Financial Accounting

Sixth Edition

Financial Statement Analysis

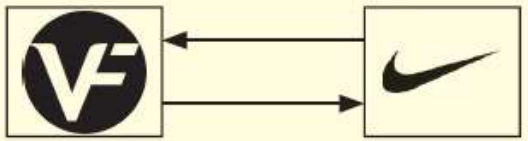
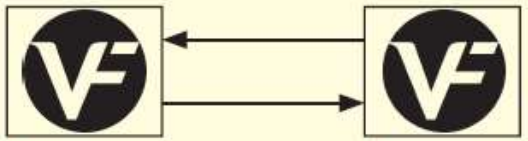
CHAPTER 12

Spiceland • Thomas • Herrmann

PART A

COMPARISON OF FINANCIAL ACCOUNTING INFORMATION

Illustration 12–1
Three Types of Comparisons

Type of Comparison	Example
1. Comparisons between companies	
 Sales Growth — Sales Growth	Compare sales growth for **VF Corporation** with sales growth for **Nike**.
2. Comparisons over time	
 Earnings in Current Year — Earnings in Previous Year	Compare VF's earnings in the current year versus previous year.
3. Comparisons to industry	
 Company Risk — Industry Risk	Compare VF's level of risk with the average degree of risk for the apparel industry.*

Rose Carson/Shutterstock; VF Corporation

*Industry averages can be obtained from websites such as Yahoo! Finance or from financial ratings agencies such as Dun & Bradstreet, Moody's, and Standard & Poor's.

Learning Objective 1

LO12–1 Perform vertical analysis.

Vertical Analysis

- Expressing each item in a financial statement as **a percentage of the same base amount measured in the same period**.
- For example:
  - **Income statement** items expressed as a percentage of **sales**
  - **Balance sheet** items expressed as a percentage of **total assets**

Illustration 12–2
Common-Size Income Statements

VF AND NIKE
Common-Size Income Statements
For the years ended March 31, 2020, and May 31, 2020
($ in millions)

	VF		NIKE	
	Amount	**%**	**Amount**	**%**
Net sales	$10,489	**100.0**	$37,403	**100.0**
Cost of goods sold	4,691	**44.7**	21,162	**56.6**
Gross profit	5,798	**55.3**	16,241	**43.4**
Operating Expenses	4,870	**46.4**	13,126	**35.1**
Operating income	928	**8.8**	3,115	**8.3**
Other income (expense)	–201	**–1.9**	–228	**–0.6**
Income before tax	727	**6.9**	2,887	**7.7**
Income tax expense	98	**0.9**	348	**0.9**
Net income	$ 629	**6.0**	$ 2,539	**6.8**

$\frac{\$4,691}{\$10,489} = 44.7\%$

The red arrow indicates the direction in which to read this statement.

All dollar amounts are expressed as a **percentage of net sales**

Illustration 12–3
Common-Size Balance Sheets

$\frac{\$5,027}{\$11,133} = 53.9\%$

The red arrow indicates the direction in which to read this statement.

VF AND NIKE
Common-Size Balance Sheets
March 31, 202, and May 31, 2020
($ in millions)

	VF		NIKE	
	Amount	**%**	**Amount**	**%**
Assets				
Current assets	$ 5,027	**45.2**	$20,556	**65.6**
Property and equipment	954	**8.6**	4,866	**15.5**
Intangible assets	3,011	**27.0**	497	**1.6**
Other assets	2,141	**19.2**	5,423	**17.3**
Total assets	$11,133	**100.0**	$31,342	**100.0**
Liabilities & Stockholders' Equity				
Current liabilities	$ 3,024	**27.2**	$ 8,284	**26.4**
Long-term liabilities	928	**42.7**	15,003	**47.9**
Retained earnings	1,207	**30.2**	8,055	**25.7**
Total	$3,644	**100.0**	$31,342	**100.0**

All dollar amounts are expressed as a **percentage of total assets**

Key Point

For vertical analysis, we express each item as **a percentage of the same base amount**, such as:

- A percentage of **sales** in the income statement
- A percentage of **total assets** in the balance sheet

Concept Check 12–1

When using vertical analysis, we express income statement items as a percentage of:

a. Net income

b. Sales

c. Gross profit

d. Total assets

When using vertical analysis, each item in the income statement is expressed as a percentage of sales.

Concept Check 12–2

When using vertical analysis, we express balance sheet items as a percentage of:

a. Total assets

b. Total liabilities

c. Total equity

d. Total revenues

When using vertical analysis, each item in the balance sheet is expressed as a percentage of total assets.

