THE BALANCE SHEET AND FINANCIAL DISCLOSURES

The balance sheet (statement of financial position)

Usefulness: The broad usefulness of the balance sheet is to indicate how the assets of the firm were financed (assets=liabilities+equity). More specifically, it provides information useful for assessing future cash flows, liquidity, and long-term solvency.

Limitations: Assets minus liabilities, measured according to GAAP, is not likely to be representative of the market value of the entity (number of common stock shares outstanding multiplied by price per share).

Classification of Elements

Assets	=	Liabilities	+	Shareholders' Equity
1. Current assets		1. Current liabilities		1. Paid-in capital
2. Long-term assets:		2. Long-term liabilities		2. Retained earnings

The operating cycle for a typical manufacturing company refers to the period of time necessary to convert cash to raw materials, raw materials to a finished product, the finished product to receivables, and then finally receivables back to cash.

① Use cash to acquire raw materials

↓

② Convert raw materials to finished product

↓

③ Deliver product to customer

↓

④ Collect cash from customer

CURRENT ASSETS

Include cash and all other assets expected to become cash or be consumed within one year or the operating cycle, whichever is longer.

- Cash and Cash Equivalents

Cash includes: Bank drafts, Cashier's checks, Money orders

Cash Equivalents include liquid investments (readily converted to cash) that have a maturity date of three months or less from the date of purchase, such as Treasury bills, Commercial paper, Money market funds, and Money Market Savings Certificates.

Treasury Bills: U.S. government obligations generally having 91 or 182-day maturities

Commercial Paper: Short-term notes (30 to 270 days) issued by corporations with good credit ratings

Money Market Funds: Variation of the mutual fund. Yield is determined by mix of Treasury bills and commercial paper in the portfolio.

Money Market Savings Certificates (CDs): Issued by banks or savings and loans institutions in denominations of $10,000 or more for 6 to 48 months.

NOTE: All of the above pay interest and therefore have a maturity date. All of the above are cash equivalents if they mature within 3 months from the date the entity purchased the item.

CAUTION: Watch for questions that give you a maturity date and a date of purchase. Recall, to be considered as cash equivalents, the debt investment must mature within 3 months of the client's date of purchase (3-month test).

HINT: Draw the time line to do the 3-month test; place on the line the purchase and maturity dates

Are investments in marketable securities (classified on the entity's balance sheet as trading investments) cash equivalents? No, cash equivalents are not investments in stocks (equities) of other entities. Cash equivalents are investments in debt that mature and pay interest to the investor. Stock does not mature. Stock does not bear interest. Investment in shares of stock (equities) is not a cash equivalent.

Bank overdrafts:

If the cash in a checking account is not sufficient to pay an obligation (account payable), the bank provides the difference. The journal entry is:

Dr. Account payable

    Cr. Cash

    Cr. Bank overdraft

Therefore, Bank overdrafts are usually reported as a liability.

Be careful, net overdrawn checking accounts are cash equivalents only when the checking accounts are within the same bank.

- Short-term Investments are classified as current if the company’s management intends to liquidate the investment in the next year or operating cycle, whichever is longer, and has the ability to do so, i.e., the investment is marketable (stocks and bonds of other firms).
- Accounts Receivable arise from the sale of goods or services on credit. They are valued net of allowance for uncollectible accounts.
- Inventories consist of assets that a retail or wholesale company acquires for resale or goods that manufacturers produce for sale.
- Prepaid Expenses arise when a cash payment creates benefits beyond the current period (e.g. repaid rent and prepaid insurance).

NONCURRENT ASSETS

- Investments: Assets not used directly in the operations of the business (e.g. Investments in equity and debt securities of other corporations, Land held for speculation, Noncurrent receivables, Cash set aside for special purposes).
- Property, Plant, and Equipment: Tangible, long-lived assets used in the operations of the business. They are usually the primary revenue-generating assets of the business (e.g. Land, buildings, equipment, machinery, and furniture, Natural resources (such as mineral mines, and oil and gas wells)
- Intangible Assets: They lack physical existence and represent exclusive rights to something — a product, process, etc. (e.g. Patents, Copyrights, Franchises, Goodwill)
- Other Assets: A catch-all classification that includes long-term prepaid expenses, called deferred charges, and any noncurrent asset not falling in one of the other classifications.

CURRENT LIABILITIES

Current liabilities are those obligations that are expected to be satisfied within one year or the operating cycle, whichever is longer.

