

GLOBAL
EDITION



Twelfth Edition

UNDERSTANDING **FINANCIAL STATEMENTS**

FRASER | ORMISTON





UNDERSTANDING FINANCIAL STATEMENTS

TWELFTH EDITION
GLOBAL EDITION

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Accrued Liabilities

Like most large corporations, Sage Inc. uses the accrual rather than the cash basis of accounting: Revenue is recognized when it is earned, and expenses are recorded when they are incurred, regardless of when the cash is received or paid. Accrued liabilities result from recognition of an expense in the accounting records prior to the actual payment of cash. Thus, they are liabilities because there will be an eventual cash outflow to satisfy the obligations.

Assume that a company has a \$100,000 note outstanding, with 12% annual interest due in semiannual installments on March 31 and September 30. For a balance sheet prepared on December 31, interest will be accrued for three months (October, November, and December):

$$\begin{aligned} \$100,000 \times 0.12 &= \$12,000 \text{ annual interest} \\ \$12,000/12 &= \$1,000 \text{ monthly interest} \\ \$1,000 \times 3 &= \$3,000 \text{ accrued interest for three months} \end{aligned}$$

The December 31 balance sheet would include an accrued liability of \$3,000. Accruals also arise from salaries, rent, insurance, taxes, and other expenses.

Reserve accounts are often set up for the purpose of estimating obligations for items such as warranty costs, sales returns, or restructuring charges, and are recorded as accrued liabilities. Generally, the only way to determine whether a company has set up a reserve account is to read the notes to the financial statements carefully. Reserve accounts are also set up to record declines in asset values; the allowance for doubtful accounts explained earlier in the chapter is an example.

The potential for manipulation exists whenever a firm is estimating amounts to be recorded on financial statements. Reserve accounts are discussed in more detail in Appendix 3A.

Unearned Revenue or Deferred Credits

Companies that are paid in advance for services or products record a liability on the receipt of cash. The liability account is referred to as *unearned revenue* or *deferred credits*. The amounts in this account will be transferred to a revenue account when the service is performed or the product is delivered as required by the matching concept of accounting. Sage Inc. does not have unearned revenue because it is a retail company that does not generally receive payment in advance of selling its products. However, companies in high-technology, publishing, entertainment, and manufacturing industries are apt to have unearned revenue accounts on their balance sheets.

For example, Netflix reported deferred revenue at year-end 2021 of \$1,209.3 million, carried as a current liability on its balance sheet. The note to the Netflix financial statements on Revenue Recognition states that members are billed in advance of the start of their monthly membership, and revenues are recognized over the monthly membership period. Deferred revenue consists of membership fees billed that have not been recognized, as well as gift and other prepaid memberships that have not been fully redeemed.⁹

⁹Extracted from 10-K filings for Netflix Inc. 2021. Obtained from U.S. Securities and Exchange Commission. www.sec.gov.



Deferred Federal Income Taxes

Deferred taxes are the result of temporary differences in the recognition of revenue and expense for taxable income relative to reported income. Most large companies use one set of rules for calculating income tax expense, paid to the IRS, and another set for figuring income reported in the financial statements. The objective is to take advantage of all available tax deferrals to reduce actual tax payments, while showing the highest possible amount of reported net income. There are many areas in which firms are permitted to use different procedures for tax and reporting purposes. Most firms use an accelerated method of depreciation (the Modified Accelerated Cost Recovery System) to figure taxable income and the straight-line method for reporting purposes. The effect is to recognize more depreciation expense in the early years of an asset's useful life for tax calculations.

Although depreciation methods are the most common source, other temporary differences arise from the methods used to account for installment sales, long-term contracts, leases, warranties and service contracts, pensions and other employee benefits, and subsidiary investment earnings. They are called *temporary differences* (or *timing differences*) because, in theory, the total amount of expense and revenue recognized will eventually be the same for tax and reporting purposes. There are also *permanent differences* in income tax accounting. Municipal bond revenue, for example, is recognized as income for reporting purposes but not for tax purposes; life insurance premiums on officers are recognized as expense for financial reporting purposes but are not deductible for income tax purposes. These permanent differences do not affect deferred taxes because a tax will never be paid on the income or the expense will never be deducted on the tax return.

The deferred tax account reconciles the temporary differences in expense and revenue recognition for any accounting period. Business firms recognize deferred tax liabilities for all temporary differences when the item causes financial income to exceed taxable income with an expectation that the difference will be offset in future accounting periods. Deferred tax assets are reported for deductible temporary

differences and operating loss and tax credit carryforwards. A deductible temporary difference is one that causes taxable income to exceed financial income, with the expectation that the difference will be offset in the future. Measurement of tax liabilities and assets is based on provisions of the enacted tax law; effects of future anticipated changes in tax law are not considered. A *valuation allowance* is used to reduce deferred tax assets to expected realizable amounts when it is determined that it is more likely than not that some of the deferred tax assets will not be realized.¹⁰