Learning Objective 2

LO12–2 Perform horizontal analysis.

Horizontal Analysis

Analyzing trends in financial statement data **for a single company over time**:

$$\text{\% Increase (Decrease)} = \frac{\text{Current-year amount} - \text{Prior-year amount}}{\text{Prior-year amount}}$$

Illustration 12-4

Horizontal Analysis of VF's Income Statements

VF
Income Statements
For the years ended March 31
($ in millions)

	Year		Increase (Decrease)	
	2020	**2019**	**Amount**	**%**
Net sales	$10,489	$10,267	**$ 222**	**2.2**
Cost of goods sold	4,691	4,656	**35**	**0.8**
Gross profit	5,798	5,611	**187**	**3.3**
Operating expenses	4,870	4,421	**449**	**10.2**
Operating income	928	1,190	**–262**	**–22.0**
Other expenses	–201	–152	**49**	**–32.2**
Income before tax	727	1,038	**–311**	**–30.0**
Income tax expense	98	168	**–70**	**–41.7**
Net income	$ 629	$ 870	**$–241**	**–27.7**

$\frac{\$222}{\$10,267} = 2.2\%$

The red arrow indicates the direction in which to read this statement.

Illustration 12–5

Horizontal Analysis of VF's Balance Sheets

$\frac{\$354}{\$4,673}$ = 7.6%

VF
Balance Sheets
March 31
($ in millions)

	Year		Increase (Decrease)	
	2020	2019	Amount	%
Assets				
Current assets	$ 5,027	$ 4,673	$ 354	7.6
Property and equipment	954	876	78	8.9
Intangible assets	3,011	3,399	–388	–11.4
Other assets	2,141	1,409	732	52.0
Total assets	$11,133	$10,357	$ 776	7.5
Liabilities and Stockholders' Equity				
Current liabilities	$ 3,024	$2,662	$ 362	13.6
Long-term liabilities	4,752	3,396	1,356	39.9
Stockholders' equity	3,357	4,299	–942	–21.9
Total liabilities and equities	$11,133	$10,357	$ 776	7.5

The red arrow indicates the direction in which to read this statement.

Key Point

We use horizontal analysis to analyze trends in financial statement data, such as:

the amount of change and the percentage change, for one company over time.

Concept Check 12–3

Horizontal analysis examines trends:

a. Between companies in the same year

b. Between balance sheet accounts in the same year

c. For a single company over time

d. As a percentage of sales on every financial statement

We use horizontal analysis to analyze trends in financial statement data for a single company over time. With horizontal analysis, we calculate the amount and percentage change in an account from last year to this year.

PART B

USING RATIOS TO ASSESS RISK AND PROFITABILITY

Common Mistake

In comparing an income statement account with a balance sheet account, some students incorrectly use the balance sheet account's ending balance, rather than the *average* of its beginning and ending balances.

Since income statement accounts are measured over a period of time, comparisons to related balance sheet accounts also need to be over time by taking the average of the beginning and ending balances.

Illustration 12–6
VF's Financial Statements—Income Statement

VF
Income Statement
For the year ended March 31, 2020
($ in millions)

	2020
Net sales	$10,489
Cost of goods sold	4,691
Gross profit	5,798
Operating expenses	4,870
Operating income	928
Other expense	– 201*
Income before tax	727
Income tax expense	98
Net income	$ 629

*Other expense includes interest expense of $92 million

Illustration 12–6 (continued)
VF's Financial Statements—Balance Sheets

VF
Balance Sheets, March 31
($ in millions)

	2020	2019
Assets		
Current assets:		
Cash	$ 1,369	$ 402
Net receivables	1,308	1,373
Inventory	1,294	1,173
Other current assets	1,056	1,725
Total current assets	5,027	4,673
Property and equipment	954	876
Intangible assets	3,011	3,399
Other assets	2,141	1,409
Total assets	$11,133	$10,357
Liabilities and Stockholders' Equity		
Current liabilities	$ 3,024	$ 2,662
Long-term liabilities	4,752	3,396
Stockholders' equity	3,357	4,299
Total liabilities and stockholders' equity	$11,133	$10,357

Learning Objective 3

LO12–3 Use ratios to analyze a company's risk.

