

I. **PURPOSE**

- A. The Balance Sheet shows the financial position of the company at a specific point in time (a date)
- This differs from the Income Statement which measures revenues and expenses (net income) over a period of time from a certain date to the end of the period, another date e.g. from a date to a date.

II. **FORMAT**

- A. The format of the balance sheet is in handout 1A which can be downloaded from the website
- Please note the valuation basis of the different types of account

III. **LIMITATIONS**

- A. Assets are carried at historical cost adjusted for depreciation/amortization
- This valuation often has no relationship to fair market value
- B. The contra accounts used in the valuation of accounts are based on estimates that may be inaccurate
- C. Many items with significant financial value are either omitted (value of employees skills/efficiency) or miss-valued
- Liabilities are often not recorded at all (off balance sheet financing e.g. liabilities of consolidated subsidiaries).

IV. **SPECIAL ITEMS**

A. Contingencies:

- Contingencies are defined by SFAS 5 as "... existing condition, situation or set of circumstances involving uncertainty as to possible gain (*gain contingency*) or loss (*loss contingency*) to an enterprise that will ultimately be resolved when one or more future events occur."

a. Gain contingencies:

- Claims or rights to receive assets or have liabilities reduced; examples include
  - Possible gifts, donations, bonuses etc.
  - Refunds from disputes (tax disputes etc)
  - Pending court cases where a positive result will be financially favorable
  - Tax loss carryforwards

- Gain contingencies are not recorded (IAW conservatism principle)

b. Loss contingencies:

- Often call contingent liabilities
  - Obligations that are dependent upon the occurrence or nonoccurrence of future events
- Disclosure depends if the likelihood of future events is
  - Probable:** future event is likely to occur
  - Reasonably Possible:** Future event is more than remote but less than likely
  - Remote:** The chance of the future event occurring is slight.

- Disclosure of contingent liabilities is made only if the likelihood of the loss occurring is **both**:

- Probable** and
- The amount can be reasonably estimated**

iv. Cash and Accrual basis:

- Cash basis:
  - The only method utilized for tax purposes.
  - Warranty costs are charged to expense as they are incurred.
  - No liability is recorded for future costs
  - Required to be used if liability is not accrued in the year of sale either because
    - It is not probable that a liability has occurred or
    - The amount of the liability cannot be reasonably estimated.

(ii) Accrual basis

- Must be used for **reporting purposes** if it is probable that customers will make claims under warranties **and** a reasonable estimate of the warranty costs can be made.
- The accrual basis is the only GAAP method and should be used whenever the warranty is an integral and inseparable part of the sale.
  - Warranty expense is viewed as a loss contingency.

v. Examples of loss contingencies:

(i) Litigation, claims, assessments

(ii) Guarantee/warranty costs (Expense warranty approach)

1. Record Sale:	Cash/Accounts receivable	300,000	
	Sales		300,000
2. Record Est. Exp	Warranty expense	15,000	
	Est. warranty Liability		15,000
3. Record actual Exp:	Warranty expense	3,000	
	Cash/Inventory/etc		3,000 (depends of what is given as warranty pmt)
1a. Record Sale:	Cash	312,000	
	Sales		300,000
	Unearned warranty revenue		12,000
2a. Record Warranty revenue end of year when extended warranty takes affect	Unearned warranty revenue	6,000	
	Warranty revenue		6,000

**Expense Warranty approach:**

Used when the warranty is an integral and inseparable part of the sale

**Sales Warranty Approach:**

Used when warranties are sold separately from product (extended warranty)

(iii) Premiums/coupons

1. Charged to expense in the period of sale of related product. To illustrate the recording of premiums assume the following facts:

- a. Bozo Cakemix Company offers its customers a mixing bowl in exchange for 25 cents and 10 boxtops of Bozo Cakemix
- b. Bozo estimates that 60% of the boxtops will be redeemed.
- c. The mixing bowl costs Bozo 75 cents.
- d. Bozo purchased 20,000 mixing bowls to satisfy expected redemptions.

