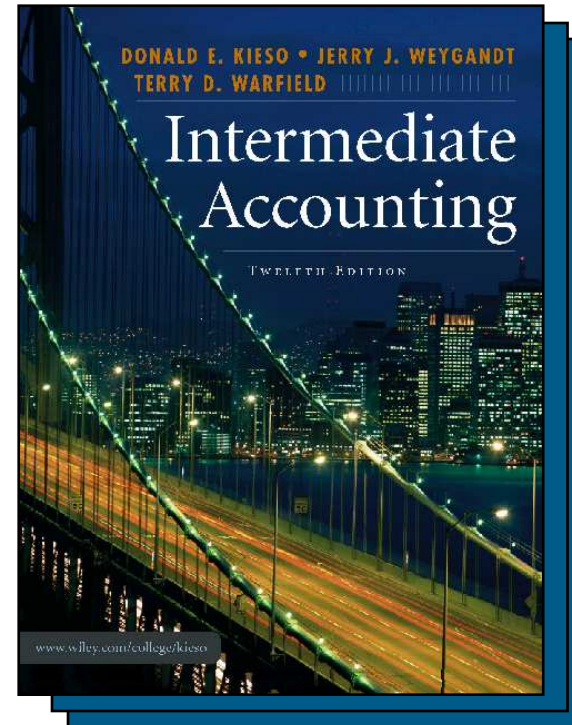


Examining the Balance Sheet and Statement of Cash Flows

Chapter 5

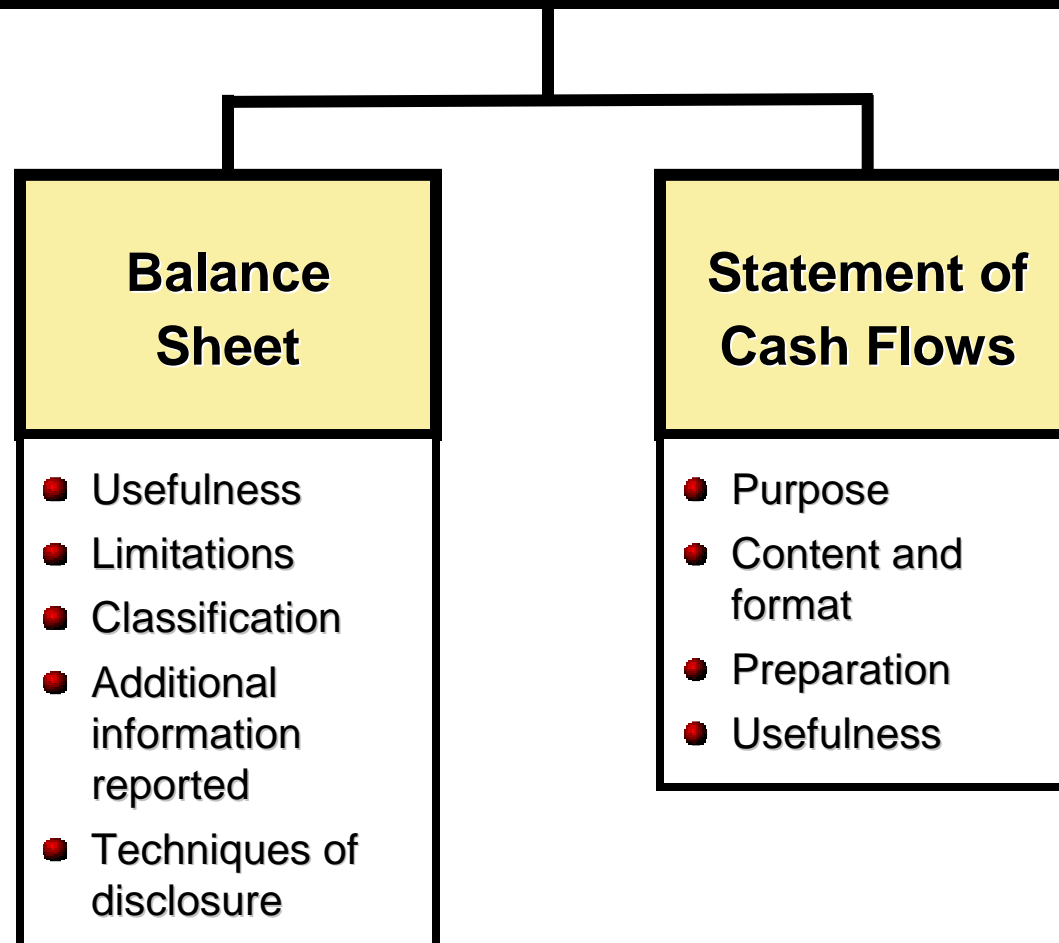
Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Learning Objectives

