Chapter Two

Challenge Exercise 1

Expands on: E2-5
LO: 1, 2, 4

These items were taken from the financial statements of Bush Company at December 31, 2014:

Buildings	$105,800	Common stock (20,000 shares)	$60,000
Accounts receivable	15,600	Retained earnings (1/1/14)	40,000
Prepaid insurance	3,200	Accumulated depreciation-buildings	45,800
Cash	11,800	Accounts payable	8,500
Equipment	82,720	Notes payable	93,600
Land	61,000	Accumulated depreciation-equipment	18,720
Insurance expense	700	Interest payable	3,600
Depreciation expense	4,900	Service revenue	17,700
Interest expense	2,200		

Instructions
(a) Prepare a classified balance sheet. Assume that $16,300 of the note payable will be paid in 2015.
(b) Compute the following: (1) working capital, (2) current ratio, (3) debt to assets ratio, and (4) earnings per share.

Challenge Exercise 1 – Solution

(a)

BUSH COMPANY
Balance Sheet
December 31, 2014
Assets

Current assets				
Cash			$11,800	
Accounts receivable			15,600	
Prepaid insurance			3,200	
Total current assets				$ 30,600
Property, plant, and equipment				
Land		61,000		
Buildings		$105,800		
Less: Accumulated depreciation—buildings	45,800	60,000		
Equipment		82,720		
Less: Accumulated depreciation—equipment		18,720	64,000	185,000
Total assets				$215,600

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	$ 8,500	
Current maturity of note payable	16,300	
Interest payable	3,600	
Total current liabilities		$ 28,400
Long-term liabilities		
Note payable ($93,600 – $16,300)		77,300
Total liabilities		105,700
Stockholders' equity		
Common stock	60,000	
Retained earnings ($40,000 + $9,900*)	49,900	
Total stockholders' equity		109,900
Total liabilities and stockholders' equity		$215,600

* Net income = $17,700 - $700 - $4,900 - $2,200 = $9,900

Challenge Exercise 1 – Solution (Cont'd)

(b) (1) Working capital: \$30,600 - \$28,400 = \$2,200

(2) Current ratio: \$30,600 ÷ \$28,400 = 1.08 : 1

(3) Debt to assets ratio: \$105,700 ÷ \$215,600 = 49%

(4) Earnings per share: \$9,900 ÷ 20,000 shares = \$0.495 per share

Challenge Exercise 2

Expands on: E2-13
LO: 7

Mendez Company had three major business transactions during 2014.

(a) Security investments with a market value of $10,000 were reported in the financial statements at their original cost $9,300.
(b) The death of the company's Chief Executive Officer was reported as a $1,000,000 loss in the company's income statement.
(c) The annual report did not include any notes to the financial statements.

Instructions
In each situation, identify the assumption or principle that has been violated, if any, and discuss what the company should have done.

Challenge Exercise 2 – Solution

(a) This is a violation of the fair value principle. Security investments should be reported at their fair market value in the financial statements.

(b) This is a violation of the monetary unit assumption. Only those transactions that can be measured in dollars and cents are recorded and reported in the financial statements. The death of the CEO should be reported in a news release and possibly in the management discussion and analysis section of the annual report.

(c) This is a violation of the full disclosure principle. All information capable of making a difference in financial statement users' decision-making should be disclosed in the financial statements. The notes to the financial statements are an integral part of the financial statements, and should be included.

SOLUTIONS TO CASES FOR MANAGEMENT DECISION MAKING

CASE 1

1. A predetermined manufacturing overhead rate means that all manufacturing overhead costs, are allocated to each job based on a cost driver. Often this is done based on the expected volume of units produced. That is, products that are produced in higher volume are allocated more overhead.

   In the case of Wall Décor, in addition to volume sold, the base used is the cost of each print sold. That is, each print is allocated an amount of manufacturing overhead based on the cost of the print. The management of Wall Décor felt that this approach was logical because it was expected that more expensive prints would be more likely to be framed, and that the processing of framing requires the incurrence of considerably more overhead costs.

2. The advantages of using the cost of each print as the manufacturing overhead cost driver are that: (1) it is relatively inexpensive to implement in a business, (2) it is easy to explain, and (3) it keeps accounting records in compliance with GAAP.

   The primary disadvantage of using the cost of each print as the manufacturing overhead cost driver is that it may not result in a reasonable estimate of the cost of a job, batch, or service. That is, the assumed relationship—that the cost of the print is related to the amount of overhead cost incurred—may be incorrect. Many of the overhead costs incurred are the result of the framing and matting processes. However, the approach used by Wall Décor will result in a high overhead allocation to expensive prints, even if those prints are not framed. Furthermore, even if overhead costs are related to the cost of prints, and substantially more unframed prints are sold than framed prints, then an inordinate amount of overhead will still be allocated to the unframed prints simply because more of those are sold. By allocating overhead in an inappropriate fashion, product costs are distorted, and, as a consequence, management decision making is affected.

3. **Under a job order costing system, a predetermined overhead rate must be used, since the cost of jobs must be calculated throughout the year (rather than just at year-end). This predetermined overhead rate is based on expected costs and the expected total amount of the cost driver. Therefore, the first thing that must be done is to compute the total expected overhead cost. This step was completed in the information provided by the accounting and production teams. It was determined to be $375,200 (Illustration CA 1-2).**

   The second step is to determine the total expected cost of prints for the period.

Unframed:	**80,000 X $12 =**	**$ 960,000**
Steel-framed:	**15,000 X $16 =**	**240,000**
Wood-framed:	**7,000 X $20 =**	**140,000**
Total expected cost of prints		**$1,340,000**

   Once the total expected overhead cost and total expected print cost are known, the overhead rate can be determined.

   Predetermined overhead rate = $375,200 ÷ $1,340,000 = $0.28

   This means that for every $1 of print cost, it is assumed that 28¢ of manufacturing overhead costs are consumed. For example, a $12 print will be assigned $3.36 ($12 X $0.28) of overhead.

CASE 1 (Continued)

4.

	Lance Armstrong Print	John Elway Steel-Framed Print, No Matting	Lambeau Field Wood-Framed Print, with Matting
Direct material			
Print	$12.00	$16.00	$20.00
Frame and glass		4.00	6.00
Matting			4.00
Direct labor			
Picking			
([10/60] X $12)	2.00	2.00	2.00
Matting and framing			
([20/60] X $21)		7.00	
([30/60] X $21)			10.50
Manufacturing overhead			
(0.28 X $12, $16, $20)	3.36	4.48	5.60
Total product cost	$17.36	$33.48	$48.10

5.

(a)	Unframed prints	80,000 X $12 X $0.28 =	$268,800
(b)	Steel-framed prints	15,000 X $16 X $0.28 =	67,200
(c)	Wood-framed prints	7,000 X $20 X $0.28 =	39,200
			$375,200

(d) As a percentage, unframed prints are being allocated 71.6 percent or ($268,800 ÷ $375,200) of the total overhead cost.

6. No. Unframed prints are being allocated too much manufacturing overhead and framed prints too little manufacturing overhead. In designing the allocation approach, management had assumed that since the average cost of framed prints would exceed the average cost of unframed prints, more of the overhead would be allocated to framed prints. However, the cause of the apparent misallocation is that the volume of unframed prints is much greater than the volume of framed prints. This dramatic difference in volume far outweighs the difference in price. Therefore, unframed prints as a category end up absorbing the bulk of the overhead costs. This does not seem appropriate since a review of the manufacturing overhead costs shows that many of the overhead costs are associated with the framing and matting component of the production area, such as salaries, rent of factory equipment, and information systems.

CASE 1 (Continued)

7. The high-volume unframed prints will be overcosted and the low-volume framed prints will be undercosted. This will occur because the category of prints that are sold most frequently will generally carry the greatest amount of overhead. For example, in reference to the solution to question 4, the framed and matted print is being allocated only $5.60, but an unframed print is allocated $3.36 of manufacturing overhead. This is not logical because a substantial portion of manufacturing overhead costs is dedicated to framing and matting prints.

As a result, Wall Décor might end up selling framed prints at a price that is too low to cover its cost. Changing the way the overhead is allocated may improve the profit center's performance.

Chapter Two

Challenge Exercise 1

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LO: 1, 2, 4

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(b) Compute the following: (1) working capital, (2) current ratio, (3) debt to assets ratio, and (4) earnings per share.

Challenge Exercise 2

Expands on: E2-13

LO: 7

Mendez Company had three major business transactions during 2014.

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(b) The death of the company's Chief Executive Officer was reported as a $1,000,000 loss in the company's income statement.
(c) The annual report did not include any notes to the financial statements.

Instructions

In each situation, identify the assumption or principle that has been violated, if any, and discuss what the company should have done.

CCC2 CONTINUING COOKIE CHRONICLE

(a) The balance sheet reports the assets, liabilities, and stockholders' equity of a company at a specific date. The income statement presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. The retained earnings statement summarizes the changes in retained earnings for a specific period of time. Finally, the cash flow statement provides information about the cash inflows and cash outflows for a specific period of time.

(b) By looking at the balance sheet and the cash flow statement and calculating liquidity ratios we can measure a company's short term ability to pay its obligations. Liquidity ratios include the calculation of working capital (current assets minus current liabilities) and current ratio (current assets divided by current liabilities).

(c) By looking at the balance sheet and the cash flow statement and calculating solvency ratios we are able to measure a company's ability to survive over a long period of time. These solvency ratios include debt to total assets (total liabilities divided by total assets) and free cash flow (cash provided by operations minus dividends and capital expenditures).

(d) By looking at the income statement we can determine if Biscuits is profitable. If revenues earned by Biscuits exceed expenses incurred, then Biscuits is profitable. Profitability ratios can measure a company's ability to generate earnings over a period of time. One profitability ratio is earnings per share (net income minus preferred dividends divided by average common shares outstanding).

(e) By looking at the balance sheet we can determine if Biscuits has any debt. By looking at the balance sheet and cash flow statement and calculating solvency ratios we are able to determine whether a company has the ability to repay its long-term debt. Profitability ratios will help in determining whether a company is able to pay its interest expense. The more profitable the company the better able it is to repay its long-term obligations as well as the amount of interest it is paying on its debt.

CONTINUING COOKIE CHRONICLE (Continued)

(f) **By looking at the statement of cash flows we can determine whether Biscuits has paid any dividends to its shareholders.**

(g) **Be aware that financial statements of Biscuits provide a historical perspective of what has already taken place. The financial statements may prove to be a good indicator of what will happen in the future but remember that is not necessarily guaranteed. Consumer tastes change and as a result the demand for Biscuits' product may also change.**

There are other issues that Natalie must consider as well. Does she have the ability to meet the demands of Biscuits? Will she be able to produce 1,500 dozen cookies a week? Does she have enough staff to enable her to do so? Does she have a large enough oven to do so? Does she have enough cash to pay her staff, purchase supplies, and cover operating expenses until she receives payment from Biscuits?

CHAPTER 2

A Further Look at Financial Statements

Learning Objectives

1. Identify the sections of a classified balance sheet.
2. Identify tools for analyzing financial statements and ratios for computing a company's profitability.
3. Explain the relationship between a retained earnings statement and a statement of stockholders' equity.
4. Identify and compute ratios for analyzing a company's liquidity and solvency using a balance sheet.
5. Use the statement of cash flows to evaluate solvency.
6. Explain the meaning of generally accepted accounting principles.
7. Discuss financial reporting concepts.

Summary of Questions by Learning Objectives and Bloom's Taxonomy

Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT
							Questions							
1.	1	K	6.	2, 4, 5	C	10.	4, 5	K	14.	7	C	18.	7	C
2.	1	K	7.	2, 4, 5	K	11.	2, 4, 5	C	15.	7	C	19.	7	C
3.	1	C	8.	4	C	12.	6	K	16.	7	C	20.	1	C
4.	1	C	9.	4, 5	C	13.	6, 7	K	17.	6	C			
5.	1	K												
							Brief Exercises							
1.	1	K	4.	3	K	7.	6	K	9.	7	K	11.	7	K
2.	1	AP	5.	4	AP	8.	7	K	10.	7	K			
3.	2	AP	6.	4, 5	AP									
							Do It! Review Exercises							
1.	1	AP	2.	1	AP	3.	4, 5	K	4.	7	K			
							Exercises							
1.	1	AP	4.	1	AP	7.	2	AP	10.	4	AP	12.	7	K
2.	1	AP	5.	1	AP	8.	1, 3, 4	AP	11.	4, 5	AP	13.	7	C
3.	1	AP	6.	1	AP	9.	4	AP						
							Problems: Set A							
1.	1	AP	3.	1, 3	AP	5.	2, 4, 5	AP	7.	2, 4, 5	AP	8.	6, 7	E
2.	1, 3	AP	4.	2, 4, 5	AN	6.	2, 4, 5	AP						
							Problems: Set B							
1.	1	AP	3.	1, 3	AP	5.	2, 4, 5	AP	7.	2, 4, 5	AP	8.	6, 7	E
2.	1, 3	AP	4.	2, 4, 5	AN	6.	2, 4, 5	AP						

ASSIGNMENT CHARACTERISTICS TABLE

Problem Number	Description	Difficulty Level	Time Allotted (min.)
1A	Prepare a classified balance sheet.	Simple	10–20
2A	Prepare financial statements.	Moderate	20–30
3A	Prepare financial statements.	Moderate	20–30
4A	Compute ratios; comment on relative profitability, liquidity, and solvency.	Moderate	20–30
5A	Compute and interpret liquidity, solvency, and profitability ratios.	Simple	10–20
6A	Compute and interpret liquidity, solvency, and profit-ability ratios.	Moderate	15–25
7A	Compute ratios and compare liquidity, solvency, and profitability for two companies.	Moderate	15–25
8A	Comment on the objectives and qualitative characteristics of financial reporting.	Simple	10–20
1B	Prepare a classified balance sheet.	Simple	10–20
2B	Prepare financial statements.	Moderate	20–30
3B	Prepare financial statements.	Moderate	20–30
4B	Compute ratios; comment on relative profitability, liquidity, and solvency.	Moderate	20–30
5B	Compute and interpret liquidity, solvency, and profitability ratios.	Simple	10–20
6B	Compute and interpret liquidity, solvency, and profit-ability ratios.	Moderate	15–25
7B	Compute ratios and compare liquidity, solvency, and profitability for two companies.	Moderate	15–25
8B	Comment on the objectives and qualitative characteristics of accounting information.	Simple	10–20

ANSWERS TO QUESTIONS

1. A company's operating cycle is the average time that is required to go from cash to cash in producing revenue.

2. Current assets are assets that a company expects to convert to cash or use up within one year of the balance sheet date or the company's operating cycle, whichever is longer. Current assets are listed in the order in which they are expected to be converted into cash.

3. Long-term investments are investments in stocks and bonds of other companies where the conversion into cash is not expected within one year or the operating cycle, whichever is longer and plant assets not currently in operational use. Property, plant, and equipment are tangible resources of a relatively permanent nature that are being used in the business and not intended for sale.

4. Current liabilities are obligations that will be paid within the coming year or operating cycle, whichever is longer. Long-term liabilities are obligations that will be paid after one year.

5. The two parts of stockholders' equity and the purpose of each are: (1) **Common stock** is used to record investments of assets in the business by the owners (stockholders). (2) **Retained earnings** is used to record net income retained in the business.

6. (a) Lorie is not correct. There are three characteristics: liquidity, profitability, and solvency.

(b) The three parties are not primarily interested in the same characteristics of a company. Short-term creditors are primarily interested in the liquidity of the company. In contrast, long-term creditors and stockholders are primarily interested in the profitability and solvency of the company.

7. (a) Liquidity ratios: Working capital and current ratio.

(b) Solvency ratios: Debt to assets and free cash flow.

(c) Profitability ratio: Earnings per share.

8. Debt financing is riskier than equity financing because debt must be repaid at specific points in time, whether the company is performing well or not. Thus, the higher the percentage of assets financed by debt, the riskier the company.

9. (a) Liquidity ratios measure the short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.

(b) Profitability ratios measure the income or operating success of a company for a given period of time.

(c) Solvency ratios measure the company's ability to survive over a long period of time.

10. (a) The increase in earnings per share is good news because it means that profitability has improved.

(b) An increase in the current ratio signals good news because the company improved its ability to meet maturing short-term obligations.

(c) The increase in the debt to assets ratio is bad news because it means that the company has increased its obligations to creditors and has lowered its equity "buffer."

(d) A decrease in free cash flow is bad news because it means that the company has become less solvent. The higher the free cash flow, the more solvent the company.

11. (a) The debt to assets ratio and free cash flow indicate the company's ability to repay the face value of the debt at maturity and make periodic interest payments.

(b) The current ratio and working capital indicate a company's liquidity and short-term debt-paying ability.

(c) Earnings per share indicates the earning power (profitability) of an investment.

12. (a) Generally accepted accounting principles (GAAP) are a set of rules and practices, having substantial support, that are recognized as a general guide for financial reporting purposes.

(b) The body that provides authoritative support for GAAP is the Financial Accounting Standards Board (FASB).

13. (a) The primary objective of financial reporting is to provide information useful for decision making.

(b) The fundamental qualitative characteristics are relevance and faithful representation. The enhancing qualities are comparability, consistency, verifiability, timeliness, and understandability.

