

CHAPTER 5

Balance Sheet and Statement of Cash Flows

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Disclosure principles, uses of the balance sheet, financial flexibility.	1, 2, 3, 4, 5, 6, 7, 10, 18, 22, 23, 25	1			4, 5
2. Classification of items in the balance sheet and other financial statements.	11, 12, 13, 14, 15, 16, 18, 19	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11	1, 2, 3, 4, 6, 7, 8, 9, 10		1, 2, 3
3. Preparation of balance sheet; issues of format, terminology, and valuation.	4, 7, 8, 9, 16, 17, 20, 21, 24		4, 5, 6, 7, 11, 12	1, 2, 3, 4, 5	3, 4, 5
4. Statement of cash flows.	25, 26, 27, 28, 29, 30, 31, 32	12, 13, 14, 15, 16	13, 14, 15, 16, 17, 18	6, 7	6

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Problems
1. Explain the uses and limitations of a balance sheet.			7
2. Identify the major classifications of the balance sheet.		1, 2, 3, 4, 6, 8, 9	
3. Prepare a classified balance sheet using the report and account formats.	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11	1, 2, 3, 4, 5, 6, 7, 9, 10, 11, 12, 17	1, 2, 3, 4, 5, 6, 7
4. Determine which balance sheet information requires supplemental disclosure.		10	4
5. Describe the major disclosure techniques for the balance sheet.			
6. Indicate the purpose of the statement of cash flows.			
7. Identify the content of the statement of cash flows.		13	
8. Prepare a statement of cash flows.	12, 13, 14, 15	14, 15, 16, 17, 18	6, 7
9. Understand the usefulness of the statement of cash flows.	16	15, 16, 18	6, 7

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E5-1	Balance sheet classifications.	Simple	15–20
E5-2	Classification of balance sheet accounts.	Simple	15–20
E5-3	Classification of balance sheet accounts.	Simple	15–20
E5-4	Preparation of a classified balance sheet.	Simple	30–35
E5-5	Preparation of a corrected balance sheet.	Simple	30–35
E5-6	Corrections of a balance sheet.	Complex	30–35
E5-7	Current assets section of the balance sheet.	Moderate	15–20
E5-8	Current vs. long-term liabilities.	Moderate	10–15
E5-9	Current assets and current liabilities.	Complex	30–35
E5-10	Current liabilities.	Moderate	15–20
E5-11	Balance sheet preparation.	Moderate	25–30
E5-12	Preparation of a balance sheet.	Moderate	30–35
E5-13	Statement of cash flows—classifications.	Moderate	15–20
E5-14	Preparation of a statement of cash flows.	Moderate	25–35
E5-15	Preparation of a statement of cash flows.	Moderate	25–35
E5-16	Preparation of a statement of cash flows.	Moderate	25–35
E5-17	Preparation of a statement of cash flows and a balance sheet.	Moderate	30–35
E5-18	Preparation of a statement of cash flows, analysis.	Moderate	25–35
P5-1	Preparation of a classified balance sheet, periodic inventory.	Moderate	30–35
P5-2	Balance sheet preparation.	Moderate	35–40
P5-3	Balance sheet adjustment and preparation.	Moderate	40–45
P5-4	Preparation of a corrected balance sheet.	Complex	40–45
P5-5	Balance sheet adjustment and preparation.	Complex	40–50
P5-6	Preparation of a statement of cash flows and a balance sheet.	Complex	35–45
P5-7	Preparation of a statement of cash flows and a balance sheet.	Complex	40–50
C5-1	Reporting for financial effects of varied transactions.	Moderate	25–30
C5-2	Current asset and liability classification.	Moderate	30–35
C5-3	Identifying balance sheet deficiencies.	Moderate	20–25
C5-4	Critique of balance sheet format and content.	Simple	25–30
C5-5	Presentation of property, plant, and equipment.	Simple	20–25
C5-6	Cash flow analysis.	Complex	40–50

