current and long-term liabilities) by total assets.

## Study Objective 8 - Identify and Compute Ratios for Analyzing a Company's Liquidity and Solvency Using a Statement of Cash Flows

The **statement of cash flows** provides financial information about the sources and uses of a company's cash. To aid in the analysis of cash, the **statement of cash flows** reports the cash effect of company's:

- ◆ **Financing activities** - Cash inflows from sources funding the business (i. e. sale of stock, sale of bonds, borrowings, etc.).
- ◆ **Investing activities** - Cash outflows from purchasing resources needed in operating the business.
- ◆ **Operating activities** - Cash inflows and cash outflows associated with the primary operations of the business.

### Review the Statements of Cash Flows of Best Buy Corporation.

The statement of cash flows can also be used to calculate additional measures of liquidity and solvency.

- ◆ **Liquidity**
  - **Current cash debt coverage ratio**

- Calculated as cash provided by operating activities divided by average current liabilities.
- Indicates the company's ability to generate sufficient cash to meet its short-term needs.

♦ **Solvency**

▪ **Cash debt coverage ratio**

- Calculated as cash provided by operating activities divided by average total liabilities.
- Indicates the company's ability to generate sufficient cash to meet its long-term needs.

## Chapter 2 Review

- ✓ What are generally accepted accounting principles? Name the standard setting body that promulgates these principles. What is the basic objective of financial reporting?
  
- ✓ Name and explain the significance of the qualitative characteristics of accounting information.
  
- ✓ What are the two constraints in accounting? Why are they important?
  
- ✓ Identify sections of a classified balance sheet.
  
- ✓ Name two profitability ratios. How are these ratios computed? How are the results interpreted?
  
- ✓ What is the relationship between a retained earnings statement and a statement of stockholders' equity? Which contains the most information?
  
- ✓ Compute ratios for analyzing a firm's liquidity and solvency. How are these ratios interpreted?
  
- ✓ Identify the sections of the statement of cash flows and the purpose of each.

**Chapter 2**

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Information of any sort is \_\_\_\_\_ if it would influence a decision. Accounting information is \_\_\_\_\_ if it would make a difference in a business decision. For example, when Best Buy issues financial statements, the information in the statements is considered \_\_\_\_\_ because it provides a basis for forecasting Best Buy's future earnings. Accounting information is also \_\_\_\_\_ to business decisions because it confirms or corrects prior expectations. Thus, Best Buy's financial statements help \_\_\_\_\_ future events and provide feedback about prior expectations about the financial health of the company. In addition, for accounting information to be relevant it must be \_\_\_\_\_. That is it must be available to decision makers before it loses its capacity to influence decisions.

\_\_\_\_\_ of information means that the information can be depended on. To be reliable, accounting information must be \_\_\_\_\_ --we must be able to prove that it is free of error. The information must be a \_\_\_\_\_ of what it purports to be--it must be factual. Finally, accounting information must be \_\_\_\_\_ --it cannot be selected, prepared, or presented to favor one set of interested users over another. To ensure reliability, certified public accountants audit financial statements.

## Solutions to Reading Comprehension Check I

### Chapter 2

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Information of any sort is Relevant if it would influence a decision. Accounting information is Relevant if it would make a difference in a business decision. For example, when Best Buy issues financial statements, the information in the statements is considered relevant because it provides a basis for forecasting Best Buy's future earnings. Accounting information is also relevant to business decisions because it confirms or corrects prior expectations. Thus, Best Buy's financial statements help predict future events and provide feedback about prior expectations about the financial health of the company. In addition, for accounting information to be relevant it must be timely. That is it must be available to decision makers before it loses its capacity to influence decisions.

Reliability of information means that the information can be depended on. To be reliable, accounting information must be verifiable--we must be able to prove that it is free of error. The information must be a faithful representation of what it purports to be--it must be factual. Finally, accounting information must be neutral--it cannot be selected, prepared, or presented to favor one set of interested users over another. To ensure reliability, certified public accountants audit financial statements.