14. Jantz is correct. Consistency means using the same accounting principles and accounting methods from period to period within a company. Without consistency in the application of accounting principles, it is difficult to determine whether a company is better off, worse off, or the same from period to period.

15. Comparability results when different companies use the same accounting principles. Consistency means using the same accounting principles and methods from year to year within the same company.

16. The cost constraint allows accounting standard-setters to weigh the cost that companies will incur to provide information against the benefit that financial statement users will gain from having the information available.

17. Accounting standards are not uniform because individual countries have separate standard-setting bodies. Currently many non-U.S. countries are choosing to adopt International Financial Reporting Standards (IFRS). It appears that accounting standards in the United States will move toward compliance with IFRS.

18. Accounting relies primarily on two measurement principles. Fair value is sometimes used when market price information is readily available. However, in many situations reliable market price information is not available. In these instances, accounting relies on historical cost as its basis.

19. The economic entity assumption states that every economic entity can be separately identified and accounted for. This assumption requires that the activities of the entity be kept separate and distinct from (1) the activities of its owners (the shareholders) and (2) all other economic entities. A shareholder of a company charging personal living costs as expenses of the company is an example of a violation of the economic entity assumption.

20. At December 31, 2011 Tootsie Roll's largest current asset was Cash and Cash Equivalents of $78,612, its largest current liability is accrued liabilities of $43,069 and its largest item under other assets was trademarks of $175,024. (Note: amounts are in thousands)

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

CL	Accounts payable	CL	Income taxes payable
CA	Accounts receivable	LTI	Investment in long-term bonds
PPE	Accumulated depreciation	PPE	Land
PPE	Buildings	CA	Inventory
CA	Cash	IA	Patent
IA	Goodwill	CA	Supplies

BRIEF EXERCISE 2-2

MORALES COMPANY
Partial Balance Sheet

Current assets	
Cash	$10,400
Debt investments	8,200
Accounts receivable	14,000
Supplies	3,800
Prepaid insurance	2,600
Total current assets	$39,000

BRIEF EXERCISE 2-3

$$\text{Earnings per share} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shares outstanding}}$$

$$= \frac{\$220\text{ million} - \$0}{333\text{ million shares}} = \$.66\text{ per share}$$

BRIEF EXERCISE 2-4

ICS	(a)	Issued new shares of common stock
DRE	(b)	Paid a cash dividend
IRE	(c)	Reported net income of $75,000
DRE	(d)	Reported net loss of $20,000

BRIEF EXERCISE 2-5

Working capital = Current assets – Current liabilities

Current assets	$102,500,000
Current liabilities	201,200,000
Working capital	($ 98,700,000)

Current ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$102,500,000}{\$201,200,000}$$

$$= .51:1$$

BRIEF EXERCISE 2-6

(a) Current ratio $\frac{\$262,787}{\$293,625} = 0.89:1$

(b) Debt to assets $\frac{\$376,002}{\$439,832} = 85.5\%$

(c) Free cash flow $62,300 – $24,787 – $12,000 = $25,513

BRIEF EXERCISE 2-7

(a) True.
(b) False.

BRIEF EXERCISE 2-8

(a) Predictive value.
(b) Confirmatory value.
(c) Materiality
(d) Complete.
(e) Free from error.
(f) Comparability.
(g) Verifiability.
(h) Timeliness.

BRIEF EXERCISE 2-9

(a) Relevant.
(b) Faithful representation.
(c) Consistency.

BRIEF EXERCISE 2-10

(a) 1. Predictive value.
(b) 2. Neutral.
(c) 3. Verifiable.
(d) 4. Timely.

BRIEF EXERCISE 2-11

(c)

SOLUTIONS TO DO IT! REVIEW EXERCISES

DO IT! 2-1

LONYEAR CORPORATION
Balance Sheet (partial)
December 31, 2014

Assets		
Current assets		
Cash	$ 13,000	
Accounts receivable	22,000	
Inventory	58,000	
Supplies	7,000	
Total current assets		$100,000
Property, plant, and equipment		

DO IT! 2-2

IA	Trademarks	CA	Inventory
CL	Notes payable (current)	PPE	Accumulated depreciation
NA	Interest revenue	PPE	Land
CL	Income taxes payable	SE	Common stock
LTI	Debt investments (long-term)	NA	Advertising expense
CL	Unearned sales revenue	LTL	Mortgage payable (due in 3 years)

DO IT! 2-3

(a)

2014

$$\frac{(\$80{,}000 - \$6{,}000)}{(40{,}000 + 75{,}000)/2} = \$1.29$$

2013

$$\frac{(\$40{,}000 - \$6{,}000)}{(30{,}000 + 40{,}000)/2} = \$0.97$$

Benser's profitability, as measured by the amount of income available for each share of common stock, increased by 33 percent (($1.29 – $0.97)/$0.97) during 2014. Earnings per share should not be compared across companies because the number of shares issued by companies varies widely. Thus, we cannot conclude that Benser Corporation is more profitable than Matile Corporation based on its higher EPS in 2014.

(b)

	2014	2013
Current ratio	$\frac{\$54{,}000}{\$22{,}000} = 2.45:1$	$\frac{\$36{,}000}{\$30{,}000} = 1.20:1$
Debt to assets ratio	$\frac{\$72{,}000}{\$240{,}000} = 30\%$	$\frac{\$100{,}000}{\$205{,}000} = 49\%$

The company's liquidity, as measured by the current ratio improved from 1.20:1 to 2.45:1. Its solvency also improved, because the debt to assets ratio declined from 49% to 30%.

(c)

Free cash flow 2014: $90,000 – $6,000 – $3,000 – $27,000 = $54,000
2013: $56,000 – $6,000 – $1,500 – $12,000 = $36,500

The amount of cash generated by the company above its needs for dividends and capital expenditures increased from $36,500 to $54,000.

DO IT! 2-4

1. **Monetary unit assumption**
2. **Faithful representation**
3. **Economic entity assumption**
4. **Cost constraint**
5. **Consistency**
6. **Historical cost principle**
7. **Relevance**
8. **Periodicity assumption**
9. **Full disclosure principle**
10. **Materiality**
11. **Going concern assumption**
12. **Comparability**

SOLUTIONS TO EXERCISES

EXERCISE 2-1

CL	Accounts payable	CA	Inventory
CA	Accounts receivable	CA	Stock investments
PPE	Accumulated depreciation—equip.	PPE	Land (in use)
PPE	Buildings	LTL	Mortgage payable
CA	Cash	CA	Supplies
CL	Interest payable	PPE	Equipment
IA	Goodwill	CA	Prepaid rent
CL	Income taxes payable		

EXERCISE 2-2

CA	Prepaid advertising	IA	Patents
PPE	Equipment	LTL	Bonds payable
IA	Trademarks	SE	Common stock
CL	Salaries and wages payable	PPE	Accumulated depreciation—equipment
CL	Income taxes payable	CL	Unearned sales revenue
SE	Retained earnings	CA	Inventory
CA	Accounts receivable		
LTI	Land (held for future use)		

EXERCISE 2-3

THE BOEING COMPANY
Partial Balance Sheet
December 31, 2014
(in millions)

Assets		
Current assets		
Cash	$ 9,215	
Debt investments	2,008	
Accounts receivable	5,785	
Notes receivable	368	
Inventory	16,933	
Total current assets		$34,309
Long-term investments		
Notes receivable		5,466
Property, plant, and equipment		

EXERCISE 2-4

H. J. HEINZ COMPANY
Partial Balance Sheet
April 30, 2014
(in thousands)

Assets			
Current assets			
Cash		$ 373,145	
Accounts receivable		1,171,797	
Inventory		1,237,613	
Prepaid insurance		125,765	
Total current assets			$
2,908,320			
Property, plant, and equipment			
Land			
76,193			
Buildings	$4,033,369		
Less: Accumulated depreciation— Buildings	2,131,260	1,902,109	1,978,302
Intangible assets			
Goodwill		3,982,954	

EXERCISE 2-5

DONOVAN COMPANY
Balance Sheet
December 31, 2014

Assets

Current assets			
Cash			
$11,840			
Accounts receivable.			
12,600			
Prepaid insurance		3,200	
Total current assets			$
27,640			
Property, plant, and equipment			
Land			
61,200			
Buildings	$105,800		
Less: Accumulated depreciation— buildings	45,600	60,200	

Liabilities and Stockholders'

Equity Current liabilities			
Accounts payable.		$	
9,500			
Current maturity of note payable			
13,600			
Interest payable		3,600	
Total current liabilities			$
Total liabilities.			
106,700			
Stockholders' equity			
Common stock.			
60,000			
Retained earnings ($40,000 + $6,020*).		46,020	
Total stockholders' equity			106,020

*Net income = $14,700 – $780 – $5,300 – $2,600 = $6,020

EXERCISE 2-6

TEXAS INSTRUMENTS, INC.
Balance Sheet
December 31, 2014
(in millions)

Assets		
Current assets		
Cash .	$ 1,182	
Debt investments.	1,743	
Accounts receivable.		
Total current assets.		$ 6,114
Long-term investments		
Stock investments		637
Property, plant, and equipment		3,158
Intangible assets		
Patents		2,210
Total assets		$12,119
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$1,459	
Total current liabilities.		$ 1,587
Long-term liabilities		
Notes payable.		810
Total liabilities		2,397
Stockholders' equity		
Total stockholders' equity		9,722
Total liabilities and stockholders' equity		$12,119

EXERCISE 2-7

(a) Earnings per share $= \dfrac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shares outstanding}}$

2014 : $\dfrac{\$66{,}176{,}000 - 0}{(66{,}282{,}000 + 64{,}507{,}000) / 2} = \$\ 1.01$

2013 : $\dfrac{\$54{,}587{,}000 - 0}{(73{,}139{,}000 + 66{,}282{,}000) / 2} = \$\ .78$

(b) Using net income (loss) as a basis to evaluate profitability, Callaway Golf's income improved by 21% [($66,176 – $54,587) ÷ 54,587] between 2013 and 2014. Its earnings per share increased by 29% [($1.01 – $0.78) ÷ $0.78].

(c) To determine earnings per share, dividends on preferred stock are subtracted from net income, but dividends on common stock are not subtracted.

EXERCISE 2-8

(a)

BARFIELD CORPORATION
Income Statement
For the Year Ended July 31, 2014

Revenues		
Service revenue	$66,100	
Rent revenue	8,500	
Total revenues		$74,600
Expenses		
Salaries and wages expense	57,500	
Supplies expense	15,600	
Depreciation expense	4,000	
Total expenses		77,100
Net loss		$ (2,500)

Retained earnings, August 1, 2013		$34,000
Less: Net loss	$2,500	
Dividends	4,000	6,500

(b)

BARFIELD CORPORATION
Balance Sheet
July 31, 2014

Assets

Current assets		
Cash	$29,200	
Accounts receivable	9,780	
Total current assets		$38,980
Property, plant, and equipment		
Equipment	18,500	
Less: Accumulated depreciation—		

EXERCISE 2-8 (Continued)

(b)

BARFIELD CORPORATION
Balance Sheet (Continued)
July 31, 2014

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable . ... $
4,100

Salaries and wages payable . ...
2,080

Total current liabilities. .... $

Total liabilities . ...
7,980

Stockholders' equity

Common stock . ...
16,000

Retained earnings. 27,500

(c) $$\text{Current ratio} = \frac{\$38,980}{\$6,180} = 6.3:1$$

$$\text{Debt to assets ratio} = \frac{\$7,980}{\$51,480} = 15.5\%$$

(d) The current ratio would not change because equipment is not a current asset and a 5-year note payable is a long-term liability rather than a current liability.

The debt to assets ratio would increase from 15.5% to 39.1%*.

Looking solely at the debt to assets ratio, I would favor making the sale because Barfield's debt to assets ratio of 15.5% is very low. Looking at additional financial data, I would note that Barfield reported a significant loss for the current year which would lead me to question its ability to make interest and loan payments (and even remain in business) in the future. I would not make the proposed sale unless Barfield convinced me that it would be capable of earnings in the future rather than losses.

I would also consider making the sale but requiring a substantial down-payment and smaller note.

*($7,980 + $20,000) ÷ ($51,480 + $20,000)

EXERCISE 2-9

(a)

	Beginning of Year	End of Year
Working capital	$3,361 – $1,635 = $1,726	$3,217 – $1,601 = $1,616
Current ratio	$\frac{\$3,361}{\$1,635}$ = 2.06:1	$\frac{\$3,217}{\$1,601}$ = 2.01:1

(b) Nordstrom's liquidity decreased slightly during the year. Its current ratio decreased from 2.06:1 to 2.01:1. Also, Nordstrom's working capital decreased by $110 million.

(c) Nordstrom's current ratio at both the beginning and the end of the recent year exceeds Best Buy's current ratio for 2011 (and 2010). Nordstrom's end-of-year current ratio (2.01) exceeds Best Buy's 2011 current ratio (1.21*). Nordstrom would be considered much more liquid than Best Buy for the recent year.

*(see text, pg. 57)

EXERCISE 2-10

(a) $\text{Current ratio} = \frac{\$60,000}{\$30,000} = 2.0:1$

Working capital = $60,000 – $30,000 = $30,000

(b) $\text{Current ratio} = \frac{\$40,000^{*}}{\$10,000^{**}} = 4.0:1$

Working capital = $40,000 – $10,000 = $30,000

*$60,000 – $20,000 **$30,000 – $20,000

(c) Liquidity measures indicate a company's ability to pay current obligations as they become due. Satisfaction of current obligations usually requires the use of current assets.

If a company has more current assets than current liabilities it is more likely that it will meet obligations as they become due. Since working capital and the current ratio compare current assets to current liabilities, both are measures of liquidity.

EXERCISE 2-10 (Continued)

Payment of current obligations frequently requires cash. Neither working capital nor the current ratio indicate the composition of current assets. If a company's current assets are largely comprised of items such as inventory and prepaid expenses it may have difficulty paying current obligations even though its working capital and current ratio are large enough to indicate favorable liquidity. In Grienke's case, payment of $20,000 of accounts payable will leave only $5,000 cash. Since salaries payable will require $10,000, the company may need to borrow in order to make the required payment for salaries.

(d) The CFO's decision to use $20,000 of cash to pay off accounts payable is not in itself unethical. However, doing so just to improve the year-end current ratio could be considered unethical if this action misled creditors. Since the CFO requested preparation of a "preliminary" balance sheet before deciding to pay off the liabilities he seems to be "managing" the company's financial position, which is usually considered unethical.

EXERCISE 2-11

	2014	2013
(a) Current ratio	$\frac{\$925,359}{\$401,763} = 2.30:1$	$\frac{\$1,020,834}{\$376,178} = 2.71:1$
(b) Earnings per share	$\frac{\$179,061}{205,169} = \$0.87$	$\frac{\$400,019}{216,119} = \$1.85$
(c) Debt to assets ratio	$\frac{\$554,645}{\$1,963,676}$ = 28.2%	$\frac{\$527,216}{\$1,867,680}$ = 28.2%
(d) Free cash flow	$302,193 – $265,335 – $82,394 = ($45,536)	$464,270 – $250,407 – $80,796 = $133,067

(e) Using the debt to assets ratio and free cash flow as measures of solvency produces deteriorating results for American Eagle Outfitters. Its debt to assets ratio remained constant from 2013 to 2014. However, its free cash flow decreased by 134% indicating a significant decline in solvency.

(f) In 2013 American Eagle Outfitters's cash provided by operating activities was greater than the cash used for capital expenditures. It was generating plenty of cash from operations to cover its investing needs. In 2014, American Eagle Outfitters experienced negative free cash flow. This deficiency could have been covered by issuing stock or debt.

EXERCISE 2-12

(a) 2 Going concern assumption
(b) 6 Economic entity assumption
(c) 3 Monetary unit assumption
(d) 4 Periodicity assumption
(e) 5 Historical cost principle
(f) 1 Full disclosure principle

EXERCISE 2-13

(a) This is a violation of the historical cost principle. The inventory was written up to its fair value when it should have remained at cost.

(b) This is a violation of the economic entity assumption. The treatment of the transaction treats Sal Garcia and Garcia Co. as one entity when they are two separate entities. The cash used to purchase the truck should have been treated as part of salaries and wages expense.

(c) This is a violation of the periodicity assumption. This assumption states that the economic life of a business can be divided into artificial time periods (months, quarters, or a year). By adding two more weeks to the year, Garcia Co. would be misleading financial statement readers. In addition, 2014 results would not be comparable to previous years' results. The company should use a 52 week year.