1. Explain the uses and limitations of a balance sheet.
2. Identify the major classifications of the balance sheet.
3. Prepare a classified balance sheet using the report and account formats.
4. Determine which balance sheet information requires supplemental disclosure.
5. Describe the major disclosure techniques for the balance sheet.
6. Indicate the purpose of the statement of cash flows.
7. Identify the content of the statement of cash flows.
8. Prepare a statement of cash flows.
9. Understand the usefulness of the statement of cash flows.

Balance Sheet and Statement of Cash Flows



Balance Sheet

Usefulness of the Balance Sheet

- Evaluating the capital structure.
- Assess risk and future cash flows.
- Analyze the company's:
 - Liquidity,
 - Solvency, and
 - Financial flexibility.

Balance Sheet

Limitations of the Balance Sheet

- Most assets and liabilities are reported at historical cost.
- Use of judgments and estimates.
- Many items of financial value are omitted.

Balance Sheet

Classification in the Balance Sheet

Three General Classifications

- Assets, Liabilities, and Stockholders' Equity

Companies further divide these classifications:

Assets	Liabilities and Owners' Equity
Current assets	Current liabilities
Long-term investments	Long-term debt
Property, plant, and equipment	Owners' equity
Intangible assets	Capital stock
Other assets	Additional paid-in capital
	Retained earnings

Illustration 5-1
Balance Sheet
Classification

Balance Sheet

Current Assets

Cash and other assets a company expects to convert into cash, sell, or consume either in one year or in the operating cycle, whichever is longer.

Illustration 5-2
Accounts and
basis of valuation

Item	Basis of Valuation
Cash and cash equivalents	Fair value
Short-term investments	Generally, fair value
Receivables	Estimated amount collectible
Inventories	Lower of cost or market
Prepaid expenses	Cost

Balance Sheet

Review

The correct order to present current assets is

- a. Cash, accounts receivable, prepaid items, inventories.
- b. Cash, accounts receivable, inventories, prepaid items.**
- c. Cash, inventories, accounts receivable, prepaid items.
- d. Cash, inventories, prepaid items, accounts receivable.

Balance Sheet - "Current Assets"

Cash

- Generally any monies available "on demand."
- **Cash equivalents** are short-term highly liquid investments that will mature within three months or less.
- Any restrictions or commitments must be disclosed.

Alterra Healthcare Corp.		Illustration 5-3
<u>Current assets</u>		
Cash	\$18,728,000	
Restricted cash and investments (Note 7)	7,191,000	
Note 7: Restricted Cash and Investments. Restricted cash and investments consist of certificates of deposit restricted as collateral for lease arrangements and debt service with interest rates ranging from 4.0% to 5.5%.		

Balance Sheet - "Current Assets"

Short-Term Investments

Portfolios	Type	Valuation	Classification
Held-to-Maturity	Debt	Amortized Cost	Current or Noncurrent
Trading	Debt or Equity	Fair Value	Current
Available-for-Sale	Debt or Equity	Fair Value	Current or Noncurrent

Balance Sheet - "Current Assets"

Receivables

Claims held against customers and others for money, goods, or services.

- Accounts receivable - oral promises
- Notes receivable - written promises

Major categories of receivables should be shown in the balance sheet or the related notes.

Balance Sheet - "Current Assets"

Accounts Receivable - Presentation Options

1

Current Assets:

Cash		\$ 346
Accounts receivable	500	
Less allowance for doubtful accounts	25	475
	<hr/>	
Inventory		812
		<hr/>
Total current assets		\$1,633
		<hr/>

2

Current Assets:

Cash		\$ 346
Accounts receivable, net of \$25 allowance		475
Inventory		812
		<hr/>
Total current assets		\$1,633
		<hr/>

Balance Sheet - "Current Assets"

Inventories

Company discloses:

- basis of valuation (e.g., lower-of-cost-or-market) and
- the method of pricing (e.g., FIFO or LIFO).

Balance Sheet - "Current Assets"

Prepaid Expenses

Payment of cash, that is recorded as an asset because service or benefit will be received in the future.

