Today’s Content

- The Balance Sheet
  - Consolidated
  - Comparative
  - Liquidity
  - Current assets
    - Cash & cash equivalents
    - Inventory & cost flow assumptions

The Balance Sheet

- The balance sheet “balances!”
  - Assets = Liabilities + Stockholder’s equity
  - What it owns = What it owes outside creditors + what it owes equity investors (stockholders)
- The balance sheet is made up of “accounts”
  - Each account: Name (title) & Amount (balance)
Consolidated Balance Sheet

- “Consolidated” … more than one company
  - Any company that owns more than 50% of the voting stock of another company must present “consolidated financial statements”
  - “Wholly owned subsidiary” … means 100% owned by the reporting company

Comparative

- “Comparative” … two years of comparative balance sheet data are required
- Also notice the sentence at the bottom of the balance sheet:
  - “The accompanying notes are an integral part of these consolidated financial statements.”
Assets & Liabilities

- **Assets & Liabilities on a Balance sheet**
  - Presented in order of liquidity … from most to least “liquid” (essentially a measure of the “ability to convert to cash” rapidly)
  - Subdivided into “current” & “long term”
    - Current assets (& liabilities) are those that are expected to be used up & replenished on an on-going basis during the accounting period
    - Long term assets (& liabilities) are expected to last more than the accounting period

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Current Assets

- **Current assets on the balance sheet**
  - Cash and cash equivalents
    - Cash in the bank or readily available cash-like instruments
  - Short-term investments ( Marketable securities)
    - Are temporary investments of cash not currently needed for operations

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Current Assets (continued)

- **Current assets on the balance sheet**
  - Accounts receivable, net (Accounts receivable, less allowance for doubtful accounts)
    - Are outstanding customer credit reported at their “estimated” net realizable value
  - Inventories
    - Are items held for sale or use in the manufacture of a product
    - Often a significant balance sheet item as a percentage of assets … varies dramatically between industries & between companies
Current Assets - Inventory

• The valuation of inventory is often a very important item to understand in order to understand the financial statements
  - Different inventory accounting methods result in very different inventory valuations on the balance sheet … and “cost of goods sold” on the income statement
  - Inventory valuation is based on a “cost flow assumption” … a “matching principle”

Inventory Cost Flow Assumptions

• A cost flow assumption has nothing to do with the actual flow of goods as they are sold or used in production
• A cost flow assumption has everything to do with economic conditions & price fluctuations
• Three major cost flow assumptions:
  – FIFO … LIFO … Average cost

Cost Flow Assumptions

(Example Part 1)

• A computer reseller buys five computers at the costs listed below:
  – Computer | Cost
  – #1      | $1,000
  – #2      | $1,200
  – #3      | $1,300
  – #4      | $1,500
  – #5      | $1,600
Cost Flow Assumptions
(Example continued)

• FIFO (first in, first out)
  – Assumes items sold: 1, 2, & 3 - therefore: COGS = $3,500 and Inventory valuation = $3,100
• LIFO (last in, first out)
  – Assumes items sold: 5, 4, & 3 - therefore: COGS = $4,400 and Inventory valuation = $2,200
• Average cost (based on average price of items)
  – COGS = $3,900 and Inv. valuation = $2,600

Cost Flow Assumptions
(discussion)

• Remember … cost flow assumptions correspond to economic conditions & price fluctuations
  NOT the actual flow of products
• As we see from this very simple example, different cost flow assumptions result in very different results that effect both the balance sheet and the income statement

Cost Flow Assumption - FIFO

• Notice in this example that prices are rising!
• FIFO (first in, first out)
  – During a time of rising prices (from inflation or the nature of the product or industry):
    • Inventory valuation on the balance sheet ($3,100 in our example) more closely approximates “current prices”
    • However, COGS on the income statement ($3,500 in our example) is actually undervalued relative to current prices
Cost Flow Assumption - LIFO

- LIFO (last in, first out)
  - During a time of rising prices (from inflation or the nature of the product or industry):
    - COGS on the income statement ($4,400 in our example) most closely approximates “current costs”
    - However, Inventory valuation on the balance sheet ($2,200 in our example) is now undervalued relative to current prices
    - LIFO adjusts for this using what is called “LIFO layers” which we will talk about later

Cost Flow Assumption - Average Cost

- The average cost is very straightforward in that it simply calculates an average cost of all items either in inventory or sold during an accounting period

Cost Flow Assumptions

- Why do you suppose that most retail and manufacturing companies use the LIFO cost flow assumption?
  - Rising prices are a reality of their business environment
  - Taxes are also a major consideration
    - Since LIFO produces the highest COGS, which is an expense item, it lowers a company’s reported net income and therefore its taxes
IT Examples

- Dell … “values inventory at the lower of cost or market with cost being determined using the FIFO method”
  - Ref: Note 1, Dell financial statements
- Intel …”inventory costs is computed on a currently adjusted standard basis which approximates first in, first out”
  - Ref: Note 1, Intel financial statements

Cost Flow Assumptions & IT

- Why do you suppose that most IT companies use the FIFO cost flow assumption?
  - Falling prices are a reality of their business environment

Other Current Asset Accounts

- Prepaid expenses …can include things like insurance, rent, taxes, utilities, etc. paid in advance but will expire in one year or one operating cycle
- Deferred income taxes … prepaid taxes or tax credits
- Other … other short-lived assets
Summary

- The balance sheet balances
- Consolidated & comparative
- Presentation in order of liquidity
- Inventory valuation & cost flow assumptions
  - FIFO
  - LIFO
  - Average cost