SOLUTIONS TO PROBLEMS

PROBLEM 2-1A

YAHOO! INC.
Balance Sheet
December 31, 2014
(Amounts are in millions)

Assets		
Current assets		
Cash		
$2,292		
Debt investments.	1,160	
Accounts receivable.	1,061	
Total current assets.		$
4,746		
Long-term investments		
Stock investments.		
3,247		
Less: Accumulated depreciation—		
equipment.	201	1,536
Intangible assets		
Goodwill.	3,927	
Patents	234	4,161
Total assets.		
Liabilities and Stockholders'		
Equity Current liabilities		
Accounts payable.	$ 152	
Unearned sales revenue	413	
Total current liabilities		$
565		
Long-term liabilities		
Notes payable		
		734
Total liabilities		
1,299		
Total stockholders' equity		12,391
Total liabilities and stockholders'		
equity		$13,690

PROBLEM 2-2A

TRESH CORPORATION
Income Statement
For the Year Ended December 31, 2014

Revenues		
Service revenue		$68,000
Expenses		
Salaries and wages expense	$37,000	
Depreciation expense	3,600	
Insurance expense	2,200	
Utilities expense	2,000	
Maintenance and repairs expense	1,800	
Total expenses		46,600
Net income		$21,400

Retained earnings, January 1, 2014	$31,000
Add: Net income	21,400
	52,400
Less: Dividends	12,000
Retained earnings, December 31, 2014	$40,400

PROBLEM 2-2A (Continued)

TRESH CORPORATION
Balance Sheet
December 31, 2014

Assets

Current assets

Cash	$10,100	
Accounts receivable.............................. 11,700		
Prepaid insurance	3,500	
Total current assets...................................... $25,300		
Property, plant, and equipment		
Equipment	66,000	

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable.. $18,300		
Salaries and wages payable................................ 3,000		
Total current liabilities $21,300		
Stockholders' equity		
Common stock..		

PROBLEM 2-3A

(a)

RAMIREZ ENTERPRISES
Income Statement
For the Year Ended April 30, 2014

Sales revenue	$5,100	
Expenses		
Cost of goods sold	$1,060	
Salaries and wages expense	700	
Interest expense		
Total expenses		2,870
Net income		$2,230

RAMIREZ ENTERPRISES
Retained Earnings Statement For
the Year Ended April 30, 2014

Retained earnings, May 1, 2013	$1,600
Add: Net income	2,230
	3,830
Less: Dividends	325
Retained earnings, April 30, 2014	$3,505

PROBLEM 2-3A (Continued)

(b)

RAMIREZ ENTERPRISES
Balance Sheet
April 30, 2014

Assets

Current assets			
Cash $1,270			
Stock investments			
Inventory		967	
Prepaid insurance		60	
Total current assets			$4,307
Property, plant, and equipment			
Land.. 3,100			
Equipment.	$2,420		
Less: Accumulated depreciation—equipment.	670	1,750	4,850

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable 61	$	
Accounts payable. 834		
Salaries and wages payable. 222		
Total liabilities. 4,752		
Stockholders' equity		
Common stock. 900		
Retained earnings	3,505	

PROBLEM 2-4A

(a) Bosch Company's net income for 2014 is $248,000 ($1,800,000 – $1,175,000 – $283,000 – $9,000 – $85,000). Its earnings per share is $3.10 ($248,000 ÷ 80,000 shares outstanding). Fielder's net income for 2014 is $142,200 ($620,000 – $340,000 – $98,000 – $3,800 – $36,000). Its earnings per share is $2.84 ($142,200 ÷ 50,000 shares outstanding).

(b) Bosch appears to be more liquid. Bosch's 2014 working capital of $340,875 ($407,200 – $66,325) is more than twice as high as Fielder's working capital of $156,620 ($190,336 – $33,716). In addition, Bosch's 2014 current ratio of 6.1:1 ($407,200 ÷ $66,325) is higher than Fielder's current ratio of 5.6:1 ($190,336 ÷ $33,716).

(c) Bosch appears to be slightly more solvent. Bosch's 2014 debt to total assets ratio of 18.6% ($174,825 ÷ $939,200)[a] is lower than Fielder's ratio of 22.5% ($74,400 ÷ $330,064)[b]. The lower the percentage of debt to assets, the lower the risk is that a company may be unable to pay its debts as they come due.

Another measure of solvency, free cash flow, also indicates that Bosch is more solvent. Bosch had $12,000 ($138,000 – $90,000 – $36,000) of free cash flow while Fielder had only $1,000 ($36,000 – $20,000 – $15,000).

[a]$174,825 ($66,325 + $108,500) is Bosch's 2014 total liabilities.
$939,200 ($407,200 + $532,000) is Bosch's 2014 total assets.

[b]$74,400 ($33,716 + $40,684) is Fielder's 2014 total liabilities.
$330,064 ($190,336 + $139,728) is Fielder's 2014 total assets.

PROBLEM 2-5A

(a) (i) Working capital = \$458,900 – \$195,500 = \$263,400.

(ii) Current ratio = $\frac{\$458,900}{\$195,500}$ = 2.35:1.

(iii) Free cash flow = \$190,800 – \$92,000 – \$31,000 = \$67,800

(iv) Debt to assets ratio = $\frac{\$395,500}{\$1,034,200}$ = 38.2%.

(v) Earnings per share = $\frac{\$153,100}{50,000 \text{ shares}}$ = \$3.06.

(b) During 2014, the company's current ratio increased from 1.65:1 to 2.35:1 and its working capital increased from \$160,500 to \$263,400. Both measures indicate an improvement in liquidity during 2014.

The company's debt to assets ratio increased from 31.0% in 2013 to 38.2% in 2014 indicating that the company is less solvent in 2014. Another measure of solvency, free cash flow, increased from \$48,700 to \$67,800. This suggests an improvement in solvency, thus we have conflicting measures of solvency.

Earnings per share decreased from \$3.15 in 2013 to \$3.06 in 2014. This indicates a decline in profitability during 2014.

PROBLEM 2-6A

	2013	2014
(a)	**Earnings per share.**	
	$\frac{\$60,000}{30,000 \text{ shares}} = \$2.00$	$\frac{\$70,000}{33,000 \text{ shares}} = \$2.12$
(b)	**Working capital.**	
	(\$20,000 + \$62,000 + \$73,000) – \$70,000 = \$85,000	(\$28,000 + \$70,000 + \$90,000) – \$75,000 = \$113,000
(c)	**Current ratio.**	
	$\frac{\$155,000}{\$70,000} = 2.2:1$	$\frac{\$188,000}{\$75,000} = 2.5:1$
(d)	**Debt to assets ratio.**	
	$\frac{\$160,000}{\$685,000} = 23.4\%$	$\frac{\$155,000}{\$760,000} = 20.4\%$
(e)	**Free cash flow.**	
	\$56,000 – \$38,000 – \$15,000 = \$3,000	\$82,000 – \$45,000 – \$20,000 = \$17,000

(f) Net income and earnings per share have increased, indicating that the underlying profitability of the corporation has improved. The liquidity of the corporation as shown by the working capital and the current ratio has improved slightly. Also, the corporation improved its solvency by improving its debt to assets ratio as well as free cash flow.

PROBLEM 2-7A

	Ratio	Target	Wal-Mart
		(All Dollars are in Millions)	
(a)	Working capital	\$17,488 – \$10,512 = \$6,976	\$48,949 – \$55,390 = (\$6,441)
(b)	Current ratio	1.66:1 (\$17,488 ÷ \$10,512)	.88:1 (\$48,949 ÷ \$55,390)
(c)	Debt to assets ratio	68.9% (\$30,394 ÷ \$44,106)	60.0% (\$98,144 ÷ \$163,429)
(d)	Free cash flow	\$4,430 – \$3,547 – \$465 = \$418	\$23,147 – \$11,499 – \$3,746 = \$7,902
(e)	Earnings per share	$\$2.86 = \frac{\$2,214}{774}$	$\$3.39 = \frac{\$13,400}{3,951}$

(f) The comparison of the two companies shows the following:

Liquidity—Target's current ratio of 1.66:1 is much better than Wal-Mart's .88:1 and Target has significantly higher working capital than Wal-Mart.

Solvency—Wal-Mart's debt to assets ratio is about 13% less than Target's and its free cash flow is much larger.

Profitability—Earnings per share should not be used to compare profitability between companies because of the difference in the number of shares outstanding. However, Wal-Mart's profitability as measured by net income is more than 6-times that of Target.

PROBLEM 2-8A

(a) **Accounting information is the compilation and presentation of financial information for a company. It provides information in the form of financial statements and additional disclosures that is useful for decision making.**

The accounting rules and practices that have substantial authoritative support and are recognized as a general guide for financial reporting purposes are referred to as generally accepted accounting principles (GAAP). The biotechnology company that employs Sue will follow GAAP to report its assets, liabilities, stockholders' equity, revenues, and expenses as it prepares financial statements.

(b) **Sue is correct in her understanding that the low success rate for new biotech products will be a cause of concern for investors. Her suggestion that detailed scientific findings be reported to prospective investors might offset some of their concerns but it probably won't conform to the qualitative characteristics of accounting information.**

These characteristics consist of relevance, faithful representation, comparability, consistency, verifiability, timeliness, and understandability. They apply to accounting information rather than the scientific findings that Sue wants to include.

PROBLEM 2-1B

STARBUCKS CORPORATION
Balance Sheet
September 30, 2014
(Amounts are in millions)

Assets		
Current assets		
Cash	$281	
Debt investments	157	
Accounts receivable	288	
Inventory	692	
Prepaid rent	278	
Total current assets		
$1,696		
Long-term investments		
Stock investments		280
Property, plant and equipment		
Equipment	3,036	
Less: Accumulated depreciation— equipment	145	2,891
Intangible assets		
Goodwill		477
Liabilities and Stockholders' Equity		
Current liabilities		
Notes payable	$	
1,468		
Accounts payable	391	
Unearned sales revenue	297	
Total current liabilities		
$2,156		
Long-term liabilities		
Notes payable	550	
Total liabilities		3,060
Stockholders' equity		
Common stock	40	
Retained earnings	2,244	
Total stockholders' equity		2,284
Total liabilities and stockholders' equity		$5,344

PROBLEM 2-2B

MUELLER, INC.
Income Statement
For the Year Ended December 31, 2014

Revenues		
Service revenue		
$51,000		
Expenses		
Salaries and wages expense	$34,000	
Depreciation expense...		
4,300		
Maintenance and repairs expense		
2,600		
Utilities expense..		
2,100		
Insurance expense		
1,800		
Total expenses		44,800
Net income		$ 6,200

Retained earnings, January 1	$14,000
Plus: Net income..	6,200
	20,200
Less: Dividends	2,600
Retained earnings, December 31.	$17,600

PROBLEM 2-2B (Continued)

MUELLER, INC.
Balance Sheet
December 31, 2014

Assets

Current assets		
Cash	$ 6,100	
Accounts receivable	2,900	
Prepaid insurance	2,400	
Total current assets		
$11,400		
Property, plant, and equipment		
Equipment	30,000	
Less: Accumulated depreciation	7,600	22,400

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	$	
7,200		
Salaries and wages payable		
3,000		
Total current liabilities		
$10,200		
Stockholders' equity		
Common stock		

PROBLEM 2-3B

(a)

VERN CORPORATION
Income Statement
For the Year Ended April 30, 2014

Revenues		
Sales revenue $20,450		
Expenses		
Salaries and wages expense. $5,840		
Depreciation expense 3,200		
Total expenses.		10,750
Net income		$ 9,700

VERN CORPORATION
Retained Earnings Statement For the Year Ended April 30, 2014

Retained earnings, May 1, 2013	$13,960
Plus: Net income	9,700
	23,660
Less: Dividends.	2,800
Retained earnings, April 30, 2014.	$20,860

PROBLEM 2-3B (Continued)

(b)

VERN CORPORATION
Balance Sheet
April 30, 2014

Assets

Current assets		
Cash		
$20,955		
Accounts receivable		
10,150		
Prepaid rent		
380		
Total current assets		
$31,485		

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	$	
3,100		
Income taxes payable		
300		
Interest payable	175	
Total liabilities		
8,275		
Stockholders' equity		
Common stock		
20,000		
Retained earnings	20,860	

PROBLEM 2-4B

(a) Wise's net income is $215,000 ($900,000 – $450,000 – $150,000 – $10,000 – $75,000).

Its earnings per share is $.43 ($215,000 ÷ 500,000 shares).

Omaz's net income is $74,000 ($450,000 – $225,000 – $130,000 – $6,000 – $15,000).

Its earnings per share is $.37 ($74,000 ÷ 200,000 shares).

(b) Wise's 2014 working capital of $470,000 ($700,000 – $230,000) is over 4 times as high as Omaz's working capital of $105,000 ($180,000 – $75,000). And Wise's 2014 current ratio of 3.0:1 ($700,000 ÷ $230,000) is higher than Omaz's current ratio of 2.4:1 ($180,000 ÷ $75,000).

(c) Omaz appears to be less solvent. Omaz's 2014 debt to assets ratio of 34% ($265,000 ÷ $780,000)[a] is slightly higher than Wise's ratio of 29% ($430,000 ÷ $1,500,000)[b]. The lower the percentage of debt to assets, the lower the risk that a company may be unable to pay its debts as they come due.

Omaz's free cash flow is only $26,000 ($46,000 – $20,000) compared to $125,000 ($180,000 – $50,000 – $5,000) for Wise. More free cash flow indicates that Wise will be better able to finance more capital expenditures without taking on more debt.

[a]$265,000 ($75,000 + $190,000) is Omaz's 2014 total liabilities.
$780,000 ($180,000 + $600,000) is Omaz's 2014 total assets.

[b]$430,000 ($230,000 + $200,000) is Wise's 2014 total liabilities.
$1,500,000 ($700,000 + $800,000) is Wise's 2014 total assets.

PROBLEM 2-5B

(a) (i) Current ratio = $\frac{\$302,600}{\$148,700}$ = 2.0:1.

(ii) Working capital = \$302,600 – \$148,700 = \$153,900.

(iii) Debt to assets ratio = $\frac{\$258,700}{\$763,900}$ = 34%.

(iv) Free cash flow = \$61,300 – \$42,000 – \$10,000 = \$9,300.

(v) Earnings per share = $\frac{\$99,200}{65,000}$ = \$1.53.

(b) During 2014, Divine's current ratio decreased from 2.4:1 to 2.0:1 and its working capital dropped from \$178,000 to \$153,900. Both measures indicate a slight decline in liquidity during 2014.

Divine's debt to assets ratio increased from 31% in 2013 to 34% in 2014 indicating that the company is less solvent in 2014. Using another measure of solvency, free cash flow, we see that Divine's solvency has not improved during 2014. Earnings per share increased from \$1.35 to \$1.53 in 2014. This 13% increase indicates better profitability in 2014.

PROBLEM 2-6B

	2013	2014
(a)	**Earnings per share.**	
	$\frac{\$113,000}{320,000 \text{ shares}} = \$.35$	$\frac{\$100,000}{370,000 \text{ shares}} = \$.27$
(b)	**Working capital.**	
	($30,000 + $55,000 + $73,000) – $65,000 = $93,000	($50,000 + $80,000 + $74,000) – $88,000 = $116,000
(c)	**Current ratio.**	
	$\frac{\$158,000}{\$65,000} = 2.43:1$	$\frac{\$204,000}{\$88,000} = 2.32:1$
(d)	**Debt to assets ratio.**	
	$\frac{\$135,000}{\$619,000} = 21.8\%$	$\frac{\$178,000}{\$802,000} = 22.2\%$
(e)	**Free cash flow.**	**Free cash flow.**
	$178,000 – $45,000 – $13,000 = $120,000	$165,000 – $85,000 – $20,000 = $60,000

(f) **The underlying profitability of the corporation as measured by earnings per share has declined. The overall liquidity of the corporation has dropped as shown by the slight decrease in the current ratio. Also, the corporation appears to be increasing its debt burden as its debt to assets ratio increased slightly indicating a decrease in solvency. Comparing free cash flow, we find a drop in this measure of solvency also.**

PROBLEM 2-7B

	Ratio	Home Depot	Lowe's
		(All Dollars are in Millions)	
(a)	Working capital	\$14,674 – \$12,706 = \$1,968	\$8,686 – \$7,751 = \$935
(b)	Current ratio	1.2:1 (\$14,674 ÷ \$12,706)	1.1:1 (\$8,686 ÷ \$7,751)
(c)	Debt to assets ratio	60.0% (\$26,610 ÷ \$44,324)	47.9% (\$14,771 ÷ \$30,869)
(d)	Free cash flow	\$5,727 – \$3,558 – \$1,709 = \$460	\$4,347 – \$4,010 – \$428 = (\$91)
(e)	Earnings per share	$\$2.38 = \frac{\$4,395}{1,849}$	$\$1.90 = \frac{\$2,809}{1,481}$

(f) **The comparison of the two companies shows the following:**

Liquidity—Home Depot's current ratio of 1.2:1 is slightly better than Lowes' 1.1:1 and Home Depot has significantly higher working capital than Lowe's.

Solvency—Home Depot's debt to assets ratio is about 25% more than Lowe's but its free cash flow is much larger.

Profitability—Home Depot's earnings per share is about 25% higher than Lowe's.

PROBLEM 2-8B

(a) The primary objective of financial reporting is to provide information useful for decision making. Since Yocum's shares appear to be actively traded, investors must be capable of using the information made available by Yocum to make decisions about the company.

(b) The investors must feel as if the company will show earnings in the future. They must recognize that information relevant to their investment choice is indicated by more than Yocum's net income.

(c) The change from Canadian dollars to U.S. dollars for reporting purposes should make Yocum's more comparable with companies traded on U.S. stock exchanges.