ANSWERS TO QUESTIONS

1. The balance sheet provides information about the nature and amounts of investments in enterprise resources, obligations to enterprise creditors, and the owners' equity in net enterprise resources. That information not only complements information about the components of income, but also contributes to financial reporting by providing a basis for (1) computing rates of return, (2) evaluating the capital structure of the enterprise, and (3) assessing the liquidity and financial flexibility of the enterprise.
2. Solvency refers to the ability of an enterprise to pay its debts as they mature. For example, when a company carries a high level of long-term debt relative to assets, it has lower solvency. Information on long-term obligations, such as long-term debt and notes payable, in comparison to total assets can be used to assess resources that will be needed to meet these fixed obligations (such as interest and principal payments).
3. Financial flexibility is the ability of an enterprise to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities. An enterprise with a high degree of financial flexibility is better able to survive bad times, to recover from unexpected setbacks, and to take advantage of profitable and unexpected investment opportunities. Generally, the greater the financial flexibility, the lower the risk of enterprise failure.
4. Some situations in which estimates affect amounts reported in the balance sheet include:
 - a) allowance for doubtful accounts.
 - b) depreciable lives and estimated salvage values for plant and equipment.
 - c) warranty returns.
 - d) determining the amount of revenues that should be recorded as unearned.

When estimates are required, there is subjectivity in determining the amounts. Such subjectivity can impact the usefulness of the information by reducing the reliability of the measures, either because of bias or lack of verifiability.

5. An increase in inventories increases current assets, which is in the numerator of the current ratio. Therefore, inventory increases will increase the current ratio. In general, an increase in the current ratio indicates a company has better liquidity, since there are more current assets relative to current liabilities.

Note to instructors—When inventories increase faster than sales, this may not be a good signal about liquidity. That is, inventory can only be used to meet current obligations when it is sold (and converted to cash). That is why some analysts use a liquidity ratio—the acid test ratio—that excludes inventories from current assets in the numerator.

6. Liquidity describes the amount of time that is expected to elapse until an asset is converted into cash or until a liability has to be paid. The ranking of the assets given in order of liquidity is:
 - (1) (d) Short-term investments.
 - (2) (e) Accounts receivable.
 - (3) (b) Inventories.
 - (4) (c) Buildings.
 - (5) (a) Goodwill.
7. The major limitations of the balance sheet are:
 - (1) The values stated are generally historical and not at fair value.
 - (2) Estimates have to be used in many instances, such as in the determination of collectibility of receivables or finding the approximate useful life of long-term tangible and intangible assets.
 - (3) Many items, even though they have financial value to the business, presently are not recorded. One example is the value of a company's human resources.

Questions Chapter 5 (Continued)

8. Some items of value to technology companies such as Intel or IBM are the value of research and development (new products that are being developed but which are not yet marketable), the value of the “intellectual capital” of its workforce (the ability of the companies’ employees to come up with new ideas and products in the fast changing technology industry), and the value of the company reputation or name brand (e.g., the “Intel Inside” logo). In most cases, the reasons why the value of these items are not recorded in the balance sheet concern the lack of reliability of the estimates of the future cash flows that will be generated by these “assets” (for all three types) and the ability to control the use of the asset (in the case of employees). Being able to reliably measure the expected future benefits and to control the use of an item are essential elements of the definition of an asset, according to the Conceptual Framework.
9. Classification in financial statements helps users by grouping items with similar characteristics and separating items with different characteristics. Current assets are expected to be converted to cash within one year or one operating cycle, whichever is longer—property, plant and equipment will provide cash inflows over a longer period of time. Thus, separating long-term assets from current assets facilitates computation of useful ratios such as the current ratio.
10. Separate amounts should be reported for accounts receivable and notes receivable. The amounts should be reported gross, and an amount for the allowance for doubtful accounts should be deducted. The amount and nature of any nontrade receivables, and any amounts designated or pledged as collateral, should be clearly identified.
11. Available-for-sale securities should be reported as a current asset only if management expects to convert them into cash as needed within one year or the operating cycle, whichever is longer. If available-for-sale securities are not held with this expectation, they should be reported as long-term investments.
12. The relationship between current assets and current liabilities is that current liabilities are those obligations that are reasonably expected to be liquidated either through the use of current assets or the creation of other current liabilities.
13. The total selling price of the season tickets is \$20,000,000 (10,000 X \$2,000). Of this amount, \$9,000,000 has been earned by 12/31/07 (18/40 X \$20,000,000). The remaining \$11,000,000 should be reported as unearned revenue, a current liability in the 12/31/07 balance sheet (22/40 X \$20,000,000).
14. Working capital is the excess of total current assets over total current liabilities. This excess is sometimes called net working capital. Working capital represents the net amount of a company’s relatively liquid resources. That is, it is the liquidity buffer available to meet the financial demands of the operating cycle.
15.
 - (a) Stockholders’ Equity. “Treasury stock (at cost).”
Note: This is a reduction of total stockholders’ equity.
 - (b) Current Assets. Included in “Cash.”
 - (c) Investments. “Land held as an investment.”
 - (d) Investments. “Sinking fund.”
 - (e) Long-term debt (adjunct account to bonds payable). “Unamortized premium on bonds payable.”
 - (f) Intangible Assets. “Copyrights.”
 - (g) Investments. “Employees’ pension fund,” with subcaptions of “Cash” and “Securities” if desired. (Assumes that the company still owns these assets.)
 - (h) Stockholders’ Equity. “Premium on capital stock” or “Additional paid-in capital in excess of par value.”