Cash Payment

BEFORE

Expense Recorded

Prepayments often occur in regard to:

- insurance
- supplies
- advertising
- rent
- maintenance on equipment

Balance Sheet - "Noncurrent Assets"

Long-Term Investments

Generally consists of four types:

- **Securities**
- **Fixed assets**
- **Special funds**
- **Nonconsolidated subsidiaries** or affiliated companies.

Balance Sheet - "Noncurrent Assets"

Long-Term Investments

Securities

- bonds,
- stock, and
- long-term notes

For marketable securities, management's intent determines current or noncurrent classification.

Balance Sheet (in thousands)

Current assets

Cash	\$ 285,000
------	------------

Investments:

Investment in ABC bonds	321,657
Investment in UC Inc.	253,980
Notes receivable	150,000
Land held for speculation	550,000
Sinking fund	225,000
Pension fund	653,798
Cash surrender value	84,321
Investment in Uncon. Sub.	457,836
Total investments	2,696,592

Property, Plant, and Equip.

Building	1,375,778
Land	975,000

Balance Sheet - "Noncurrent Assets"

Long-Term Investments

Fixed Assets

- Land held for speculation



Balance Sheet (in thousands)

Current assets

Cash \$ 285,000

Investments:

Investment in ABC bonds 321,657

Investment in UC Inc. 253,980

Notes receivable 150,000

Land held for speculation 550,000

Sinking fund 225,000

Pension fund 653,798

Cash surrender value 84,321

Investment in Uncon. Sub. 457,836

Total investments 2,696,592

Property, Plant, and Equip.

Building 1,375,778

Land 975,000

Balance Sheet - "Noncurrent Assets"

Long-Term Investments

Special Funds

- Sinking fund
- Pensions fund
- Cash surrender value of life insurance

Balance Sheet (in thousands)

Current assets

Cash \$ 285,000

Investments:

Investment in ABC bonds 321,657

Investment in UC Inc. 253,980

Notes receivable 150,000

Land held for speculation 550,000

Sinking fund 225,000

Pension fund 653,798

Cash surrender value 84,321

Investment in Uncon. Sub. 457,836

Total investments 2,696,592

Property, Plant, and Equip.

Building 1,375,778

Land 975,000

Balance Sheet - "Noncurrent Assets"

**Long-Term
Investments**

**Nonconsolidated
Subsidiaries or
Affiliated
Companies**

Balance Sheet (in thousands)

Current assets

Cash \$ 285,000

Investments:

Investment in ABC bonds 321,657

Investment in UC Inc. 253,980

Notes receivable 150,000

Land held for speculation 550,000

Sinking fund 225,000

Pension fund 653,798

Cash surrender value 84,321

Investment in Uncon. Sub. 457,836

Total investments 2,696,592

Property, Plant, and Equip.

Building 1,375,778

Land 975,000

Balance Sheet - "Noncurrent Assets"

Property, Plant, and Equipment

Assets of a durable nature used in the regular operations of the business.

Balance Sheet (in thousands)

Current assets

Cash	\$ 285,000
------	------------

Total investments	2,696,592
-------------------	-----------

Property, Plant, and Equip.

Building	1,375,778
----------	-----------

Land	975,000
------	---------

Machinery and equipment	234,958
-------------------------	---------

Capital leases	384,650
----------------	---------

Leasehold improvements	175,000
------------------------	---------

Accumulated depreciation	(975,000)
--------------------------	-----------

Total PP&E	2,170,386
------------	-----------

Intangibles

Goodwill	3,000,000
----------	-----------

Patents	177,000
---------	---------

Trademarks	40,000
------------	--------

Balance Sheet - "Noncurrent Assets"

Intangibles

Lack physical substance and are not financial instruments.

- Limited life intangibles amortized.
- Indefinite-life intangibles tested for impairment.

Balance Sheet (in thousands)

Current assets

Cash \$ 285,000

Accumulated depreciation (975,000)
Total PP&E 2,170,386

Intangibles

Goodwill 2,000,000

Patents 177,000

Trademark 40,000

Franchises 125,000

Copyright 55,000

Total intangibles 2,397,000

Other assets

Prepaid pension costs 133,000

Deferred income tax 40,000

Total other 173,000

Balance Sheet - "Exercise"

BE5-6 Mickey Snyder Corporation's adjusted trial balance contained the following asset accounts at December 31, 2007: Prepaid Rent \$12,000; Goodwill \$40,000; Franchise Fees Receivable \$2,000; Franchises \$47,000; Patents \$33,000; Trademarks \$10,000. Prepare the **intangible assets section** of the balance sheet.