Illustration 12–7
Risk Ratios

Risk Ratios	Chapter	Calculations
Liquidity		
Receivables turnover ratio	5	$\frac{\text{Net credit sales}}{\text{Average accounts receivable}}$
Average collection period	5	$\frac{\text{365 days}}{\text{Receivables turnover ratio}}$
Inventory turnover ratio	6	$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$
Average days in inventory	6	$\frac{\text{365 days}}{\text{Inventory turnover ratio}}$
Current ratio	8	$\frac{\text{Current assets}}{\text{Current liabilities}}$
Acid-test ratio	8	$\frac{\text{Cash + Current investments + Accounts receivable}}{\text{Current liabilities}}$
Solvency		
Debt to equity ratio	9	$\frac{\text{Total liabilities}}{\text{Stockholders' equity}}$
Times interest earned ratio	9	$\frac{\text{Net income + Interest expense + Income tax expense}}{\text{Interest expense}}$

Illustration 12–8

Receivables Turnover Ratio

- Measures how many times receivables are collected during the year

Receivables Turnover Ratio	VF		Nike
$\frac{\text{Net credit sales}}{\text{Average accounts receivable}}$	$\frac{\$10,489}{(\$1,308 + \$1,373)/2}$	= 7.8 times	10.7 times

- Is a lower or higher receivables turnover ratio better?
  - A high inventory turnover ratio usually is a positive sign. It indicates that inventory is selling quickly, less cash is tied up in inventory, and the risk of outdated inventory is lower

Illustration 12–9

Average Collection Period

- Measures the days it takes to convert receivables into cash

Average Collection Period	VF	Nike
$\frac{365 \text{ days}}{\text{Receivables turnover ratio}}$	$\frac{365}{7.8}$ = 46.8 days	34.1 days

- Is a longer or shorter average collection period better?
  - The shorter the average collection period, the better.

Illustration 12–10

Inventory Turnover Ratio

- Measures how many times average inventory is sold during the year

Inventory Turnover Ratio	VF		Nike
$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$	$\frac{\$4{,}691}{(\$1{,}294 + \$1{,}173)/2}$	= 3.8 times	3.3 times

- What would a high inventory turnover ratio indicate?
  - A inventory turnover high ratio indicates that inventory is selling quickly.
  - An extremely high ratio might indicate lost sales due to inventory shortages.

Illustration 12–11

Average Days in Inventory

- Measures the average number of days it takes to sell its entire inventory during the year

Average Days in Inventory	VF	Nike
$\frac{365 \text{ days}}{\text{Inventory turnover ratio}}$	$\frac{365}{3.8}$ = 96.1 days	110.6 days

- Is a shorter or longer average number of days in inventory better?
  - Companies try to minimize the number of days they hold inventory.

Illustration 12–12

Current Ratio

- Compares current assets to current liabilities

Current Ratio	VF	Nike
$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{\$5,207}{\$3,024} = 1.7$ to 1	2.5 to 1

- Would a company want a high current ratio?
  - A higher current ratio usually indicates less risk.

Illustration 12–13

Acid-Test Ratio

- A more conservative measure of a company's ability to pay current liabilities

Acid-Test Ratio	VF	Nike
$\frac{\text{Cash + Current investments + Accounts receivable}}{\text{Current liabilities}}$	$\frac{\$1{,}369 + \$0 + \$1{,}308}{\$3{,}024}$ = 0.9 to 1	1.4 to 1

- Why is the acid-test ratio more conservative?
  - Because it eliminates current assets such as inventories and prepaid expenses that are less readily convertible into cash, the acid-test ratio often provides a better indication of a company's liquidity than does the current ratio.

Illustration 12–14

Debt to Equity Ratio

- Indicates the risk of bankruptcy

Debit to Equity Ratio	VF	Nike
$\frac{\text{Total liabilities}}{\text{Stockholders' equity}}$	$\frac{\$3{,}024 + \$4{,}752}{\$3{,}357} = 231.6\%$	289.1%

- Would a higher debt to equity ratio indicate lower or higher risk?
  - Other things being equal, the higher the debt to equity ratio, the higher the risk of bankruptcy.
  - More debt increases the risk of bankruptcy, but it also increases the potential returns investors can enjoy.

Illustration 12–15

Times Interest Earned Ratio

- Compares interest payments with a company's income available to pay those charges
- Classified as a solvency ratio rather than a liquidity ratio

Times Interest Earned Ratio	VF	Nike
$\frac{\text{Net income + Interest expense + Income tax expense}}{\text{Interest expense}}$	$\frac{\$629 + \$92 + \$98}{\$92}$ = 8.9 times	20.1 times

- Is a higher or lower times interest earned ratio better?
  - A company wants higher net income before interest expense and income tax expense in relation to the amount it needs for interest expense alone.

