CHAPTER 2
INVESTING AND FINANCING DECISIONS AND THE ACCOUNTING SYSTEM

Learning Objectives and Related Assignment Materials

Learning Objectives	*Mini-Exercises*	*Exercises*	*Problems*	*Alternate Problems*	*Continuing Problem*	*Cases and Projects*
2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.	1, 2, 4	1, 2, 3, 5, 7, 21	1	1		1, 2, 5, 7, 8
2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.	2, 3, 4	1, 2, 3, 21	1, 2, 3, 5	1, 2, 3		1, 2, 3, 4, 6, 9
2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.	2, 5	1, 4, 5	2	2		
2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.	1, 2, 6, 7, 8, 9	1, 3, 6, 7, 8, 9, 10, 11, 12, 13, 14 15, 16, 17, 18,	1, 3, 5	1, 3	1	6
2-5 Prepare a trial balance and simple classified balance sheet and analyze the company using the current ratio.	10, 11, 12	11, 12, 15, 16, 21,	2, 3, 5	2, 3	1	1, 2, 3, 4, 5, 6, 7, 9
2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.	13	19, 20, 21	4, 6	4	1	1, 2, 3, 4, 9

Synopsis of Chapter Revisions

Focus Company: Chipotle Mexican Grill

- Chapter 2 introduces the accounting cycle for **Chipotle Mexican Grill**, a relatively simple company facing mounting competition. The chapter integrates typical financial information for investing and financing activities for the first quarter of 2018, resulting in a quarterly balance sheet (with a few simplifications). This fast-casual restaurant does not utilize franchising, thus reducing the complexities found with most other competitors and allowing focused emphasis on transaction analysis, journal entries, T-accounts, and the structure of the balance sheet.
- **Simplified illustration numbers** (now in millions).
- Modified the **format of journal entries** to be consistent with what students will see in Connect.
- Added **DATA ANALYTICS** feature that introduces students to the concept, how Chipotle Mexican Grill utilizes data analytics in decision making, and provides information on what a data-driven focus means to future employment opportunities.
- Focus and contrast company data updated.
- Highlighted **GUIDED HELP** features provide free access to step-by-step video instruction applying transaction analysis to identify accounts and effects on the accounting equation and another Guided Help for recording, posting, and classifying accounts for financing and investing activities.
- ***New* General Ledger Problem** designations for a few exercises and problems that also may be completed manually.
- ***New* General Ledger Problem** designation for the **CONTINUING PROBLEM** in the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 2, students prepare journal entries, post to T-accounts, prepare a trial balance and classified balance sheet, identify investing and financing activities affecting cash flows, and compute and interpret the current ratio based on the balance sheet for Penny's Pool Service & Supply.
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.
- Revised Annual Report Cases that can be graded through Connect.

PowerPoint Slides

Learning Objectives	*PowerPoint® Slides*
2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.	2-4 through 2-9
2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.	2-10 through 2-13
2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.	2-14 through 2-23
2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.	2-24 through 2-36
2-5 Prepare a trial balance and simple classified balance sheet and analyze the company using the current ratio.	2-37 through 2-44
2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.	2-45 through 2-46

Chapter Take-Aways

2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.

Objective:

- The primary objective of financial reporting to external users is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

Qualitative characteristics of useful financial information:

- Relevance (including materiality) allows users to assess past activities and/or predict future activities.
- Faithful representation requires information to be complete, neutral, and free from error.
  - To enhance its qualitative characteristics, information should also be comparable (to other companies and over time), verifiable, timely, and understandable.

Key recognition, measurement, and disclosure concepts:

Assumptions—

- Separate entity assumption—Transactions of the business are accounted for separately from transactions of the owner.
- Going concern assumption—A business is expected to continue to operate into the foreseeable future.
- Monetary unit assumption—Financial information is reported in the national monetary unit without adjustment for changes in purchasing power.

Principles—

- Mixed-attribute measurement model—Most balance sheet elements are recorded following the historical cost (or cost) principle—financial statement elements should be recorded at the cash equivalent cost on the date of the transaction; however, these values may be adjusted to other amounts, such as market value, depending on certain conditions.

Elements of the balance sheet:

- Assets—Probable future economic benefits owned or controlled by the entity as a result of past transactions.
- Liabilities—Probable future sacrifices of economic benefits arising from present obligations of a business as a result of past transactions.
- Stockholders' equity—Residual interest of owners in the assets of the entity after settling liabilities; the financing provided by the owners (contributed capital) and by business operations (earned capital).

2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.

- An exchange of cash, goods, or services for cash, goods, services, or promises between a business and one or more external parties to a business (not the exchange of a promise for a promise), or
- A measurable internal event, such as adjustments for the use of assets in operations.

An account is a standardized format that organizations use to accumulate the dollar effects of transactions related to each financial statement item. Typical balance sheet account titles include the following:

- *Assets*: Cash, Accounts Receivable, Inventory, Prepaid Expenses, Investments, Property (buildings and land) and Equipment, and Intangible (rights without physical substance).
- *Liabilities*: Accounts Payable, Notes Payable, Accrued Expenses Payable, Unearned Revenues, and Taxes Payable.
- *Stockholders' Equity*: Common Stock, Additional Paid-in Capital, and Retained Earnings.

<u>Chapter Take-Aways</u>, continued

2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.

