LEVEL 1:

FINANCIAL REPORTING & ANALYSIS

Reading 18 (4th out of 12): BALANCE SHEET

Difficulty: **medium**

Benchmark Study Time: **3.5h**

2022

INTENTIONALLY EMPTY

THIS E-BOOK:

- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep all important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g. write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to your study plan and change the Reading's status to **green**:
   (it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

BALANCE SHEET INTRODUCTION

Definitions

A balance sheet gives information about the company's financial position at a given point in time, for example at year end.

assets = liabilities + owners' equity

According to the IFRS framework:

- an asset is defined as a resource controlled by the company as a result of past events if it is expected to bring future economic benefits to the company,
- a liability is a present obligation of the company arising from past events, the settlement of which is expected to result in an outflow from the company of resources embodying economic benefits,
- owners' equity (also called shareholders equity, owners' residual interest in the assets of the company) represents the excess of the company's assets over liabilities.

<u>Basic accounting equation</u>

assets = liabilities + owners' equity

company's resources = sources of financing company's resources

OR

owners' equity = assets – liabilities

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Balance sheet limitations

A balance sheet doesn't indicate what the intrinsic value or the market value of the company is. This is because:

- different methods (e.g. historical cost, current value, etc.) are used to measure different types of assets and liabilities,
- the balance sheet gives information about the company's financial position at a given moment of time. Therefore, the data included in the balance sheet may not be sufficient to measure the company's value between balance sheet dates,
- the balance sheet doesn't reflect factors that impact the company's value, like expected future cash flows, human capital, etc.

Balance sheet presentation

Methods of balance sheet presentation:

- current/non-current presentation,
- liquidity based presentation.

<u>Current/non-current presentation</u>

Assets can be divided into:

- non-current assets,
- current assets.

If the company:

- expects to sell, use up or convert into cash an asset within one year (or one operating cycle), the asset is classified as a <u>current asset</u>,
- doesn't expect to sell, use up or convert into cash an asset within one year (or one operating cycle), the asset is classified as a <u>non-current asset</u>. (Non-current assets are those assets that are not current assets.)

non-current assets = long-term assets = long-lived assets

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Liabilities can be divided into:

- non-current liabilities,
- current liabilities.

If the company expects to settle the liability within one year (or one operating cycle), the liability is classified as a current liability.

Non-current liabilities are those liabilities that are not current liabilities.

A balance sheet that distinguishes between current and non-current assets and liabilities is called a classified balance sheet.

working capital = current assets – current liabilities

Liquidity based presentation

According to a liquidity based presentation, assets and liabilities are presented in order of liquidity.

A liquidity based presentation:

- doesn’t classify assets and liabilities into current and non-current,
- is often applied by banks,
- is allowed under IFRS.

Here knowledge retention happens – place for: my notes, examples, rewriting formulas, definitions, relations, etc.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

TYPES OF CURRENT ASSETS AND LIABILITIES

Definitions

amortized cost = historical cost adjusted for amortization and impairment

fair value under IFRS = the amount at which an asset could be exchanged or a liability settled in an arm's length transaction between knowledgeable and willing parties

fair value under U.S. GAAP = the amount at which the asset could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party, other than in a liquidation sale

net realizable value (NRV) = estimated selling price – (estimated costs of completion +

+ estimated costs of sale)

market value (U.S. GAAP) = current replacement cost

NRV – normal profit margin < market value < NRV

Current assets

Examples of current assets include:

- cash and cash equivalents,
- marketable securities,
- accounts receivable,
- inventories,
- financial assets (short maturity).

Cash and cash equivalents

Cash equivalents are:

- highly liquid, short-term investments with short time to maturity (less than 3 months),
- reported at amortized cost or fair value (which are practically the same values).

Cash equivalents examples:

demand deposits with banks, T-bills, commercial papers, money market funds

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

<u>Marketable securities</u>

Marketable securities:

- are financial assets,
- include investments in equity and debt securities of public companies.

Marketable securities examples:

T-bills, bonds, common stocks, mutual funds shares

<u>Accounts receivable</u>

Accounts receivable are:

- financial assets,
- generally reported at net realizable value,
- amounts owed to the company's by its customers for products and services delivered to them by the company.

accounts receivable = trade receivables

Analysts pay attention to:

- the ratio of accounts receivable to sales,
- allowance for doubtful accounts,
- credit risk concentration.

