**Balance Sheet Basics**

- **What is a balance sheet?**
  - Tells where the entity stands financially;
  - "AS OF";
  - Better way to think of it is as a "Statement of Financial Position"
- **Transaction based.**
  - Something has to actually HAPPEN first
  - Historical cost basis
- **Important Fact:** Inherently relies upon estimates. Example:
  - Valuation of receivables and inventories;
  - Goodwill valuation;
  - Completeness of reported impairments;
- **Comparative balance sheet analysis** is a substantial tool in understanding whether the Company is improving or deteriorating.

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**No Statement Stands on its Own**

ALL OF THE STATEMENTS AND NOTES ARE INTERDEPENDENT

The balance sheet needs an income statement and a statement of cash flows and note disclosure to tell a complete picture... Think of the "self balancing" aspect. If you debit a/r and credit sales, then you need to see the balance sheet AND the income statement to have the complete picture.

For instance if a Company generates $1,000,000 of net income, and their total average equity for the year was $1.75, would you be impressed?... What about if their average equity was $100 billion?

What if a Company had operating income on the income statement but showed negative cash flows from operating activities on the statement of cash flows- might you want to know why?

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**Learning Objectives**

1. Identify the uses and limitations of a balance sheet.
2. Identify the major classifications on the balance sheet.
3. Prepare a classified balance sheet using the account format. (Not using the report format from the text)
4. Identify balance sheet information requiring supplemental disclosure.
5. Identify major balance sheet disclosure techniques.
6. Explain the purpose of the statement of cash flows.
7. Identify the content of the statement of cash flows.
8. Not preparing a statement of cash flows as per text.
9. Understand the usefulness of the statement of cash flows.
Some important balance sheet tools and terms

- **Liquidity**: How fast can an asset turn into cash?
- **Solvency**: How able is the Company to pay its debts?
- Combined (Liquidity and Solvency) represents the Company’s “financial flexibility”
  - If a company is dependent upon lenders for working capital, they typically must comply with “restrictive covenants”

Balance Sheet Limitations

- **Historical Cost Based.**
  - Newhall Land and Farming Company purchased land in late 1800’s. On their 2002 annual report, their Net Assets, at historical cost were $136,000,000 VS conservative appraisal value of $389,000,000. They were later purchased by Lennar for $1 billion!
- **Transaction-based**: something has to happen first
  - Omits many items that have value (but are not based on a past transaction- remember the statements are transaction-based) Example:
    - Human resource
    - Technological discoveries
- **Requires estimation/Judgment.**
  - INSTRUCTOR NOTE: RP

WHAT’S A FINANCIAL INSTRUMENT

**DEFINITION**: Cash, an ownership interest, or a contractual right to receive or obligation to deliver cash or another financial instrument.

**SUCH AS**: Most current assets and liabilities and Debt.

**NOT**: Fixed assets, intangible assets.

FAIR VALUE OF FINANCIAL INSTRUMENTS

**FASB No. 157**:
- Provides guidance on HOW to measure fair value
  - Uses a market participant approach
  - Results in more comparable (potentially less accurate) data
  - NOT When to apply... Only applicable if other literature requires measurement at fair value.

**FASB No. 159**:
- Makes presentation of financial instruments at fair value optional- very unusual and very contradictory to the notion of “comparability”

**NOTE**: If presented at cost on the balance sheet, then fair value is disclosed in the notes. Therefore the fair value of all financial instruments is presented somewhere within the financial statements!
INTERESTING ABOUT FAIR VALUES

- How long have fair value measurements been in f/s’s?
- How many people will come to the same fair value est.?
- How many people will come to the same cost basis?

What impact does FAS 157 have on items previously accounted for at cost?

These points add up to the need for FAS 157

- It "Blends" additional information of fair value with consistency of cost basis.

If you remember one point, remember this:

- FAS 157 looks to use data which is going to result in two companies coming to as close to the exact same valuation of fair value for similar items as possible.

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Fas157... levels of inputs

Which Data are they using?