To determine the economic effect of a transaction on an entity in terms of the accounting equation, each transaction must be analyzed to determine the accounts (at least two) that are affected. In an exchange, the company receives something and gives up something. If the accounts, direction of the effects, and amounts are correctly analyzed, the accounting equation will stay in balance. The transaction analysis model is:

ASSETS (many accounts)	=	**LIABILITIES** (many accounts)	+	**STOCKHOLDERS' EQUITY** — **Contributed Capital** (2 accounts)	**STOCKHOLDERS' EQUITY** — **Earned Capital** (1 account)
				Common Stock and **Additional Paid-in Capital**	**Retained Earnings**
+ debit | – credit		– debit | + credit		– debit | + credit (Investments by owners)	– debit (Dividends declared) | + credit (Net income (expanded in Ch. 3))

Systematic transaction analysis includes (1) determining the accounts that were received and were given in the exchange, including the type of each account (A, L, or SE), the amounts, and the direction of the effects, and (2) determining that the accounting equation remains in balance.

2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.

- Journal entries express the effects of a transaction on accounts in a debits-equal-credits format. The accounts and amounts to be debited are listed first. Then the accounts and amounts to be credited are listed below the debits and indented, resulting in debit amounts on the left and credit amounts on the right. Each entry needs a reference (date, number, or letter).

		<u>Debit</u>	<u>Credit</u>
(a)	Cash (+A)	62,300	
	Common Stock (+SE)		100
	Additional Paid-in Capital (+SE)		62,200

- T-accounts summarize the transaction effects for each account. These tools can be used to determine balances and draw inferences about a company's activities.

+ (dr) **Assets**	(cr) –
Beginning balance Increases	Decreases
Ending balance	

– (dr) **Liabilities and Stockholders' Equity**	(cr) +
Decreases	Beginning balance Increases
	Ending balance

Chapter Take-Aways, continued

2-5 Prepare a trial balance and simple classified balance sheet and analyze the company using the current ratio.

A trial balance lists all accounts and their balances, with debit balances in left column and credit balances in the right column. The two columns are added to determine if debits equal credits.

Classified balance sheets are structured as follows:

- Assets are categorized as current assets (those to be used or turned into cash within the year, with inventory always considered a current asset) and noncurrent assets, such as long-term investments, property and equipment, and intangible assets.
- Liabilities are categorized as current liabilities (those that will be paid within the next 12 months with current assets) and long-term liabilities.
- Stockholders' equity accounts are listed as Common Stock (number of shares × par value per share) and Additional Paid-in Capital (number of shares × excess of market value over par value per share) first, followed by Retained Earnings (earnings reinvested in the business).

The current ratio (Current Assets ÷ Current Liabilities) measures a company's liquidity, that is, the ability of the company to pay its short-term obligations with current assets.

2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.

A statement of cash flows reports the sources and uses of cash for the period by the type of activity that generated the cash flow: operating, investing, and financing. Investing activities include purchasing and selling long-term assets and making loans and receiving principal repayments from others. Financing activities include borrowing from and repaying to banks the principal on loans, issuing and repurchasing stock, and paying dividends.

Key Ratio

Current ratio measures the ability of the company to pay its short-term obligations with current assets. Although a ratio above 1.0 indicates sufficient current assets to meet obligations when they come due, many companies with sophisticated cash management systems have ratios below 1.0 (see the "Key Ratio Analysis" box in the How is the Balance Sheet Prepared and Analyzed? Section):

Current Ratio = Current Assets ÷ Current Liabilities

Finding Financial Information

BALANCE SHEET		INCOME STATEMENT
Current Assets	***Current Liabilities***	*To be presented in Chapter 3*
Cash	Accounts payable	
Short-term investments	Accrued expenses payable	
Accounts receivable	Short-term notes payable	
Notes receivable	Unearned revenue	
Inventory	***Noncurrent Liabilities***	
Prepaid expenses	Long-term debt (notes payable)	
Noncurrent Assets	***Stockholders' Equity***	
Long-term investments	Common Stock	
Property and equipment	Additional paid-in capital	
Intangibles	Retained earnings	

STATEMENT OF CASH FLOWS	NOTES
Operating Activities	*To be discussed in future chapters*
To be presented in Chapter 3	
Investing Activities	
+ Sales of noncurrent assets and investments for cash	
– Purchases of noncurrent assets and investments for cash	
– Loans to others	
+ Receipt of loan principal payments from others	
Financing Activities	
+ Borrowing from banks	
– Repayment of loan principal to banks	
+ Issuance of stock	
– Repurchasing stock	
– Dividends paid	

