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CHAPTER 2 The Financial Statements

SYNOPSIS

The author opens the chapter with an illustration of the flow of capital through a business. Operating, investing and financing activities are introduced. The author then presents overviews that include the various components of each financial statement: the classified balance sheet, the income statement, the statement of shareholders' equity, and the statement of cash flows. The main part of the chapter ends with a discussion of the relationships among the financial statements.

An international perspective is presented on how financial statements differ in other countries. This discussion includes an examination of the financial statements of Unilever, a leading supplier of consumer brands registered in the Netherlands.

The ethics vignette considers issues faced by a Swiss manager who is hesitant to adopt IFRS.

The Internet research exercise considers the financial results and corporate strategy of JCPenney.

The following key points are emphasized in Chapter 2:

1. The three basic activities of a business and how they are reflected in the financial statements.

2. The balance sheet, income statement, statement of shareholders' equity, and statement of cash flows and how these financial statements are used.

3. Non-U.S. financial statement format and terminology, similarities and differences.

TEXT/LECTURE OUTLINE

The financial statements.

I. How businesses are conducted.

A. Flow of capital through a business.

B. Three activities of a business.

1. Financing activities: those activities involving the collection of capital through debt or equity issuances and any associated payments.

2. Investing activities: those activities involving the acquisition and the sale of producing assets (i.e., the assets used to produce and support the goods and services provided).

3. Operating activities: those activities involving the sale of goods and services.

II. The four fundamental financial statements.

A. Classified balance sheet.

1. The classified balance sheet is a statement of the company's financial position as of a point in time. The balance sheet is a statement of the fundamental accounting equation.

2. In a classified balance sheet, assets and liabilities are grouped into sub-classifications; in an unclassified balance sheet, assets and liabilities are not grouped into sub-classifications, they are simply listed.

3. Assets and liabilities are listed on the balance sheet in order of liquidity.

4. Asset groupings.

a) Current assets.

(1) Current assets are assets that are expected to be realized or converted into cash in the near future, usually within one year.

(2) Current assets typically include cash, short-term investments, accounts receivable, inventory, and prepaid expenses.

b) Long-term investments.

c) Property, plant, and equipment.

d) Intangible assets.

5. Liability groupings.

a) Current liabilities.

(1) Current liabilities are liabilities that are expected to be settled through the use of current assets.

(2) Current liabilities typically include accounts payable, miscellaneous other payables (such as wages payable, interest payable, and so forth), and current maturities of long-term debts.

b) Long-term liabilities.

6. Shareholders' equity groupings.

a) Contributed capital.

b) Retained earnings (i.e., earned capital).

c) Effect of organizational form (i.e., corporate versus partnership) on the equity section.

B. Income statement.

1. The income statement explains the change in the company's net assets (i.e., total assets less total liabilities) during the accounting period due to operating activities.

2. The change in net assets from operating activities is called net income (or loss) and is computed as revenues less expenses.

a) Revenues are defined as inflows of assets or outflows of liabilities over a period of time due to a company's operating activities.

b) Expenses are defined as outflows of assets or inflows of liabilities over a period of time due to a company's operating activities.

3. Since revenues and expenses are defined by the changes in assets and liabilities, every transaction affecting the income statement also affects at least one asset or liability account on the balance sheet.

C. Statement of shareholders' equity.

1. The statement of shareholders' equity explains the change in the retained earnings and contributed capital balances during the accounting period.

2. The change in the retained earnings balance is due to the company's net income or loss and distributions to the company's owners (i.e., dividends).

3. The change in the contributed capital balance is due to capital collected from the sale of equity securities.

D. Statement of cash flows.

1. The statement of cash flows explains (i.e., summarizes) the change in the cash balance during the accounting period.

a) Cash flows from operating activities.

b) Cash flows from investing activities.

c) Cash flows from financing activities.

III. Relationships among the financial statements.

IV. International perspective.

V. Review Problem: Bed Bath & Beyond.

VI. Ethics in the real world.

VII. Internet research exercise.

LECTURE TIPS

1. The illustration of the flow of capital through a business introduces the concept of operating, investing and financing activities.

2. Students should be encouraged to read the text carefully so as to thoroughly understand what each account measures. A useful in-class drill requires students to explain what the amount reported on the balance sheet for a particular account represents.

3. Many introductory students have difficulty differentiating between cash collections and revenue and between cash disbursements and expenses. It is critical that these differentiations are made when discussing the income statement versus the operating activities section of the statement of cash flows.