- LEVEL 1- Quoted Market Price for the item
- LEVEL 2- Quoted Market Price for the type of item
- LEVEL 3- Unobservable/ Company Generated

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BALANCE SHEET SUMMARY

Assets  =  Liabilities  +  Equity

DEFINED:
Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
FLOWS:
Current assets 
Noncurrent assets
Intangibles
Other assets

DEFINED:
Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
FLOWS:
Current liabilities
Noncurrent liabilities

DEFINED:
Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.
FLOWS:
Capital stock
APIC
Retained earnings
AOCI
Treasury Stock

CLASSIFICATION- CURRENT VS NONCURRENT

- Current- expected to “convert” in one year or operating cycle (whichever is longer). Otherwise it is non-current
- Some company’s don’t need a “classified” balance sheet, which means that the balance sheet does not distinguish current from long-term
  - Real estate Company- because the majority of what would be their “operating” assets are non-current in nature.
- Don’t forget to check debt for the “current portion”
Certain assets have reductions called “contra-asset” accounts:
- Accounts receivable/ allowance
- Fixed assets/ accumulated depreciation
- Intangible assets/ accum. amortization.

Can present as a line-item or as part of the description. Examples on next slide.

In-Class Exercise

Based on the following information, prepare the balance sheet for XYZ, Inc.:
- 10,000 shares outstanding, $1 par which were sold to investors for $110,000;
- Debt in the amount of $1,000,000 outstanding. Principal matures at $250,000 per year until repaid;
- Cash of $125,000;
- Accounts receivable $250,000, excluding the allowance for doubtful accounts $25,000;
- Prepaid insurance of $175,000
- PP&E $2,000,000. Accumulated depreciation is $200,000.
- Capitalized commissions paid to leasing agents $115,000.
- Accumulated amortization $15,000.
- Accounts payable $58,000
- Retained earnings $757,000
- Accumulated other comprehensive income $500,000

Assessment Comments
- Meta analysis of the feedback on the presentation.
- Suggestions for improvement.
- Questions and discussions on the material covered.

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ASSETS
Cash 125,000
Accounts receivable, net of $25,000 allowance 225,000
Prepaid expenses 175,000
Total current assets 575,000
PP&E 2,000,000
Accumulated depreciation 200,000
Net PP&E 1,800,000
Intangible asset, net of accumulated amortization of $15,000 100,000
TOTAL ASSETS 2,425,000

LIABILITIES & STOCKHOLDERS EQUITY
Accounts payable 58,000
current maturities of LTD 250,000
Total current liabilities 308,000
Long-term debt, less current maturities 750,000
EQUITY
Common stock (10,000 SHARES $1 PAR) 10,000
APIC 150,000
Retained Earnings 757,000
Accumulated Other Comp Income 500,000
TOTAL LIABILITIES & EQUITY 2,425,000
Additional balance sheet information

- Disclosure may be parenthetical or in notes.
  - Parenthetical disclosure example:
    Held for sale investments ($100,000 cost), $128,000 at estimated fair value
  - Note disclosure example:
    Property, plant and equipment (Note 7) $1,750,000

<table>
<thead>
<tr>
<th>Note 7 Property plant and equipment</th>
<th>$1,750,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$800,000</td>
</tr>
<tr>
<td>Building</td>
<td>$300,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$750,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>$100,000</td>
</tr>
<tr>
<td>Property plant &amp; equipment, net</td>
<td>$1,750,000</td>
</tr>
</tbody>
</table>

Investments/Securities

Long-term investments may be carried at:
- FAS 115- if do not have significant influence (generally <20% ownership)
- Equity- if have significant influence (generally 20-50% ownership)
- Consolidated if “Controlled”- separate equity item for “non-controlling interest” (generally >50% ownership)

Statement of Cash Flows

- As stated in previous lectures, the statement of cash flows fills in the gap created by applying accrual accounting. It tells the users where the cash went to and came from. It also breaks those sources and uses into three broad categories:
  - Cash flows from operations
    - Net income and changes in current assets & liabilities
  - Cash flows from investing
    - Cash flows from purchase and sale of long term assets
    - Presented “Gross” - i.e. purchase and sale separate
  - Cash flows from financing
    - Cash flows from long-term debt and equity activity
    - Presented “Gross” - i.e. borrowing and repayment separate

Covered in greater detail in chapter 23.