Chapter Outline	Teaching Notes
LO 2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.	
I. Overview of Accounting Concepts—Concepts Emphasized in Chapter 2	*Conceptual Framework summarized in Exhibit 2.1*
A. Objective of Financial Reporting 1. Primary objective of external financial reporting is to provide useful economic information about a business to help external parties make sound financial decisions about providing resources to the entity 2. Decision makers—users of accounting information; include existing and potential investors, lenders, and other creditors. 3. Most are interested in information needed to assess amount, timing, and uncertainty of business's future cash inflows and outflows.	
B. Qualitative Characteristics of Financial Information 1. Relevant information—can influence a decision; it is timely and has predictive and/or feedback value. To be reported, the information should also be material in amount. 2. Faithful representation—requires information to be complete, neutral, and free from error 3. Qualitative aspects that enhance the usefulness of information that is relevant and faithfully representative include: comparability, verifiability, timeliness, and understandability	
C. Recognition and Measurement Concepts 1. Separate-entity assumption—business transactions are accounted for separately from the transactions of owners 2. Going concern assumption (also called continuity assumption)—unless there is evidence to the contrary, business is expected to continue operating into the foreseeable future 3. Monetary unit assumption—each business entity accounts for and reports its financial results primarily in terms of the national monetary unit without any adjustments for changes in purchasing power 4. Mixed-attribute measurement model: a. Applied to measuring different assets and liabilities b. Most balance sheet elements are recorded at their cost (historical cost), which is the cash-equivalent value on the date of the transaction	
D. Elements of the Balance Sheet 1. Assets—probable future economic benefits owned or controlled by an entity as a result of past transactions or events	*Chipotle's Balance Sheet illustrated in Exhibit 2.2*

2. Assets are listed in order of liquidity—how soon an asset is expected by management to be turned into cash or used
   i. Current assets –will be used or turned into cash within one year
   ii. All other assets are considered long term (or noncurrent); that is, they are to be used or turned into cash after the coming year.

See Financial Analysis feature "Unrecorded But Valuable Assets and Liabilities"

3. Liabilities—probable future sacrifices of economic benefits arising from present obligations of a business to transfer cash or other assets or to provide services as a result of past transactions or events
   a. Creditors—entities that a company owes money
   b. Liabilities are usually listed on the balance sheet in order of maturity (how soon an obligation is to be paid)
      i. Current liabilities—obligations that will be settled by providing cash, goods, other current assets, or services within the coming year
      ii. All other liabilities are considered long term (or noncurrent)
4. Stockholders' equity (also called shareholders' equity or owners' equity)—the residual interest in the assets of the entity after subtracting liabilities
   a. Financing provided by owners—referred to as contributed capital
   b. Financing provided by operations—referred to as earned capital or retained earnings
      i. When companies earn profits, they can be distributed to owners as dividends or reinvested in the business; the portion of profits reinvested in the business is called retained earnings
      ii. Companies with a growth strategy often pay little or no dividends to retain funds for expansion

Refer students to Pause for Feedback – Self-Study Quiz

LO 2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.

II. What Business Activities Cause Changes in Financial Statement Amounts?
   A. Nature of Business Transactions
      1. A transaction is an event that has economic impact on the entity; these events are recorded as part of the accounting process.
      2. Only economic resources and debts resulting from past transactions are recorded on the balance sheet
         a. External events—exchanges of assets, goods, or services by one party for assets, services, or promises to pay (liabilities) by one or more other parties
         b. Internal events—include certain events that are not

exchanges between the business and other parties but nevertheless have a direct and measurable effect on the entity

   c. Some important events have a future economic impact on a company, but are not reflected in the financial statements (e.g., an exchange of promises)

B. Accounts

1. Account—a standardized format that organizations use to accumulate the dollar effect of transactions on each financial statement item — *Illustrated in Exhibit 2.3*
2. Chart of accounts—a list of all account titles and their unique numbers; are usually organized by financial statement element (asset, liability, stockholders' equity, revenue, and expense accounts in that order)
3. Every company creates its own chart of accounts to fit the nature of its business activities
4. The accounts in the financial statements of large companies are actually summations of a number of specific accounts in their recordkeeping system

LO 2-3 *Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.*

III. How Do Transactions Affect Accounts?

A. Principles of Transaction Analysis

1. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation
2. Two principles underlying the transaction analysis:
   a. Every transaction affects at least two accounts; correctly identifying those accounts and the direction of the effect (increase or decrease) is critical — *Stress the importance of a clear understanding of these principles*
   b. The accounting equation must remain in balance after each transaction
3. Dual effects concept—every transaction has at least two effects on the basic accounting equation
4. Most transactions with external parties involve an exchange by which the business entity both receives something and gives up something in return
   a. If Chipotle purchases tomatoes for cash, it receives food supplies (an increase in an asset) and gives up cash (a decrease in an asset)
   b. If Chipotle purchases tomatoes on credit (that is, money is owed to suppliers) for cash, it would engage in two separate transactions at different points in time
      i. It receives food supplies (an increase in an asset) and gives a promise to pay later (an increase in a liability)
      ii. Later, It pays cash (a decrease in an asset) and eliminates the promise (a decrease in a liability)

c. Not all important business activities result in a transaction that affects the financial statements
   i. Most importantly, signing a contract involving the exchange of two promises to perform does not result in an accounting transaction that is recorded
   ii. For example, if Chipotle sent an order for tomatoes to its food supplier and the supplier accepted the order but did not fill it immediately, no transaction took place

5. Balancing the Accounting Equation
   a. Step 1: Ask—What was received and what was given?
      i. Identify the account affected by title, making sure that at least two accounts change
      ii. Classify them by type of account—Asset (A), a liability (L), or a stockholders' equity (SE) account?
      iii. Determine the direction of the effect—Did the account increase (+) or decrease (−)?
   b. Step 2: Verify—Is the accounting equation in balance? (A = L + SE)