- Accounts Payable: Obligations to suppliers of merchandise or services purchased on open account. Payment usually is due in 30 to 60 days.
- Notes Payable: Written promises to pay cash at some future date. Usually require the payment of explicit interest.
- Deferred Revenues: Represent cash received from a customer for goods or services to be provided in a future period.
- Accrued Liabilities: Obligations created when expenses have been incurred but won't be paid until a subsequent reporting period (e.g. Accrued salaries payable, Accrued interest payable, Accrued taxes payable).
- Current Maturities of Long-term Debt

LONG-TERM LIABILITIES

Long-term liabilities are those obligations that are not expected to be satisfied within one year or the operating cycle, whichever is longer (e.g. Long-term notes, Bonds, Pension obligations, Lease obligations).

SHAREHOLDERS' EQUITY

Shareholders' equity is comprised of paid-in capital (invested capital) and retained earnings (earned capital).

- Paid-in capital: Amounts invested by shareholders.
- Retained earnings: Accumulated net income reported since the inception of the company and not yet paid to shareholders.

FINANCIAL DISCLOSURES

Disclosure notes include certain required notes as well as notes fashioned to suit the disclosure needs of the reporting enterprise.

- Summary of Significant Accounting Policies: It is a required disclosure and examples include principles of consolidations, definition of cash equivalents, valuation of inventory, method for recording depreciation, and policy for revenue recognition.
- Subsequent events: significant occurrences between the date of the financial statements and the date the statements are issued or available to be issued.
- Related-party transactions: They require disclosure of the nature of the relationship, a description of the transaction, and any dollar amounts involved.
- Management discussion and analysis: It provides a biased but informed perspective of operations, liquidity, and capital resources.
- Management responsibilities: They indicate the responsibility of management for the information contained in the annual report as well as an assessment of the company's internal control systems.
- Compensation of Directors and Top Executives: The proxy statement, which must be provided each year to all shareholders, serves as an invitation to attend the company's annual meeting and as a means to vote on issues before the shareholders. The proxy statement also contains disclosures on compensation to directors and executives.
- Auditors' report: It provides an independent and professional opinion about the fairness of the representations in the financial statements and the effectiveness of the company's internal control over financial reporting. The four basic types of auditors' reports are: a) Unqualified (or "clean"), b) Unqualified with an explanatory paragraph (lack of consistency, going concern, or emphasis of matter), c) Qualified (scope limitation or departure from GAAP), and d) Adverse (serious misstatement) or disclaimer (severe scope limitation).

Financial Statement Analysis

1. Comparative financial statements—compare year-to-year financial position, results of operations, and cash flows.

2. Horizontal analysis—percentage change in financial statement item since a base year.

3. Vertical analysis—financial statement item expressed as a percentage of a total amount.

4. Ratio analysis—convert financial statement items to ratios.

Risk Analysis

Liquidity Ratios

Liquidity refers to the ability of a company to convert its assets to cash to pay its current obligations.

- Working capital, the difference between current assets and current liabilities, is a popular measure of a company's ability to satisfy its short-term obligations.
  Working Capital = Current Assets – Current Liabilities

- The current ratio, calculated by dividing current assets by current liabilities, expresses working capital as a ratio that allows for interfirm comparisons.
  Current Ratio = Current Assets / Current Liabilities

- The acid-test ratio provides a more stringent indication of a company's ability to pay its current obligations. The ratio excludes inventories and prepaid expenses from current assets before dividing by current liabilities.
  Acid-test ratio = Quick assets/Current Liabilities.

Solvency Ratios

Solvency ratios provide some indication of the riskiness of a company with regard to its ability to pay its long-term debts.

- The debt to equity ratio indicates the extent of reliance on creditors, rather than owners, in providing resources (extent of financial leverage).
  Debt to equity = Total liabilities/Shareholders' equity.

- The times interest earned ratio indicates the margin of safety provided to creditors.
  Times interest earned = (Net income+interest expense+taxes)/interest expense.

Favorable financial leverage means earning a return on borrowed funds that exceeds the cost of borrowing the funds.

Reporting Segment Information

Segment reporting facilitates the financial statement analysis of diversified companies.

Information is reportable for identifiable operating segments.

An operating segment is a component of an enterprise

- That engages in business activities from which it may recognize revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise).
- Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.
- For which discrete financial information is available.

Only segments of a certain size (10% or more of total company revenues, assets, or net income) must be disclosed. However, a company must account for at least 75% of consolidated revenue through segment disclosures.

For areas determined to be reportable operating segments, the following disclosures are required:

- General information about the operating segment.

- Information about reported segment profit or loss, including certain revenues and expenses included in reported segment profit or loss, segments assets, and the basis of measurement.

- Reconciliations of the totals of segments revenues, reported profit or loss, assets, and other significant items to corresponding enterprise amounts.

- Interim period information.

GAAP requires an enterprise to report certain geographic information unless it is impracticable to do so.

- Revenues from major customers must be disclosed.

