

Monday, April 29 2:30–4:00 pm

# 401 Reading & Understanding a Balance Sheet New to In-house Track

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## **Basic Principles**

- GAAP
- GAAS

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## The Two Epiphanies

- Accounting presentations are <u>NOT</u> objective . . .
  - GAAP is flexible, not rigid
  - Audits only relate to GAAP
- ... Nor are they Neutrally Portrayed
  - management prepared
  - inherent bias to:
    - minimize the cost of capital
    - maximize reported earnings

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ACC	Association of Corporate Counsel	JOURNAL ENTRIES		
<u>Date</u> 1/1/06	Effect (A↑)	Cash	<u>Dr.</u>	<u>Cr.</u>
171700	(OE↑)	Common Stock (no par value) Issuance of common stock	\$200	\$200
1/1/06	(A↑) (L↑)	Cash Note Payable Interest Free Loan from Dad	\$1,000	\$1,000
1/1/06	(A↑) (A↓)	Inventory (lemons) Cash Purchase of lemons for 1 year	\$200	\$200
1/1/06	(A↑) (A↓)	Property and Equipment Cash Purchase of Lemonade Stand	\$1,000	\$1,000
1/1/06	(E↑) (A↓)	Supply Expense Cash Purchase of Lemonade Stand	\$1,000	\$1,000
12/31/06	(A↑) (R↑)	Cash Sales	\$1,200	\$1,200
	(E↑) (A↓)	Cost of Goods Sold Inventory Year-end sales entry (no salary)	\$200	\$200
12/31/06	(E↑) (A↓)	Depreciation Expense Accumulated Depreciation - Property and Equipment Depreciation of Lemonade Stand	\$200	\$200

CAPITALIZE COSTS  Mark's Lemonade Income Statement For Year End 12/31/06								
Sales			\$	1,200.00				
Cost of Goods Sold			\$	200.00				
Gross Margin on Sales:			\$	1,000.00				
Operating Expenses:								
Depreciation Expense	\$	200.00	\$	200.00				
Income from Operations:			\$	800.00				
Other Expenses:								
Interest Expense	\$		\$	<u>-</u>				
Income before income tax:			\$	800.00				
Income Tax Expense			\$	<u>-</u>				
Net Income:			\$	800.00				
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#### **CAPITALIZE COSTS**

#### Mark's Lemonade Balance Sheet at December 31, 2006

**Assets** 

**Current Assets:** 

 Cash
 \$1,200.00

 Inventory
 \$0.00

 Total Current Assets:
 \$1,200.00

**Operational Assets:** 

Property and Equipment \$1,000.00

Accumulated Depre. - (\$200.00) \$800.00

Total Operational Assets: \$800.00
Total Assets: \$2,000.00

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#### **CAPITALIZE COSTS**

#### Mark's Lemonade Balance Sheet at December 31, 2006

#### Liabilities

Long-Term Liabilities:

Note Payable \$1,000.00 Total Liabilities: \$1,000.00

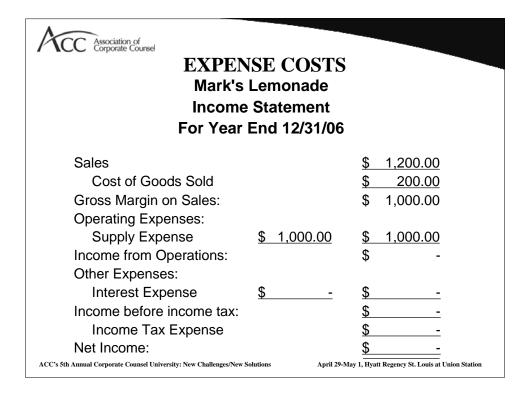
Stockholders' Equity

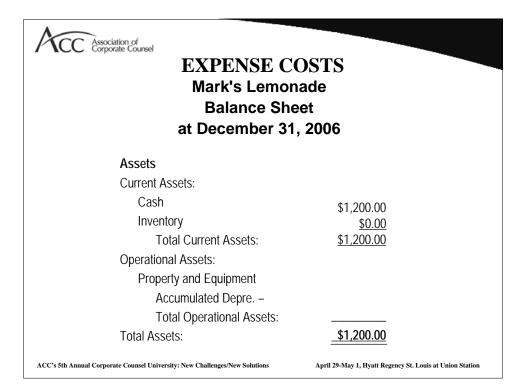
Contributed Capital:

Common Stock (no par value) \$200.00 Retained Earnings \$800.00

Total Stockholders' Equity: \$1,000.00
Total Liabilities and Stockholders' Equity: \$2,000.00

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#### **EXPENSE COSTS**

#### Mark's Lemonade Balance Sheet at December 31, 2006

#### Liabilities

Long-Term Liabilities:

Note Payable \$1,000.00 Total Liabilities: \$1,000.00

Stockholders' Equity

Contributed Capital:

Common Stock (no par value) \$200.00 Retained Earnings \$0.00

Total Stockholders' Equity: \$200
Total Liabilities and Stockholders' Equity: \$1,200.00

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## **Transparent Financial Disclosure**

\*An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices."