B. Analyzing Chipotle's Transactions (all amounts in millions, except per share data)

Use Supplemental Enrichment Activity #1

Use Supplemental Enrichment Activity#2

1. Transaction (a) Chipotle issued (sold) 100 additional shares of common stock with a par value of $.01 per share and at a market value of $3.00 per share, receiving $300 in cash from investors—a financing activity
   a. Related terminology
      i. Par value—a legal amount per share established by the board of directors; it represents the minimum amount a stockholder must contribute and has no relationship to the market price of the stock
      ii. Common stock—the account that is equal to the number of shares issued by a corporation times the par value per share
      iii. Additional paid-in capital (or Paid-in Capital or Contributed Capital in Excess of Par)—the amount of capital contributed by the shareholders less the par value of the stock
   a. Step 1: What was received and what was given?
      Received: Cash (+A) $300
      Given: Additional stock shares, Common Stock (+SE) $1 (100 shares × $0.01) and Additional Paid-in Capital $299 ($300 -$1)
   b. Step 2: Is the accounting equation in balance?
      Yes. The left side increased by $300 and the right side increased by $300
      Assets = Liabilities + Stockholders' Equity
      Cash (A) + 300 = Common Stock (SE) + 1 +
      Additional Paid-in Capital (SE) + 299

2. Transaction (b) Chipotle borrowed \$2 from its local bank, signing a note to be paid in three years—a financing activity
   a. Step 1: What was received and what was given?
      Received: Cash (+A) \$2
      Given: Written promise to the bank, Long-Term Notes Payable (+L) \$2
   b. Step 2: Is the accounting equation in balance?
      Yes. The left side increased by \$2 and the right side increased by \$2
      Assets = Liabilities + Stockholders' Equity
      Cash (A) + 2= Long-Term Notes Payable (L) + 2
3. Transaction (c) Chipotle purchased \$8 in additional land, \$34 in new buildings, \$10 in new equipment, and \$3 in additional intangible assets; paid \$54 in cash and signed a short-term note payable for the remainder owed (\$1)—an investing activity
   a. Step 1: What was received and what was given?
      Received: Property and Equipment (+A) \$52 and Intangible Assets (+A) \$3
      Given: (1) Cash (−A) \$54 (2) Short-Term Notes Payable (+L) \$1
   b. Step 2: Is the accounting equation in balance?
      Yes. The left side increased by \$1 and the right side increased by \$1
      Assets = Liabilities + Stockholders' Equity
      Cash (A) − 54 + Property and Equipment (A) + 52+ Intangible Assets (A) +3= Short-Term Notes Payable (L) + 1
4. Transaction (d) Chipotle paid \$1 on the short-term note payable in (c)—a financing activity (ignore interest)
   a. Step 1: What was received and what was given?
      Received: Reduction in amount due: Short-Term Notes Payable (−L) \$1 Given: Cash (−A) \$1
   b. Step 2: Is the accounting equation in balance?
      Yes. The equation stays in balance because assets and liabilities decrease by the same amount, \$1
      Assets = Liabilities + Stockholders' Equity
      Cash (A) –1 = Short-Term Notes Payable (L) – 1

5. Transaction (e) Chipotle purchased the stock of other companies as investments, paying $44 in cash; of this $9 was in short-term investments and $35 was in long-term investments—an investing activity
   a. Step 1: What was received and what was given?
      Received: Short-Term Investments (+A) $9 and Long-Term Investments (+A) $35
      Given: Cash (−A) $44
   b. Step 2: Is the accounting equation in balance?
      Yes. The equation stays in balance because assets increase and decrease by the same amount, $44
      Assets = Liabilities + Stockholders' Equity
      Cash (A) – 44,000 + Short-Term Investments (A) + 9 + Long-Term Investments (A) + 35 = No change
6. Transaction (f) Chipotle's board of directors declared that the Company will pay $2 in cash dividends to shareholders next quarter—a financing activity
   a. Step 1: What was received and what was given?
      Received: Lower claim from stockholders, Retained Earnings (−SE) $2
      Given: Dividends Payable (+L) $2
   b. Step 2: Is the accounting equation in balance?
      Yes. The equation stays in balance because liabilities increase and stockholders' equity decreases by the same amount, $2
      Assets = Liabilities + Stockholders' Equity
      No change = Dividends Payable (L) + $2 + Retained Earnings (SE) − $2

Note that Chipotle does actually not pay dividends; it reinvests profits

Refer students to Pause for Feedback – Self-Study Quiz

Refer students to Guided Help 2-1

LO2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.

IV. How Do Companies Keep Track of Account Balances?
   A. The accounting cycle—the process followed by entities to analyze and record transactions, adjust the records at the end of the period, prepare financial statements, and prepare the records for the next cycle; during the accounting cycle:
      1. Transactions are analyzed and recorded in the general journal in chronological order
      2. The related accounts are updated in the general ledger

Accounting cycle illustrated in Exhibit 2.4

   B. The Direction of Transaction Effects
      1. Each account is set up as a "T" with the following structure:
         a. Increases in asset accounts are on the left because assets are on the left side of the accounting equation
         b. Increases in liability and stockholders' equity accounts are on the right because liability and stockholders' equity are on the right side of the accounting equation

Illustrated in Exhibit 2.5

2. Names for each side of an account:
   a. Debit (dr) is on the left side of the T
   b. Credit (cr) is on the right side of the T
3. Rules for increases and decreases:
   a. Asset accounts increase on the left (debit) side and they normally have debit balances
   b. Liability and stockholders' equity accounts increase on the right (credit) side and they normally have credit balances
4. Summary:

