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Quality of Financial Reporting—The Balance Sheet

An extensive discussion of financial reporting quality and its impact on financial performance is provided as an Appendix to Chapter 3, but it is important to introduce here some of the qualitative issues that relate to the balance sheet. As has been documented in earlier sections of the book, the economic recession of 2008 and many of the market gyrations since then can be traced directly to the overvaluation of balance sheet assets, such as the subprime mortgages carried by financial institutions. When financial reporting does not reflect economic reality, the quality, and thus the usefulness, of that information is significantly impaired.

In addition to the overvaluation of assets, other examples of balance sheet items that relate directly to the quality of financial reporting include the type of debt used to finance assets, commitments and contingencies, and the classification of leases. In general, a firm should strive for a matching of debt to the type of asset being financed; that is, short term debt should be used to finance current assets, and long-term debt (or equity) should be used to finance long-term assets. A mismatching of debt to assets could indicate that the firm may be having trouble finding financing sources.

As discussed earlier in the chapter, the “Commitments and Contingencies” disclosure in the notes to the financial statements should be read and evaluated carefully because these disclosures can provide important information about off-balance sheet financing and other complex financing arrangements. Enron is a prime example of a company that had enormous activity, leading ultimately to its downfall, reported in these notes to its financial statement presentation. Enron’s notes included extensive discussions of financial information that was relevant to the firm’s current and future operations but that was not quantified on the balance sheet, such as balance sheet partnerships, a proposed merger, price risk management and financial instruments, unconsolidated subsidiaries, regulatory issues, and litigation.
The nine pages of notes to the financial statements related to the commitments and contingencies of Pfizer Inc. in 2013 may help the financial statement user understand potential liabilities that can affect the firm in the future. Besides operating lease commitments and guarantees, Pfizer is involved in many legal proceedings. Some of the lawsuits Pfizer is party to involve patents, product litigation, commercial matters, and government investigations, among other legal proceedings. Though most of the information in the notes cannot be quantified on a financial statement, the notes do allow readers to determine that there are significant litigation issues.

Also included in the commitments note is information relating to capital and operating leases. While capital leases are included on the balance sheet, the financial statement user should consider the effects on debt ratios (discussed in Chapter 5) if operating leases are extensive because the firm is committed to making lease payments, similar to payments involved in servicing debt. If such leases had been negotiated as capital leases, there would be a higher amount of debt on the balance sheet. The consumer goods retailer Walmart provides a good example. Walmart reported long-term debt in the amount of $38.4 billion and capital lease obligations of $3 billion in 2013. In addition, Walmart had $16.8 billion of operating lease commitments, reported in the notes to the financial statements, and the analyst would want to be aware of the increased risk associated with this off-balance sheet item.

The appendix on financial reporting quality following Chapter 3 will include further discussion of such balance sheet issues as the allowance for doubtful accounts, inventory valuation, inventory write-downs, asset impairment, and gains (losses) from sales of assets.

Other Balance Sheet Items

Corporate balance sheets are not limited to the accounts described in this chapter for Sage Inc. and other companies. The reader of annual reports will encounter additional accounts and will also find many of the same accounts listed under a variety of different titles. Those discussed in this chapter, however, should be generally sufficient for understanding the basics of most balance sheet presentations in a set of published financial statements. The balance sheet will recur throughout the remaining chapters of this book given the interrelationship among the financial statements and its important role in the analysis of financial data.

Self-Test

Solutions are provided in Appendix B.

1. What does the balance sheet summarize for a business enterprise?
   (a) Operating results for a period.
   (b) Financial position at a point in time.
   (c) Financing and investment activities for a period.
   (d) Profit or loss at a point in time.

2. What is the balancing equation for the balance sheet?
   (a) Assets = Liabilities + Stockholders’ equity.
   (b) Assets + Stockholders’ equity = Liabilities.
   (c) Assets + Liabilities = Stockholders’ equity.
   (d) Revenues - Expenses = Net income.
3. What is a common-size balance sheet?
   (a) A statement that expresses each account on the balance sheet as a percentage of net income.
   (b) A statement that is common to an industry.
   (c) A statement that expresses each account on the balance sheet as a percentage of total assets.
   (d) A statement that expresses each asset account on the balance sheet as a percentage of total assets and each liability account on the balance sheet as a percentage of total liabilities.

4. Which of the following assets would be classified as current assets on the balance sheet?
   (a) Cash, accounts payable, deferred income taxes.
   (b) Cash equivalents, inventory, prepaid expenses.
   (c) Accounts receivable; prepaid expenses; property, plant, and equipment.
   (d) Inventory, goodwill, unearned revenue.

5. What items should be calculated when analyzing the accounts receivable and allowance for doubtful accounts?
   (a) The growth rates of sales and inventories.
   (b) The growth rates of sales, accounts receivable, and the allowance for doubtful accounts, as well as the percentage of the allowance account relative to the total or gross accounts receivable.
   (c) The common-size balance sheet.
   (d) The growth rates of all assets and liabilities.