Allowance for doubtful accounts is:

- a contra account,
- the amount of accounts receivable which the company expects not to be paid by its customers.

<u>Inventories</u>

Inventories are goods that are either:

- used by the company as inputs in the production of final goods which will be later sold to customers, or
- finished goods that are ready to be sold immediately.

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Other current assets

Other current assets include:

- prepaid expenses,
- deferred tax assets.

Current liabilities

Examples of current liabilities:

- accounts payable.
- notes payable,
- accrued expense,
- deferred income.

Accounts payable

accounts payable = trade payables

Accounts payable are amounts that the company owes for products and services delivered to it by other entities.

Analysts pay attention to:

- the ratio of accounts payable to purchases,
- the changes of the ratio of accounts payable to purchases.

Notes payable

Notes payable are:

- financial liabilities that the company owes to its creditors and that are due within one year (or one operating cycle of the company),
- a part of long-term financial liabilities that is due within one year.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

ACCRUALS

According to the accrual-basis accounting, revenues and expenses are reported when some specific criteria of revenue and expense recognition are met. Generally speaking:

- revenue should be earned, and
- expenses should be incurred.

accruals = the differences between cash-basis accounting and accrual-basis accounting

Types of accruals

- unearned (deferred) revenue,
- accrued (unbilled) revenue,
- prepaid expenses,
- accrued expenses.

Unearned (deferred) revenue

Unearned revenue occurs when the payment is received before revenue is earned.

Unearned revenue is a **liability**.

Accrued (unbilled) revenue

Accrued revenue is when revenue is earned before the payment for provided goods or services is made and the company has not billed the customer yet.

Accrued revenue is an **asset**.

Prepaid expenses

Prepaid expense is when the payment is made in advance, that is when it concerns future fiscal periods.

Prepaid expense is an **asset**.

Accrued expenses

Accrued expense is when the expense is recognised before the payment is actually made.

Accrued expense is a **liability**.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

LIQUIDITY RATIOS & SOLVENCY RATIOS

Defintions

In a **common-size balance sheet** every item is related to total assets.

Liquidity is the company's ability to meet its short-term obligations.

Solvency is the company's ability to fulfill long-term obligations.

Liquidity ratios

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{quick ratio} = \frac{\text{cash} + (\text{short-term marketable investments}) + \text{accounts receivable}}{\text{current liabilities}}$$

$$\text{cash ratio} = \frac{\text{cash} + (\text{short-term marketable investments})}{\text{current liabilities}}$$

Solvency ratios

$$\text{long-term debt to equity ratio} = \frac{\text{total long} - \text{term debt}}{\text{total equity}}$$

$$\text{debt to equity ratio} = \frac{\text{total debt}}{\text{total equity}}$$

$$\text{total debt ratio} = \text{debt to assets ratio} = \frac{\text{total debt}}{\text{total assets}}$$

$$\text{debt to capital ratio} = \frac{\text{total debt}}{\text{total debt} + \text{total equity}}$$

$$\text{financial leverage} = \frac{\text{total assets}}{\text{total equity}}$$

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Summarizing key concepts:

☐ Balance sheet limitations

My summary:

☐ Balance sheet presentation

My summary:

☐ Types of current assets and liabilities

My summary:

☐ Accruals

My summary:

☐ Liquidity ratios

My summary:

☐ Solvency ratios

My summary:

Reviewing formulas:

assets = liabilities + owners' equity

Write down the formula:

net realizable value (NRV) = estimated selling price – (estimated costs of completion +

+ estimated costs of sale)

Write down the formula:

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

Write down the formula:

$$\text{quick ratio} = \frac{\text{cash} + (\text{short-term marketable investments}) + \text{accounts receivable}}{\text{current liabilities}}$$

Write down the formula:

$$\text{cash ratio} = \frac{\text{cash} + (\text{short-term marketable investments})}{\text{current liabilities}}$$

Write down the formula:

$$\text{long-term debt to equity ratio} = \frac{\text{total long} - \text{term debt}}{\text{total equity}}$$

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Write down the formula:

$$\text{debt to capital ratio} = \frac{\text{total debt}}{\text{total debt} + \text{total equity}}$$

Write down the formula:

$$\text{financial leverage} = \frac{\text{total assets}}{\text{total equity}}$$

Write down the formula:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

✔ Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	

TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	