Assets	=	Liabilities	+	Stockholders' Equity
Increase with debits		Increase with credits		Increase with credits
Accounts have debit balances		Accounts have credit balances		Accounts have credit balances

5. If the correct accounts and effects are identified, the accounting equation will remain in balance because the total debits will equal the total credits in a transaction

Refer students to Pause for Feedback – Self-Study Quiz

C. Analytical Tools:
1. Transactions are recorded in chronological order in a general journal (or simply, journal)
2. Journal entry—an accounting method for expressing the effects of a transaction on accounts in a debits-equal-credits format
   a. It is useful to include a date or some form of reference for each transaction
   b. The debited accounts are written first (on top) with the amounts recorded in the left column
   c. The credited accounts are written below the debits and are usually indented with the credited amounts written in the right column
   d. Total debits equal total credits.
   e. Compound entry—a journal entry that affects more than two accounts
3. T-account—A tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities
   a. By themselves, journal entries do not provide the balances in accounts
   b. After journal entries are recorded, the dollar amounts are posted (transferred) to each account affected by the transaction to determine the new account balances
   c. As a group, the accounts are called a general ledger

Posting transaction effects illustrated in Exhibit 2.6

See Financial Analysis feature "Inferring Business Activities from T-Accounts"

T-accounts illustrated in Exhibit 2.7

Use Supplemental Enrichment Activity #3

Use Supplemental Enrichment Activity#4

D. Transaction Analysis Illustrated (all amounts in millions, except per share data)
   1. Transaction (a) Chipotle issued (sold) 100 additional shares of common stock with a par value of $.01 per share and at a market value of $3 per share, receiving $300 in cash from investors

dr Cash (+A)	300	
cr Common Stock (+SE)		1
cr Additional Paid-in Capital (SE)		299

      Assets = Liabilities + Stockholders' Equity
      Cash (A) + 300 = Common Stock (SE) + 1 + Additional Paid-in Capital + 299 (SE)
   2. Transaction (b) Chipotle borrowed $2 from its local bank, signing a note to be paid in three years

dr Cash (+A)	2	
cr Long-Term Notes Payable (+L)		2

      Assets = Liabilities + Stockholders' Equity
      Cash (A) + 2 = Long-Term Notes Payable (L) + 2
   3. Transaction (c) Chipotle purchased $8 in additional land, $34 in new buildings, $10 in new equipment, and $3 in additional intangible assets; paid $54 in cash and signed a short-term note payable for the remainder owed ($1)

dr Land (+A)	8	
dr Buildings (+A)	34	
dr Equipment (+A)	10	
dr Intangible Assets (+A)	3	
cr Cash (–A)		54
cr Short-Term Notes Payable (+L)		1

      Assets = Liabilities + Stockholders' Equity
      Cash (A) – 54 + Land (A) + 8 + Buildings (A) + 34 + Equipment (A) + 10 + Intangible Assets (A) + 3 = Short-Term Notes Payable (L) + 1
   4. Transaction (d) Chipotle paid $1 on the short-term note payable in (c) (ignore interest)

dr Short-Term Notes Payable (–L)	1	
cr Cash (–A)		1

      Assets = Liabilities + Stockholders' Equity
      Cash (A) − $1= Short -Term Notes Payable (L) − $11 1

5. Transaction (e) Chipotle purchased the stock of other companies as investments, paying $44 in cash; of this $9 was in short-term investments and $35 was in long-term investments dr Short-Term Investments (+A) 35 dr Long-Term Investments (+A) 9 cr Cash (–A) 44 Assets = Liabilities + Stockholders' Equity Cash (A) – 44 + Short-Term Investments (A) + 35 + Long-Term Investments (A) + 9 = No change	*Refer students to Pause for Feedback – Self-Study Quiz*
6. Transaction (f) Chipotle's board of directors declared that the Company will pay $3,000 in cash dividends to shareholders next quarter dr Retained Earnings (–SE) 2 cr Dividends Payable (+L) 2 Assets = Liabilities + Stockholders' Equity No change = Dividends Payable (L) + $2 + Retained Earnings (SE) − $2	*Refer students to Guided Help 2-2* *See Data Analytics feature "Using Big Data for Business Expansion"*
7. Posting of these transactions to the T-accounts is illustrated in the text after the analysis of transaction (f)	*Use Supplemental Enrichment Activity #5*

LO 2-5 Prepare a trial balance and simple classified balance sheet and analyze the company using the current ratio.