4. It is critical to students' understanding of accounting and how to use financial statement information that they grasp how the four financial statements relate. However, most students often view each financial statement as independent and do not appreciate how thestatements relate. Therefore, explain and demonstrate how the financial statements are linked together and complement one another.

5. When first discussing how to use the information in the financial statements, provide a general overview of how a potential investor would ascertain the company's solvency (i.e., compare its assets to its obligations) and earning power. Then provide a more detailed discussion by using a classified balance sheet (i.e., using current assets versus current liabilities), the income statement, the statement of cash flows, and ratio analysis.

OUTSIDE ASSIGNMENT OPPORTUNITIES

Study of annual reports: evaluation of profitability and solvency using financial statements and other information.

1. Obtain a recent annual report for a local publicly held company. Read the financial statements and notes and evaluate profitability and solvency using concepts developed in the chapter. Read the letter to shareholders and other information in the annual report and compare with the results of your analysis; especially note instances where the letter to shareholders or the other information reads more favorably than indicated in the financial statements. Report your findings in writing and/or in a brief presentation to the class.

Comparative study of annual reports: a foreign company compared to a U.S. company.

2. Obtain a recent annual report for a publicly held foreign company. Compare the form, content, and terminology used in its financial statements to that of a U. S. public company, preferably one in the same industry. Report your findings in writing and/or in a brief presentation to the class.

ANSWERS TO IN-TEXT DISCUSSION QUESTIONS

Page No.

31. Cash provided by operating activities includes cash collected from the sale products and cash payments for related costs and expenses. Investing activities consist of capital expenditures for additional plant and equipment and other assets that relate to the productive capacity of the business. Financing activities include proceeds from the issuance of debt and/or equity, and related repayments of debt and/or payment of dividends.

34. McDonald's Corporation's total assets consist mostly of property, plant, and equipment because McDonald's is a traditional ―brick and mortar‖ business, whereas Google is an internet company whose presence exists mostly in cyberspace and which is valued mostly for it's intangible assets and intellectual property.

34. The principal revenue producing asset of a retailer such as Sears is its inventory of merchandise, which is included in current assets. The amount of inventory would be high relative to property, plant and equipment, especially given that many retailers lease, rather than own, their premises, and leasehold interests and obligations are not shown on the balance sheet. Current assets also include cash, short-term investments, receivables, and prepaid expenses. AT&T, a legacy telephone company, has a huge investment in equipment which is spread throughout its network. All this equipment is a non-current asset. AT&T has little inventory and its current assets are mostly cash and receivables.

35. Short-term investments are made in readily marketable debt and equity securities to earn income on otherwise idle funds. An insurance company such as WellPoint maintains a high level of short-term investments to insure that they will be able to pay claims, make refunds, and so on, on a timely basis.

35. The principal activities of banks such as JP Morgan Chase are to earn net interest income by gathering deposits and in turn loaning those funds out to others, as well as providing fee-based services. The largest asset category involved in this process is the loan portfolio, a category of receivable. Wal-Mart is a retailer. It's main business involves buying and re-selling inventory. Receivables are a relatively minor facet of Wal-Mart's business.

35. Retailers such as Home Depot and manufacturers such as Goodyear Tire & Rubber are in the business of selling products, and carry significant amounts of inventory. Service enterprises such as Yahoo and financial institutions such as Bank of America do not deal in products and therefore do not have inventories.

36. These are the production and/or acquisition costs of television programming that has not yet been licensed or sold. These costs will be expensed when the programs are licensed or sold.

37. Patents are intangible assets that are reflected on a company's balance sheet when it purchases them from another company. The costs of developing patents internally are generally expensed when incurred. The costs of registering a patent, however, are capitalized. Patents are intellectual property of great value and can confer a monopoly on a patent holder. Patent rights must be zealously protected to prevent their value from being diminished. Patents are reported in the balance sheet at cost, net of accumulated amortization.

38. The intangible asset goodwill is reflected on a company's balance sheet when it purchases another company for an amount greater than the market value of its identifiable assets and liabilities. A large portion of goodwill on Cisco System's balance sheet indicates that Cisco Systems is growing through acquisitions of other companies as opposed to growth through internal expansion.

39. The primary source of funding for banks such as Bank of America is through deposits gathered from its diverse customer base. Banks do not present classified balance sheets, butmost deposits are relatively short-term (current). Borrowings are a secondary source of funding, and are not as great as the deposit liability. Banks are highly leveraged, i.e., shareholders' equity represents a smaller portion of total assets (usually less than 10%).