Key Point

We categorize risk ratios into liquidity ratios and solvency ratios.

Liquidity ratios focus on the company's ability to pay *current* liabilities, whereas solvency ratios include *long-term* liabilities.

Concept Check 12–4

Which of the following is considered a liquidity ratio?

a. Profit margin

b. Asset turnover

c. Receivables turnover ratio

d. Times interest earned ratio

The receivables turnover ratio measures how many times, on average, a company collects its receivables during the year and is an example of a liquidity ratio.

Concept Check 12–5

Which of the following is considered a solvency ratio?

a. Profit margin

b. Asset turnover

c. Receivables turnover ratio

d. Times interest earned ratio

The times interest earned ratio compares interest payments with a company's income available to pay those charges and is considered a solvency ratio.

Learning Objective 4

LO12–4 Use ratios to analyze a company's profitability.

Illustration 12–16
Profitability Ratios

Profitability Ratios	Chapter	Calculations
Gross profit ratio	6	$\frac{\text{Gross profit}}{\text{Net sales}}$
Return on assets	7	$\frac{\text{Net income}}{\text{Average total assets}}$
Profit margin	7	$\frac{\text{Net income}}{\text{Net sales}}$
Asset turnover	7	$\frac{\text{Net sales}}{\text{Average total assets}}$
Return on equity	10	$\frac{\text{Net income}}{\text{Average stockholders' equity}}$
Earnings per share	10	$\frac{\text{Net income} - \text{Dividends on preferred stock}}{\text{Average shares of common stock outstanding}}$
Price-earnings ratio	10	$\frac{\text{Stock price}}{\text{Earnings per share}}$

Illustration 12–17

Gross Profit Ratio

- Indicates the portion of each dollar of sales above its cost of goods sold

Gross Profit Ratio	VF	Nike
$\frac{\text{Gross profit}}{\text{Net sales}}$	$\frac{\$5,798}{\$10,489} = 55.3\%$	43.4%

- True or False: Gross profit ratios vary by industry.
  - True. Retail typically has a smaller gross profit ratio (25%) than drug manufacturers (68%), because retail is a more competitive industry.

Illustration 12–18

Return on Assets

- Measures the income the company earns on each dollar invested in assets

Return on Assets	VF	Nike
$\frac{\text{Net income}}{\text{Average total assets}}$	$\frac{\$629}{(\$11{,}133 + \$10{,}357)/2} = 5.9\%$	9.2%

- Is a higher or lower return on assets better?
  - A higher percentage would indicate a higher amount earned compared to the assets that it owns.

Illustration 12–19

Components of Return on Assets

- Return on assets = Profit margin x Asset turnover
- Some companies rely on high profit margins
- Other companies rely more on asset turnover

$$\frac{\textbf{Return on Assets}}{\text{Net income}} = \frac{\textbf{Profit margin}}{\text{Net income}} \times \frac{\textbf{Asset turnover}}{\text{Net sales}}$$
$$\frac{\text{Net income}}{\text{Average total assets}} = \frac{\text{Net income}}{\text{Net sales}} \times \frac{\text{Net sales}}{\text{Average total assets}}$$

- Investors are especially intrigued by companies that can obtain both—high profit margins and high asset turnover.

Illustration 12–20
Profit Margin

- Measures the income earned on each dollar of sales

Profit Margin	VF	Nike
$\frac{\text{Net income}}{\text{Net sales}}$	$\frac{\$629}{\$10,489} = 6.0\%$	6.8%

- What does a higher profit margin indicate?
  - A higher profit margin indicates a higher amount actually earned (after expenses are accounted for) compared to its total revenues.

Illustration 12–21

Asset Turnover

- Measures sales volume in relation to the investment in assets

Asset Turnover	VF		Nike
Net sales / Average total assets	$10,489 / ($11,133 + $10,357)/2	= 1.0 times	1.4 times

- Is a higher or lower asset turnover ratio better?
  - A company wants higher revenues compared to each dollar invested in assets.

Illustration 12–22

Return on Equity

- Measures the income earned for each dollar in stockholders' equity

Return on Equity	VF		Nike
$\frac{\text{Net income}}{\text{Average stockholders' equity}}$	$\frac{\$629}{(\$3{,}357 + \$4{,}299)/2}$	= 16.4%	29.7%

- Is a higher or lower return on equity ratio better?
  - Answer: A **higher** amount earned compared to the investment made by the owners of the company (the stockholders) is desirable.