Questions 6, 7, and 8 are based on the table provided: A new company in its first year of operations purchases six products on sale in the order and the costs as shown:

<table>
<thead>
<tr>
<th>Unit</th>
<th>Cost per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>$5</td>
</tr>
<tr>
<td>#2</td>
<td>$10</td>
</tr>
<tr>
<td>#3</td>
<td>$12</td>
</tr>
<tr>
<td>#4</td>
<td>$15</td>
</tr>
<tr>
<td>#5</td>
<td>$17</td>
</tr>
<tr>
<td>#6</td>
<td>$19</td>
</tr>
</tbody>
</table>

6. If the company uses the cost flow assumption of FIFO, what would be the total cost of goods sold if three units are sold, and the corresponding ending inventory cost to be reported in the balance sheet?
   (a) Cost of goods sold = $27; Ending inventory = $51.
   (b) Cost of goods sold = $51; Ending inventory = $27.
   (c) Cost of goods sold = $39; Ending inventory = $39.
   (d) Cost of goods sold = $32; Ending inventory = $46.

7. What would the cost of goods sold and ending inventory be if LIFO was used instead?
   (a) Cost of goods sold = $27; Ending inventory = $51.
8. What if the average cost method was used instead?
(a) Cost of goods sold = $27; Ending inventory = $51.
(b) Cost of goods sold = $51; Ending inventory = $27.
(c) Cost of goods sold = $32; Ending inventory = $46.
(d) Cost of goods sold = $39; Ending inventory = $39.

9. Assuming a period of inflation, which statement is true?
(a) The FIFO method understates balance sheet inventory.
(b) The FIFO method understates cost of goods sold on the income statement.
(c) The LIFO method overstates balance sheet inventory.
(d) The LIFO method understates cost of goods sold on the income statement.

10. Which of the following statements is false?
(a) Fixed assets other than land are “depreciated” over the period of time they benefit the firm.
(b) Management normally can choose two methods of depreciation, the straight-line method or the accelerated method.
(c) The annual depreciation expense reported in the first year of depreciation generally reduces the reported income, if the straight-line method is used as compared to the accelerated method.
(d) The total amount of depreciation over the asset’s life is the same regardless of the method, although the rate of depreciation varies.

11. Which of the following describes the primary objective of the balance sheet?
(a) To measure the net income of a business up to a particular point in time.
(b) To report the difference between cash inflows and cash outflows for the period.
(c) To report the financial position of the reporting entity at a particular point in time.
(d) To report the market value of assets, liabilities, and stockholders’ equity at a particular point in time.

12. A company has a $250,000 note outstanding, with 8% annual interest paid in semiannual installments on March 31 and September 30. For a balance sheet prepared on December 31, how much is the amount of interest accrued?
(a) $20,000.
(b) $5,000.
(c) $10,000.
(d) $7,500.

13. Which of the following statements is true?
(a) Goodwill arises when one company acquires another company for a price in excess of the fair market value of the net identifiable assets acquired.
(b) If it is determined that the book value or carrying value of goodwill exceeds fair value, the excess book value should not be written off as an impairment expense.
(c) There is a fixed period of goodwill to be amortized which is 40 years.
(d) Goodwill should be recorded on the liability side of the balance sheet.

14. How is the working capital of a company measured?
   (a) Profits – Retained Earnings.
   (b) Assets – Liabilities.
   (c) Current Assets – Current Liabilities.
   (d) Fixed Assets – Non-current Liabilities.

15. What do current liabilities and current assets have in common?
   (a) Current assets are claims against current liabilities.
   (b) If current assets increase, there will be a corresponding increase in current liabilities.
   (c) Current liabilities and current assets are converted into cash.
   (d) Current liabilities and current assets are those items that will be satisfied and converted into cash, respectively, in one year or one operating cycle, whichever is longer.

16. Which of the following items could cause the recognition of accrued liabilities?
   (a) Sales, interest expense, rent.
   (b) Sales, taxes, interest income.
   (c) Salaries, rent, insurance.
   (d) Salaries, interest expense, interest income.

17. Which statement is false?
   (a) Deferred taxes are the product of temporary differences in the recognition of revenue and expense for taxable income relative to reported income.
   (b) Deferred taxes arise from the use of the same method of depreciation for tax and reporting purposes.
   (c) Deferred taxes arise when taxes actually paid are less than tax expense reported in the financial statements.
   (d) Temporary differences causing the recognition of deferred taxes may arise from the methods used to account for items such as depreciation, installment sales, leases, and pensions.

18. Which of the following would be classified as long-term debt?
   (a) Mortgages, current maturities of long-term debt, bonds.
   (b) Mortgages, long-term notes payable, bonds due in 10 years.
   (c) Accounts payable, bonds, obligations under leases.
   (d) Accounts payable, long-term notes payable, long-term warranties.

19. What accounts are most likely to be found in the stockholders’ equity section of the balance sheet?
   (a) Common stock, long-term debt, preferred stock.
   (b) Common stock, additional paid-in capital, liabilities.
   (c) Common stock, retained earnings, dividends payable.
   (d) Common stock, additional paid-in capital, retained earnings.