Questions Chapter 5 (Continued)

- (i) Investments. Nature of investments should be given together with parenthetical information as follows: “pledged to secure loans payable to banks.”
- 16.
- (a) Allowance for doubtful accounts receivable should be deducted from accounts receivable.
 - (b) Merchandise held on consignment should not appear on the consignee’s balance sheet except possibly as a note to the financial statements.
 - (c) Advances received on sales contract are normally a current liability and should be shown as such in the balance sheet.
 - (d) Cash surrender value of life insurance should be shown as a long-term investment.
 - (e) Land should be reported in property, plant, and equipment unless held for investment.
 - (f) Merchandise out on consignment should be shown among current assets under the heading of inventories.
 - (g) Franchises should be itemized in a section for intangible assets.
 - (h) Accumulated depreciation of plant and equipment should be deducted from the plant and equipment accounts.
 - (i) Materials in transit should not be shown on the balance sheet of the buyer, if purchased f.o.b. destination.
- 17.
- (a) Trade accounts receivable should be stated at their estimated amount collectible, often referred to as net realizable value. The method most generally followed is to deduct from the total accounts receivable the amount of the allowance for doubtful accounts.
 - (b) Land is generally stated in the balance sheet at cost.
 - (c) Inventories are generally stated at the lower of cost or market.
 - (d) Trading securities (consisting of common stock of other companies) are stated at fair value.
 - (e) Prepaid expenses should be stated at cost less the amount apportioned to and written off over the previous accounting periods.
18. Assets are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. If a building is leased, the future economic benefits of using the building are controlled by the lessee (tenant) as the result of a past event (the signing of a lease agreement).
19. Agazzi is incorrect. Retained earnings is a **source** of assets, but is not an asset itself. For example, even though the funds obtained from issuing a note payable are invested in the business, the note payable is not reported as an asset. It is a **source** of assets, but it is reported as a liability because the company has an obligation to repay the note in the future. Similarly, even though the earnings are invested in the business, retained earnings is not reported as an asset. It is reported as part of stockholders’ equity because it is, in effect, an investment by owners which increases the ownership interest in the assets of an entity.
20. The notes should appear as long-term liabilities with full disclosure as to their terms. Each year, as the profit is determined, notes of an amount equal to two-thirds of the year’s profits should be transferred from the long-term liabilities to current liabilities until all of the notes have been liquidated.
21. Some of the techniques of disclosure for the balance sheet are:
- 1. Parenthetical explanations.
 - 2. Notes to the financial statements.
 - 3. Cross references and contra items.
 - 4. Supporting schedules.