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\_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ are assets with relatively long useful lives that are used in operating the business. This category includes land, \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_, delivery equipment and furniture. \_\_\_\_\_ is the practice of allocating the cost of the assets to a number of years, rather than simply \_\_\_\_\_ the full purchase price in the year of purchase. Assets that the company depreciates should be reported on the balance sheet at \_\_\_\_\_ less \_\_\_\_\_. The \_\_\_\_\_ account shows the total amount of depreciation taken over the \_\_\_\_\_ of the asset.

Many companies have assets that cannot be seen yet often are very valuable. These assets are referred to as \_\_\_\_\_. Intangible assets are noncurrent assets that do not have physical substance. They include \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ or \_\_\_\_\_ that give the company exclusive right of use for a specified period of time.

## Solutions to Reading Comprehension Check II

### Chapter 2

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Property, plant, and equipment are assets with relatively long useful lives that are used in operating the business. This category includes land, buildings, machinery and equipment, delivery equipment and furniture. Depreciation is the practice of allocating the cost of the assets to a number of years, rather than simply expensing the full purchase price in the year of purchase. Assets that the company depreciates should be reported on the balance sheet at cost less accumulated depreciation. The accumulated depreciation account shows the total amount of depreciation taken over the life of the asset.

Many companies have assets that cannot be seen yet often are very valuable. These assets are referred to as intangible assets. Intangible assets are noncurrent assets that do not have physical substance. They include patents, copyrights, and trademarks or trade names that give the company exclusive right of use for a specified period of time.

**Chapter 2**

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- \_\_\_\_\_ 1. Assets of a relatively permanent nature that are being used in the business and are not intended for resale.
- \_\_\_\_\_ 2. The quality of information that indicates the information makes a difference in a decision.
- \_\_\_\_\_ 3. A measure used to evaluate a company's liquidity and short-term debt-paying ability, computed by dividing current assets by current liabilities.
- \_\_\_\_\_ 4. A financial statement that presents the factors that caused stockholders' equity to change during the period, including those things that caused retained earnings to change.
- \_\_\_\_\_ 5. The constraint of determining if an item is important enough to likely influence the decision of a reasonably prudent investor or creditor.
- \_\_\_\_\_ 6. Resources not expected to be realized in cash within the next year or operating cycle.
- \_\_\_\_\_ 7. Obligations reasonably expected to be paid from existing current assets through the creation of other current liabilities within the next year or operating cycle, whichever is longer.
- \_\_\_\_\_ 8. The excess of current assets over current liabilities.
- \_\_\_\_\_ 9. Measures the percentage of each dollar of sales that results in net income, computed by dividing net income by net sales.
- \_\_\_\_\_ 10. Cash and other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year or the operating cycle, whichever is longer.

## Solutions to Vocabulary Quiz

### Chapter 2

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1. Property, plant and equipment
2. Relevance
3. Current ratio
4. Statement of stockholders' equity
5. Materiality
6. Long-term investments
7. Current liabilities
8. Working capital
9. Profit margin ratio
10. Current assets

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1. **Generally Accepted Accounting Principles (GAAP)** are issued by the:
  - a. Securities and Exchange Commission.
  - b. Financial Accounting Standards Board.
  - c. International Accounting Standards Committee.
  - d. American Accounting Association.
  
2. Which of the characteristics is **not necessary** in order for accounting information to be **reliable**:
  - a. conservative.
  - b. a faithful representation.
  - c. verifiable.
  - d. neutral.
  
3. **Consistency** of information means that:
  - a. the information would influence a decision.
  - b. different companies use the same accounting principles.
  - c. the amounts involved are material.
  - d. a company uses the same accounting principles and methods from year to year.
  