CCC 2-1 CONTINUING COOKIE CHRONICLE

(a) The balance sheet reports the assets, liabilities, and stockholders' equity of a company at a specific date. The income statement presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. The retained earnings statement summarizes the changes in retained earnings for a specific period of time. Finally, the cash flow statement provides information about the cash inflows and cash outflows for a specific period of time.

(b) By looking at the balance sheet and the cash flow statement and calculating liquidity ratios, we can measure a company's short term ability to pay its obligations. Liquidity ratios include the calculation of working capital (current assets minus current liabilities) and current ratio (current assets divided by current liabilities).

(c) By looking at the balance sheet and the cash flow statement and calculating solvency ratios we are able to measure a company's ability to survive over a long period of time. These solvency ratios include debt to assets (total liabilities divided by total assets) and free cash flow (cash provided by operations minus dividends paid and capital expenditures).

(d) By looking at the income statement we can determine if Biscuits is profitable. If revenues earned by Biscuits exceed expenses incurred, then Biscuits is profitable. Profitability ratios can measure a company's ability to generate earnings over a period of time. One profitability ratio is earnings per share (net income minus preferred dividends divided by average common shares outstanding).

(e) By looking at the balance sheet we can determine if Biscuits has any debt. By looking at the balance sheet and cash flow statement and calculating solvency ratios we are able to determine whether a company has the ability to repay its long-term debt. Profitability ratios will help in determining whether a company is able to pay its interest expense. The more profitable the company the better able it is to repay its long-term obligations as well as the amount of interest it is paying on its debt.

(f) By looking at the statement of cash flows we can determine whether Biscuits has paid any dividends to its shareholders.

(g) Be aware that financial statements of Biscuits provide a historical perspective of what has already taken place. The financial statements may prove to be a good indicator of what will happen in the future but remember that is not necessarily guaranteed. Consumer tastes change and as a result the demand for Biscuits' product may also change.

There are other issues that Natalie must consider as well. Does she have the ability to meet the demands of Biscuits? Will she be able to produce 1,500 dozen cookies a week? Does she have enough staff to enable her to do so? Does she have a large enough oven to do so? Does she have enough cash to pay her staff, purchase supplies, and cover operating expenses until she receives payment from Biscuits?

BYP 2-1 FINANCIAL REPORTING PROBLEM

(a) **Total current assets were $212,201,000 at December 31, 2011, and $235,167,000 at December 31, 2010.**

(b) **Current assets are properly listed in the order of liquidity. As you will learn in a later chapter, inventories are considered to be less liquid than receivables. Thus, they are listed below receivables and before prepaid expenses.**

(c) **The asset classifications are similar to the text: (a) current assets, (b) property, plant, and equipment, and (c) other assets.**

(d) **Total current liabilities were $58,355,000 at December 31, 2011, and $58,505,000 at December 31, 2010.**

BYP 2-2 COMPARATIVE ANALYSIS PROBLEM

(a)

($ in thousands)		Hershey Company	Tootsie Roll
1.	Working capital	$2,046,558 – $1,173,775 = $872,783	$212,201 – $58,355 = $153,846
2.	Current ratio	$2,046,558 ÷ $1,173,775 = 1.7:1	$212,201 ÷ $58,355 = 3.6:1
3.	Debt to assets ratio	$\frac{\$3,539,551}{\$4,412,199} = 80.2\%$	$\frac{\$191,921^{*}}{\$857,856} = 22.4\%$
4.	Free cash flow	$580,867 – $323,961 – $304,083 = ($47,177)	$50,390 – $16,351 – $18,407 = $15,632
5.	Earnings per share	$\frac{\$628,962 - 0}{220,688} = \$2.85$	$\frac{\$43,938 - 0}{57,892} = \$0.76$

*$58,355 + $133,566

(b) *Liquidity*

Hershey Company appears much more liquid since it has about $719 million more working capital than Tootsie Roll. But, looking at the current ratios, we see that Tootsie Roll's ratio is more than two times as large as Hershey's.

Solvency

Based on the debt to assets ratio, Tootsie Roll is more solvent. Tootsie Roll's debt to assets ratio is significantly lower than Hershey's and, therefore, Tootsie Roll would be considered better able to pay its debts as they come due.

Comparing free cash flow, Tootsie Roll generates much more excess cash than Hershey—$15.6 million versus negative free cash flow of $47 million.

Profitability

While earnings per share cannot be used to compare profitability between companies, Hershey's net income is more than 14-times as great as Tootsie Roll's.

BYP 2-3 RESEARCH CASE

(a) **Many large companies, big accounting firms, and accounting standard setters tend to favor a switch to IFRS because they believe that global accounting standards would save companies money by consolidating their bookkeeping. They also believe it would make it easier to raise capital around the world. In addition, investors would have less trouble comparing companies from different countries. They also feel that having international accounting standards would lead to an improvement in the enforcement of securities laws.**

(b **Many small companies are opposed to switching to IFRS because (1) they say that the switch would be very costly, and (2) because they don't have operations outside of the U.S., so they see any benefit to their company of using international standards.**

(c) **It has been suggested that IFRS lacks standards that are specific to utility companies that U.S. GAAP contains.**

(d) **Condorsement (a word invented by the SEC) represents a combination of convergence and endorsement. Under condorsement, U.S. standard setters would continue to work with international standard setters to try to reduce differences in standards. In addition, as new international standards are issued, U.S. standard setters would review those standards and consider whether to endorse them by absorbing them into U.S. GAAP.**

BYP 2-4 INTERPRETING FINANCIAL STATEMENTS

(a) The percentage decrease in Gap's total assets during this period is calculated as:

$$\frac{\$7,065 - \$8,544}{\$8,544} = 17.3\%$$

The average decrease per year can be approximated as:

$$\frac{17.3\%}{4 \text{ years}} = 4.3\% \text{ per year}$$

(b) Gap's working capital and current ratio decreased (2007), increased (2008 and 2009) and then decreased (2010) during this period, indicating a decline, an improvement and then another decline in liquidity. The current ratio is a better measure of liquidity because it provides a relative measure; that is, current assets compared to current liabilities. Working capital only tells us the net amount of current assets less current liabilities. It is hard to say whether a given amount of working capital is adequate or inadequate without knowing the size of the company.

(c) The debt to assets ratio suggests that Gap's solvency didn't change much during the period. Debt to assets was .39 in 2006, rose to .45 in 2007 and then came back down to .42 in 2010.

(d) The earnings per share suggests that Gap's profitability improved significantly from 2006 to 2010, increasing from $0.94 to $1.89. However, based on the years shown, it appears that earnings varied a great deal during this period.

REAL-WORLD FOCUS

BYP 2-5

Answers will vary depending on the company chosen and the date.

BYP 2-6

Answers will vary depending on the company chosen and the date.

BYP 2-7 DECISION MAKING ACROSS THE ORGANIZATION

The current ratio increase is a favorable indication as to liquidity, but alone tells little about the prospects of the client. From this ratio change alone, it is impossible to know the amount and direction of the changes in individual accounts, total current assets, and total current liabilities. Also unknown are the reasons for the changes.

The working capital increase is also a favorable indication as to liquidity, but again the amount and direction of the changes in individual current assets and current liabilities cannot be determined from this measure.

The increase in free cash flow is a favorable indicator for solvency. An increase in free cash flow means the company can replace assets, pay dividends, and have "free cash" available to pay down debt or expand operations.

The decrease in the debt to assets ratio is a favorable indicator for solvency and going-concern prospects. The lower the percentage of debt to assets, the lower the risk that a company may be unable to pay its debts as they come due. A decline in the debt to assets ratio is also a positive sign regarding going-concern potential.

The increase in net income is a favorable indicator for both solvency and profitability prospects although much depends on the quality of receivables generated from sales and how quickly they can be converted into cash. A significant factor here may be that despite a decline in sales the client's management has been able to reduce costs to produce this increase. Indirectly, the improved income picture may have a favorable impact on solvency and going-concern potential by enabling the client to borrow currently to meet cash requirements.

The earnings per share increase is a favorable indicator for profitability. A 109% (from $1.15 to $2.40) increase indicates a significant increase in net income and provides a favorable sign regarding going-concern potential.

BYP 2-8 COMMUNICATION ACTIVITY

To: F. P. Fernetti

From: Accounting Major

Subject: Financial Statement Analysis

(a) Ratios can be classified into three types, which measure three different aspects of a company's financial health:

1. Liquidity ratios—These measure a company's ability to pay its current obligations.

2. Solvency ratios—These measure a company's ability to pay its long-term obligations and survive over the long-term.

3. Profitability ratios—These measure the ability of the company to generate a profit.

(b) 1. Examples of liquidity measures are:

Working capital = Current assets – Current liabilities

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

2. Examples of solvency measures are:

$$\text{Debt to assets ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Free cash flow = Cash provided by operating activities – Capital expenditures – Cash dividends

BYP 2-8 (Continued)

3. **Example of profitability measure:**

$$\text{Earnings per share} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shares outstanding}}$$

(c) There are three bases for comparing a company's results:

The bases of comparison are:

1. **Intracompany—This basis compares an item or financial relationship within a company in the current year with the same item or relationship in one or more prior years.**

2. **Industry averages—This basis compares an item or financial relationship of a company with industry averages (or norms).**

3. **Intercompany—This basis compares an item or financial relationship of one company with the same item or relationship in one or more competing companies.**

BYP 2-9 ETHICS CASE

(a) The stakeholders in this case are: Boeing's management; CEO, public relations manager, Boeing's stockholders, McDonnell Douglas stockholders, other users of the financial statements; especially potential investors of the new combined company.

(b) The ethical issues center around full disclosure of financial information. Management attempted to "time" the release of bad news in order to complete a merger that would have been revoked if cost overruns had been disclosed as soon as management became aware of them.

(c) The periodicity assumption requires that financial results be reported on specific, pre-determined dates.

The full disclosure principle requires that all circumstances and events that make a difference to financial statement users must be disclosed.

(d) It is not ethical to "time" the release of bad news. GAAP requires that all significant financial information be released to allow users to make informed decisions.

(e) Answers will vary. One possibility: Release the information regarding cost overruns as it became available. Describe the causes of such overruns and explain how Boeing would address them (probably by improving production methods to eliminate the inefficiencies alluded to in the text).

(f) Investors and analysts should be aware that Boeing's management will probably "manage" information in the future in ways that will interfere with full disclosure.

BYP 2-10 ALL ABOUT YOU

Answers will vary.

BYP 2-11 FASB CODIFICATION ACTIVITY

(a)

1. **Current assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.**

2. **Current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.**

(b) Access FASB Codification 210-20-45

A right of set off exists when all of the following conditions are met:

1. **Each of two parties owes the other determinable amounts.**

2. **The reporting party has the right to set off the amount owed with the amount owed by the other party.**

3. **The reporting party intends to set off.**

4. **The right of set off is enforceable at law. As a result, a company may not offset accounts payable against cash on its balance sheet.**

BYP 2-12 PEOPLE, PLANET AND PROFIT

(a) The existence of three different forms of certification would most likely create confusion for coffee purchasers. It would difficult to know what aspects of the coffee growing process each certification covered. Similarly, if there were multiple groups that certified financial statements, each with different criteria, it would be difficult for financial statement users to know what each certification promised.

(b) The Starbucks certification appears to be the most common in that area. It has the advantage of having a direct link to the Starbucks coffee market. Although it does not guarantee that Starbucks will buy its coffee, it is a requirement that must be met before Starbucks will buy somebody's coffee. Note that the article states that the Starbucks certification "incorporates elements of social responsibility and environmental leadership, but quality of coffee is the first criteria." The Smithsonian Bird Friendly is considered to have the strictest requirements and, as a result, appears to be the least common.

(c) The certifications have multiple objectives including organic farming as a means to protect bird species, biodiversity and wildlife habitat. Some included requirements are to improve workers' living conditions, such as providing running water in worker housing, child labor regulations and education requirements. As mentioned above, the Starbucks certification has the potential financial benefit of making Starbucks a potential customer, which can stabilize farmers' earnings. Certifications can also be financially beneficial because companies can benefit from the positive public relations effects of either producing or buying coffee produced using sustainable practices.

IFRS CONCEPTS AND APPLICATION

IFRS 2-1

The statement of financial position required under IFRS and the balance sheet prepared under GAAP usually present the same information regarding a company's assets, liabilities, and stockholders' equity at a point in time. IFRS does not dictate a specific order but most companies list noncurrent items before current. Differences in ordering are

Statement of Financial Position presentation	Balance Sheet presentation
Noncurrent assets	Current assets
Current assets	Noncurrent assets
Equity	Current liabilities
Noncurrent liabilities	Noncurrent liabilities
Current liabilities	Stockholders' equity

Under IFRS, current assets are usually listed in the reverse order of liquidity.

IFRS 2-2

No, in a recently completed project on the conceptual framework, the two boards agreed on the objective of financial reporting and a common set of desired qualitative characteristics.

IFRS 2-3

IFRS uses Share Capital—Ordinary rather than Common Stock and statement of financial position rather than balance sheet.

IFRS 2-4

RUIZ COMPANY
Partial Statement of Financial Position

Current assets	
Prepaid insurance	£ 3,600
Supplies	5,200
Accounts receivable	12,500
Debt investments	6,700
Cash	15,400
Total	£43,400

IFRS 2-5

WIDMER COMPANY
Partial Statement of Financial
Position December 31, 2014

Property, plant and equipment		
Equipment	CHF21,700	
Less: Accumulated depreciation	5,700	CHF16,000
Long-term investments		
Share investments		
6,500		
Current assets		
Inventories	2,900	
Accounts receivable	4,300	
Debt investments	120	
Cash	13,400	20,720

IFRS 2-6

COLE BOWLING ALLEY
Statement of Financial Position
December 31, 2014

Assets			
Property, plant, and equipment			
Land		$64,000	
Buildings	$128,800		
Less: Acc. depr.—buildings	42,600	86,200	
Equipment	62,400		
Less: Acc. depr.—equipment	18,720	43,680	
$193,880			
Current assets			
Prepaid insurance		4,680	
Accounts receivable		14,520	
Cash		18,040	37,240

Equity and Liabilities		
Equity		
Share capital—ordinary	$100,000	
Retained earnings ($15,000 + $3,440*)	18,440	$118,440
Non-current liabilities		
Notes payable		
83,880		
Current liabilities		
Current portion of notes payable	13,900	
Accounts payable	12,300	
Interest payable	2,600	28,800

*Net income = $14,180 – $780 – $7,360 – $2,600 = $3,440

IFRS 2-7

It is possible to compare liquidity and solvency for companies using different currencies. The ratios that are used to do so, such as the current ratio and debt to total assets, indicate relative amounts of assets and liabilities rather than absolute monetary values.

IFRS 2-8 INTERNATIONAL COMPARATIVE ANALYSIS PROBLEM

Differences in the format of the statement of financial position (balance sheet) used by Zetar and Tootsie Roll include the following:

	Zetar	Tootsie Roll
1.	Non-current assets listed first	Current assets listed first
2.	Goodwill listed before property, plant and equipment	Property, plant, and equipment listed before goodwill
3.	Current assets are shown in reverse order of liquidity with cash being last	Current assets are shown in order of liquidity with cash being first
4.	Current liabilities are subtracted from current assets to show net current liabilities/assets	No similar amount appears
5.	Total liabilities are subtracted from total assets to show net assets	No similar amount appears
6.	The equity section uses Share capital and Share premium	The equity section uses Common stock and Capital in excess of par value
7.	Reporting currency is £ (pounds)	Reporting currency is $ (dollars)

CHAPTER 2

SOLUTIONS TO EXERCISES—SET B

EXERCISE 2-1B

CL	Accounts payable
CA	Accounts receivable
PPE	Accumulated depreciation—buildings
PPE	Buildings
CA	Cash
CA	Interest receivable
IA	Goodwill
CL	Notes payable
CA	Inventory
LTI	Investments
PPE	Land
LTL	Mortgage payable
CA	Supplies
PPE	Equipment
CA	Prepaid rent

EXERCISE 2-2B

CA	Prepaid rent
PPE	Equipment
IA	Copyrights
CL	Salaries and wages payable
CL	Income taxes payable
SE	Retained earnings
CA	Accounts receivable
PPE	Land
IA	Patents
LTL	Bonds payable
SE	Common stock
PPE	Accumulated depreciation—equipment
CL	Unearned sales revenue
CA	Inventory

EXERCISE 2-3B

BOEING COMPANY
Partial Balance Sheet
December 31, 2014
(in millions)

Assets

Current assets

Cash	$ 7,042	
Debt investments...	2,266	
Accounts receivable...	5,740	
Notes receivable	328	
Inventory..	9,563	
Total current assets.....................................		$24,939

Long term investments

Notes receivable..		6,777

EXERCISE 2-4B

H. J. HEINZ COMPANY
Partial Balance Sheet
April 30, 2014
(in thousands)

Assets

Current assets			
Cash		$ 617,687	
Accounts receivable		1,161,481	
Inventory			
1,378,216 Prepaid insurance		168,182	
Total current assets			$ 3,325,566
Property, plant, and equipment			
Land			
56,007			
Buildings	$4,344,269		
Less: Accumulated depr-buildings	2,295,563	2,048,706	
2,104,713 Intangible assets			
Goodwill		4,411,521	5,134,764
Total assets			$10,565,043

EXERCISE 2-5B

TROTTER COMPANY
Balance Sheet
December 31, 2014

Assets			
Current assets			
Cash		$18,840	
Accounts receivable		10,600	
Prepaid insurance		3,200	
Total current assets			$32,640
Property, plant, and equipment			
Land	61,200		
Buildings	$115,800		
Less: Accumulated depreciation—buildings	45,600	70,200	
Liabilities and Stockholders' Equity			
Current liabilities			
Accounts payable		$9,500	
Current maturity of note payable		13,600	
Interest payable		3,600	
Total liabilities			106,700
Stockholders' equity			
Common stock		75,000	
Retained earnings ($40,000 + $6,020*)		46,020	
Total stockholders' equity			121,020
Total liabilities and stockholders' equity			$227,720

*$14,700 – $780 – $5,300 – $2,600 = $6,020

EXERCISE 2-6B

TEXAS INSTRUMENTS, INC.
Balance Sheet
December 31, 2014
(in millions)

Assets		
Current assets		
Cash .	$ 1,328	
Debt investments .	1,596	
Accounts receivable .		
Total current assets		$ 6,918
Long-term investments		
Stock investments		267
Property, plant, and equipment		
Equipment.	7,568	
Less: Accumulated depreciation—equipment	3,959	3,609
Intangible assets		
Patents		1,873
Total assets		$12,667
Liabilities and Stockholders' Equity		
Current liabilities		
Total current liabilities.		$ 2,025
Noncurrent liabilities		
Notes payable.		667
Total liabilities.		2,692
Stockholders' equity		
Total stockholders' equity		9,975
Total liabilities and stockholders' equity		$12,667

EXERCISE 2-7B

(a) Earnings (loss) per share = $\dfrac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shares outstanding}}$

2014 : $\dfrac{\$(18{,}804) - 0}{(64{,}473{,}000 + 64{,}406{,}000) / 2} = \$(0.29)$

2013 : $\dfrac{\$(15{,}260) - 0}{(64{,}507{,}000 + 64{,}473{,}000) / 2} = \$(0.24)$

(b) Using net loss as a basis to evaluate profitability, Callaway Company's net loss increased by 23% [($18,804 – $15,260) ÷ $15,260]. Its loss per share increased by 21% [($0.29 – $0.24) ÷ $0.24].