Questions Chapter 5 (Continued)

22. A note entitled “Summary of Significant Accounting Policies” would indicate the basic accounting principles used by that enterprise. This note should be very useful from a comparative standpoint, since it should be easy to determine whether the company uses the same accounting policies as other companies in the same industry.
23. General debt obligations, lease contracts, pension arrangements and stock option plans are four items for which disclosure is mandatory in the financial statements. The reason for disclosing these contractual situations is that these commitments are of a long-term nature, are often significant in amount, and are very important to the company’s well-being.
24. The profession has recommended that the use of the word “surplus” be discontinued in balance sheet presentations of owners’ equity. This term has a connotation outside accounting that is quite different from its meaning in the accounts or in the balance sheet. The use of the terms capital surplus, paid-in surplus, and earned surplus is confusing to the nonaccountant and leads to misinterpretation.
25. The purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period. It differs from the balance sheet and the income statement in that it reports the sources and uses of cash by operating, investing, and financing activity classifications. While the income statement and the balance sheet are accrual basis statements, the statement of cash flows is a cash basis statement—noncash items are omitted.
26. The difference between these two amounts may be due to increases in current assets (e.g., an increase in accounts receivable from a sale on account would result in an increase in revenue and net income but have no effect yet on cash). Similarly a cash payment that results in a decrease in an existing current liability (e.g., accounts payable would decrease cash provided by operations without affecting net income.)
27. The difference between these two amounts could be due to noncash charges that appear in the income statement. Examples of noncash charges are depreciation, depletion, and amortization of intangibles. Expenses recorded but unpaid (e.g., increase in accounts payable) and collection of previously recorded sales on credit (i.e. now decreasing accounts receivable) also would cause cash provided by operating activities to exceed net income.
28. **Operating activities** involve the cash effects of transactions that enter into the determination of net income. **Investing activities** include making and collecting loans and acquiring and disposing of debt and equity instruments; property, plant, and equipment and intangibles. **Financing activities** involve liability and owners’ equity items and include obtaining capital from owners and providing them with a return on (dividends) and a return of their investment and borrowing money from creditors and repaying the amounts borrowed.
29. (a) Net income is adjusted downward by deducting \$7,000 from \$90,000 and reporting cash provided by operating activities as \$83,000.
- (b) The issuance of the preferred stock is a financing activity. The issuance is reported as follows:
- | | |
|--------------------------------------|-------------|
| Cash flows from financing activities | |
| Issuance of preferred stock | \$1,150,000 |

Questions Chapter 5 (Continued)

- (c) Net income is adjusted as follows:
- | | |
|---|-----------------|
| Cash flows from operating activities | |
| Net income | \$90,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Depreciation expense | 14,000 |
| Premium amortization | <u>(5,000)</u> |
| Net cash provided by operating activities | <u>\$99,000</u> |
- (d) The increase of \$20,000 reflects an investing activity. The increase in Land is reported as follows:
- | | |
|---------------------------------------|-------------------|
| Cash flows from investing activities: | |
| Investment in Land | <u>\$(20,000)</u> |

30. The company appears to have good liquidity and reasonable financial flexibility. Its current cash debt coverage ratio is $.90 \left(\frac{\$900,000}{\$1,000,000} \right)$, which indicates that it can pay off its current liabilities in a given year from its operations. In addition, its cash debt coverage ratio is also good at $.60 \left(\frac{\$900,000}{\$1,500,000} \right)$, which indicates that it can pay off approximately 60% of its debt out of current operations.
31. Free cash flow = \$860,000 – \$75,000 – \$20,000 = \$765,000.
32. Free cash flow is net cash provided by operating activities less capital expenditures and dividends. The purpose of free cash flow analysis is to determine the amount of discretionary cash flow a company has for purchasing additional investments, retiring its debt, purchasing treasury stock, or simply adding to its liquidity.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 5-1

Current assets

Cash.....		\$27,000
Accounts receivable.....	\$110,000	
Less: Allowance for doubtful accounts.....	<u>(8,000)</u>	102,000
Inventories.....		290,000
Prepaid insurance.....		<u>9,500</u>
Total current assets.....		<u>\$428,500</u>

BRIEF EXERCISE 5-2

Current assets

Cash.....		\$ 7,000
Trading securities.....		11,000
Accounts receivable.....	\$90,000	
Less: Allowance for doubtful accounts.....	<u>(4,000)</u>	86,000
Inventory.....		34,000
Prepaid insurance.....		<u>5,200</u>
Total current assets.....		<u>\$143,200</u>