For homework work on E3-6, E3-15, E3-17, P3-6, and P3-8.

1. Listed below are year-end account balances ($ in millions) taken from the records of Symphony Stores.

	Debit	Credit
Accounts receivable–trade	730	
Building and equipment	920	
Cash–checking	34	
Interest receivable	30	
Inventory	16	
Land	150	
Notes receivable (long-term)	450	
Petty cash fund	5	
Prepaid rent	20	
Supplies	8	
Trademark	40	
Accounts payable–trade		560
Accumulated depreciation		80
Additional paid-in capital		485
Allowance for uncollectible accounts		20
Cash dividends payable		30
Common stock, at par		15
Income tax payable		65
Notes payable (long-term)		800
Retained earnings		308
Deferred revenues		40
TOTALS	2,403	2,403

What is the amount of working capital for Symphony?

Current assets: ($730 – 20) + 34 + 30 + 16 + 5 + 20 + 8 =	$ 823
Current liabilities: $560 + 30 + 65 + 40 =	695
Working capital	$ 128

2. The December 31, 2018, post-closing trial balance ($ in thousands) for Libby Corporation is presented below:

	Debits	Credits
Cash	22,500	
Investments (long-term)	55,000	
Accounts receivable	30,000	
Allowance for uncollectible accounts		7,500
Prepaid insurance	4,500	
Inventories	100,000	
Land	45,000	
Buildings	140,000	
Accumulated depreciation–buildings		50,000
Equipment	132,500	
Accumulated depreciation–equipment		30,000
Patents (unamortized balance)	5,000	
Accounts payable		37,500
Notes payable, due 2019		65,000
Interest payable		10,000
Bonds payable, due 2028		120,000
Common stock, no par, 20,000 shares authorized, issued, and outstanding		150,000
Retained earnings		64,500
Totals	534,500	534,500

Required: Prepare a classified balance sheet for Libby Corporation at December 31, 2018.

Libby Corporation Balance Sheet
At December 31, 2018
($ in thousands)

Assets

Cash		$22,500
Accounts receivable	$30,000	
Less: Allowance for uncollectible accounts	7,500	22,500
Inventories		100,000
Prepaid insurance		4,500
Total current assets		149,500
Investments		55,000
Property, plant, and equipment:		
Land	45,000	
Buildings	140,000	
Equipment	132,500	
	317,500	
Less: Accumulated depreciation	80,000	
Net Property, plant, and equipment		237,500
Intangibles:		
Patents		5,000
Total assets		$447,000

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable		$37,500
Notes payable, due 2019		65,000
Interest payable		10,000
Total current liabilities		112,500
Long-term liabilities:		
Bonds payable, due 2028		120,000
Total liabilities		232,500
Shareholders' equity:		
Common stock, no par, 20,000 shares authorized, issued, and outstanding	$150,000	
Retained earnings	64,500	
Total shareholder's equity		$214,500
Total liabilities and shareholders' equity		$447,000

3. The condensed balance sheet and income statement for Marjoram Company are presented below.

Marjoram Company
Balance Sheet
At December 31, 2018

Cash	$ 19,000
Nontrade receivable due August 15, 2019	35,000
Accounts receivable (net)	48,400
Merchandise inventory	70,600
Property, plant, and equipment (net)	250,000
Intangible assets	12,400
Total Assets	$435,400
Current liabilities	$108,400
11% Bonds payable, long term	100,000
Paid in capital	70,000
Retained earnings	157,000
Total liabilities and equity	$435,400

Marjoram Company
Income Statement
For the Year ended December 31, 2018

Sales	$704,000
Cost of goods sold	422,400
Gross profit	$281,600
Operating expenses	166,200
Operating income	$115,400
Interest expense	11,000
Income before income taxes	$104,400
Income taxes	31,320
Net income	$ 73,080

Compute the current ratio for Marjoram Company. Round your answer to two decimal places.

($19,000 + 35,000 + 48,400 + 70,600) /$108,400 = 1.60 Current ratio

Compute the acid-test ratio for Marjoram Company. Round your answer to two decimal places.

($19,000 + 35,000 + 48,400) /$108,400 = .94 Acid-test ratio

Compute the debt to equity ratio for Marjoram Company. Round your answer to two decimal places.

($108,400 + 100,000) / ($70,000 + 157,000) = .92 Debt to equity ratio

Compute the times interest earned ratio for Marjoram Company. Round your answer to two decimal places.

($73,080 + 31,320 + 11,000) /$11,000 = 10.49 Times interest earned ratio

Compute the return on shareholders' equity ratio for Marjoram Company. Round your answer to two decimal places.

$73,080 / ($70,000 + 157,000) = 32% Return on shareholders' equity