(c) To determine earnings (loss) per share, dividends on preferred stock are subtracted from net income (added to net loss), but dividends on common stock are not subtracted.

EXERCISE 2-8B

(a)

WI-HAUL CORPORATION
Income Statement
For the Year Ended July 31, 2014

Revenues		
Service revenue...	$66,100	
Rent revenue..	8,500	
Total revenues......................................		
$74,600		
Expenses		
Salaries and wages expense	57,500	
Supplies expense...	17,600	
Depreciation expense..................................		
4,000		
Total expenses		79,100
Net loss		$
(4,500)		

Retained earnings, August 1, 2013.		
$34,000		
Less: Net loss	$4,500	
Dividends	4,000	8,500

(b)

WI-HAUL CORPORATION
Balance Sheet
July 31, 2014

Assets		
Current assets		
Cash...	$26,200	
Accounts receivable	11,780	
Total current assets		
$37,980		
Property, plant, and equipment		
Equipment..		
17,500		
Less: Accumulated depreciation—		

EXERCISE 2-8B (Continued)

(b)

WI-HAUL CORPORATION
Balance Sheet (Continued)
July 31, 2014

Liabilities and Stockholders'
Equity Current liabilities

Accounts payable. 4,100	$	
Salaries and wages payable. 2,080		
Total current liabilities.		$
Total liabilities 7,980		
Stockholders' equity		
Common stock. 16,000		
Retained earnings	25,500	

(c) $\text{Current ratio} = \frac{\$37,980}{\$6,180} = 6.1:1$

$\text{Debt to assets ratio} = \frac{\$7,980}{\$49,480} = 16.1\%$

(d) The current ratio would not change because equipment is not a current asset and a 5-year note payable is a long-term liability rather than a current liability.

The debt to assets ratio would increase from 16.1% to 40.3%*.

Looking solely at the debt to assets ratio, I would favor making the sale because Wi-Haul's debt to assets ratio of 16.1% is very low. Looking at additional financial data, I would note that Wi-Haul reported a significant loss for the current year which would lead me to question its ability to make interest and loan payments (and even remain in business) in the future. I would not make the proposed sale unless Wi-Haul convinced me that it would be capable of earnings in the future rather than losses.

I would also consider making the sale but requiring a substantial down-payment and smaller note.

*($7,980 + $20,000) ÷ ($49,480 + $20,000)

EXERCISE 2-9B

(a)

	Beginning of Year	End of Year
Working capital	\$2,742 – \$1,433 = \$1,309	\$3,361 – \$1,635 = \$1,726
Current ratio	$\frac{\$2,742}{\$1,433}$ = 1.91:1	$\frac{\$3,361}{\$1,635}$ = 2.06:1

(b) Nordstrom's liquidity increased during the year. Its current ratio increased from 1.91:1 to 2.06:1. Also, Nordstrom's working capital increased by \$417,000,000.

(c) Nordstrom's current ratio at both the beginning and the end of the recent year exceeds Best Buy's current ratio for 2011 and 2010. Nordstrom's end-of-year current ratio (2.06) exceeds Best Buy's 2011 current ratio of 1.21 (see page 59 of text). Nordstrom would be considered much more liquid than Best Buy for the recent year.

EXERCISE 2-10B

(a) $\text{Current ratio} = \frac{\$60,000}{\$30,000} = 2.0:1$

Working capital = \$60,000 – \$30,000 = \$30,000

(b) $\text{Current ratio} = \frac{\$42,000^{*}}{\$12,000^{**}} = 3.5:1$

Working capital = \$42,000 – \$12,000 = \$30,000

*\$60,000 – \$18,000 **\$30,000 – \$18,000

(c) Liquidity measures indicate a company's ability to pay current obligations as they become due. Satisfaction of current obligations usually requires the use of current assets.

If a company has more current assets than current liabilities it is more likely that it will meet obligations as they become due. Since working capital and the current ratio compare current assets to current liabilities, both are measures of liquidity.

EXERCISE 2-10B (Continued)

Payment of current obligations frequently requires cash. Neither working capital nor the current ratio indicate the composition of current assets. If a company's current assets are largely comprised of items such as inventory and prepaid expenses it may have difficulty paying current obligations even though its working capital and current ratio are large enough to indicate favorable liquidity. In Abrev's case, payment of $18,000 of accounts payable will leave only $17,000 cash. Since salaries payable will require $12,000, the company may need to borrow in order to make the required payment for salaries.

(d) The CFO's decision to use $18,000 of cash to pay off accounts payable is not in itself unethical. However doing so just to improve the year-end current ratio could be considered unethical if this action misled creditors. Since the CFO requested preparation of a "preliminary" balance sheet before deciding to pay off the liabilities he seems to be "managing" the company's financial position which is usually considered unethical.

EXERCISE 2-11B

		2014	2013
(a)	Current ratio	$\frac{\$1,020,834}{\$376,178} = 2.71:1$	$\frac{\$1,189,108}{\$464,618} = 2.56:1$
(b)	Earning per share	$\frac{\$400,019}{\$216,119} = \$1.85$	$\frac{\$387,359}{\$222,662} = \$1.74$
(c)	Debt to assets ratio	$\frac{\$527,216}{\$1,867,680} = 28.2\%$	$\frac{\$562,246}{\$1,979,558} = 28.4\%$
(d)	Free cash flow	$464,270 – $250,407 – $80,796 = $133,067	$749,268 – $225,939 – $61,521 = $461,808

(e) Using the debt to assets ratio and free cash flow as measures of solvency produces negative results for American Eagle Outfitters. Its debt to assets ratio decreased slightly from 28.4% for 2013 to 28.2% for 2014 indicating a very small increase in solvency for 2014. Its free cash flow decreased by 71% indicating a significant decline in solvency.

EXERCISE 2-11B (Continued)

(f) **In both 2014 and 2013 American Eagle Outfitters's cash provided by operating activities was greater than the cash used for capital expenditures. It is generating plenty of cash from operations to cover its investing needs. This is not unusual for a company that has been operating successfully for more than ten years, as has been the case with American Eagle Outfitters. If it faced a deficiency, it could meet it by issuing stock or debt.**

EXERCISE 2-12B

(a) 2 Going concern assumption
(b) 6 Economic entity assumption
(c) 3 Monetary unit assumption
(d) 4 Periodicity assumption
(e) 5 Historical cost principle
(f) 1 Full disclosure principle

EXERCISE 2-13B

1. Incorrect. The *historical cost principle* requires that assets be recorded and reported at their cost.

2. Correct. The *monetary unit assumption* assumes the unit of measure remains sufficiently constant over time.

3. Incorrect. The *economic entity assumption* requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

SOLUTIONS TO PROBLEMS—SET C

PROBLEM 2-1C

KELLOGG COMPANY
Balance Sheet
December 31, 2014
(in millions)

Assets		
Current assets		
Cash	$ 334	
Accounts receivable, net	1,093	
Inventory	910	
Prepaid insurance	221	
Total current assets		$
2,558		
Property, plant, and equipment		
Equipment		
3,870		
Less: Accumulated depreciation—equipment	860	3,010
Intangible assets		
Goodwill		5,632
Total assets		$11,200
Liabilities and Stockholders'		
Equity Current liabilities		
Total current liabilities		$
2,288		
Long-term liabilities		
Notes payable—noncurrent		
Total long-term liabilities		6,637
Total liabilities		
8,925		
Stockholders' equity		
Common stock		
Total stockholders' equity		2,275
Total liabilities and stockholders' equity		$11,200

PROBLEM 2-2C

TILLEY, INC.
Income Statement
For the Year Ended December 31, 2014

Revenues

Service revenue ....

$53,000

Expenses

Salaries and wages expense	$36,000	
Depreciation expense		
4,300		
Maintenance and repairs expense		
2,600		
Utilities expense		

TILLEY, INC.
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1	$14,000
Plus: Net income	6,200
	20,200
Less: Dividends	2,600
Retained earnings, December 31	$17,600

PROBLEM 2-2C (Continued)

TILLEY, INC.
Balance Sheet
December 31, 2014

Assets		
Current assets		
Cash .	$ 5,100	
Accounts receivable .		
Total current assets		
$11,400		
Property, plant, and equipment		
Equipment.	8,600	22,400
Total assets		$33,800
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$8,200	
Salaries and wages payable	2,000	
Total current liabilities.		
$10,200		
Stockholders' equity		
Common stock		
6,000		
Retained earnings.		

PROBLEM 2-3C

(a)

RAPP CORPORATION
Income Statement
For the Year Ended April 30, 2014

Revenues

Sales revenue ....
$21,450

Expenses

Salaries and wages expense . ...
$6,840

Depreciation expense. ....
2,200

Income tax expense. ....
1,600

RAPP CORPORATION
Retained Earnings Statement
For the Year Ended April 30, 2014

Retained earnings, May 1, 2013.	$13,960
Plus: Net income.	9,700
	23,660
Less: Dividends.	2,800
Retained earnings, April 30, 2014.	$20,860

PROBLEM 2-3C (Continued)

(b)

RAPP CORPORATION
Balance Sheet
April 30, 2014

Assets		
Current assets		
Cash	$21,955	
Accounts receivable	9,150	
Prepaid rent	380	
Total current assets		
$31,485		
Equipment	24,250	
Less: Accumulated depreciation—equipment	6,600	
17,650		
Total assets		$49,135
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$	
Total current liabilities		$
2,575		
Notes payable		5,700
Total liabilities		
8,275		
Stockholders' equity		
Total stockholders' equity		40,860
Total liabilities and stockholders' equity		$49,135

(c) Rapp Corporation reports its revenues and expenses on the income statement with net income being the result. Net income from the income statement is reported on the retained earnings statement as an item added to beginning retained earnings as part of the determination of retained earnings at year end. The year end retained earnings is then reported as part of stockholders' equity on the balance sheet.

PROBLEM 2-4C

(a) **Weber's net income is $136,000 ($890,000 – $620,000 – $59,000 – $10,000 – $65,000).**

Its earnings per share is $.34 ($136,000 ÷ 400,000 shares).

Al Sharif's net income is $44,000 ($450,000 – $260,000 – $130,000 – $6,000 – $10,000).

Its earnings per share is $.22 ($44,000 ÷ 200,000 shares).

(b) **Weber's 2014 working capital of $400,000 ($700,000 – $300,000) is over 3 times as high as Al Sharif's working capital of $105,000 ($180,000 – $75,000). However, Weber's 2014 current ratio of 2.3:1 ($700,000 ÷ $300,000) is slightly lower than Al Sharif's current ratio of 2.4:1 ($180,000 ÷ $75,000).**

(c) **Al Sharif appears to be less solvent. Al Sharif's 2014 debt to assets ratio of 34% ($265,000 ÷ $780,000)[a] is slightly higher than Weber's ratio of 33% ($500,000 ÷ $1,500,000)[b]. The lower the percentage of debt to assets, the lower the risk that a company may be unable to pay its debts as they come due.**

Al Sharif's free cash flow is only $22,000 ($46,000 – $20,000 – $4,000) compared to $115,000 ($180,000 – $50,000 – $15,000) for Weber. More free cash flow indicates that Weber will be better able to finance more capital expenditures without taking on more debt.

[a]<u>$265,000</u> ($75,000 + $190,000) is Al Sharif's 2014 total liabilities.
<u>$780,000</u> ($180,000 + $600,000) is Al Sharif's 2014 total assets.

[b]<u>$500,000</u> ($300,000 + $200,000) is Weber's 2014 total liabilities.
<u>$1,500,000</u> ($700,000 + $800,000) is Weber's 2014 total assets.

PROBLEM 2-5C

(a) (i) Current ratio = $\frac{\$298,600}{\$148,700}$ = 2.0:1.

(ii) Working capital = $298,600 – $148,700 = $149,900.

(iii) Debt to assets ratio = $\frac{\$258,700}{\$763,900}$ = 34%.

(iv) Free cash flow = $71,300 – $42,000 – $10,000 = $19,300.

(v) Earnings per share = $\frac{\$99,200}{65,000}$ = $1.53.

(b) During 2014, DeVoe's current ratio decreased from 2.4:1 to 2.0:1 and its working capital dropped from $178,000 to $149,900. Both measures indicate a slight decline in liquidity during 2014.

DeVoe's debt to assets ratio increased from 31% in 2013 to 34% in 2014 indicating that the company is less solvent in 2014. Using another measure of solvency, free cash flow, we see that DeVoe's solvency has improved during 2014. Earnings per share increased from $1.35 to $1.53 in 2014. This 13% increase indicates better profitability in 2014.

PROBLEM 2-6C

	2013	2014
(a)	**Earnings per share.**	
	$\frac{\$163,000}{320,000 \text{ shares}} = \$.51$	$\frac{\$150,000}{370,000 \text{ shares}} = \$.41$
(b)	**Working capital.**	
	(\$24,000 + \$55,000 + \$73,000) – \$65,000 = \$87,000	(\$40,000 + \$90,000 + \$74,000) – \$88,000 = \$116,000
(c)	**Current ratio.**	
	$\frac{\$152,000}{\$65,000} = 2.34:1$	$\frac{\$204,000}{\$88,000} = 2.32:1$
(d)	**Debt to assets.**	
	$\frac{\$135,000}{\$619,000} = 21.8\%$	$\frac{\$178,000}{\$802,000} = 22.2\%$
(e)	**Free cash flow.**	**Free cash flow.**
	\$178,000 – \$45,000 – \$43,000 = \$90,000	\$165,000 – \$85,000 – \$50,000 = \$30,000

(f) The underlying profitability of the corporation as measured by earnings per share has declined. The liquidity of the corporation dropped as shown by the increase in working capital and the slight decrease current ratio. Also, the corporation appears to be increasing its debt burden as its debt to assets increased slightly indicating a decrease in solvency. Comparing free cash flow, we find a drop in this measure of solvency also.

PROBLEM 2-7C

	Ratio	Blockbuster Inc	Movie Gallery, Inc.
		(All Dollars Are in Millions)	
(a)	Working capital	\$171 (\$1,566 – \$1,395)	(\$29) (\$239 – \$268)
(b)	Current ratio	1.12:1 (\$1,566 ÷ \$1,395)	.89:1 (\$239 ÷ \$268)
(c)	Debt to assets ratio	71.6% (\$2,246 ÷ \$3,137)	120.6% (\$1,390 ÷ \$1,153)
(d)	Free cash flow	\$329 – \$79 – \$11 = \$239	(\$10) – \$20 – \$0 = (\$30)
(e)	Earnings (Loss) per share	$\$0.29 = \frac{\$55 - 0}{189.0}$	$(\$0.82) = \frac{(\$26) - 0}{31.8}$

(f) The comparison of the two companies shows the following:

<u>Liquidity</u>—Blockbuster's current ratio is 1.12:1 compared to Movie Gallery's .89:1. Its working capital is $171 compared to Movie Gallery's negative $29. Blockbuster is much more liquid than Movie Gallery using either indicator.