BRIEF EXERCISE 5-3

Long-term investments

Held-to-maturity securities.....		\$ 61,000
Land held for investment.....		39,000
Long-term note receivables.....		<u>42,000</u>
Total investments.....		<u>\$142,000</u>

BRIEF EXERCISE 5-4

Property, plant, and equipment

Land		\$ 61,000
Buildings	\$207,000	
Less: Accumulated depreciation.....	<u>(45,000)</u>	162,000
Equipment.....	\$190,000	
Less: Accumulated depreciation.....	<u>(19,000)</u>	171,000
Timberland.....		<u>70,000</u>
Total property, plant, and equipment.....		<u>\$464,000</u>

BRIEF EXERCISE 5-5

Intangible assets

Goodwill.....		\$150,000
Patents		220,000
Franchises		<u>110,000</u>
Total intangibles		<u>\$480,000</u>

BRIEF EXERCISE 5-6

Intangible assets

Goodwill.....		\$40,000
Franchises		47,000
Patents		33,000
Trademarks.....		<u>10,000</u>
Total intangible assets.....		<u>\$130,000</u>

BRIEF EXERCISE 5-7

Current liabilities

Accounts payable	\$72,000
Accrued salaries.....	4,000
Notes payable.....	12,500
Income taxes payable.....	<u>7,000</u>
Total current liabilities.....	<u>\$95,500</u>

BRIEF EXERCISE 5-8

Current liabilities

Accounts payable	\$240,000
Advances from customers.....	41,000
Wages payable.....	27,000
Interest payable	12,000
Income taxes payable.....	<u>29,000</u>
Total current liabilities.....	<u>\$349,000</u>

BRIEF EXERCISE 5-9

Long-term liabilities

Bonds payable	\$400,000	
Less: Discount on bonds payable.....	<u>24,000</u>	\$376,000
Pension liability		<u>375,000</u>
Total long-term liabilities.....		<u>\$751,000</u>

BRIEF EXERCISE 5-10

Stockholders' equity

Common stock	\$700,000
Additional paid-in capital	200,000
Retained earnings	120,000
Accumulated other comprehensive loss	<u>(150,000)</u>
Total stockholders' equity	<u>\$870,000</u>

BRIEF EXERCISE 5-11

Stockholders' equity

Preferred stock	\$172,000
Common stock	55,000
Additional paid-in capital	174,000
Retained earnings	<u>114,000</u>
Total stockholders' equity	<u>\$515,000</u>

BRIEF EXERCISE 5-12

Cash Flow Statement

Operating Activities

Net income	\$40,000
Increase in accounts receivable	(10,000)
Increase in accounts payable	5,000
Depreciation expense	<u>4,000</u>
Net cash provided by operating activities	<u>39,000</u>

BRIEF EXERCISE 5-12 (Continued)

Investing Activities

Purchase of equipment	(8,000)
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Financing Activities

Issue notes payable	20,000
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Dividends	<u>(5,000)</u>
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Net cash flow from financing activities	<u>15,000</u>
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Net change in cash (\$39,000 – \$8,000 + \$15,000)	<u>\$46,000</u>
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Free Cash Flow = \$39,000 (Net cash provided by operating activities) – \$8,000 (Purchase of equipment) – \$5,000 (Dividends) = \$26,000.

BRIEF EXERCISE 5-13

Cash flows from operating activities

Net income.....		\$151,000
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Adjustments to reconcile net income to
net cash provided by operating activities

Depreciation expense	\$39,000	
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Increase in accounts payable	9,500	
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Increase in accounts receivable.....	<u>(13,000)</u>	<u>35,500</u>
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Net cash provided by operating activities		<u>\$186,500</u>
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BRIEF EXERCISE 5-14

Sale of land and building.....	\$181,000
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Purchase of land	(37,000)
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Purchase of equipment.....	<u>(53,000)</u>
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Net cash provided by investing activities.....	<u>\$ 91,000</u>
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BRIEF EXERCISE 5-15

Issuance of common stock.....	\$147,000
Purchase of treasury stock.....	(40,000)
Payment of cash dividend.....	(85,000)
Retirement of bonds.....	<u>(100,000)</u>
Net cash used by financing activities.....	<u>\$ (78,000)</u>

BRIEF EXERCISE 5-16

Free Cash Flow Analysis

Net cash provided by operating activities	\$400,000
Less: Purchase of equipment.....	(53,000)
Purchase of land*	(37,000)
Dividends	<u>(85,000)</u>
Free cash flow	<u>\$225,000</u>

*If the land were purchased as an investment, it would be excluded in the computation of free cash flow.