Record purchase of mixing bowl inventory:	Inventory of mixing bowls (20,000@ .75)	15,000	
	Cash		15,000
Record Sales of 300,000 boxes cake mix @ \$.80/box	Cash (300,000) (.80)	240,000	
	Sales		240,000
Record actual redemption of 60,000 boxtops	Cash (60,000/10 X .25)	1,500	
	Premium Expense (.75-.25X60,000/10)	3,000	
	Inventory of Mix Bowls (60,000/10 X .75)		4,500
Record estimated liability at EOY:	Premium Expense (see schedule)	6,000	
	Estimated liability for premiums		6,000

Schedule of estimated liability at EOY:

Cakemix boxes sold in year	300,000
Estimated redemptions (sales x .6)	180,000
Less: Redemptions made	<u>(60,000)</u>
Estimated redemptions outstanding:	120,000
Cost of redemptions outstanding:	6,000 (120,000/10) x (.75-.50)

(iv) Environmental Liabilities

1. The cost of cleaning up toxic waste is approaching \$1 trillion dollars over the next 30-40 years and is therefore a major concern of business.
2. Businesses must recognize asset retirement obligations (ARO's) when the company has an existing legal obligation associated with the retirement of a long-lived asset and when the amount of the liability can be reasonably be estimated
  - a. ARO's are recorded at FMV
  - b. Examples of ARO's
    - i. Decommissioning nuclear facilities
    - ii. Dismantling, restoring, and reclaiming oil and gas properties
    - iii. Certain closure, reclamation, and removal costs of mining facilities
    - iv. Closure and post-closure costs of landfills.

(v) Self-insurance

1. Self-insurance is more properly called assumption of risk
  - a. Companies that assume risks puts itself in the position of incurring expenses/losses as they occur.
    - i. **In general, self-insurance contingencies are not recognized but the policy of self-insurance may be disclosed in the notes to the financial statements.**
    - ii. Exceptions:
      - a. Exposure to risks of loss resulting from uninsured past injury to others is an existing condition involving uncertainty about the amount and timing of losses that may develop so in these specific cases a contingency exists and normal contingency reporting standards apply (probable/reasonable estimate).

2. Presentation of contingencies:

- a. Loss is both probable and reasonably estimable: Record loss contingency and liability
- b. Loss is either probable or estimable but not both:
  - i. In the notes record the following:
    - (i) The nature of the contingency
    - (ii) An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.

V. COMMON BALANCE SHEET RATIOS

A. Basic ratios are sometimes useful in analyzing the relationship of balance sheet accounts

1. Current Ratio: Current Assets/Current Liabilities (aka working capital ratio)
  - a. Because the current ratio includes inventory, this ratio is often criticized (because of the uncertainty of the time required to convert inventory back into cash)
2. Acid-test ratio: cash + marketable securities + net receivables / current liabilities
  - a. Often considered superior to the current ratio because it excludes inventory

Practice Exercises:

**MULTIPLE CHOICE—Conceptual**

1. Which of the following is a limitation of the balance sheet?
  - a. Many items that are of financial value are omitted.
  - b. Judgments and estimates are used.
  - c. Current fair value is not reported.
  - d. All of these
2. The balance sheet is useful for analyzing all of the following except
  - a. liquidity.
  - b. solvency.
  - c. profitability.
  - d. financial flexibility.
3. The net assets of a business are equal to
  - a. current assets minus current liabilities.
  - b. total assets plus total liabilities.
  - c. total assets minus total stockholders' equity.
  - d. none of these.
4. 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.
5. The basis for classifying assets as current or noncurrent is conversion to cash within
  - a. the accounting cycle or one year, whichever is shorter.
  - b. the operating cycle or one year, whichever is longer.
  - c. the accounting cycle or one year, whichever is longer.
  - d. the operating cycle or one year, whichever is shorter.
6. The basis for classifying assets as current or noncurrent is the period of time normally required by the accounting entity to convert cash invested in
  - a. inventory back into cash, or 12 months, whichever is shorter.
  - b. receivables back into cash, or 12 months, whichever is longer.
  - c. tangible fixed assets back into cash, or 12 months, whichever is longer.
  - d. inventory back into cash, or 12 months, whichever is longer.
7. The current asset section of the balance sheet should include
  - a. machinery.
  - b. patents.
  - c. goodwill.
  - d. inventory.
8. Which of the following is a current asset?
  - a. Cash surrender value of a life insurance policy of which the company is the beneficiary.
  - b. Investment in equity securities for the purpose of controlling the issuing company.
  - c. Cash designated for the purchase of tangible fixed assets.
  - d. Trade installment receivables normally collectible in 18 months.