<u>Solvency</u>—Blockbuster is more solvent than Movie Gallery because its ratio of debt to assets is significantly lower and its free cash flow is much larger.

<u>Profitability</u>—Blockbuster reported a net income while Movie Gallery reported a net loss. Therefore, Blockbusters is more profitable.

PROBLEM 2-8C

(a) **The primary objective of financial reporting is to provide information useful for decision making. Since Net Nanny's shares appear to be actively traded, investors must be capable of using the information made available by Net Nanny to make decisions about the company.**

(b) **The investors must feel as if the company will show earnings in the future. They must recognize that information relevant to their investment choice is indicated by more than Net Nanny's net income.**

(c) **The change from Canadian dollars to U.S. dollars for reporting purposes should make Net Nanny more comparable with companies traded on U.S. stock exchanges.**

Continuing Cookie Chronicle

(*Note:* This is a continuation of the Cookie Chronicle from Chapter 1.)

CCC2 After investigating the different forms of business organization, Natalie Koebel decides to operate her business as a corporation, Cookie Creations Inc., and she begins the process of getting her business running.

While at a trade show, Natalie is introduced to Gerry Richards, operations manager of "Biscuits," a national food retailer. After much discussion, Gerry asks Natalie to consider being Biscuits' major supplier of oatmeal chocolate chip cookies. He provides Natalie with the most recent copy of the financial statements of Biscuits. He expects that Natalie will need to supply Biscuits' Watertown warehouse with approximately 1,500 dozen cookies a week. Natalie is to send Biscuits a monthly invoice, and she will be paid approximately 30 days from the date the invoice is received in Biscuits' Chicago office.

Natalie is thrilled with the offer. However, she has recently read in the newspaper that Biscuits has a reputation for selling cookies and donuts with high amounts of sugar and fat, and as a result, consumer demand for the company's products has decreased.

Instructions

Natalie has several questions. Answer the following questions for Natalie.

(a) What type of information does each financial statement provide?

(b) What financial statements would Natalie need in order to evaluate whether Biscuits will have enough cash to meet its current liabilities? Explain what to look for.

(c) What financial statements would Natalie need in order to evaluate whether Biscuits will be able to survive over a long period of time? Explain what to look for.

(d) What financial statement would Natalie need in order to evaluate Biscuits' profitability? Explain what to look for.

(e) Where can Natalie find out whether Biscuits has outstanding debt? How can Natalie determine whether Biscuits would be able to meet its interest and debt payments on any debts it has?

(f) How could Natalie determine whether Biscuits pays a dividend?

(g) In deciding whether to go ahead with this opportunity, are there other areas of concern that Natalie should be aware of?

Exercises: Set B

E2-1B The following are the major balance sheet classifications.

Classify accounts on balance sheet.
(LO 1), **AP**

Current assets (CA)	Current liabilities (CL)
Long-term investments (LTI)	Long-term liabilities (LTL)
Property, plant, and equipment (PPE)	Common stock (CS)
Intangible assets (IA)	Retained earnings (RE)

Instructions
Classify each of the following financial statement items taken from Inshore Corporation's balance sheet.

____ Accounts payable	____ Inventory
____ Accounts receivable	____ Stock investments (to be sold in 18 months)
____ Accumulated depreciation—buildings	____ Land
____ Buildings	____ Mortgage payable
____ Cash	____ Supplies
____ Interest receivable	____ Equipment
____ Goodwill	____ Prepaid rent
____ Notes payable	

E2-2B The major balance sheet classifications are listed in E2-1B above.

Classify financial statement items by balance sheet classification.
(LO 1), **AP**

Instructions
Classify each of the following financial statement items based upon the major balance sheet classifications listed in E2-1B.

____ Prepaid rent	____ Patents
____ Equipment	____ Bonds payable
____ Copyrights	____ Common stock
____ Salaries and wages payable	____ Accumulated depreciation—equipment
____ Income taxes payable	____ Unearned sales revenue
____ Retained earnings	____ Inventory
____ Accounts receivable	
____ Land	

E2-3B Suppose the following items were taken from the December 31, 2014, assets section of the Boeing Company balance sheet. (All dollars are in millions.)

Classify items as current or noncurrent, and prepare assets section of balance sheet.
(LO 1)

Inventory	$ 9,563	Patents	$16,664
Notes receivable—due after December 31, 2015	6,777	Buildings	20,180
		Cash	7,042
Notes receivable—due before December 31, 2015	328	Accounts receivable	5,740
		Debt investments (short-term)	2,266
Accumulated depreciation—buildings	11,915		

Instructions
Prepare the assets section of a classified balance sheet, listing the current assets in order of their liquidity.

E2-4B Suppose the following information (in thousands of dollars) is available for H. J. Heinz Company—famous for ketchup and other fine food products—for the year ended April 30, 2014.

Prepare assets section of a classified balance sheet.
(LO 1)

Prepaid insurance	$ 168,182	Buildings	$4,344,269
Land	56,007	Cash	617,687
Goodwill	4,411,521	Accounts receivable	1,161,481
Trademarks	723,243	Accumulated depreciation—	
Inventory	1,378,216	buildings	2,295,563

Instructions
Prepare the assets section of a classified balance sheet, listing the items in proper sequence and including a statement heading.

Prepare a classified balance sheet.
(LO 1), AP

E2-5B These items are taken from the financial statements of Trotter Co. at December 31, 2014.

Buildings	$115,800
Accounts receivable	10,600
Prepaid insurance	3,200
Cash	18,840
Equipment	82,400
Land	61,200
Insurance expense	780
Depreciation expense	5,300
Interest expense	2,600
Common stock	75,000
Retained earnings (January 1, 2014)	40,000
Accumulated depreciation—buildings	45,600
Accounts payable	9,500
Notes payable	93,600
Accumulated depreciation—equipment	18,720
Interest payable	3,600
Service revenue	14,700

Instructions

Prepare a classified balance sheet. Assume that $13,600 of the note payable will be paid in 2015.

Prepare a classified balance sheet.
(LO 1), AP

E2-6B Suppose the following items were taken from the 2014 financial statements of Texas Instruments, Inc. (All dollars are in millions.)

Common stock	$2,671	Accumulated depreciation—equipment	$3,959
Prepaid rent	834	Accounts payable	1,368
Equipment	7,568	Patents	1,873
Income taxes payable	657	Notes payable (long-term)	667
Stock investments (long-term)	267	Retained earnings	7,304
Debt investments (short-term)	1,596	Accounts receivable	1,742
Cash	1,328	Inventory	1,418

Instructions

Prepare a classified balance sheet in good form as of December 31, 2014.

Compute and interpret profitability ratio.
(LO 2), AP

E2-7B Suppose the following information is available for Callaway Golf Company for the years 2014 and 2013. (Dollars are in thousands, except share information.)

	2014	2013
Net sales	$ 967,656	$ 950,799
Net income (loss)	(18,804)	(15,260)
Total assets	884,979	875,930
Share information		
Shares outstanding at year-end	64,406,000	64,473,000
Preferred dividends	–0–	–0–

There were 64,507,000 shares outstanding at the end of 2012.

Instructions

(a) What was the company's earnings (loss) per share for each year?
(b) Based on your findings above, how did the company's profitability change from 2013 to 2014?
(c) Suppose the company had paid dividends on preferred stock and on common stock during the year. How would this affect your calculation in part (a)?

Prepare financial statements.
(LO 1, 3, 4), AP

E2-8B These financial statement items are for Wi-Haul Corporation at year-end, July 31, 2014.

Salaries and wages payable	$ 2,080
Salaries and wages expense	57,500
Supplies expense	17,600
Equipment	17,500
Accounts payable	4,100

Service revenue	$66,100
Rent revenue	8,500
Notes payable (due in 2017)	1,800
Common stock	16,000
Cash	26,200
Accounts receivable	11,780
Accumulated depreciation—equipment	6,000
Dividends	4,000
Depreciation expense	4,000
Retained earnings (beginning of the year)	34,000

Instructions

(a) Prepare an income statement and a retained earnings statement for the year. Wi-HAUL Corporation did not issue any new stock during the year.
(b) Prepare a classified balance sheet at July 31.
(c) Compute the current ratio and debt to assets ratio.
(d) Suppose that you are the president of Crescent Equipment. Your sales manager has approached you with a proposal to sell $20,000 of equipment to Wi-HAUL. He would like to provide a loan to Wi-HAUL in the form of a 10%, 5-year note payable. Evaluate how this loan would change Wi-HAUL's current ratio and debt to assets ratio, and discuss whether you would make the sale.

Compute liquidity ratios and compare results.
(LO 4), **AP**

E2-9B Nordstrom, Inc. operates department stores in numerous states. Selected financial statement data (in millions of dollars) for a recent year are as follows.

	End of Year	Beginning of Year
Cash and cash equivalents	$ 358	$ 403
Receivables (net)	1,788	684
Merchandise inventory	956	997
Other current assets	259	658
Total current assets	$3,361	$2,742
Total current liabilities	$1,635	$1,433

Instructions

(a) Compute working capital and the current ratio at the beginning of the year and at the end of the current year.
(b) Did Nordstrom's liquidity improve or worsen during the year?
(c) Using the data in the chapter, compare Nordstrom's liquidity with Best Buy's.

Compute liquidity measures and discuss findings.
(LO 4), **AP**

E2-10B The chief financial officer (CFO) of Abrev Corporation requested that the accounting department prepare a preliminary balance sheet on December 30, 2014, so that the CFO could get an idea of how the company stood. He knows that certain debt agreements with its creditors require the company to maintain a current ratio of at least 2:1. The preliminary balance sheet is as follows.

ABREV CORP.
Balance Sheet
December 30, 2014

Current assets			Current liabilities		
Cash	$35,000		Accounts payable	$ 18,000	
Accounts receivable	20,000		Salaries and wages payable	12,000	$ 30,000
Prepaid insurance	5,000	$ 60,000	Long-term liabilities		
Equipment (net)		200,000	Notes payable		80,000
Total assets		$260,000	Total liabilities		110,000
			Stockholders' equity		
			Common stock	100,000	
			Retained earnings	50,000	150,000
			Total liabilities and stockholders' equity		$260,000

Instructions

(a) Calculate the current ratio and working capital based on the preliminary balance sheet.

(b) Based on the results in (a), the CFO requested that $18,000 of cash be used to pay off the balance of the accounts payable account on December 31, 2014. Calculate the new current ratio and working capital after the company takes these actions.
(c) Discuss the pros and cons of the current ratio and working capital as measures of liquidity.
(d) Was it unethical for the CFO to take these steps?

Compute and interpret solvency ratios.
(LO 4, 5), **AP**

E2-11B Suppose the following data were taken from the 2014 and 2013 financial statements of American Eagle Outfitters. (All dollars are in thousands.)

	2014	2013
Current assets	$1,020,834	$1,189,108
Total assets	1,867,680	1,979,558
Current liabilities	376,178	464,618
Total liabilities	527,216	562,246
Net income	400,019	387,359
Net cash provided by operating activities	464,270	749,268
Capital expenditures	250,407	225,939
Dividends paid on common stock	80,796	61,521
Weighted-average shares outstanding	216,119	222,662

Instructions

Perform each of the following.
(a) Calculate the current ratio for each year.
(b) Calculate earnings per share for each year.
(c) Calculate the debt to assets ratio for each year.
(d) Calculate the free cash flow for each year.
(e) Discuss American Eagle's solvency in 2014 versus 2013.
(f) Discuss American Eagle's ability to finance its investment activities with cash provided by operating activities, and how any deficiency would be met.

Identify accounting assumptions and principles.
(LO 7), **K**

E2-12B Presented below are the assumptions and principles discussed in this chapter.

1. Full disclosure principle.
2. Going concern assumption.
3. Monetary unit assumption.
4. Periodicity assumption.
5. Historical cost principle.
6. Economic entity assumption.

Instructions

Identify by number the accounting assumption or principle that is described below. Do not use a number more than once.

——— (a) Is the rationale for why plant assets are not reported at liquidation value. (*Note:* Do not use the historical cost principle.)
——— (b) Indicates that personal and business record-keeping should be separately maintained.
——— (c) Assumes that the dollar is the "measuring stick" used to report on financial performance.
——— (d) Separates financial information into time periods for reporting purposes.
——— (e) Indicates that companies should not record in the accounts fair value changes subsequent to purchase.
——— (f) Dictates that companies should disclose all circumstances and events that make a difference to financial statement users.

Identify the assumption or principle that has been violated.
(LO 7), **C**

E2-13B The following situations involve accounting principles and assumptions.

1. Donkey Company owns land that is worth substantially more than it originally cost. In an effort to provide more relevant information. Donkey reports the land at market value in its accounting reports.
2. Benjamin Company includes in its accounting records only transaction data that can be expressed in terms of money.
3. Josh Borke, owner of Josh's MovieHouse, records his personal living costs as expenses of the MovieHouse.

Instructions

For each of the three situations, say if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

Problems: Set C

P2-1C Suppose the following items are from the 2014 balance sheet of Kellogg Company. (All dollars are in millions.)

Prepare a classified balance sheet.
(LO 1), **AP**

Common stock	$ 577
Accumulated depr.—equipment	860
Notes payable—current	1,211
Prepaid insurance	221
Cash	334
Bonds payable	1,802
Retained earnings	1,698
Accounts payable	1,077
Accounts receivable, net	1,093
Equipment	3,870
Inventory	910
Notes payable—noncurrent	4,835
Goodwill	5,632

Instructions

Prepare a classified balance sheet for Kellogg Company as of December 31, 2014.

Tot. current assets $2,558
Tot. assets $11,200

P2-2C These items are taken from the financial statements of Tilley, Inc.

Prepare financial statements.
(LO 1, 3), **AP**

Prepaid insurance	$ 1,400
Equipment	31,000
Salaries and wages expense	36,000
Utilities expense	2,100
Accumulated depreciation—equipment	8,600
Accounts payable	8,200
Cash	5,100
Accounts receivable	$ 4,900
Salaries and wages payable	2,000
Common stock	6,000
Depreciation expense	4,300
Retained earnings (beginning)	14,000
Dividends	2,600
Service revenue	53,000
Maintenance and repairs expense	2,600
Insurance expense	1,800

Instructions

Prepare an income statement, a retained earnings statement, and a classified balance sheet as of December 31, 2014.

Net income $6,200
Tot. assets $33,800

P2-3C You are provided with the following information for Rapp Corporation, effective as of its April 30, 2014, year-end.

Prepare financial statements.
(LO 1, 3), **AP**

Accounts payable	$ 2,100
Accounts receivable	9,150
Accumulated depreciation—equipment	6,600
Depreciation expense	2,200
Cash	21,955
Common stock	20,000
Dividends	2,800
Equipment	24,250
Sales revenue	21,450
Income tax expense	1,600
Income taxes payable	300
Interest expense	350
Interest payable	175
Notes payable (due in 2018)	5,700
Prepaid rent	380
Rent expense	760
Retained earnings, beginning	13,960
Salaries and wages expense	6,840

Net income	$9,700
Tot. current assets	$31,485
Tot. assets	$49,135

Instructions

(a) Prepare an income statement and a retained earnings statement for Rapp Corporation for the year ended April 30, 2014.
(b) Prepare a classified balance sheet for Rapp as of April 30, 2014.
(c) Explain how each financial statement interrelates with the others.

Compute ratios; comment on relative profitability, liquidity, and solvency.
(LO 2, 4, 5), **AN**

P2-4C Comparative statement data for Al Sharif Company and Weber Company, two competitors, are presented below. All balance sheet data are as of December 31, 2014.

	Al Sharif Company 2014	Weber Company 2014
Net sales	$450,000	$890,000
Cost of goods sold	260,000	620,000
Operating expenses	130,000	59,000
Interest expense	6,000	10,000
Income tax expense	10,000	65,000
Current assets	180,000	700,000
Plant assets (net)	600,000	800,000
Current liabilities	75,000	300,000
Long-term liabilities	190,000	200,000
Net cash provided by operating activities	46,000	180,000
Capital expenditures	20,000	50,000
Dividends paid	4,000	15,000
Average number of shares outstanding	200,000	400,000

Instructions

(a) Compute the net income and earnings per share for each company for 2014.
(b) Comment on the relative liquidity of the companies by computing working capital and the current ratio for each company for 2014.
(c) Comment on the relative solvency of the companies by computing the debt to assets ratio and the free cash flow for each company for 2014.

Compute and interpret liquidity, solvency, and profitability ratios.
(LO 2, 4, 5), **AP**

P2-5C The financial statements of DeVoe Company are presented here.