To illustrate the accounting for deferred taxes, assume that a company has a total annual revenue of \$500,000; expenses other than depreciation are \$250,000; and depreciation expense is \$100,000 for tax accounting and \$50,000 for financial reporting (eventually this difference would reverse and the reported depreciation expense in later years would be greater than the tax depreciation expense). The income for tax and reporting purposes would be computed two ways, assuming a 34% tax rate:

	Tax	Reporting
Revenue	\$500,000	\$500,000
Expenses	<u>(350,000)</u>	<u>(300,000)</u>
Earnings before tax	\$150,000	\$200,000
Tax expense ($\times 0.34$)	<u>(51,000)</u>	<u>(68,000)</u>
Net income	\$ 99,000	\$132,000

Taxes actually paid (\$51,000) are less than the tax expense (\$68,000) reported in the financial statements. To reconcile the \$17,000 difference between the expense recorded and the cash outflow, there is a deferred tax liability of \$17,000:

Reported tax expense	\$68,000
Cash paid for taxes	<u>51,000</u>
Deferred tax liability	\$17,000

For an additional example of deferred taxes, including the ultimate reversal of the temporary difference, see Figure 2.2.

Deferred taxes are classified as current or noncurrent on the balance sheet, corresponding to the classification of related assets and liabilities underlying the temporary difference. For example, a deferred tax asset arising from accounting for 90-day warranties would be considered current. On the other hand, a temporary difference based on five-year warranties would be noncurrent; depreciation accounting would also result in a noncurrent deferred tax because of the noncurrent classification of the underlying plant and equipment account. A deferred tax asset or liability that is not related to an asset or liability for financial reporting, including deferred tax assets

¹⁰The Tax Cuts and Jobs Act, which went into law in 2017, reduced the corporate tax rate from 35% to 21%. Because U.S. GAAP does not allow for adjustments to tax effects due to tax rate changes, the effects become stranded in other comprehensive income. The significant reduction in tax rates caused the FASB to issue ASU No. 2018-02, *Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* in February 2018. This amendment allows, but does not require, companies to reclassify the stranded tax effects of items in accumulated other comprehensive income to retained earnings.

FIGURE 2.2 Deferred Taxes—An Example

A company purchases a piece of equipment for \$30,000. The equipment is expected to last three years and have no salvage value at the end of the three-year period. Straight-line depreciation is used for financial reporting purposes, and an accelerated method is used for tax purposes. The following table shows the amounts of depreciation that would be recorded for both sets of books over the three-year life of the equipment:

Year	Depreciation expense (Financial reporting)	Depreciation expense (Tax reporting)
1	\$10,000	\$20,000
2	\$10,000	\$ 6,667
3	\$10,000	<u>\$ 3,333</u>

Assume that revenues are \$90,000 and all expenses other than depreciation are \$20,000 each year, the tax rate is 30%, and depreciation is the only temporary difference that creates the deferred tax account. Calculations to determine tax expense for reporting purposes and tax paid are below:

Year 1	Income Statement		Tax Return
Revenues	\$90,000		\$90,000
Expenses:			
Depreciation	(10,000)		(20,000)
Other	(20,000)		(20,000)
Earnings before taxes	<u>\$60,000</u>	Taxable income	<u>\$50,000</u>
Tax rate	$\times 0.30$		$\times 0.30$
Tax expense	<u>\$18,000</u>		<u>\$15,000</u>

The recording of taxes at the end of year 1 will involve a decrease in the cash account of \$15,000; an increase in tax expense of \$18,000; and an increase in the deferred tax liability account of the difference, \$3,000.

Year 2	Income Statement		Tax Return
Revenues	\$90,000		\$90,000
Expenses:			
Depreciation	(10,000)		(6,667)
Other	(20,000)		(20,000)
Earnings before taxes	<u>\$60,000</u>	Taxable income	<u>\$63,333</u>
Tax rate	$\times 0.30$		$\times 0.30$
Tax expense	<u>\$18,000</u>		<u>\$19,000</u>

The recording of taxes at the end of year 2 will involve a decrease in the cash account of \$19,000; an increase in tax expense of \$18,000; and a decrease in the deferred tax liability account of the difference, \$1,000. The deferred tax liability account will now have a balance of \$2,000 at the end of year 2.

Year 3	Income Statement		Tax Return
Revenues	\$90,000		\$90,000
Expenses:			
Depreciation	(10,000)		(3,333)
Other	(20,000)		(20,000)
Earnings before taxes	<u>\$60,000</u>	Taxable income	<u>\$66,667</u>
Tax rate	$\times 0.30$		$\times 0.30$
Tax expense	<u>\$18,000</u>		<u>\$20,000</u>

The recording of taxes at the end of year 3 will involve a decrease in the cash account of \$20,000; an increase in tax expense of \$18,000; and a decrease in the deferred tax liability account of the difference, \$2,000. The deferred tax liability account will now have a balance of \$0 at the end of year 3, as the temporary difference has completely reversed.