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9. Which of the following should not be considered as a current asset in the balance sheet?
- Installment notes receivable due over 18 months in accordance with normal trade practice.
  - Prepaid taxes which cover assessments of the following operating cycle of the business.
  - Equity or debt securities purchased with cash available for current operations.
  - The cash surrender value of a life insurance policy carried by a corporation, the beneficiary, on its president.
10. Equity or debt securities held to finance future construction of additional plants should be classified on a balance sheet as
- current assets.
  - property, plant, and equipment.
  - intangible assets.
  - long-term investments.
11. When a portion of inventories has been pledged as security on a loan,
- the value of the portion pledged should be subtracted from the debt.
  - an equal amount of retained earnings should be appropriated.
  - the fact should be disclosed but the amount of current assets should not be affected.
  - the cost of the pledged inventories should be transferred from current assets to noncurrent assets.
12. Which of the following is *not* a long-term investment?
- Cash surrender value of life insurance
  - Franchise
  - Land held for speculation
  - A sinking fund
13. A generally accepted method of valuation is
- trading securities at market value.
  - accounts receivable at net realizable value.
  - inventories at current cost.
- 1
  - 2
  - 3
  - 1 and 2
14. Which item below is *not* a current liability?
- Unearned revenue
  - Stock dividends distributable
  - The currently maturing portion of long-term debt
  - Trade accounts payable
15. Working capital is
- capital which has been reinvested in the business.
  - unappropriated retained earnings.
  - cash and receivables less current liabilities.
  - none of these.

16. An example of an item which is not an element of working capital is
  - a. accrued interest on notes receivable.
  - b. goodwill.
  - c. goods in process.
  - d. temporary investments.
17. Long-term liabilities include
  - a. obligations not expected to be liquidated within the operating cycle.
  - b. obligations payable at some date beyond the operating cycle.
  - c. deferred income taxes and most lease obligations.
  - d. all of these.
18. Which of the following should be *excluded* from long-term liabilities?
  - a. Obligations payable at some date beyond the operating cycle
  - b. Most pension obligations
  - c. Long-term liabilities that mature within the operating cycle and will be paid from a sinking fund
  - d. None of these
19. Treasury stock should be reported as a(n)
  - a. current asset.
  - b. investment.
  - c. other asset.
  - d. reduction of stockholders' equity.
20. Which of the following should be reported for capital stock?
  - a. The shares authorized
  - b. The shares issued
  - c. The shares outstanding
  - d. All of these
21. Which of the following would be classified in a different major section of a balance sheet from the others?
  - a. Capital stock
  - b. Common stock subscribed
  - c. Stock dividend distributable
  - d. Stock investment in affiliate
22. The owners' equity section is usually divided into what three parts?
  - a. Preferred stock, common stock, treasury stock
  - b. Preferred stock, common stock, retained earnings
  - c. Capital stock, additional paid-in capital, retained earnings
  - d. Capital stock, appropriated retained earnings, unappropriated retained earnings
23. Which of the following is *not* an acceptable major asset classification?
  - a. Current assets
  - b. Long-term investments
  - c. Property, plant, and equipment
  - d. Deferred charges