Intangibles

Goodwill	\$ 40,000
Franchises	47,000
Patents	33,000
Trademarks	10,000
Total	<u>\$130,000</u>

Balance Sheet - "Noncurrent Assets"

Other Assets

This section should include only unusual items sufficiently different from assets in the other categories.

Balance Sheet (in thousands)

Current assets

Cash	\$ 285,000
------	------------

Intangibles

Goodwill	2,000,000
Patents	177,000
Trademark	40,000
Franchises	125,000
Copyright	55,000
Total intangibles	2,397,000

Other assets

Prepaid pension costs	133,000
Deferred income tax	40,000
Total other	173,000

Total Assets	\$ 9,210,978
---------------------	---------------------

Balance Sheet

Current Liabilities

“Obligations that a company reasonably expects to liquidate either through the use of current assets or the creation of other current liabilities.”

Balance Sheet (in thousands)

Current liabilities

Notes payable	\$ 233,450
Accounts payable	131,800
Accrued compensation	43,000
Unearned revenue	17,000
Income tax payable	23,400
Current maturities LT debt	121,000

Total current liabilities	569,650
---------------------------	---------

Long-term liabilities

Long-term debt	979,500
Obligations capital lease	345,800
Deferred income taxes	77,909

Total long-term liabilities	2,093,859
-----------------------------	-----------

Stockholders' equity

Balance Sheet

Long-Term Liabilities

“Obligations that a company does not reasonably expect to liquidate within the normal operating cycle.”

All covenants and restrictions must be disclosed.



Balance Sheet (in thousands)

Current liabilities

Notes payable	\$ 233,450
Accounts payable	131,800
Accrued compensation	43,000
Unearned revenue	17,000
Income tax payable	23,400
Current maturities LT debt	121,000
Total current liabilities	<u>569,650</u>

Long-term liabilities

Long-term debt	979,500
Obligations capital lease	345,800
Deferred income taxes	77,909
Total long-term liabilities	<u>2,093,859</u>

Stockholders' equity

Balance Sheet - "Exercise"

BE5-9 Included in Ewing Company's December 31, 2007, trial balance are the following accounts: Accounts Payable \$240,000; Pension Liability \$375,000; Discount on Bonds Payable \$24,000; Advances from Customers \$41,000; Bonds Payable \$400,000; Wages Payable \$27,000; Interest Payable \$12,000; Income Taxes Payable \$29,000. Prepare the **long-term liabilities** section of the balance sheet.

Long-term liabilities

Pension liability	\$375,000
Bonds payable	400,000
Discount on bonds payable	(24,000)
Total	<u>751,000</u>

Balance Sheet

Owners' Equity

Companies usually divide equity into three parts, (1) Capital Stock, (2) Additional Paid-In Capital, and (3) Retained Earnings.

Illustration 5-15

Quanex Corporation

(in thousands)

Stockholders' equity (Note 12):

Preferred stock, no par value, 1,000,000 shares authorized; 345,000 issued and outstanding	\$ 86,250
Common stock, \$0.50 par value, 25,000,000 shares authorized; 13,638,005 shares issued and outstanding	6,819
Additional paid-in capital	87,260
Retained earnings	57,263
	<u>\$237,592</u>

Balance Sheet Classification Exercise

Account	Classification
(a) Investment in preferred stock	(a) Current asset/Investment
(b) Treasury stock	(b) Equity
(c) Common stock	(c) Equity
(d) Cash dividends payable	(d) Current liability
(e) Accumulated depreciation	(e) Contra-asset
(f) Interest payable	(f) Current liability
(g) Deficit	(g) Equity
(h) Trading securities	(h) Current asset
(i) Unearned revenue	(i) Current liability

Balance Sheet - Format

Classified Balance Sheet

- **Account form**
- **Report form**

Accounting Trends and Techniques—2004 (New York: AICPA) indicates that all of the 600 companies surveyed use either the "report form" (506) or the "account form" (94), sometimes collectively referred to as the "customary form."

Additional Information Reported

There are normally four types of information that are supplemental to account titles and amounts presented in the balance sheet:

- Contingencies
- Accounting Policies
- Contractual Situations
- Fair Values

Techniques of Disclosure

- Parenthetical Explanations
- Notes
- Cross-Reference and Contra Items
- Supporting Schedules
- Terminology

The Statement of Cash Flows

One of the three basic objectives of financial reporting is

“assessing the amounts, timing, and uncertainty of cash flows.”