V. How Is the Balance Sheet Prepared and Analyzed?	
A. Trial Balance	
1. Trial balance—list of all accounts with their balances to provide a check on the equality of the debits and credits	*Use Supplemental Enrichment Activity #6*
2. A trial balance spreadsheet is created first for internal purposes before preparing statements for external users	
3. A trial balance lists the names of the T-accounts in one column in financial statement order (assets, liabilities, stockholders' equity, revenues, and expenses), with their ending debit or credit balances in the next two columns	
4. Debit balances are indicated in the left column and credit balances are indicated in the right column	
5. Then the two columns are totaled to provide a check on the equality of the debits and credits	
6. Errors in a computer-generated trial balance may exist if wrong accounts and/or amounts are used in the journal entries	
B. Classified Balance Sheet 1. Prepared from the trial balance 2. The assets and liabilities are classified into two categories: current and noncurrent	*Chipotle's Balance Sheet illustrated in Exhibit 2.8* *Use Supplemental Enrichment Activity #7*
3. Dollar signs are indicated at the top and bottom of the asset section and top and bottom of the liabilities and shareholders' equity section	

4. Includes comparative data; when multiple periods are presented, the most recent balance sheet amounts are usually listed on the left

See International Perspective feature "Understanding Foreign Financial Statements"

C. Ratio Analysis in Decision Making
   1. Users of financial information compute a number of ratios in analyzing a company's past performance and financial condition as input in predicting its future potential
   2. How ratios change over time and how they compare to the ratios of the company's competitors or industry averages provide valuable information about a company's strategies for its operating, investing, and financing activities

D. Key Ratio Analysis: Current Ratio
   1. Current Ratio = Current Assets – Current Liabilities
   2. Creditors and security analysts use the current ratio to measure the ability of the company to pay its short-term obligations with short-term assets

      Use Supplemental Enrichment Activity #8
   3. Generally, the higher the ratio, the more cushion a company has to pay its current obligations if future economic conditions take a downturn
   4. While a high ratio normally suggests good liquidity, too high of a ratio suggests inefficient use of resources
   5. An old rule of thumb was that companies should have a current ratio between 1.0 and 2.0; today, many strong companies have current ratios below 1.0

      Refer students to Pause for Feedback – Self-Study Quiz

LO 2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.

VI. Focus on Cash Flows - Investing and Financing Activities

A. The statement of cash flows divides all transactions that affect cash into three categories:
   1. Operating activities (covered in Chapter 3)
   2. Investing activities include buying and selling noncurrent assets and investments
   3. Financing activities include borrowing and repaying debt, including short-term bank loans, issuing and repurchasing stock, and paying dividends

4. Effects of transactions in this chapter on the statement of cash flows:
   Operating Activities
   (None of the transactions impact operating activities)
   Investing Activities
   − Purchasing long-term assets and investments for cash
   + Selling long-term assets and investments for cash
   − Lending cash to others
   Financing Activities
   + Borrowing cash from banks
   − Repaying the principal on borrowings from banks
   + Issuing stock for cash
   − Paying cash dividends

Refer students to Pause for Feedback – Self-Study Quiz

Supplemental Enrichment Activities

Note: These activities would be suitable for individual or group activities.

1. Handout 2-1

   Use this handout for an in-class activity designed to review the analysis of various investing and financing transactions. The solution follows the handout master.

2. Handout 2-2

   This activity is a continuation of Activity #1. Use this handout for an in-class activity designed to continue the review of the analysis of various investing and financing transactions. The solution follows the handout master.

3. Handout 2-3

   Use Handout 2-3 for an in-class activity designed to review the debit/credit framework. Note that these transactions are the same as those analyzed on Handout 2-1. However, it can be assigned even if Activity #1 was not assigned. The solution follows the handout master.

4. Handout 2-4

   This activity is a continuation of Activity #3. Use this handout for an in-class activity designed to review the debit/credit framework. Note that these transactions are the same as those analyzed on Handout 2-2. However, it can be assigned even if Activity #2 was not assigned. The solution follows the handout master.

5. Handout 2-5

   Use this handout for an in-class activity designed to review the posting of various investing and financing transactions to T-accounts. This activity is a continuation of Activity #3 and Activity #4; it should be assigned only if both of those activities were assigned. The solution follows the handout master.

6. Handout 2-6

   Use this handout for an in-class activity designed to review the preparation of a trial balance. This activity is a continuation of Activity #5; it should be assigned only if that activity was assigned. The solution follows the handout master.

7. Handout 2-7

   Use this handout for an in-class activity designed to review the preparation of a classified balance sheet. This activity is a continuation of Activity #6; it should be assigned only if that activity was assigned. The solution follows the handout master.

8. Use Handout 2-8

   Use this handout for an in-class activity designed to review the calculation and interpretation of the current ratio. This activity is a continuation of Activity #7; it should be assigned only if that activity was assigned. The solution follows the handout master.

HANDOUT 2 – 1

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

<u>HANDOUT 2 – 1</u>, continued

(d) Purchase $300 worth of supplies from a vendor on credit. (“On credit,” or “on account,” means that the company received the supplies now and will pay for them later.)

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(e) Sign contract for first website design for $10,000.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities			+	Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)						=					
(b)						=					
(c)						=					
(d)						=					
Total						=					
						=					
						=					

HANDOUT 2 – 1 SOLUTION

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

1.	Decide if a transaction took place.	Yes – received cash and gave stock.
2.	Identify the accounts affected.	Cash and Common Stock
3.	Classify each account affected.	Cash is an Asset (A) and Common Stock is Stockholders' Equity (SE)
4.	Identify direction and amount.	Cash (A) + $10,000 = Common Stock (SE) + $10,000.
5.	Ensure the accounting equation is in balance.	Yes – see below.

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

1.	Decide if a transaction took place.	Yes – received cash and gave a short-term note payable.
2.	Identify the accounts affected.	Cash and Short-Term Notes Payable
3.	Classify each account affected.	Cash is an Asset (A) and Short-Term Notes Payable is a Liability (L)
4.	Identify direction and amount.	Cash (A) + $15,000 = Short-Term Notes Payable + $15,000.
5.	Ensure the accounting equation is in balance.	Yes – see below.