4. **Comparability** of information results when:
  - a. the information would influence a decision.
  - b. different companies use the same accounting principles.
  - c. the amounts involved are material.
  - d. a company uses the same accounting principles and methods from year to year.
  
5. **Gross profit** may be referred to as:
  - a. sales revenue.
  - b. total sales.
  - c. merchandising profit
  - d. net income from operations.
  
6. **A Current liabilities** include:
  - a. obligations to be paid within the coming year.
  - b. accounts payable.
  - c. wages payable.
  - d. all of the above.
  
7. **Working capital** is:
  - a. current assets less current liabilities.
  - b. current assets divided by current liabilities.
  - c. income divided by average assets
  - d. net income divided by net sales.

8. All of the following are current assets **except**:
- a. accounts receivable.
  - b. cash.
  - c. patents.
  - d. marketable securities.
9. The current ratio is a:
- a. solvency ratio.
  - b. profitability ratio.
  - c. liquidity ratio.
  - d. none of the above.
10. Buying a cash register for a fast food business is an example of a(n):
- a. merchandising activity.
  - b. financing activity.
  - c. operating activity.
  - d. investing activity.

## Solutions to Multiple Choice

### Chapter 2

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1. b
2. a
3. d
4. b
5. c
6. d
7. a
8. c
9. c
10. d

## Exercise 1 - Research and Communication Activity

### Chapter 2

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Blaire and Mark married last year and immediately opened a small computer business. Blaire is responsible for managing the business while Mark is responsible for the accounting. At the end of each month, Mark tells Blaire that the business is earning a profit. Blaire, however, is very frustrated and skeptical. She calls the bank periodically and much to her amazement, the business has no more money in the checking account than it did on the opening day. Blaire and Mark heard that you were taking an accounting course at a local university and have come to you, a friend, for help.

Write a memo to the young entrepreneurs explaining how it is indeed possible to have a net income and not have an increase in cash.

**Solution:**

**DATE:** 9/5/200X

**TO:** Blaire and Mark

**FROM:** Accounting Student

Net income and cash flow are totally different. Therefore, it is quite possible for a business to have a significant amount of net income and no increase in net income. Think about the transactions of your business during the past year. Has inventory increased? Have you purchased additional equipment, furniture, or fixtures?

Did you withdraw money from the business. All of the aforementioned transactions, while necessary, decrease cash. However, if you have added inventory, equipment, furniture, and/or fixtures, you have increased assets other than cash. Therefore your business is worth more than it was at the onset.

## Exercise 2 - Financial Statement Analysis and Decision Making Activity

### Chapter 2

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Select two competing companies (i.e. Ford-GM, Eli Lilly-Merck, Ben & Jerry's-Edy's), and locate annual reports for these companies on the internet or in your school library. These companies can be found on the Internet at [www.tootsie.com](http://www.tootsie.com), [ford.com](http://ford.com), [www.gm.com](http://www.gm.com), [www.elililly.com](http://www.elililly.com), [www.merck.com](http://www.merck.com), [www.benjerry.com](http://www.benjerry.com), and [www.edys.com](http://www.edys.com).

1. Compute the return on assets and profit margin for the two companies you have selected.
2. Compute current ratio and debt to total assets ratio for the companies you have selected.
3. Which company would you recommend as an investment?
4. Why did you answer Question 3 as you did? Have you considered the issues presented in the Decision Toolkits in Chapter 1?

**Solutions:** Information available on website.

**Note:** The website is constantly being updated. Please check to see that the information requested in this exercise is available.

## Exercise 3 - Ratio Analysis and Creative Activity

### Chapter 2

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Refer to the loan application prepared for your fictitious business in Campus Town USA in Exercise 3 of Chapter 1 in answering the following questions:

1. Compute the return on assets and profit margin for your fictitious company.
2. Compute current ratio and debt to total assets ratio for your fictitious company.
3. Would you like to amend the financial statements prepared in chapter 1? Additional loan application forms are provided for your convenience.