Illustration 12–23

Price-Earnings Ratio

- Compares a company's share price with its earnings per share

Price-Earnings Ratio	VF	Nike
$\frac{\text{Stock price}}{\text{Earnings per share}}$	$\frac{\$54.08}{\$1.59} = 34.0$	60.5

- What does a higher PE Ratio indicate?
  - A higher PE Ratio indicates that investors have a higher expectation of earnings growth.

Key Point

Profitability ratios measure the earnings or operating effectiveness of a company over a period of time, such as a year.

Investors view profitability as the number one measure of company success.

Concept Check 12–6

The Sports Zone reports net income of $50,000, net sales of $500,000, and average total assets of $400,000. What is their asset turnover?

a. 10%

b. 10 times

c. 1.25 times

d. 0.8 times

The asset turnover ratio is computed as net sales divided by average total assets:

$500,000 / $400,000 = 1.25 times

Concept Check 12–7

The Sports Zone reports net income of $50,000, net sales of $500,000, and average total assets of $400,000. What is their profit margin?

a. 10%
b. 80%
c. 125%
d. 25%

The profit margin is computed as net income divided by net sales:

$$\$50,000 / \$500,000 = 10\%$$

Concept Check 12–8

The Sports Zone reports net income of $50,000, sales of $500,000, and average assets of $400,000. What is their return on assets?

a. 10%

b. 80%

c. 12.5%

d. 25%

The return on assets is computed by dividing net income by average total assets:

$50,000 / $400,000 = 12.5%

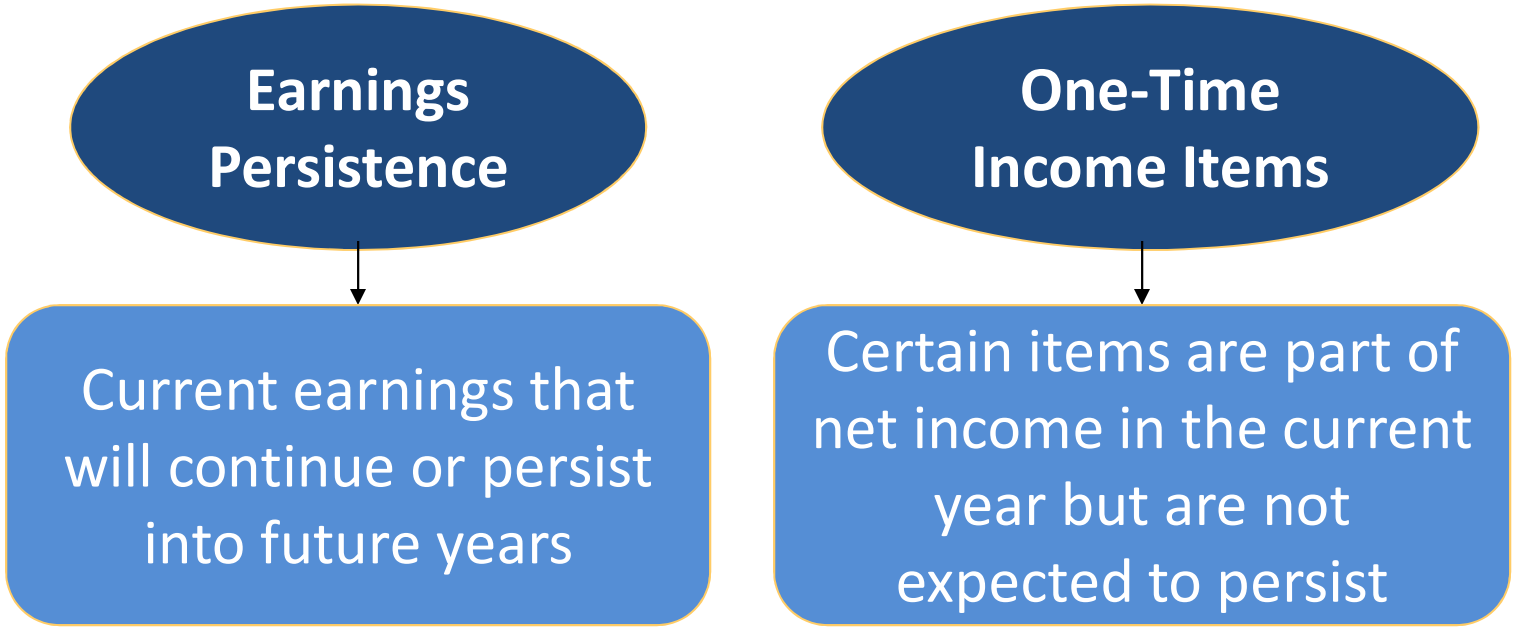
PART C

EARNINGS PERSISTENCE AND EARNINGS QUALITY

Learning Objective 5

LO12–5 Distinguish persistent earnings from one-time items.