The Statement of Cash Flows

Purpose of the Statement

To provide relevant information about the cash receipts and cash payments of an enterprise during a period.

The statement provides answers to the following questions:

1. Where did the cash come from?
2. What was the cash used for?
3. What was the change in the cash balance?

The Statement of Cash Flows

Content and Format

Three different activities:

- Operating, ● Investing, ● Financing

Illustration 5-24

Statement of Cash Flows	
Cash flows from operating activities	\$XXX
Cash flows from investing activities	XXX
Cash flows from financing activities	<u>XXX</u>
Net increase (decrease) in cash	XXX
Cash at beginning of year	<u>XXX</u>
Cash at end of year	<u><u>\$XXX</u></u>

The Statement of Cash Flows

Content and Format

Operating

Cash inflows and outflows from operations.

Investing

Cash inflows and outflows from non-current assets.

Financing

Cash inflows and outflows from non-current liabilities and equity.

The statement's value is that it helps users evaluate liquidity, solvency, and financial flexibility.

The Statement of Cash Flows

Preparation

Information obtained from several sources:

- (1) comparative balance sheets,
- (2) the current income statement, and
- (3) selected transaction data.

The Statement of Cash Flows

Preparation

BE 5-12 Midwest Beverage Company reported the following items in the most recent year.

		<u>Activity</u>
Net income	\$40,000	Operating
Dividends paid	5,000	Financing
Increase in accounts receivable	10,000	Operating
Increase in accounts payable	5,000	Operating
Purchase of equipment (capital expenditure)	8,000	Investing
Depreciation expense	4,000	Operating
Issue of notes payable	20,000	Financing

Required: Prepare a Statement of Cash Flows

The Statement of Cash Flows

Preparation

Statement of Cash Flow (in thousands)

Operating activities

Net income	\$ 40,000
Increase in accounts receivable	(10,000)
Increase in accounts payable	5,000
Depreciation expense	40,000
Cash flow from operations	<u>75,000</u>

Noncash credit to revenues.

Noncash charge to expenses.

Investing activities

Purchase of equipment	<u>(8,000)</u>
-----------------------	----------------

Financing activities

Proceeds from notes payable	20,000
Dividends paid	<u>(5,000)</u>
Cash flow from financing	<u>15,000</u>

Increase in cash	<u>\$ 82,000</u>
-------------------------	-------------------------

Balance Sheet

Review

In preparing a statement of cash flows, which of the following transactions would be considered an investing activity?

- ☒ a. Sale of equipment at book value
- b. Sale of merchandise on credit
- c. Declaration of a cash dividend
- d. Issuance of bonds payable at a discount receivable.

Additional Information Reported

Significant financing and investing activities that do not affect cash are reported in either a separate schedule at the bottom of the statement of cash flows or in the notes.

Examples include:

- Issuance of common stock to purchase assets.
- Conversion of bonds into common stock.
- Issuance of debt to purchase assets.
- Exchanges on long-lived assets.

Usefulness of the Statement of Cash Flows

Without cash, a company will not survive.

Cash flow from Operations:

- **High amount** - company able to generate sufficient cash to pay its bills.
- **Low amount** - company may have to borrow or issue equity securities to pay bills.

Usefulness of the Statement of Cash Flows

Financial Liquidity

$$\text{Current Cash Debt Coverage Ratio} = \frac{\text{Net Cash Provided by Operating Activities}}{\text{Average Current Liabilities}}$$

Ratio indicates whether the company can pay off its current liabilities from its operations. A ratio near 1:1 is good.

Usefulness of the Statement of Cash Flows

Financial Flexibility

$$\text{Cash Debt Coverage Ratio} = \frac{\text{Net Cash Provided by Operating Activities}}{\text{Average Total Liabilities}}$$

This ratio indicates a company's ability to repay its liabilities from net cash provided by operating activities, without having to liquidate the assets employed in its operations.

Usefulness of the Statement of Cash Flows

Free Cash Flow

Illustration 5-34

NESTOR COMPANY FREE CASH FLOW ANALYSIS	
Net cash provided by operating activities	\$411,750
Less: Capital expenditures	(252,500)
Dividends	<u>(19,800)</u>
Free cash flow	<u><u>\$139,450</u></u>

The amount of discretionary cash flow a company has for purchasing additional investments, retiring its debt, purchasing treasury stock, or simply adding to its liquidity.

Balance Sheet

Review

The current cash debt coverage ratio is often used to assess

- a. financial flexibility.
- ☒ b. liquidity.
- c. profitability.
- d. solvency.

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