DEVOE COMPANY
Income Statement
For the Year Ended December 31, 2014

Net sales	$700,000
Cost of goods sold	400,000
Selling and administrative expenses	150,000
Interest expense	7,800
Income tax expense	43,000
Net income	$ 99,200

DEVOE COMPANY
Balance Sheet
December 31, 2014

Assets	
Current assets	
Cash	$ 18,100
Debt investments	34,800
Accounts receivable (net)	90,700
Inventory	155,000
Total current assets	298,600
Plant assets (net)	465,300
Total assets	$763,900

Liabilities and Stockholders' Equity	
Current liabilities	
Accounts payable	$119,700
Income taxes payable	29,000
Total current liabilities	148,700
Bonds payable	110,000
Total liabilities	258,700
Stockholders' equity	
Common stock	170,000
Retained earnings	335,200
Total stockholders' equity	505,200
Total liabilities and stockholders' equity	$763,900
Net cash provided by operating activities	$ 71,300
Capital expenditures	$ 42,000
Dividends paid	$ 10,000
Average number of shares outstanding	65,000

Instructions

(a) Compute the following values and ratios for 2014. (We provide the results from 2013 for comparative purposes.)
   (i) Current ratio. (2013: 2.4:1)
   (ii) Working capital. (2013: $178,000)
   (iii) Debt to assets ratio. (2013: 31%)
   (iv) Free cash flow. (2013: $13,000)
   (v) Earnings per share. (2013: $1.35)

(b) Using your calculations from part (a), discuss changes from 2013 in liquidity, solvency, and profitability.

P2-6C Condensed balance sheet and income statement data for Fellenz Corporation are presented below.

Compute and interpret liquidity, solvency, and profitability ratios.
(LO 2, 4, 5), **AP**

FELLENZ CORPORATION
Balance Sheets
December 31

Assets	**2014**	**2013**
Cash	$ 40,000	$ 24,000
Receivables (net)	90,000	55,000
Other current assets	74,000	73,000
Long-term investments	78,000	60,000
Plant and equipment (net)	520,000	407,000
Total assets	$802,000	$619,000

Liabilities and Stockholders' Equity	**2014**	**2013**
Current liabilities	$ 88,000	$ 65,000
Long-term debt	90,000	70,000
Common stock	370,000	320,000
Retained earnings	254,000	164,000
Total liabilities and stockholders' equity	$802,000	$619,000

FELLENZ CORPORATION
Income Statements
For the Years Ended December 31

	2014	**2013**
Sales revenue	$770,000	$800,000
Cost of goods sold	420,000	400,000
Operating expenses (including income taxes)	200,000	237,000
Net income	$150,000	$163,000

Net cash provided by operating activities	$165,000	$178,000
Cash used for capital expenditures	85,000	45,000
Dividends paid	50,000	43,000
Average number of shares outstanding	370,000	320,000

Instructions

Compute the following values and ratios for 2013 and 2014.

(a) Earnings per share.
(b) Working capital.
(c) Current ratio.
(d) Debt to assets ratio.
(e) Free cash flow.
(f) Based on the ratios calculated, discuss briefly the improvement or lack thereof in the financial position and operating results of Fellenz from 2013 to 2014.

Compute ratios and compare liquidity, solvency, and profitability for two companies.
(LO 2, 4, 5), **AP**

P2-7C Selected financial data of two competitors, Blockbuster Inc. and Movie Gallery, Inc., in a recent year are presented below. (All dollars are in millions.)

	Blockbuster Inc.	Movie Gallery, Inc.
	Income Statement Data for Year	
Net sales	$ 5,524	$2,542
Cost of goods sold	2,476	1,012
Selling and administrative expenses	2,755	1,431
Interest expense	102	120
Other expense	212	3
Income tax expense (refund)	(76)	2
Net income (loss)	$ 55	$ (26)

	Blockbuster Inc.	Movie Gallery, Inc.
	Balance Sheet Data (End of Year)	
Current assets	$ 1,566	$ 239
Property, plant, and equipment (net)	736	243
Intangible assets	835	671
Total assets	$ 3,137	$1,153
Current liabilities	$ 1,395	$ 268
Long-term liabilities	851	1,122
Total stockholders' equity	891	(237)
Total liabilities and stockholders' equity	$ 3,137	$1,153
Net cash provided by operating activities	$329	$(10)
Cash used for capital expenditures	79	20
Dividends paid	11	–0–
Average shares outstanding	189.0	31.8

Instructions

For each company, compute these values and ratios.

(a) Working capital.
(b) Current ratio. (Round to two decimal places.)
(c) Debt to assets ratio.
(d) Free cash flow.
(e) Earnings per share.
(f) Compare the liquidity, profitability, and solvency of the two companies.

Comment on the objectives and qualitative characteristics of accounting information.
(LO 6, 7), **E**

P2-8C Net Nanny Software International Inc., headquartered in Vancouver, specializes in Internet safety and computer security products for both the home and commercial markets. In a recent balance sheet, it reported a deficit (negative retained earnings) of US $5,678,288. It has reported only net losses since its inception. In spite of these losses, Net Nanny's common shares have traded anywhere from a high of $3.70 to a low of $0.32 on the Canadian Venture Exchange.

Net Nanny's financial statements have historically been prepared in Canadian dollars. Recently, the company adopted the U.S. dollar as its reporting currency.

Instructions

(a) What is the objective of financial reporting? How does this objective meet or not meet Net Nanny's investors' needs?

(b) Why would investors want to buy Net Nanny's shares if the company has consistently reported losses over the last few years? Include in your answer an assessment of the relevance of the information reported on Net Nanny's financial statements.

(c) Comment on how the change in reporting information from Canadian dollars to U.S. dollars likely affected the readers of Net Nanny's financial statements. Include in your answer an assessment of the comparability of the information.

CHAPTER 2

A Further Look at **Financial Statements**

Learning Objectives

1. Identify the sections of a classified balance sheet.
2. Identify tools for analyzing financial statements and compute ratios for analyzing a company’s profitability.
3. Explain the relationship between a retained earnings statement and a statement of stockholders’ equity.
4. Identify and compute ratios for analyzing a company’s liquidity and solvency using a balance sheet.
5. Use the statement of cash flows to evaluate solvency.
6. Explain the meaning of generally accepted accounting principles.
7. Discuss financial reporting concepts.

Chapter Outline

Learning Objective 1 - Identify the Sections of a Classified Balance Sheet.

In a **classified balance sheet,** companies often group similar assets and similar liabilities together using standard classifications and sections. This is useful because items within the groups have similar economic characteristics. The groupings help users determine: (1) whether the company has enough assets to pay its debts and (2) what claims by short-and long-term creditors exist on the company's total assets.

A **classified balance sheet** generally contains the following standard classifications:

- **Current Assets**
  - Assets that are expected to be converted to cash or used up in the business within one year or one operating cycle whichever is longer.
  - Examples of current assets: cash, short-term investments (which include short-term U.S. government securities), receivables (accounts receivable, notes receivable, and interest receivable), inventories, and prepaid expenses (rent, supplies, insurance, and advertising).
  - On the balance sheet, current assets are listed in the order in which they are expected to be converted into cash (order of liquidity).
  - Some companies use a period longer than one year to classify assets and liabilities as current because they have an operating cycle longer than one year. The **operating cycle** of a company is the average time required to go from cash to cash in producing revenue-buy inventory, sell it, and collect the cash from the customers.

TEACHING TIP

(a) Discuss the difference between notes receivable and accounts receivable; different types of prepaid expenses; and the fact that inventory, supplies, and prepaid expenses will become expenses when they are used up. Explain why these assets are classified as current. (b) Discuss the concept of short-term investments.

- **Long-Term Investments**
  - Assets that can be converted into cash, but whose conversion is not expected within one year.
  - These include long-term assets not currently used in the company's operations (i.e., land, buildings, etc.) and investments in stocks and bonds of other corporations.

TEACHING TIP

Explain to students that there are individuals in large companies who do nothing but take care of long-term investments.

Discuss the difference between short-term and long-term investments in stocks and bonds of other corporations.

Example: A homebuilder has the following assets: (1) lots in a subdivision that are ready for sale to buyers; (2) land on which the corporate office building sits; and (3) land several miles north of town on which it plans a new subdivision in 5 years. Ask students where each of these parcels of land would go on a classified balance sheet. This shows that the classification depends on the use by the company.

Also, ask students how they would classify a certificate of deposit that will mature in 5 years and be used to pay for the new subdivision.

- **Property, Plant, and Equipment**
  - Assets with relatively long useful lives.
  - Assets currently used in operating the business.
  - Sometimes called *fixed assets* or *plant assets.*
  - Examples include land, buildings, machinery, equipment, and furniture and fixtures.
  - Record these assets at **cost** and **depreciate** them (except land) over their useful lives. The full purchase price is not expensed in the year of purchase because the assets will be used for more than one accounting period.
    - **Depreciation** is the practice of allocating the cost of assets to a number of years.
    - **Depreciation expense** is the amount of the allocation for one accounting period.
    - **Accumulated depreciation** is the total amount of depreciation that has been expensed since the asset was placed in service.
    - Cost less accumulated depreciation is reported on the balance sheet.

TEACHING TIP

Explain that depreciation is not a valuation of assets. It is the allocation of their cost over the periods in which they will benefit the business. Many students believe the balance sheet shows the value of the business. Stress that accounting (with a few exceptions that are covered in later chapters) records cost – not value.

- **Intangible Assets**
  - Noncurrent assets.
  - Assets that have no physical substance.
  - Examples are goodwill, patents, copyrights, and trademarks or trade names.

TEACHING TIP

Briefly discuss types of intangible assets. Encourage students to think about companies that have large investments in intangible assets. Remind students that this topic is discussed in more detail in Chapter 9.

- **Current Liabilities**
  - Obligations that are to be paid within the coming year or operating cycle whichever is longer.
  - Common examples are notes payable, accounts payable, wages payable, bank loans payable, interest payable, taxes payable, and current maturities of long-term obligations.
  - Within the current liabilities section, companies usually list notes payable first, followed by accounts payable, and then the remaining items in the order of their magnitude.

> **TEACHING TIP**
>
> (a) Discuss the following payables: wages payable, interest payable, taxes payable, etc. (b) Discuss the difference between accounts payable and notes payable. (c) Discuss how notes payable can be current or long-term, depending on the maturity date.

- **Long-Term Liabilities**
  - Obligations expected to be paid after one year.
  - Liabilities in this category include bonds payable, mortgages payable, long-term notes payable, lease liabilities, and pension liabilities.
  - Many companies report long-term debt maturing after one year as a single amount in the balance sheet and show the details of the debt in notes that accompany the financial statements.

> **TEACHING TIP**
>
> Bonds have been mentioned several times. Students need to understand the difference between notes payable and bonds payable. Also discuss the difference between interest payable and notes or bonds payable.

- **Stockholders' Equity:** Stockholders' equity consists of two parts:
  - **Common Stock** - investments of assets into the business by the stockholders.
  - **Retained Earnings** - income retained for use in the business.

> **TEACHING TIP**
>
> Tell students that companies can issue different types of stock and that common stock is sometimes referred to as capital stock. Mention that stockholders' equity is discussed in more detail in Chapter 11. Until then, they will work with common stock.

Learning Objective 2 - Identify Tools for Analyzing Financial Statements and Ratios for Computing a Company's Profitability.

- **Ratio analysis** expresses the relationship among selected items of financial statement data.
  - A **ratio** expresses the mathematical relationship between one quantity and another.
  - Ratios shed light on company performance
    - **Intracompany** comparisons – covers two years for the same company
    - **Industry-average** comparisons – based on average ratios for particular industries
    - **Intercompany** comparisons – based on comparisons with a competitor in the same industry.

> **TEACHING TIP**
>
> Discuss your preference for rounding. Explain how to compute percentages. Encourage students to use a spreadsheet for computations and presentation. Also encourage them to see if their answers are reasonable and to always reflect on what the computation means – not to just make the computation and then fail to understand what it tells a user.

> **TEACHING TIP**
>
> Discuss ways for students to find industry averages and ratios from sources on the web and in the library. Encourage them to start watching shows on the financial networks and reading business periodicals as well as the business section of newspapers. Ask them to share interesting information with the class.

- **Using the Income Statement--**Creditors and investors are interested in evaluating profitability. Profitability is frequently used as a test of management's effectiveness. To supplement an evaluation of the income statement, ratio analysis is used. **Profitability ratios** - measure the operating success of a company for a given period of time.
  - **Earnings per share**
    - Is a profitability ratio that measures the net income earned on each share of common stock.
    - Is computed by dividing (**net income** less preferred dividends) by the average number of **common shares** outstanding during the year.
    - By comparing earnings per share of a single company over time, one can evaluate its relative earnings performance on a per share basis.
    - Comparisons of earnings per share across companies are not meaningful because of the wide variations in numbers of shares of outstanding stock among companies.

TEACHING TIP

Ask students to watch one of the financial channels for at least 30 minutes and report on the references to earnings per share. If you use a discussion board, students can post their comments on it. This is an efficient way to share the information with the class without taking up too much classroom time.

Learning Objective 3 - Explain the Relationship Between a Retained Earnings Statement and a Statement of Stockholders' Equity.

- **Retained Earnings Statement**
  - Describes the events that caused changes in the retained earnings account for the period.
  - Add net income to and subtract dividends from the beginning balance of retained earnings to arrive at the ending balance of retained earnings.

- **Statement of Stockholders' Equity**
  - Reports **all changes** in stockholders' equity accounts (i.e., capital stock issued or retired).

TEACHING TIP

Walk through Best Buy's Statement of Stockholders' Equity. Explain how the Statement of Stockholders' Equity provides more information than a Retained Earnings Statement.

Learning Objective 4 - Identify and Compute Ratios for Analyzing a Company's Liquidity and Solvency Using a Balance Sheet.

- **Using A Classified Balance Sheet**--An analysis of the relationship between a company's assets and liabilities can provide users with information about the firm's liquidity and solvency.
  - **Liquidity** - The ability to pay obligations expected to come due within the next year or operating cycle. Two measures of liquidity include:
    - **Working capital**
      - Measure of short-term ability to pay obligations
      - Excess of current assets over current liabilities
      - Positive **working capital** (Current Assets > Current Liabilities) indicates the likelihood for paying liabilities is favorable.
      - Negative **working capital** (Current Liabilities > Current Assets) indicates that a company might not be able to pay short-term creditors and may be forced into bankruptcy.
    - **Current ratio**
      - Measure of short-term ability to pay obligations
      - Computed by dividing current assets by current liabilities
      - More dependable indicator of liquidity than working capital

- Does not take into account the composition of current assets (like slow-moving inventory versus cash)

TEACHING TIP

Explain that a 1.60:1 ratio means that for every $1 of current liabilities, the company has $1.60 in current assets.

Also, students need to be aware of the fact that the composition of the assets may be very important. For example if a company had most of its current assets in cash it could be more sure of its liquidity position than another company with the majority of its current assets in inventory. What happens if the company cannot sell the inventory?

- **Solvency** - The ability of a company to pay interest as it comes due and to repay the balance of debt due at its maturity. Solvency ratios include:
  - **Debt to Total Assets Ratio**
    - Measures the percentage of assets financed by creditors
    - The higher the percentage of debt financing, the riskier the company.
    - Computed by dividing total debt (both current and long-term liabilities) by total assets

TEACHING TIP

Compare ratios to tests performed by a doctor. Each test provides information. The doctor must ask the patient questions and then review the results of all tests before making a diagnosis. Students need to realize that ratios are indicators and must be analyzed properly before a decision can be made regarding the financial condition of a company. For example, a negative working capital does not always mean potential bankruptcy. The results of other ratios, as well as specific company information, must be analyzed.

Learning Objective 5 – Use the Statement of Cash Flows to Evaluate Solvency.

- In the **statement of cash flows,** cash provided by operating activities indicates the cash-generating capability of the company. However, cash provided by operating activities fails to take into account that a company must invest in new property, plant, and equipment and at least maintain dividends at current levels to satisfy investors.

  - Free cash flow indicates a company's ability to generate cash from operations that is sufficient to pay debts, acquire assets, and distribute dividends.
  - It describes the cash remaining from operations after adjusting for capital expenditures and dividends.
  - It is computed by subtracting capital expenditures and cash dividends from cash provided by operations.

TEACHING TIP

Go over the free cash flow calculation for Best Buy.

Ask students to compute the free cash flow for a company and report their findings to the class.

Learning Objective 6 - Explain the Meaning of Generally Accepted Accounting Principles.

- **Generally Accepted Accounting Principles (GAAP)** are a set of rules and practices that provide answers to the following questions.
  - How does a company decide on the type of financial information to disclose?
  - What format should a company use?
  - How should a company measure assets, liabilities, revenues, and expenses?

- The **Securities and Exchange Commission (SEC)** is a U.S. government agency that oversees U.S. financial markets and accounting standard-setting bodies.

- The primary accounting standard-setting body in the U. S. is the **Financial Accounting Standards Board (FASB)**.

- The **International Accounting Standards Board (IASB)** sets standards called International **Financial Reporting Standards (IFRS)** for many countries outside the U.S.

- The **Public Company Accounting oversight Board (PCAOB)** determines auditing standards and reviews the performance of auditing firms.

TEACHING TIP

Remind students that financial statements consist of the income statement, retained earnings statement, balance sheet, and statement of cash flows. Again, it may be good to remind them that there are internal and external users.

TEACHING TIP

Discuss the issue of IFRS and making different countries' businesses more "transparent." What does transparency mean in this context? Why is this so important for successful transition to IFRS?

Learning Objective 7 – Discuss Financial Reporting Concepts.

- **Qualities of Useful Information**--To be useful, information should possess two fundamental qualities: **relevance and faithful representation**.

  - **Relevance** - if information has the ability to make a difference in a decision scenario, it is **relevant.** Accounting information is considered **relevant** if it provides information that
    - has **predictive value**--helps provide accurate expectations about the future
    - has **confirmatory value** – confirms or corrects prior expectations.
    - an item is **material** when its size makes it likely to influence the decision of an investor or a creditor.