Earnings Persistence and One-Time Income Items



Discontinued Operations

- Sale or disposal of business or component of business representing *strategic shift* that has a *major effect* on an organization's operations and financial results
- Examples:
  - Major geographical area
  - Major line of business
  - Major investment in which company has significant influence
- Any gains or losses on discontinued operations in the current year are reported separately

Illustration 12–24
Presentation of a Discontinued Operation

FEDERER SPORTS APPAREL Income Statement For the year ended December 31, 2024	
Net sales	$ 15,500,000
Cost of goods sold	7,000,000
Gross profit	8,500,000
Operating expenses	1,200,000
Depreciation expense	1,000,000
Other revenues and expenses	300,000
Income before tax	6,000,000
Income tax expense	2,000,000
Income from continuing operations	4,000,000
Discontinued operation:	
Income from tennis shoe segment, net of tax	**1,000,000**
Net income	$ 5,000,000

Illustration 12–25

Other Revenues and Expenses

Other Revenues and Expenses
Examples
1. Losses due to the write-down of receivables, inventory, or long-term assets.
2. Gains or losses on the sale of long-term assets.
3. Losses due to an employee strike.
4. Losses due to business restructuring.
5. Uninsured losses from a natural disaster such as a flood, earthquake, or hurricane.

Concept Check 12–9

Which of the following items would be reported at the bottom of the income statement, just before net income?

a. Losses due to the write down of inventory

b. Gain on sale of long-term assets

c. Discontinued operations

d. Losses due to restructuring

Discontinued operations is reported separately, net of tax, in the income statement, right before net income.

Learning Objective 6

LO12–6 Distinguish between conservative and aggressive accounting practices.

Quality of Earnings

- Ability of reported earnings to reflect true earnings
- Usefulness of reported earnings to predict future earnings