Exercise 3 - Ratio Analysis and Creative Activity (Continued)

Chapter 2

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LOAN APPLICATION FORM

Name of Company \_\_\_\_\_

Address \_\_\_\_\_

Phone Number \_\_\_\_\_

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Annual Income

Revenue

Cost of goods sold

Operating expense

Rent

Utilities

Wages

Advertising

Others

Net income (loss)

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Assets

Cash

Account receivable

Inventory

Property, plant, & equipment

Others

Total assets

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Liability

Account payable

Notes payable

Others

Total liability

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Stockholders' Equity

Total stockholders' equity

Total liability & stockholders' equity

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## Chapter 2

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### Exercise 4 - Financial Statement and Creative Activity

## Chapter 2

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1. Prepare personal financial statements, including an income statement and a balance sheet. Remember to include all of your sources of revenues; income from jobs, allowance from parents, etc. In addition, please consider all of your assets, clothes, jewelry, automobiles, electronic equipment, etc.
2. Keep a record of your income and expenses for a month.
3. At the end of the month, prepare financial statements, including an income statement, balance sheet and a statement of cash flows.

## Exercise 5 - Financial Statements and Creative Activity

### Chapter 2

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The Ice Cats, a professional ice hockey team moved to College Town USA. Joe Enterprise, organized Joe's Tees to take advantage of the large number of fans the team attracted by selling tee shirts with the team's name and logo printed in the team's colors. Joe sold the shirts from a cart in front of the arena where the Ice Cats perform. Joe bought the cart for \$5,000. Joe anticipates the cart will last for five years. The shirts cost \$14 and Joe sold them for \$25. In addition, Joe is required to buy a city license for \$125.

During the first season, there were 10 home games at which Joe averaged selling 32 shirts a game. Compute Joe's net income or net (loss).

**Solution:**

Revenue		\$8,000	
Less expenses:			
Cost of shirts	\$4,480		
Cart	5,000*		
License	<u>125</u>	<u>9,605</u>	
Net loss			<u>(\$1,605)</u>

\*Most students are not yet familiar with accrual accounting or the concept of depreciation.

You may want to keep a copy of the students' work. This exercise will be revisited in a later chapter.

**Exercise 6 - World Wide Web Research, Financial Statement Analysis, and  
International Activity**

**Chapter 2**

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Select two competing companies, one a domestic company, the other an foreign company (i.e. Nike-Fila, Ford-Daimler-Benz, and Exxon-BP), and locate annual reports for these companies on the internet. These companies can be found at [www.nike.com](http://www.nike.com), [www.fila.com](http://www.fila.com), [www.ford.com](http://www.ford.com), [www.daimler-bmw.com](http://www.daimler-bmw.com), [www.exxon.com](http://www.exxon.com), and [www.bp.com](http://www.bp.com).

1. Where are the headquarters for the two companies you selected?
2. In what currency are the financial statements of the foreign company stated?
3. How are the financial statements similar? How are the financial statements different?

**Solutions:** Information available on website.

**Note:** The website is constantly being updated. Please check to see that the information requested in this exercise is available.

## Exercise 7 - Accounting Career Activity

### Chapter 2

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Public accounting is one of the largest sectors of the accounting field. In order to retain a job in public accounting, one must become a Certified public Accountant (CPA). An accountant may be designated a CPA only after he or she has passed a uniform exam and has met the experience requirements of the state in which they are certified. The American Institute of Certified public Accountants is responsible for administering the CPA exam. Visit the AICPA at [www.aicpa.org](http://www.aicpa.org) and click on **Become a CPA** to find answers to the following questions.

1. What is a CPA? What are the requirements to become a CPA?
2. What are the recommended areas of study to become a CPA?
3. What skills are needed to become a successful accountant/CPA?
4. What are the different career paths in accounting?

**Solutions:** Information available on website.