40. A deficit in retained earnings means that Amazon.com has not been profitable on a cumulative basis since its inception, net of any distributions to shareholders. This is not an uncommon situation for young companies, especially those in Internet related businesses.

42. Cost of goods sold represents the original cost of inventory items sold by manufacturers, wholesalers, and retailers. This inventory cost is reported separately from other operating expenses. Service businesses such as H & R Block provide services and do not sell inventory, thus there is no cost of goods to report.

43. If the profits were the result of expense reductions, and continued expense reductions were in doubt, continued profits would be doubtful as well.

43. An excess of other (non-operating) expenses over other (non-operating) revenues would cause net income to be lower than net income from operating activities. In AMR's case, there is an overall net loss. Investors would be more concerned about net income from operating activities which would be expected to recur while (significant) other revenues and expenses tend to be one-time items. Analysts may see potential for on-going profitability if non-operating expenses can be controlled, but there should be caution given the overall loss shown by the company.

44. Dividends are reported in the statement of shareholders' equity as a reduction in retained earnings. Net income is reported as an increase in retained earnings in the statement of shareholders' equity. Retained earnings represent the portion of net income not paid to shareholders as dividends. The difference–60% to 70% of net income in the case of Johnson & Johnson–represents the portion of earnings normally reinvested in the business.

45. Cash flows from operating activities generally are usually be expected to continue, whereas cash flows from investing activities are understood to vary considerably from year to year. Furthermore, cash flows from operating activities are more closely tied to profitability than are investing cash flows, which tend to be negative when a company is healthy and growing. Reclassifying cash outflows from operating to investing would make the company's continuing operations appear more profitable while the increase cash outflows for investing would make the company appear to be enjoying positive growth.

46. Cash flow from (or used) in operations is shown in the first section of the statement of cash flows under the caption ―operating activities‖. Analysts do not necessarily react negatively to negative cash flows from operations for emerging businesses. Negative cash flows during the introductory phase of a company's life cycle are not uncommon. A favorable trend in cash flows, and prospects for positive cash flows as the business grows, would be important to the analyst.

46. Cash flows from investing activities include cash inflows and outflows associated with the purchase and sale of productive assets (property, plant and equipment, and intangibles), including the acquisition of other businesses, and long-term investments in securities. Yahoo's use of cash for investing activities indicates additional investment in assets, while Amazon appears to have sold more assets than it purchased.

46. Cash flows from financing activities include proceeds from the issuance of common stock, so both companies would likely have had positive cash flows from financing activities during their early years.

CHARACTERISTICS OF END-OF-CHAPTER ASSIGNMENTS

Item	Difficulty	Description
Brief Exercises:		
BE2–1	E	Dividends as a percentage of net income
BE2–2	E	Financing assets
BE2–3	E	Assessing solvency

BE2-4	E	The statement of cash flows across time
BE2-5	E	Financial statement formats - International

Exercises:

E2-1	M	Identifying financing, investing, and operating transactions
E2-2	M	Identifying financing, investing, and operating transactions
E2-3	E	Balance sheet or income statement account?
E2-4	M	Financial statements and the lending decision
E2-5	M	Retained earnings changes across time
E2-6	M	Retained earnings changes across time
E2-7	M	Using working capital to assess solvency
E2-8	H	Solvency, financing and debt covenants
E2-9	M	The statement of cash flows across time
E2-10	M	The statement of cash flows across time
E2-11	H	Preparing a statement of cash flows
E2-12	H	Preparing a statement of cash flows
E2-13	H	Preparing financial statements from simple transactions
E2-14	H	Preparing financial statements from simple transactions

Problems:

P2-1	E	Classifying balance sheet accounts
P2-2	E	Classifying income statement accounts
P2-3	M	Financial statement interrelationships
P2-4	H	Preparing a balance sheet in proper form
P2-5	M	Balance sheet and income statement relationships across time
P2-6	M	Using financial statements to assess solvency and earning power
P2-7	H	Balance sheet value and the fair market values of the assets
P2-8	M	Analyzing financial statements
P2-9	M	Analyzing financial statements
P2-10	H	Debt covenants and financial statements

Issues for discussion:

ID2-1	M	Relationships among cash flows, income, and dividends
ID2-2	H	Income statement analysis
ID2-3	E	Debt covenants
ID2-4	H	Statement of cash flow patterns across companies
ID2-5	H	Statement of cash flow patterns across time
ID2-6	H	Balance sheet—IFRS
ID2-7	M	Net income vs. cash flow from operations
ID2-8	M	Transactions and the financial statements
ID2-9	M	IFRS versus GAAP
ID2-10	M	The annual report of Google