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

1.	Decide if a transaction took place.	Yes – paid cash and received truck and equipment.
2.	Identify the accounts affected.	Cash and Equipment
3.	Classify each account affected.	Cash is an Asset (A) and Equipment is an Asset (A)
4.	Identify direction and amount.	Cash (A) - $20,000 and Equipment (A) + $20,000
5.	Ensure the accounting equation is in balance.	Yes – see below.

HANDOUT 2 – 1 SOLUTION, continued

(d) Purchase $300 worth of supplies from a vendor on credit. (“On credit,” or “on account,” means that the company received the supplies now and will pay for them later.)

1.	Decide if a transaction took place.	Yes – received supplies and obligated to pay for them.
2.	Identify the accounts affected.	Supplies and Accounts Payable
3.	Classify each account affected.	Supplies is an Asset (A) and Accounts Payable is a Liability (L)
4.	Identify direction and amount.	Supplies (A) + $300 and Accounts Payable (L) + $300.
5.	Ensure the accounting equation is in balance.	Yes – see below.

(e) Sign contract for first website design for $10,000.

1.	Decide if a transaction took place.	No – no exchange took place.
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities			+	Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)	+10,000					=					+10,000
(b)	+15,000					=			+15,000		
(c)	–20,000				+20,000	=					
(d)			+300			=	+300				
Total	5,000		300		20,000		300		15,000		10,000
	Assets $25,300					=	Liabilities $15,300 + Stockholders' Equity $10,000				
	$25,300					=	$25,300				

HANDOUT 2 – 2

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(f) Company pays $300 on accounts payable to the vendor in (d).

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(g) Company pays for and receives $600 worth of supplies.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(h) Company acquires and receives $1,000 worth of equipment.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

HANDOUT 2 – 2, continued

(i) Order a $900 lawn mower, to be delivered next month.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities			+	Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)	+10,000					=					+10,000
(b)	+15,000					=			+15,000		
(c)	–20,000				+20,000	=					
(d)			+300			=	+300				
(f)						=					
(g)						=					
(h)						=					
(i)						=					
Total						=					
						=					
						=					

HANDOUT 2 – 2 SOLUTION

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(f) Company pays $300 on accounts payable to the vendor in (d).

1.	Decide if a transaction took place.	Yes – paid cash to reduce accounts payable.
2.	Identify the accounts affected.	Cash and Accounts Payable
3.	Classify each account affected.	Cash is an Asset (A) and Accounts Payable is a Liability (L)
4.	Identify direction and amount.	Cash (A) – $300 = Liabilities (L) – $300
5.	Ensure the accounting equation is in balance.	Yes – see below.

(g) Company pays for and receives $600 worth of supplies.

1.	Decide if a transaction took place.	Yes – paid cash to purchase supplies.
2.	Identify the accounts affected.	Cash and Supplies
3.	Classify each account affected.	Cash is an Asset (A) and Supplies is an Asset
4.	Identify direction and amount.	Cash (A) – $600 and Supplies (A) + $600.
5.	Ensure the accounting equation is in balance.	Yes - see below.

(h) Company acquires and receives $1,000 worth of equipment.

1.	Decide if a transaction took place.	Yes – paid cash to purchase equipment
2.	Identify the accounts affected.	Cash and Equipment
3.	Classify each account affected.	Cash is an Asset (A) and Equipment is an Asset (A)
4.	Identify direction and amount.	Cash (A) – $1,000 and Equipment (A) + $1,000
5.	Ensure the accounting equation is in balance.	Yes - see below.

HANDOUT 2 – 2 SOLUTION, continued

(i) Order a $900 computer, to be delivered next month.

1.	Decide if a transaction took place.	No exchange took place.
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities			+	Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)	+10,000					=					+10,000
(b)	+15,000					=			+15,000		
(c)	–20,000				+20,000	=					
(d)			+300			=	+300				
(f)	–300						–300				
(g)	–600		+600								
(h)	–1,000				+1,000						
(i)											
Total	3,100		900		21,000		0		15,000		10,000
	Assets $25,000					=	Liabilities $15,000 + Stockholders' Equity $10,000				
	$25,000					=	$25,000				

HANDOUT 2 – 3

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

<u>HANDOUT 2 – 3</u>, continued

(d) Purchase $300 worth of supplies from a vendor on credit. ("On credit," or "on account," means that the company received the supplies now and will pay for them later.)

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(e) Sign contract for first website design for $10,000.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

HANDOUT 2 – 3 SOLUTION

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

Debit and credit the accounts affected

(a)	Cash (+A)	10,000	
	Common Stock (+SE)		10,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	+10,000					Common Stock	+10,000

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

Debit and credit the accounts affected

(b)	Cash (+A)	15,000	
	Short-Term Notes Payable (+L)		15,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	+15,000		Short-Term Notes Payable	+15,000			

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

Debit and credit the accounts affected

(c)	Equipment (+A)	20,000	
	Cash (–A)		20,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash Equipment	–20,000 +20,000						

<u>HANDOUT 2 – 3 SOLUTION</u>, continued

(d) Purchase $300 worth of supplies from a vendor on credit. ("On credit," or "on account," means that the company received the supplies now and will pay for them later.)