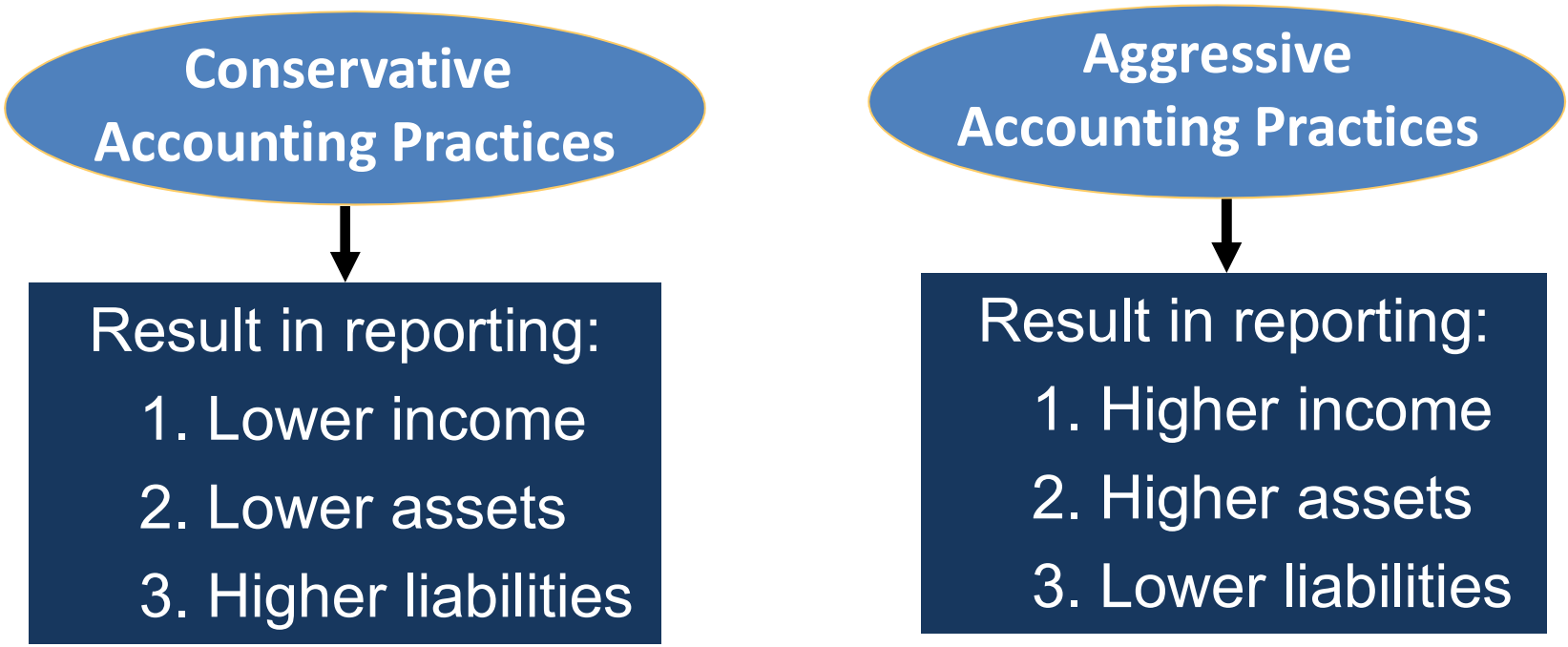


Illustration 12–26
Financial Statements Prepared by Mr. Nadal

FEDERER SPORTS APPAREL
Income Statement
For the year ended December 31, 2025

Net sales	$18,800,000
Cost of goods sold	13,400,000
Gross profit	5,400,000
Operating expenses	1,600,000
Depreciation expense	1,000,000
Loss (litigation)	1,500,000
Income before tax	1,300,000
Income tax expense	450,000
Net income	$ 850,000

FEDERER SPORTS APPAREL
Balance Sheets
December 31

	2025	2024
Cash	$ 2,300,000	$ 800,000
Accounts receivable	1,500,000	1,200,000
Inventory	2,800,000	1,700,000
Buildings	11,000,000	11,000,000
Less: Accumulated depreciation	(2,000,000)	(1,000,000)
Total assets	$15,600,000	$13,700,000
Accounts payable	$ 1,450,000	$ 1,700,000
Contingent liability	1,500,000	0
Common stock	8,000,000	8,000,000
Retained earnings	4,650,000	4,000,000
Total liabilities and stockholders' equity	$15,600,000	$13,700,00

Illustration 12–26 (continued)

FEDERER SPORTS APPAREL Statement of Cash Flows For the year ended December 31, 2025		
Cash Flows from Operating Activities		
Net income	$ 850,000	
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation expense	1,000,000	
Increase in accounts receivable	(300,000)	
Increase in inventory	(1,100,000)	
Decrease in accounts payable	(250,000)	
Increase in contingent liability	1,500,000	
Net cash flows from operating activities		$1,700,000
Cash Flows from Investing Activities		
Net cash flows from investing activities		0
Cash Flows from Financing Activities		
Payment of cash dividends	(200,000)	
Net cash flows form financing activities		(200,000)
Net increase (decrease) in cash		1,500,000
Cash at the beginning of the period		800,000
Cash at the end of the period		$2,300,000

Illustration 12–27
Mr. Djokovic's Proposed Changes

Mr. Djokovic's Proposed Changes

1. **Estimate of bad debts.** At the end of 2025, Mr. Nadal estimated that future bad debts will be 6% to 10% of current accounts receivable. He decided to play it safe and recorded an allowance equal to 10% of accounts receivable, or $150,000. Mr. Djokovic proposes changing the estimate to be 6% of accounts receivable, or $90,000. This change would increase net accounts receivable and decrease bad debt expense by $60,000.

2. **Write-down of inventory.** Mr. Nadal recorded a $200,000 write-down of inventory as follows:

December 31, 2025	Debit	Credit
Cost of Goods Sold	**200,000**	
Inventory		**200,000**

(Write-down inventory)

Mr. Djokovic insists the write-down was not necessary because the decline in inventory value was only temporary. Therefore, he proposes eliminating this entry, which would increase inventory and decrease loss on inventory write-down by $200,000.

(continued on next slide)

Illustration 12–27

Mr. Djokovic's Proposed Changes

(continued)

3. **Change in depreciation estimate.** For the building purchased for $11 million at the beginning of 2024, Mr. Nadal recorded depreciation expense of $1 million in 2024 and 2025, using the straight-line method over 10 years with an estimated salvage value of $1 million. Beginning in 2025, Mr. Djokovic proposes calculating depreciation over a total of 20 years instead of 10 and using an estimated salvage value of $500,000. That change decreases accumulated depreciation and depreciation expense in 2025 by $500,000.

