Unit 01 The Financial statements

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**Section I Balance Sheet**

Notes

A balance sheet, also called the statement of condition or statement of financial position, provides a wealth of valuable information about a business firm, particularly when examined over a period of several years and evaluated in relation to the other financial statement. A prerequisite to learning what the balance sheet can teach us, however, is a fundamental understanding of the accounts in the statement and the relationship of each account to the financial statements as a whole.

The balance sheet shows the financial condition or financial position of a company on a particular date. The statement is a summary of what the firm owns (assets) and what the firm owes to outsiders (liabilities) and to internal owners (stockholder’s equity). By definition, the account balances on a balance sheet must balance; that is, the total of all assets must equal the sum of liabilities and stockholders’ equity. The balancing equation is expressed as:

Assets = Liabilities + Stockholders’ equity

Assets are segregated on balance sheet according to how they are utilized. Current assets includes cash or those assets expected to be converted into cash within one year or operating cycle, whichever is longer. The operating cycle is the time required to purchase or manufacture inventory, sell the product, and collect the cash. For most companies, the operating cycle is less than one year, but in some industries, it is longer. The designation “current” refers essentially to those assets that are continually used up and replenished in the ongoing operation s of the business. The term working capital or net working capital is used to designate the amount by which current assets exceed current liabilities.

The cash account is exactly that, cash in any form – cash awaiting deposit or in a bank account. Marketable securities are cash substitutes, cash that is not needed immediately in the business and is temporarily invested to earn a return. These investments are in instruments with short-term maturities (less than one year) to minimize the risk of interest rate fluctuation. They must be relatively riskless securities and highly liquid so that funds can be readily withdrawn as needed. Instruments used for such purposes include U.S treasury bills, certificates, notes, and bonds, negotiable certificates of deposit at financial institutions; and commercial paper.

Accounts receivable are customer balances outstanding on credit sales and are reported on the balance sheet at their net realizable value, that is, the actual amount of the account less an allowance for doubtful accounts. Management must estimate – based on such factors as past experience, knowledge of customer quality, the state of the economy, and the firm’s collection policies. Actual losses are written off against the allowance account, which is adjusted at the end of each accounting period.

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Inventories are items held for sale or used in the manufacture of products that will be sold. A retail company lists only one type of inventory on the balance sheet: merchandise inventories purchased for resale to the public. A manufacturing firm, in contrast, would carry three different types of inventories: raw material or supplies, work-in-process, and finished goods. For most firms, inventories are the firm’s major revenue producer. Exceptions would be service-oriented companies which carry little or no inventory.

Notes

Certain expenses, such as insurance, rent, property taxes, and utilities, are sometimes paid in advance. They are included in current assets if they will expire within one year or one operating cycle, whichever is longer. Generally, prepayments are not material to the balance sheet as a whole.

The category of property, plant and equipment encompasses a company’s fixed assets (also called tangible, long-lived capital assets) – those assets not used up in the ebb and flow of annual business operations. These assets produce economic benefits for more than one year, and they are considered tangible because they have a physical substance. Fixed assets other than land (which has a theoretically unlimited life span) are depreciated over the period of time they benefit the firm. The process of depreciation is a method of allocating the cost of long-lived assets. The original cost, less any estimated residual value at the end of the asset’s life, is spread over the expected life of the asset. Cost is also considered to encompass any expenditures made to ready the asset for operating use. On any balance sheet date property, plant and equipment is shown at book value, which is the difference between original cost and any accumulated depreciation to date.

Other assets on a firm’s balance sheet can include a multitude of additional noncurrent items such as property held for sale, start-up costs in connection with a new business, the cash surrender value of life insurance policies, and long-term advance payments.

Liabilities represent claims against assets, and current liabilities are those that must be satisfied in one year or one operating cycle, whichever is longer. Current liabilities include accounts and notes payable, the current portion of long-term debt, accrued liabilities and deferred taxes.

Accounts payable are short-term obligations that arise from credit extended by suppliers for the purchase of goods and services. The ongoing process of operating a business results in the spontaneous generation of accounts payable, which increase and decrease depending on the credit policies available to the firm from its suppliers, economic conditions, and the cyclical nature of the firm’s own business operation.

Notes payable are short-term obligations in the form of promissory notes to suppliers or financial institution. A line of credit permits borrowing from a financial institution up to a maximum amount.

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When a firm has bonds, mortgage, or other forms of long-term debt outstanding, the portion of the principal that will be repaid during the upcoming year is classified as a current liability. The note lists the amount of long-term debt outstanding, less the portion due currently, and also provides the schedule of current maturities for the next five years.

Notes

Most corporations use the accrual rather than the cash basis of accounting: Revenue is recognized when it is earned, and expenses are recorded when they are incurred, regardless of when the cash is received or paid. Accrued liabilities result from the recognition of an expense in the accounting records prior to the actual payment of cash. Thus, they are liabilities because there will be an eventual cash outflow to satisfy the obligations

Companies which are paid in advance for services or products records a liability upon the receipt of cash. The liability account is referred to as unearned revenue or deferred credits. The amounts in this account will be transferred to a revenue account when the service is performed or the product delivered as required by the matching concept of accounting.

Obligations with maturities beyond one year are designated on the balance sheet as noncurrent liabilities. This category can include bonded indebtedness, long-term notes payable, mortgages, obligations under leases, pension liabilities, and long-term warranties.

The ownership interests in the company are represented in the final section of the balance sheet, stockholders’ equity or shareholders’ equity. Ownership equity is the residual interest in assets that remain after deducing liabilities. The owners bear the greatest risk because their claims are subordinate to creditors in the event of liquidation; but owners also benefit from the rewards of a successful enterprise.

Common shareholders do not ordinarily receive a fixed return but do have voting privileges in proportion to ownership interest. Dividends on common stock are declared at the discretion of company’s board of directors. Furthermore, common shareholders can benefit from stock ownership through potential price appreciation (or the reverse can occur if the share price decline). The amount listed under the common stock account is based on the par or stated value of the share issued. The par or stated value usually bears no relationship to actual market price but rather is a floor price below which the stock cannot be sold initially.

Additional paid-in capital reflects the amount by which the original sales price of the stock shares exceeded par value. It is not affected by the price changes resulting from stock trading subsequent to its original issue.

The retained earning account is the sum of every dollar a company has earned since its inception, less any payments made to shareholders in the form of cash or stock dividends. Retained earnings do not represent a pile of unused cash stashed away in corporate vaults; retained earnings are funds a company has elected to reinvest in the operations of the business rather than pay out to stockholders in dividends. Retained earnings should not be confused with cash or other financial resources currently or prospectively available to satisfy financial obligations. Rather, the retained earnings account is the measurement of all undistributed earnings.

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