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24. Which of the following is *not* a method of disclosing pertinent information?
- Supporting schedules
  - Parenthetical explanations
  - Cross reference and contra items
  - All of these are methods of disclosing pertinent information.
25. Significant accounting policies may *not* be
- selected on the basis of judgment.
  - selected from existing acceptable alternatives.
  - unusual or innovative in application.
  - omitted from financial-statement disclosure.
26. A general description of the depreciation methods applicable to major classes of depreciable assets
- is not a current practice in financial reporting.
  - is not essential to a fair presentation of financial position.
  - is needed in financial reporting when company policy differs from income tax policy.
  - should be included in corporate financial statements or notes thereto.
27. It is mandatory that the essential provisions of which of the following be clearly stated in the notes to the financial statements?
- Stock option plans
  - Pension obligations
  - Lease contracts
  - All of these
28. A generally accepted account title is
- Prepaid Revenue.
  - Appropriation for Contingencies.
  - Earned Surplus.
  - Reserve for Doubtful Accounts.
29. The financial statement which summarizes operating, investing, and financing activities of an entity for a period of time is the
- retained earnings statement.
  - income statement.
  - statement of cash flows.
  - statement of financial position.
30. Making and collecting loans and disposing of property, plant, and equipment are
- operating activities.
  - investing activities.
  - financing activities.
  - liquidity activities.
31. In preparing a statement of cash flows, sale of treasury stock at an amount greater than cost would be classified as a(n)
- operating activity.
  - financing activity.
  - extraordinary activity.
  - investing activity.
32. In preparing a statement of cash flows, cash flows from operating activities
- are always equal to accrual accounting income.
  - are calculated as the difference between revenues and expenses.
  - can be calculated by appropriately adding to or deducting from net income those items in the income statement that do not affect cash.
  - can be calculated by appropriately adding to or deducting from net income those items in the income statement that do affect cash.
33. In preparing a statement of cash flows, which of the following transactions would be considered an investing activity?
- Sale of equipment at book value
  - Sale of merchandise on credit
  - Declaration of a cash dividend
  - Issuance of bonds payable at a discount
34. Preparing the statement of cash flows involves all of the following except determining the
- cash provided by operations.
  - cash provided by or used in investing and financing activities.
  - change in cash during the period.
  - cash collections from customers during the period.
35. The cash debt coverage ratio is computed by dividing net cash provided by operating activities by
- average long-term liabilities.
  - average total liabilities.
  - ending long-term liabilities.
  - ending total liabilities.
36. The current cash debt coverage ratio is often used to assess
- financial flexibility.
  - liquidity.
  - profitability.

- d. solvency.
37. A measure of a company's financial flexibility is the
- cash debt coverage ratio.
  - current cash debt coverage ratio.
  - free cash flow.
  - cash debt coverage ratio and free cash flow.
38. Free cash flow is calculated as net cash provided by operating activities less
- capital expenditures.
  - dividends.
  - capital expenditures and dividends.
  - capital expenditures and depreciation.

**Multiple Choice Answers—Conceptual**

- |      |       |       |       |       |       |       |
|------|-------|-------|-------|-------|-------|-------|
| 1. d | 7. d  | 13. d | 19. d | 25. d | 31. b | 37. d |
| 2. c | 8. d  | 14. b | 20. d | 26. d | 32. c | 38. c |
| 3. d | 9. d  | 15. d | 21. d | 27. d | 33. a |       |
| 4. b | 10. d | 16. b | 22. c | 28. b | 34. d |       |
| 5. b | 11. c | 17. d | 23. d | 29. c | 35. b |       |
| 6. d | 12. b | 18. d | 24. d | 30. b | 36. b |       |

Solutions to those Multiple Choice questions for which the answer is "none of these."

- Total assets minus total liabilities.
- Current assets less current liabilities.
- Many answers are possible.

**MULTIPLE CHOICE—CPA Adapted**

39. Snead Corp.'s trial balance reflected the following account balances at December 31, 2001:

Accounts receivable (net)	\$24,000
Trading securities	6,000
Accumulated depreciation on equipment and furniture	15,000
Cash	11,000
Inventory	30,000
Equipment	25,000
Patent	4,000
Prepaid expenses	2,000
Land held for future business site	18,000

In Snead's December 31, 2001 balance sheet, the current assets total is

- \$90,000.
- \$82,000.
- \$77,000.
- \$73,000.

Use the following information for questions 40 through 42.

The following trial balance of Trane Corp. at December 31, 2001 has been properly adjusted except for the income tax expense adjustment.