Notice that the total amount of income tax expense (\$54,000) recorded for reporting purposes is exactly equal to the tax paid (\$54,000) over the three-year period.

related to carryforwards, is classified according to anticipated reversal or benefit. At the end of the accounting period, the firm will report one net current amount and one net noncurrent amount unless the liabilities and assets are attributable to different tax-paying components of the enterprise or to different tax jurisdictions. Thus, the deferred tax account can conceivably appear on the balance sheet as a current asset, current liability, noncurrent asset, or noncurrent liability.

Sage Inc. reports deferred federal income taxes as a current asset as well as a noncurrent liability. The temporary differences are based on store closing expenses, stock-based compensation, depreciation methods, and long-term installment sales as reported in Note 4—Income Taxes in the Sage Inc. annual report.

Long-Term Debt

Obligations with maturities beyond one year are designated on the balance sheet as noncurrent liabilities. Many different types of debt exist, but the most common forms found on balance sheets are briefly described below:

- Long-term notes payable—contractual agreement between borrower and lender (generally a bank) which designates the principal and interest repayment schedule and other conditions of the loan.
- Mortgage—loan agreement secured by real estate.
- Debentures—unsecured debt backed by the company's general credit standing.
- Bonds payable—financial instruments used to raise cash which are traded in capital markets. Bonds are generally issued in denominations of \$1,000 (face value or maturity value) and have a stated interest rate. Since bonds are traded on markets, the issue price investors are willing to pay may be more or less than the face or maturity value.
- Convertible debt—debt in the form of bonds or notes that allows the investor or lender the opportunity to exchange a company's debt for common stock of that company. The terms of the agreement are specified in a document referred to as the bond indenture. The conversion price, or dollar value at which the debt may be converted into common stock, is generally set at an amount higher than the current market price of the firm's stock when the debt is issued.
- Long-term warranties—nonmonetary liabilities that promise the delivery of goods or services during a specified warranty period. Examples would include a two-year warranty offered for new home construction or three-year warranty offered for new car purchases.

Other types of long-term debt are described in the following sections which discuss capital lease obligations and pension liabilities.

In Note 2 to the financial statements, Sage Inc. specifies the nature, maturity, and interest rate of each long-term obligation. Even though long-term debt increased by over \$4,000 from 2023 to 2024, notice that on the common-size balance sheet (Exhibit 2.2), the percentage of long-term debt relative to total assets has declined.

Leases

A lease is a contract under which one party, the lessor, agrees to rent or convey the rights to use an asset to the lessee, for a specified time, in return for a periodic payment. Prior to 2019, the accounting for leases included a distinction between capital

and operating leases. Capital leases affected both the balance sheet and the income statement, whereas operating leases affected only the income statement. Companies were required to report both an asset and a liability for capital leases on their balance sheet and interest and amortization expense on the income statement. Operating leases required the recording of an annual amount for rent expense on the income statement, with footnote disclosure of the future rental payments required for the duration of the lease. As a result, operating leases, prior to 2019, were a form of *off-balance sheet financing*. In fact, the lessee was contractually obligated to make lease payments but was not required by generally accepted accounting principles (GAAP) to record this obligation as a debt on the balance sheet. Some companies purposely negotiated a lease as an operating lease so that the long-term commitment would not have to be shown on the balance sheet.

Lease accounting rules came under further scrutiny in the United States after Enron filed for bankruptcy. Prior to Enron's bankruptcy, the firm reported \$13 billion of debt on its balance sheet and yet told its bankers they owed \$38 billion due to off-balance sheet financing. In 2005, the SEC, in a report to Congress, voiced concern about the \$1.25 trillion in noncancelable future cash obligations for operating leases that were not recognized on company balance sheets. As a result, the FASB and IASB issued new standards for lease accounting, ASU 2016-02 (ASC Topic 842) and IFRS 16, respectively, effective January 1, 2019, and mandatory for public companies for fiscal years beginning after December 15, 2018. The increase in debt on the balance sheets of U.S. public companies was projected to be \$3 trillion!¹¹

Unfortunately, the FASB and IASB could not agree on the details included in the new lease accounting standards, despite a decade of discussions. The key difference between the two standards is that IFRS 16 classifies most leases as finance leases and does not have an operating lease classification. Analysts will need to adjust the financial statements to make meaningful comparisons between U.S. firms and those firms using IFRS.

ASC Topic 842 classifies leases into three categories: short-term leases, finance leases, and operating leases. Short-term leases have lease terms of less than one year, and lease or rent expense is recorded on the income statement as the leased asset is used. No asset or liability is recorded for a short-term lease.

Finance leases are, in substance, a "purchase" rather than a "lease." If a lease contract meets any one of the following five criteria per the new FASB rule, it is considered a finance lease:

1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
3. The lease term is for the major part of the economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

¹¹Yun Li, "A Big Change in Accounting Will Put \$3 Trillion in Liabilities on Corporate Balance Sheets," CNBC, February 16, 2019.