(CICA Handbook)

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## **Accounting v. Economics**

- Not all accounting assets are economic assets
- Not all economic assets are reflected on the Balance Sheet
- Not all accounting liabilities are economic liabilities
- Not all economic liabilities are reflected on the Balance Sheet

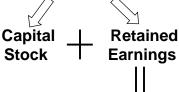
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## **Basic Integrated Accounting Equation**

Assets = Liabilities + Shareholders' Equity



**Revenues - Expenses - Dividends** 

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#### **Accounts Receivable**

- Bill your customers 10,000
  - Gross A/R = 10,000
  - Revenue = 10,000
- Estimate not collecting 5%
  - Allowance for Doubtful Accounts = 500
  - Bad Debt Expense = 500
  - Net Income = 9,500
  - Net A/R = 9.500

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#### **Accounts Receivable**

Gross A/R (starting)

Plus: Further credit extended

Less: Collections

**Less: Write Offs** 

Gross A/R (ending)

Less: AFDA (ending)

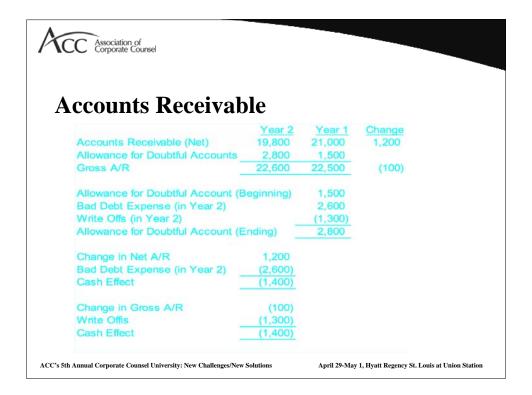
Net A/R

AFDA (starting)

Plus: Bad Debt Expense

Less: Write Offs
AFDA (ending)

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## **Inventories**

- Valuation Methods
  - Lower of cost and "market"
  - Net Realizable Value v. Replacement Cost
  - FIFO
  - LIFO
  - Average Cost

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#### **Inventories**

FIFO - First In, First Out

Q1 100 units@\$10 = \$1,000 Q2 100 units@\$15 = \$1,500 Q3 100 units@\$20 = \$2,000 Q4 100 units@\$25 = \$2,500 \$7,000

- Sold 300 units during the year.
- Ending Inventory = 100 units@\$25 = \$2,500
- Cost of Goods Sold

= \$4,500

\$7,000

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#### **Inventories**

- LIFO Last In, First Out
  - Q1 100 units@\$10 = \$1,000
  - Q2 100 units@\$15 = \$1,500
  - Q3 100 units@\$20 = \$2,000
  - Q4 100 units@\$25 = <u>\$2,500</u>

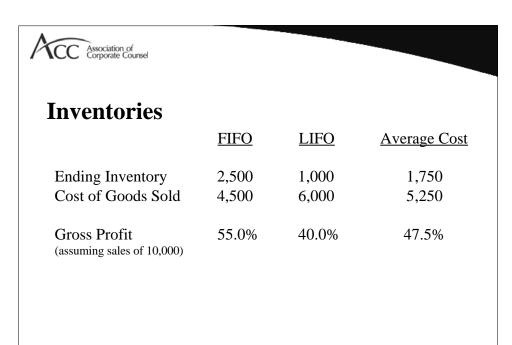
\$7,000

- Sold 300 units during the year.
- Ending Inventory = 100 units @ \$10 = \$1,000
- Cost of Goods Sold

= \$6,000

\$7,000

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## **Capital Assets**

- Historical Cost
- Less: Accumulated Amortization
- Net Book Value
- Depreciation impacts Net Income
- Not EBITDA

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#### **Future Tax Assets**

- Estimate of Useable Tax Loss Carry Forwards
- Economic Asset?

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#### **Investments in Subsidiaries**

- Levels of Ownership
  - 0% 20% = cost method (historic cost)
  - 20% 50% = equity method
  - > 50% = purchase method (consolidation)
- Equity Method = Cost +/- % of Net Income
  - Dividends Received

Cost = 100,000 for 40% of Company

NI = 10,000 for year

Book Value of Investment increased by 4,000

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## Goodwill

- Excess purchase price on acquisitions
  - Purchase price (fair value of assets liabilities)
- Written down to "fair value" every year

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#### **Hidden Assets**

- Operating Leases
- Market value > book value
- IP you created, not bought
- Contingent receivables

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#### **Unreal Assets**

- Capitalized Costs
  - spend cash on (arguably) operating expenses
  - book an asset
  - no impact on EBITDA
- Pension surpluses

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### **Deferred Revenue**

- Advanced payment for goods or services
- Owe delivery of goods or services

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### **Future Tax Liabilities**

	Accounting	<u>Tax</u>
EBITDA	5,000	5,000
Depreciation	1,000	
Capital Cost Allowance		2,000
EBIT	4,000	3,000
Interest Expense	1,000	1,000
EBT	3,000	2,000
Taxes (40%)	1,200	800
NI	1,800	1,200

Paid 800 in Cash but recorded Income Tax Expense of 1,200 Difference of 400 equals Future Income Tax Liability

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## **Minority Interest**

- $\bullet$  Only when ownership is >50%
- Consolidation is required, but don't own 100%
- % of Shareholders' Equity you don't own
- Not money owing

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#### **Pension Plan Liabilities**

- Defined Contribution v. Defined Benefit
- Defined Benefit Plans in deficit position
  - accrued benefit obligation > fair value of plan assets
  - not what's on the Balance Sheet
- Post Employment Benefits

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# **Restructuring Charges and Other Provisions**

- Record a large expense today (and create liability account)
- When costs are actually incurred . . .
- Cash goes down, Liabilities go down;
- No income statement (earnings) impact
- Reversals back into Earnings

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#### **Off Balance Sheet Liabilities**

- Operating Leases
- Guarantees
- Law Suits
- Purchase Commitments
- Grant Repayment Obligations

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## Shareholders' Equity

- Capital Stock
- Contributed Surplus
- Retained Earnings
- Accumulated Other Comprehensive Income

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