Trane Corp. Trial Balance December 31, 2001	
Dr.	Cr.
Cash	\$ 875,000
Accounts receivable (net)	2,695,000
Inventory	2,085,000
Property, plant, and equipment (net)	7,366,000
Accounts payable and accrued liabilities	\$ 1,501,000
Income taxes payable	654,000
Deferred income tax liability	85,000
Common stock	2,350,000
Additional paid-in capital	3,680,000
Retained earnings, 1/1/01	3,650,000
Net sales and other revenues	13,360,000
Costs and expenses	11,080,000
Income tax expenses	1,179,000
	<u>\$25,280,000</u>
	<u>\$25,280,000</u>

Other financial data for the year ended December 31, 2001:

- Included in accounts receivable is \$960,000 due from a customer and payable in quarterly installments of \$120,000. The last payment is due December 29, 2003.
- The balance in the Deferred Income Tax Liability account pertains to a temporary difference that arose in a prior year, of which \$20,000 is classified as a current liability.
- During the year, estimated tax payments of \$425,000 were charged to income tax expense. The current and future tax rate on all types of income is 30%.

In Trane's December 31, 2001 balance sheet,

40. The current assets total is
- \$6,080,000.
  - \$5,655,000.
  - \$5,535,000.
  - \$5,175,000.
41. The current liabilities total is
- \$1,750,000.
  - \$1,815,000.
  - \$2,175,000.
  - \$2,240,000.
42. The final retained earnings balance is
- \$4,751,000.
  - \$4,836,000.
  - \$5,176,000.
  - \$5,105,000.
43. On January 1, 2001, Ehr Co. leased a building to Dent Corp. for a ten-year term at an annual rental of \$60,000. At inception of the lease, Ehr received \$240,000 covering the first two years' rent of \$120,000 and a security deposit of \$120,000. This deposit will not be returned to Dent upon expiration of the lease but will be applied to payment of rent for the last two years of the lease. What portion of the \$240,000 should be shown as a current and long-term liability in Ehr's December 31, 2001 balance sheet?

Current Liability Long-term Liability

- |    |           |           |
|----|-----------|-----------|
| a. | \$0       | \$240,000 |
| b. | \$60,000  | \$120,000 |
| c. | \$120,000 | \$120,000 |
| d. | \$120,000 | \$60,000  |

44. Which of the following facts concerning fixed assets should be included in the summary of significant accounting policies?

- |    | <u>Depreciation Method</u> | <u>Composition</u> |
|----|----------------------------|--------------------|
| a. | No                         | Yes                |
| b. | Yes                        | Yes                |
| c. | Yes                        | No                 |
| d. | No                         | No                 |



45. In a statement of cash flows, receipts from sales of property, plant, and equipment and other productive assets should generally be classified as cash inflows from
- operating activities.
  - financing activities.
  - investing activities.
  - selling activities.
46. In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for
- operating activities.
  - borrowing activities.
  - lending activities.
  - financing activities.
47. In a statement of cash flows, proceeds from issuing equity instruments should be classified as cash inflows from
- lending activities.
  - operating activities.
  - investing activities.
  - financing activities.
48. In a statement of cash flows, payments to acquire debt instruments of other entities (other than cash equivalents) should be classified as cash outflows for
- operating activities.
  - investing activities.
  - financing activities.
  - lending activities.

**Multiple Choice Answers—CPA Adapted**

- |       |       |       |       |       |
|-------|-------|-------|-------|-------|
| 39. d | 41. a | 43. b | 45. c | 47. d |
| 40. d | 42. c | 44. c | 46. a | 48. b |

**DERIVATIONS — CPA Adapted**

No.	Answer	Derivation
39.	d	$\$24,000 + \$6,000 + \$11,000 + \$30,000 + \$2,000 = \$73,000.$
40.	d	$\$875,000 + [\$2,695,000 - (\$120,000 \times 4)] + \$2,085,000 = \$5,175,000.$
41.	a	$\$1,501,000 + (\$654,000 - \$425,000) + \$20,000 = \$1,750,000.$
42.	c	$\$3,650,000 + \$13,360,000 - \$11,080,000 - (\$1,179,000 - \$425,000) = \$5,176,000.$
43.	b	Conceptual.
44.	c	Conceptual.
45.	c	Conceptual.
46.	a	Conceptual.
47.	d	Conceptual.
48.	b	Conceptual.