TEACHING TIP

When you were trying to decide what to wear to class, did it matter whether you were going to an English class or an Accounting class? No. That information was not relevant.

On the other hand, when you were making the decision, the outside temperature did make a difference. Therefore, the temperature was a relevant factor.

TEACHING TIP

Materiality allows firms to modify GAAP. Assume a firm buys a new electric pencil sharpener that is expected to last for 6 years for $18. GAAP say that the pencil sharpener, because it is expected to last for 6 years, should be listed as an asset and depreciated—or charged off—over 6 years at a rate of $3 per year. The materiality constraint allows the firm to expense the pencil sharpener immediately because the $18 expense will not make a difference to the users of financial statements.

  - **Faithful Representation -** information accurately depicts what really happened. To provide a faithful representation, information must be:
    - **complete**—nothing important has been omitted
    - **neutral**—is not biased toward one position or another
    - **free from error**

TEACHING TIP

Financial statements must present faithful representation to be of value. The SEC requires firms listed on an organized exchange to have financial statements audited by a Certified Public Accountant (CPA). The audit ensures faithful representation. Therefore, the public can feel more comfortable about information contained in audited financial statements.

  - **Enhancing Qualities**
    - **Comparability**—when different companies use the same accounting principles. To make a comparison, companies must **disclose** the accounting methods used.

- **Consistency**—when a company uses the same accounting principles and methods from year to year
- **Verifiable—**information that is proven to be free from error.
- **Timely—**information that is available to decision makers before it loses its capacity to influence decisions.
- **Understandability**—information presented in a clear fashion so that users can interpret it and comprehend its meaning.

> **TEACHING TIP**
>
> Firms must follow prescribed accounting principles if users are to compare financial statements.
>
> Consistency requires firms to be consistent in the accounting principles used. However, if there is justification for changing from one principle to another, it must be explained in the Notes to the Financial Statements. The explanation lets users know what has happened to make the difference.

- **Assumptions and Principles in Financial Reporting--**To develop accounting standards, the FASB relies on the following key assumptions and principles:

  - **Monetary Unit Assumption**--States that only transactions expressed in money are included in accounting records.

> **TEACHING TIP**
>
> An example of a transaction expressed in terms of money would be the purchase of a building, paying the rent for the month, or paying the payroll. On the other hand, hiring an employee, ordering a product, or making a bid on a perspective job would not be a transaction expressed in terms of money.

  - **Economic Entity Assumption**
    - Every economic entity can be separately identified and accounted for.
    - Economic events can be identified with a particular unit of accountability.

> **TEACHING TIP**
>
> Explain to students that if they owned a bicycle shop in a nearby community, the economic transactions of the business would be kept separate from the students' personal transactions.

  - **Periodicity Assumption** - allows the business to be divided into artificial time periods that are useful for reporting.

TEACHING TIP

Financial statements may be prepared monthly, quarterly, or annually, depending on the needs of the business.

- **Going Concern Assumption**--Assumes the business will remain in operation for the foreseeable future

TEACHING TIP

Use this topic as a way to discuss some of the decisions the CPA must make about risk. What would be some of the factors that the CPA as an auditor would look for to support the going concern assumption?

- **Principles in Financial Reporting**

  - **Measurement Principles--**GAAP generally uses one of two measurement principles: the cost principle or the fair value principle

    - **Cost Principle** – requires assets to be recorded at original cost because that amount is verifiable.
    - **Fair value Principle** – requires that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).

TEACHING TIP

Ask students to assume they just bought a delivery van for their business. The van had a sticker price of $18,000. A neighbor purchased an identical van last week for $16,500. The student gave $15,000 for the van. At which price should the van be recorded?

  - **Full Disclosure Principle** – requires that all circumstances and events that would make a difference to financial statement users should be disclosed.

- **Cost Constraint--**Determining whether the cost that companies will incur to provide the information will outweigh the benefit that financial statement users will gain from having the information available.

IFRS

♦ A Look at IFRS

The classified balance sheet, although generally required internationally, contains certain variations in format when reporting under IFRS.

♦ KEY POINTS

- IFRS recommends but does not require the use of the title "statement of financial position" rather than balance sheet.
- The format of statement of financial position information is often presented differently under IFRS. Although no specific format is required, most companies that follow IFRS present statement of financial position information in this order:
  - Noncurrent assets
  - Current assets
  - Equity
  - Noncurrent liabilities
  - Current liabilities
- IFRS requires a classified statement of financial position except in very limited situations. IFRS follows the same guidelines as this textbook for distinguishing between current and noncurrent assets and liabilities.
- Under IFRS, current assets are usually listed in the reverse order of liquidity. For example, under GAAP cash is listed first, but under IFRS it is listed last.
- Some companies report the subtotal *net assets*, which equals total assets minus total liabilities. See, for example, the statement of financial position of Zetar plc in Appendix C.
- IFRS has many differences in terminology that you will notice in this textbook. For example in the investment category stock is called shares, and in the equity section common stock is called share capital-ordinary.
- Both IFRS and GAAP require disclosures about (1) accounting policies followed, (2) judgments that management has made in the process of applying the entity's accounting policies, and (3) the key assumptions and estimation uncertainty that could result in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
- Comparative prior-period information must be presented and financial statements must be prepared annually.
- Both GAAP and IFRS are increasing the use of fair value to report assets. However, at this point IFRS has adopted it more broadly. As examples, under IFRS companies can apply fair value to property, plant, and equipment; natural resources; and in some cases intangible assets.
- Recently, the IASB and FASB completed the first phase of a jointly created conceptual framework. In this first phase, they agreed on the objective of financial reporting and a common set of desired qualitative characteristics. These were presented in the Chapter 2 discussion.

- The monetary unit assumption is part of each framework. However, the unit of measure will vary depending on the currency used in the country in which the company is incorporated (e.g., Chinese yuan, Japanese yen, and British pound).
- The economic entity assumption is also part of each framework although some cultural differences result in differences in its application. For example, in Japan many companies have formed alliances that are so strong that they act similar to related corporate divisions although they are not actually part of the same company.

♦ LOOKING TO THE FUTURE

The IASB and the FASB are working on a project to converge their standards related to financial statement presentation. A key feature of the proposed framework is that each of the statements will be organized in the same format, to separate an entity's financing activities from its operating and investing activities and, further, to separate financing activities into transactions with owners and creditors. Thus, the same classifications used in the statement of financial position would also be used in the income statement and the statement of cash flows. The project has three phases. You can follow the joint financial presentation project at the following link: *http://www.fasb.org/project/financial_statement_presentation.shtml*.

The IASB and the FASB face a difficult task in attempting to update, modify, and complete a converged conceptual framework. For example, how do companies choose between information that is highly relevant but difficult to verify versus information that is less relevant but easy to verify? How do companies define control when developing a definition of an asset? Is a liability the future sacrifice itself or the obligation to make the sacrifice? Should a single measurement method, such as historical cost or fair value, be used, or does it depend on whether it is an asset or liability that is being measured? It appears that the new document will be a significant improvement over its predecessors and will lead to principle-based standards, which will help financial statement users make better decisions.

Chapter 2 Review

Identify sections of a classified balance sheet. Explain the differences between current and long-term assets and liabilities. Identify accounts that fit into each section.

What is measured by profitability ratios? Compute EPS and discuss how it is used to measure profitability.

What is the relationship between a retained earnings statement and a statement of stockholders' equity? Which contains the most information?

Define liquidity and solvency. Identify and compute ratios for analyzing a firm's liquidity and solvency. How are these ratios interpreted?

Use the statement of cash flows to evaluate solvency. Compute free cash flow and describe what it measures.

What are generally accepted accounting principles? Name the U.S. and international standard-setting bodies that establish these principles.

Define and explain the significance of relevance, faithful representation, comparability, and consistency. Define and explain assumptions and principles that are used in financial reporting. Define and explain cost constraint.

Vocabulary Quiz **Name _______________**

Chapter 2

______________ 1. Assets of a relatively permanent nature that are being used in the business and are not intended for resale.

______________ 2. The quality of information that indicates the information makes a difference in a decision.

______________ 3. A measure used to evaluate a company's liquidity and short-term debt-paying ability, computed by dividing current assets by current liabilities.

______________ 4. A financial statement that presents the factors that caused stockholders' equity to change during the period, including those things that caused retained earnings to change.

______________ 5. The constraint of determining whether an item is large enough to likely influence the decision of an investor or creditor.

______________ 6. An assumption that economic events can be identified with a particular unit of accountability.

______________ 7. Obligations that companies reasonably expected to pay within the next year or operating cycle, whichever is longer.

______________ 8. Use of the same accounting principles and methods from year to year within a company.

______________ 9. Cash provided by operating activities adjusted for capital expenditures and dividends paid.

______________ 10. An accounting principle that states that companies should record assets at their cost.

Solutions to Vocabulary Quiz

Chapter 2

1. Property, plant, and equipment, or fixed assets, or plant assets
2. Relevance
3. Current ratio
4. Statement of stockholders' equity
5. Materiality
6. Economic entity assumption
7. Current liabilities
8. Consistency
9. Free cash flow
10. Cost principle or historical cost principle

Multiple Choice **Name** _______________

Chapter 2

1. **Earnings per share is**:
   a. a measure of liquidity.
   b. most meaningful when used to analyze the performance of different companies.
   c. a measure of net income earned on each share of common stock.
   d. determines the amount of dividends that a company pays.

2. Which of the characteristics is **not necessary** in order for accounting information to provide **faithful representation**?
   a. conservative.
   b. free from error.
   c. complete.
   d. neutral.

3. **Consistency** of information means that:
   a. the information would influence a decision.
   b. different companies use the same accounting principles.
   c. the amounts involved are material.
   d. a company uses the same accounting principles and methods from year to year.

4. **Comparability** of information results when:

   a. the information would influence a decision.
   b. different companies use the same accounting principles.
   c. the amounts involved are material.
   d. a company uses the same accounting principles and methods from year to year.

5. The **periodicity** assumption:
   a. indicates that the company will continue in operation long enough to carry out its existing objectives.
   b. requires that financial statements be prepared each month.
   c. states that the life of a business can be divided into artificial time periods.
   d. is an example of a constraint.

6. **Current liabilities** include:
   a. obligations to be paid within the coming year.
   b. accounts payable.
   c. wages payable.
   d. all of these answer choices are correct.

7. **Working capital** is:
   a. current assets less current liabilities.
   b. current assets divided by current liabilities.
   c. income divided by average assets.
   d. net income divided by net sales.

8. All of the following are current assets **except:**
   a. accounts receivable.
   b. cash.
   c. patents.
   d. marketable securities.

9. The current ratio is a:
   a. solvency ratio.
   b. profitability ratio.
   c. liquidity ratio.
   d. none of these answer choices are correct.

10. Free cash flow:
   a. describes an unlimited supply of cash.
   b. provides additional insight regarding a company's cash-generating ability.
   c. describes the cash remaining from operations after adjusting for capital expenditures and dividends.
   d. Both provides additional insight regarding a company's cash-generating ability and describes the cash remaining from operations after adjusting for capital expenditures and dividends.

Solutions to Multiple Choice

Chapter 2

1. c
2. a
3. d
4. b
5. c
6. d
7. a
8. c
9. c
10. d

Exercise 1 - Research and Communication Activity

Chapter 2

Blaire and Mark married last year and immediately opened a small computer business. Blaire is responsible for managing the business while Mark is responsible for the accounting. At the end of each month, Mark tells Blaire that the business is earning a profit. Blaire, however, is very frustrated and skeptical. She calls the bank periodically and much to her amazement, the business has no more money in the checking account than it did on the opening day. Blaire and Mark heard that you were taking an accounting course at a local university and have come to you, a friend, for help.

Write a memo to the young entrepreneurs explaining how it is indeed possible to have a net income and not have an increase in cash.

Solution:

DATE: **9/5/201X**

TO: **Blaire and Mark**

FROM: **Accounting Student**

Net income and cash flow are totally different. Therefore, it is quite possible for a business to have a significant amount of net income and no increase in cash. Think about the transactions of your business during the past year. Has inventory increased? Have you purchased additional equipment, furniture, or fixtures? Did you withdraw money from the business. All of the aforementioned transactions, while necessary, decrease cash. However, if you have added inventory, equipment, furniture, and/or fixtures, you have increased assets other than cash. Therefore your business is worth more than it was at the onset.

Exercise 2 – Financial Statement Analysis and Decision Making Activity

Chapter 2

Select two competing companies (i.e. Ford—GM, Eli Lilly—Merck, Ben & Jerry's—Edy's), and locate annual reports for these companies on the internet. These companies can be found on the Internet at http://www.ford.com**,** http://www.gm.com, http://www.elililly.com, http://www.merck.com, http://www.benjerry.com, and http://www.edys.com.

1. Compute the current ratio, debt to total assets ratio, and free cash flow for the companies you have selected. Discuss your findings.

2. Which company would you recommend as an investment?

3. Why did you answer Question 2 as you did? Have you considered the issues presented in the Decision Toolkits in Chapter 2? Explain how this affected your recommendation.

Solutions: Information available on website.

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 3 - Ratio Analysis and Creative Activity

Chapter 2

Refer to the loan application prepared for your fictitious business in Campus Town USA in Exercise 3 of Chapter 1 in answering the following questions:

1. Compute the current ratio and debt to total assets ratio for your fictitious company.

2. Would you like to amend the financial statements prepared in chapter 1? Additional loan application forms are provided for your convenience.

Exercise 3 - Ratio Analysis and Creative Activity (Continued)

Chapter 2

LOAN APPLICATION FORM

Name of Company ________________________________

Address ________________________________

Phone Number ________________________________

Annual Income

Revenues
Cost of goods sold

Operating expenses
- Rent
- Utilities
- Wages
- Advertising
- Other

Net income (loss)

Assets

Cash
Accounts receivable
Inventory
Property, plant, & equipment
Other

Total assets

Liabilities

Accounts payable
Notes payable
Other

Total liabilities

Stockholders' Equity

Total stockholders' equity

Total liabilities & stockholders' equity

Exercise 4 - Financial Statements and Creative Activity

Chapter 2

1. Prepare personal financial statements, including an income statement and a balance sheet. Remember to include all of your sources of revenues; income from jobs, allowance from parents, etc. In addition, please consider all of your assets, clothes, jewelry, automobiles, electronic equipment, etc.

2. Keep a record of your income and expenses for a month.

3. At the end of the month, prepare financial statements, including an income statement, balance sheet, and a statement of cash flows.

Exercise 5 - Financial Statements and Creative Activity

Chapter 2

The Ice Cats, a professional ice hockey team moved to College Town USA. Joe Enterprise, organized Joe's Tees to take advantage of the large number of fans the team attracted by selling tee shirts with the team's name and logo printed in the team's colors. Joe sold the shirts from a cart in front of the arena where the Ice Cats perform. Joe bought the cart for $5,000. Joe anticipates the cart will last for five years. The shirts cost $14 and Joe sold them for $25. In addition, Joe is required to buy a city license for $125.

During the first season, there were 10 home games at which Joe averaged selling 32 shirts a game. Compute Joe's net income or net (loss).

Solution:

Revenues		**$8,000**
Less expenses:		
Cost of shirts	**$4,480**	
Cart	**5,000***	
License	**125**	**9,605**
Net loss		**($1,605)**

***Most students are not yet familiar with accrual accounting or the concept of depreciation.**

You may want to keep a copy of the students' work. This exercise will be revisited in a later chapter.

Exercise 6 - World Wide Web Research, Financial Statement Analysis, and International Activity

Chapter 2

Select two competing companies, one a domestic company, the other a foreign company (i.e. Nike—Fila and ExxonMobil—BP), and locate annual reports for these companies on the internet. These companies can be found at http://www.nike.com, http://www.fila.com, http://www.exxon.com, and http://www.bp.com.

1. Where are the headquarters for the two companies you selected?

2. In what currency are the financial statements of the foreign company stated?

3. How are the financial statements similar? How are the financial statements different?

Solutions: Information available on website.

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 7 – Accounting Career Activity

Chapter 2

Public accounting is one of the largest sectors of the accounting field. In order to retain a job in public accounting, one must become a Certified Public Accountant (CPA). An accountant may be designated a CPA only after he or she has passed a uniform exam and has met the experience requirements of the state in which they are certified. The American Institute of Certified Public Accountants is responsible for administering the CPA exam. Visit the AICPA at http://www.aicpa.org and click on **Students** to find answers to the following questions.

1. What is a CPA? What are the requirements to become a CPA?

2. What are the recommended areas of study to become a CPA?

3. What skills are needed to become a successful accountant/CPA?

4. What are the different career paths in accounting?

Solutions: Information available on website.

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 8 - World Wide Web Financial Research Activity

Chapter 2

Johnson & Johnson is an international company committed to social responsibility. Visit Johnson & Johnson at http://www.johnsonjohnson.com and click on **our Company** and **Our Credo values.**

1. Provide a brief summary outlining Johnson & Johnson's executives' position on social responsibility.

2. List specific examples of social programs in which Johnson & Johnson is involved.

Solutions: Information available on website.

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.