

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

Classified Balance Sheet – 1 of 6

A “balance sheet” is a visual numeric representation of the Foundation Equation.

First, assets are listed and totalled. The next section of the balance sheet lists liabilities, then a subtotal; then equity is sub totalled; then the total of liabilities and equity – this total **ALWAYS** equals total assets.

So what does “**Classified**” mean?

It basically means that different kinds of things are grouped by their *alike*ness. This relates to assets and liabilities, but mostly to assets.

The balance sheet items sub grouped and sub totalled yell information to readers of the financial statements. The sub groups provide key information to owners, management, creditors, investors and potential investors.

Classified Assets are categorized as:

- Current
- Long Term Investments
- Property, Plant & Equipment
- Intangibles

Classified Liabilities are categorized as:

- Current
- Long Term

The details of how Classification is done follow. The meaning of WHY it is done is on page 6.

Classified Balance Sheet – 2 of 6

There is a systematic logic to “aliqueness.” Assets are grouped by liquidity, with the most liquid being listed first and this is **ALWAYS** cash. Liquidity broadly means flow speed. Just as water flows faster than crude oil, cash flows in and out faster than accounts receivable, long term deposits invested at the bank; or buildings.

There are more kinds of assets and more sub groups of kinds of assets than anything else on the balance sheet. Why? Because in business, numerous assets are needed to keep the businesses going. Imagine what a car dealership needs to keep business going each day. Besides having vehicles on the lot to sell, called inventory assets, it needs a lot to keep them on, called the asset land. The business also needs furniture and computers and repair equipment and fences and security devices and so on and so on.

Current Assets is the first asset sub group category or classification. Current means that these assets will surely move within one year.

Current Assets are:

- Cash
- Accounts Receivable
- Inventory
- Marketable Securities
- Supplies
- Prepaids

ALWAYS LISTED IN THIS LIQUIDITY ORDER

Cash is **ALWAYS** listed first within this sub group because it moves generally within a matter of hours or a few days. Cash means cash in the bank. Cash that is on site at the business is called Petty Cash.

Cash is the most liquid asset because it moves more, and faster than any other asset. It moves in and out. It moves in when sales are being made daily, cash is being received for sales and cash is being received from customers for credit or “on account” sales in the past.

At the same time cash moves out because the business is issuing checks to pay for all the support needed to make sales – such as salaries, taxes, travel, rent, inventory, repairs, furniture, and computers and on and on. Cash is used to pay operating expenses, to purchase more assets (to generate more sales and cash), and to pay down debts.

Classified Balance Sheet – 3 of 6

Current Assets -continued

Accounts Receivable is the next most liquid current asset. Most businesses have a significant component of their sales generated by customers buying “on account” or on credit. Goods or services are provided to the customer and the customer then owes the business money directly or pays with a credit card. When credit cards are used the business has an account receivable from the credit card company.

Inventory is the next most liquid asset for merchandising companies. Companies that provide only services to customers, such as marketing consultants or travel agencies, or hotels, do not have an inventory account. The word inventory causes confusion. It can be used in the broad sense to mean “how many” or the number of items we have – so we might have an inventory of 25 desks in the office administration group. The word can also be a verb as in “we will inventory the office desks.” This means we will count them.

But on a balance sheet, Inventory has a more specific meaning. Inventory on the balance sheet refers only to goods the business is selling to customers. The inventory account shows the dollar amount the business has on hand of goods for sale at the end of the accounting period. The office desks are not for sale, so they are not inventory. Inventory is liquid because it moves. Goods are sold and depart with the customer, or are delivered to the customer AND goods are being purchased and received by the business to replace goods that have been sold. This cycle is the same whether the business is selling paper clips or cars.

So Far in these notes...

Cash, Accounts Receivable and Inventory have been described and discussed in detail. These are the critical Current Assets because they are the core of the business. This is where most of the money is moving.

Classified Balance Sheet – 4 of 6

Current Assets -continued

Marketable Securities are considered Current because they can be turned into cash quickly. Businesses devote much time to managing cash flow, and when the situation is such that there is a surplus of cash in the bank; funds are often invested in short term securities. These securities can take the form of debt instruments such as bonds, debentures or government treasury bills OR equity instruments such as publicly traded common or preferred stock. Businesses manage cash this way because the return on marketable securities is expected to be higher than the return from the bank on deposited funds.

