



**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 **NOT** 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		<b>JOURNAL ENTRIES</b>		
Date	Effect		Dr.	Cr.
1/1/06	(A↑) (OE↑)	Cash 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↑) (E↑) (A↓)	Cash Sales Cost of Goods Sold Inventory Year-end sales entry (no salary)	\$1,200 \$200	\$1,200 \$200
12/31/06	(E↑) (A↓)	Depreciation Expense Accumulated Depreciation - Property and Equipment Depreciation of Lemonade Stand	\$200	\$200


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

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<b>CAPITALIZE COSTS</b> <b>Mark's Lemonade</b> <b>Balance Sheet</b> <b>at December 31, 2006</b>	
<b>Assets</b>	
Current Assets:	
Cash	\$1,200.00
Inventory	<u>\$0.00</u>
Total Current Assets:	<u>\$1,200.00</u>
Operational Assets:	
Property and Equipment	\$1,000.00
Accumulated Depre. –	(\$200.00) <u>\$800.00</u>
Total Operational Assets:	<u>\$800.00</u>
Total Assets:	<u><u>\$2,000.00</u></u>
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<b>CAPITALIZE COSTS</b> <b>Mark's Lemonade</b> <b>Balance Sheet</b> <b>at December 31, 2006</b>	
<b>Liabilities</b>	
Long-Term Liabilities:	
Note Payable	<u>\$1,000.00</u>
Total Liabilities:	<u>\$1,000.00</u>
<b>Stockholders' Equity</b>	
Contributed Capital:	
Common Stock (no par value)	\$200.00
Retained Earnings	<u>\$800.00</u>
Total Stockholders' Equity:	<u>\$1,000.00</u>
Total Liabilities and Stockholders' Equity:	<u><u>\$2,000.00</u></u>
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<b>EXPENSE COSTS</b> <b>Mark's Lemonade</b> <b>Income Statement</b> <b>For Year End 12/31/06</b>	
Sales	\$ 1,200.00
Cost of Goods Sold	<u>\$ 200.00</u>
Gross Margin on Sales:	\$ 1,000.00
Operating Expenses:	
Supply Expense	\$ 1,000.00 <u>\$ 1,000.00</u>
Income from Operations:	\$ -
Other Expenses:	
Interest Expense	\$ - <u>\$ -</u>
Income before income tax:	<u>\$ -</u>
Income Tax Expense	<u>\$ -</u>
Net Income:	<u><u>\$ -</u></u>
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<b>EXPENSE COSTS</b> <b>Mark's Lemonade</b> <b>Balance Sheet</b> <b>at December 31, 2006</b>	
Assets	
Current Assets:	
Cash	\$1,200.00
Inventory	<u>\$0.00</u>
Total Current Assets:	<u>\$1,200.00</u>
Operational Assets:	
Property and Equipment	
Accumulated Depre. -	
Total Operational Assets:	<u>          </u>
Total Assets:	<u><u>\$1,200.00</u></u>
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## EXPENSE COSTS

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

#### Liabilities

##### Long-Term Liabilities:

Note Payable	<u>\$1,000.00</u>
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Total Liabilities:	<u>\$1,000.00</u>
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#### Stockholders' Equity

##### Contributed Capital:

Common Stock (no par value)	\$200.00
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Retained Earnings	<u>\$0.00</u>
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Total Stockholders' Equity:	<u>\$200</u>
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Total Liabilities and Stockholders' Equity:	<u>\$1,200.00</u>
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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**

  
**Capital Stock** + **Retained Earnings**

||  
**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: <u>Write Offs</u>	
<u>Gross A/R (ending)</u>	}
Less: <u>AFDA (ending)</u>	
<u>Net A/R</u>	
	AFDA (starting)
	Plus: Bad Debt Expense
	<u>Less: Write Offs</u>
	<u>AFDA (ending)</u>

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## Accounts Receivable

	<u>Year 2</u>	<u>Year 1</u>	<u>Change</u>
Accounts Receivable (Net)	19,800	21,000	1,200
Allowance for Doubtful Accounts	<u>2,800</u>	<u>1,500</u>	
Gross A/R	<u>22,600</u>	<u>22,500</u>	(100)
Allowance for Doubtful Account (Beginning)		1,500	
Bad Debt Expense (in Year 2)		2,600	
Write Offs (in Year 2)		<u>(1,300)</u>	
Allowance for Doubtful Account (Ending)		<u>2,800</u>	
Change in Net A/R	1,200		
Bad Debt Expense (in Year 2)	<u>(2,600)</u>		
Cash Effect	<u>(1,400)</u>		
Change in Gross A/R	(100)		
Write Offs	<u>(1,300)</u>		
Cash Effect	<u>(1,400)</u>		

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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 =	<u>\$2,500</u>
			<u>\$7,000</u>

- 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>
			<u>\$7,000</u>

- 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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## Inventories

	<u>FIFO</u>	<u>LIFO</u>	<u>Average Cost</u>
Ending Inventory	2,500	1,000	1,750
Cost of Goods Sold	4,500	6,000	5,250
Gross Profit (assuming sales of 10,000)	55.0%	40.0%	47.5%

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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



## Deferred Revenue

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



## Future Tax Liabilities

	<u>Accounting</u>	<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

- 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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