4. **Loss contingency.** At the end of 2025, the company's lawyer advised Mr. Nadal that there was a 70% chance of losing a litigation suit of $1,500,000 filed against the company. Mr. Nadal recorded the possible loss as follows:

December 31, 2025	Debit	Credit
Loss	**1,500,000**	
Contingent Liability		**1,500,000**

(Record litigation against the company)

Mr. Djokovic argues that the likelihood of losing the litigation is reasonably possible, but not probable. Therefore, he proposes removing the litigation entry from the accounting records. The change would remove the loss and decrease liabilities by $1,500,000.

Illustration 12–28

Income Statement Revised by Mr. Djokovic

FEDERER SPORTS APPAREL
Income Statement
For the year ended December 31, 2025

	Nadal	Changes	Djokovic
Net sales	$18,800,000		$18,800,000
Cost of goods sold	13,400,000	$ (200,000)	13,200,000
Gross profit	5,400,000		5,600,000
Operating expenses	1,600,000	(60,000)	1,540,000
Depreciation expense	1,000,000	(500,000)	500,000
Loss (litigation)	1,500,000	(1,500,000)	0
Income before tax	1,300,000	2,260,000	3,560,000
Income tax expense	450,000		450,000
Net income	$ 850,000	$ 2,260,000	$ 3,110,000

Illustration 12–29
Balance Sheet Revised by Mr. Djokovic

FEDERER SPORTS APPAREL
Balance Sheet
December 31, 2025

	Nadal	Changes	Djokovic
Assets			
Cash	$ 2,300,000		$ 2,300,000
Accounts receivable	1,500,000	$ 60,000	1,560,000
Inventory	2,800,000	200,000	3,000,000
Buildings	11,000,000		11,000,000
Less: Accumulation depreciation	(2,000,000)	500,000	(1,500,000)
Total assets	$15,600,000	$ 760,000	$16,360,000
Liabilities and Stockholders' Equity			
Accounts payable	$ 1,450,000		$ 1,450,000
Contingent liability	1,500,000	(1,500,000)	0
Common stock	8,000,000		8,000,000
Retained earnings	4,650,000	2,260,000	6,910,000
Total liabilities and stockholders' equity	$15,600,000	$ 760,000	$16,360,000

Illustration 12–30
Statement of Cash Flows Revised by Mr. Djokovic

FEDERER SPORTS APPAREL
Statement of Cash Flows
For the year ended December 31, 2025

	Nadal	Changes	Djokovic
Operating Activities			
Net income	$ 850,000	$ 2,260,000	$ 3,110,000
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation expense	1,000,000	(500,000)	500,000
Increase in accounts receivable	(300,000)	(60,000)	(360,000)
Increase in inventory	(1,100,000)	(200,000)	(1,300,000)
Decrease in accounts payable	(250,000)		(250,000)
Increase in contingent liability	1,500,000	(1,500,000)	0
Net cash flows from operating activities	1,700,000	0	1,700,000
Investing Activities	0		0
Financing Activities			
Payment of cash dividends	(200,000)		(200,000)
Net cash flows from financing activities	(200,000)		(200,000)
Net increase (decrease) in cash	1,500,000		1,500,000
Cash at the beginning of the period	800,000		800,000
Cash at the end of the period	$2,300,000		$2,300,000

Conservatism Versus Aggressive Accounting

- Mr. Nadal represents conservative accounting practices
- Mr. Djokovic represents aggressive accounting practices

Key Point

Changes in accounting estimates and practices alter the appearance of amounts reported in the income statement and the balance sheet.

However, changes in accounting estimates and practices usually have no effect on a company's underlying cash flows.

Concept Check 12–10

Which of the following would be considered an aggressive accounting practice?

a. Writing down inventory due to a decline in inventory value

b. Changing from straight line to the double declining balance method of depreciation

c. Deciding to remove a loss contingency when the likelihood of an unfavorable decision is probable

d. All the above

Conservative accounting practices are those that result in reporting lower income, lower assets, and higher liabilities. Aggressive policies are the opposite. Deciding to remove a loss contingency is considered an aggressive practice, especially when the likelihood of an unfavorable decision is probable. (The other two items are conservative in nature.)

End of Chapter 12