Supplies are items that are used by the business in providing goods or services. In a car wash business supplies would include soap for the machines and brushes and polish for the detailing. In a marketing consulting business supplies would include paper for the printers and photocopiers and binding components for presentation materials. Supplies are classified as Current because the business expects to use them within one year.

Prepaid means that the business has already spent the cash, and the amount paid relates to more than one accounting period. A business may pay for insurance on the basis of a five year policy because the rate is better than renewing one year at a time. Rent or lease costs may be prepaid as a condition of the rental or lease contract. All prepaid items are considered Current because the funds have been expended.

Supplies and Prepaid items **MUST be adjusted at the end of each accounting period – see Class Notes: Adjusting Entries**

Long Term Investments are called “Investments” on the balance sheet. The “long term” part means they are not “Current.” Investments represent cash the business has put in to securities that have a life longer than one year – before they can return the cash to the business. These can be investments in mortgages, term deposits (e.g. 2, 3, 5, 10 years). Investments also includes the cost of land that the business owns that is **not being used** in the business, but rather, is being held for future use or *“maybe we will sell it someday.”*

Classified Balance Sheet – 5 of 6

Assets –continued

Property, Plant & Equipment is also called “Fixed Assets” because PP&E is very stable, almost permanent in the business. All PP& E assets are not for sale in the regular course of business, but rather, exist to support business activities and objectives. Property includes the buildings and land the car dealership owns and uses for all aspects of its business. Plant refers more to a manufacturing business and also means the buildings and land owned and used by the production business. Equipment includes the hoists and tools used by the car dealership in its repair operations as well as the computers used in the sales and administration offices of the dealership. PP&E also includes vehicles, boats, planes, furniture and fixtures (such as lighting and shelving) used in the business..

All PP&E assets are depreciable except one - Land.

Different sub groups of PP&E, such as furniture, or vehicles or buildings, are depreciated at different rates. That is why they are sub grouped. Each sub group **must be shown on separately** the balance sheet with the original cost; then the accumulated depreciation; then the sub total like this:

Buildings	1,300,000	
Accumulated depreciation	<u>300,000</u>	1,000,000
Vehicles	100,000	
Accumulated depreciation	<u>8,000</u>	<u>92,000</u>
Total PP&E		<u>1,092,000</u>

The presentation showing the cost, the accumulated and the net is structured this way so that readers can quickly see how old the assets are. In the above example, the assets are fairly new, however, if the accumulated depreciation on the vehicles was \$80,000 instead of \$8,000 – you could tell immediately that these vehicles are not new.

Knowing the age of the assets is relevant information; and relevancy is one of the communication purposes of GAAP.

Classified Balance Sheet – 6 of 6

Assets –continued

Intangible literally means you can't touch them. These assets include patents, copyrights, trademarks and names that the business owns exclusively. All other assets can be seen and touched – cash, inventory, buildings, furniture and so on are physical things. Even accounts receivable is physical – invoices and statements of account. The only physical aspect to a patent or trademark is the legal piece of paper evidencing its existence and ownership, however, the value to the business can be significant, or not. Example: the Nike symbol.

Intangible assets are amortized over their estimated useful lives. The word “amortized” is used, not depreciation (only applies to PP&E). The Latin etymology of “amortize” is death.

Classifying Liabilities

See the Class Notes: LIABILITIES

Their are Only 2 Kinds; Also - Unearned Revenue & Current Portion Explained

Why? What Does it Mean?

The sub totals of the sub groups communicate quick important information about the liquidity, stability and solvency of the business. Here are some examples:

- If current assets are \$100,000 and current liabilities are \$300,000 – this is not good because debts that are “*currently*” due are not covered by current assets – cash flow problems are near. If the figures are reversed the business is liquid enough, with a good safety margin, to pay its debts coming due soon.
- A reader can quickly tell how much short term and long term debt the company has compared to total assets. The higher the proportion, the greater the level of concern.

By using other figures from the Income Statement together with classified balance sheet figures, readers and analysts can calculate important percentages and ratios that communicate how the business did during the accounting period and how it stands on the balance sheet date.

SEE CLASS NOTES: Financial Strength Calculations