Debit and credit the accounts affected

(d)	Supplies (+A)	300	
	Accounts Payable (+A)		300

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Supplies	+300		Accounts Payable	+300			

(e) Sign contract for first website design for $10,000.

No entry – this is not a transaction

HANDOUT 2 – 4

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(f) Company pays $300 on accounts payable to the vendor in (d).

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	

(g) Company pays for and receives $600 worth of supplies.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(h) Company acquires and receives $1,000 worth of equipment.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

HANDOUT 2 – 4, continued

(i) Order a $900 computer, to be delivered in 90 days.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

HANDOUT 2 – 4 SOLUTION

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(f) Company pays $300 on accounts payable to the vendor in (d).

Debit and credit the accounts affected

(f)	Accounts Payable (–L)	300	
	Cash (–A)		300

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	–300		Acct. Pay.	–300			

(g) Company pays for and receives $600 worth of supplies.

Debit and credit the accounts affected

(g)	Supplies (+A)	600	
	Cash (–A)		600

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	
Supplies	+600					
Cash	–600					

(h) Company acquires and receives $1,000 worth of equipment.

Debit and credit the accounts affected

(h)	Equipment (+A)	1,000	
	Cash (–A)		1,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	
Equipment	+1,000					
Cash	–1,000					

(i) Order a $900 computer, to be delivered in 90 days.

No entry – this is not a transaction.

HANDOUT 2 – 5

POSTING TO T-ACCOUNTS

Post the transactions from handouts 2-3 and 2-4 and determine the ending balances of each of the following T-accounts.

Assets	Liabilities	Stockholders' Equity
+ Cash –	- Accounts Payable +	- Common Stock +
+ Supplies –	- Short-Term Notes Payable +	- Retained Earnings +
+ Equipment –		

HANDOUT 2 – 5 SOLUTION

POSTING TO T-ACCOUNTS

Post the transactions from handouts 2-3 and 2-4 and determine the ending balances of each of the following T-accounts.

Assets

+ Cash –

BegBal	0		
(a)	10,000		
(b)	15,000	20,000	(c)
		300	(f)
		600	(g)
		1,000	(h)
EndBal	3,100		

+ Supplies –

BegBal	0		
(d)	300		
(g)	600		
EndBal	900		

+ Equipment –

BegBal	0		
(c)	20,000		
(h)	1,000		
EndBal	21,000		

Liabilities

- Accounts Payable +

		0	BegBal
(f)	300	300	(d)
		0	EndBal

- Short-Term Notes Payable +

		0	BegBal
		15,000	(b)
		15,000	EndBal

Stockholders' Equity

- Common Stock +

		0	BegBal
		10,000	(a)
		10,000	EndBal

- Retained Earnings +

		0	BegBal
		0	EndBal

HANDOUT 2 – 6

PREPARING A TRIAL BALANCE

Use the ending balances from the T-accounts on Handout 2-5 to prepare a trial balance for World Wide Webster as of December 31 of the current year.

World Wide Webster
Trial Balance
At December 31, Current Year

	Debit	Credit

HANDOUT 2 – 6

PREPARING A TRIAL BALANCE

Use the ending balances from the T-accounts on Handout 2-5 to prepare a trial balance for World Wide Webster as of December 31 of the current year.

World Wide Webster
Trial Balance
At December 31, Current Year

	Debit	Credit
Cash	$ 3,100	
Supplies	900	
Equipment	21,000	
Short-Term Notes Payable		$15,000
Common Stock		10,000
Totals	$25,000	$25,000

HANDOUT 2 – 7 SOLUTION

PREPARING A BALANCE SHEET

Use the balances from the trial balance on Handout 2-6 to prepare a classified balance sheet for World Wide Webster as of December 31 of the current year.

HANDOUT 2 – 7 SOLUTION

PREPARING A BALANCE SHEET

Use the balances from the trial balance on Handout 2-6 to prepare a classified balance sheet for World Wide Webster as of December 31 of the current year.

World Wide Webster
Balance Sheet
At December 31, Current Year

Assets

Current Assets:	
Cash	$ 3,100
Supplies	900
Total Current Assets	4,000
Equipment	21,000
Total Assets	$25,000

Liabilities

Current Liabilities:	
Short-Term Notes Payable	$15,000
Total Current Liabilities	15,000

Stockholders' Equity

Common Stock	10,000
Retained Earnings	0
Total Stockholders' Equity	10,000
Total Liabilities and Stockholders' Equity	$25,000

HANDOUT 2 – 8

CURRENT RATIO

Refer to the classified balance sheet from Handout 2-7 and calculate the current ratio of World Wide Webster as of December 31 of the current year. Then, interpret the current ratio.

Calculation:

Interpretation:

HANDOUT 2 – 8 SOLUTION

CURRENT RATIO

Refer to the classified balance sheet from Handout 2-7 and calculate the current ratio of World Wide Webster as of December 31 of the current year. Then, interpret the current ratio.

Calculation:

Current Ratio = Current Assets ÷ Current Liabilities

Current ratio = $4,000 ÷ $15,000 = 0.27

Interpretation:

A current ratio of 0.27 indicates that the company has $0.27 of current assets for $1.00 of current liabilities. It does not appear that the company's current assets are sufficient to pay its current liabilities.