SOLUTIONS TO EXERCISES

EXERCISE 5-1 (15–20 minutes)

- (a) If the investment in preferred stock is readily marketable and held primarily for sale in the near term to generate income on short-term price differences, then the account should appear as a current asset and be included with trading securities. If, on the other hand, the preferred stock is not a trading security, it should be classified as available for sale. Available for sale securities are classified as current or noncurrent depending upon the circumstances.
- (b) If the company accounts for the treasury stock on the cost basis, the account should properly be shown as a reduction of total stockholders' equity.
- (c) Stockholders' equity.
- (d) Current liability.
- (e) Property, plant, and equipment (as a deduction).
- (f) If the warehouse in process of construction is being constructed for another party, it is properly classified as an inventory account in the current asset section. This account will be shown net of any billings on the contract. On the other hand, if the warehouse is being constructed for the use of this particular company, it should be classified as a separate item in the property, plant, and equipment section.
- (g) Current asset.
- (h) Current liability.
- (i) Retained earnings.

EXERCISE 5-1 (Continued)

(j) Current asset.

(k) Current liability.

(l) Current liability.

(m) Current asset (inventory).

(n) Current liability.

EXERCISE 5-2 (15–20 minutes)

- | | | | |
|-----|----|-----|----|
| 1. | h. | 11. | b. |
| 2. | d. | 12. | f. |
| 3. | f. | 13. | a. |
| 4. | f. | 14. | h. |
| 5. | c. | 15. | c. |
| 6. | a. | 16. | b. |
| 7. | f. | 17. | a. |
| 8. | g. | 18. | a. |
| 9. | a. | 19. | g. |
| 10. | a. | 20. | f. |

EXERCISE 5-3 (15–20 minutes)

- | | | | |
|----|----|-----|--------------------------|
| 1. | a. | 10. | f. |
| 2. | b. | 11. | a. |
| 3. | f. | 12. | f. |
| 4. | a. | 13. | a. or e. (preferably a.) |
| 5. | f. | 14. | c. and N. |
| 6. | h. | 15. | f. |
| 7. | i. | 16. | X. |
| 8. | d. | 17. | f. |
| 9. | a. | 18. | c. |

EXERCISE 5-4 (30–35 minutes)

**Denis Savard Inc.
Balance Sheet
December 31, 20–**

<u>Assets</u>			
<u>Current assets</u>			
Cash	\$XXX		
Less: Cash restricted for plant expansion	XXX	\$XXX	
Accounts receivable	XXX		
Less: Allowance for doubtful accounts	XXX	XXX	
Notes receivable		XXX	
Receivables—officers		XXX	
Inventories			
Finished goods	XXX		
Work in process	XXX		
Raw materials	XXX	XXX	
Total current assets			\$XXX
<u>Long-term investments</u>			
Preferred stock investments		XXX	
Land held for future plant site		XXX	
Cash restricted for plant expansion		XXX	
Total long-term investments			XXX
<u>Property, plant, and equipment</u>			
Buildings		XXX	
Less: Accum. depreciation—buildings		XXX	XXX
<u>Intangible assets</u>			
Copyrights			XXX
Total assets			<u>\$XXX</u>

EXERCISE 5-4 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accrued salaries payable	\$XXX	
Notes payable, short-term.....	XXX	
Unearned subscriptions revenue	XXX	
Unearned rent revenue.....	<u>XXX</u>	
Total current liabilities.....		\$XXX

Long-term debt

Bonds payable, due in four years.....	\$XXX	
Less: Discount on bonds payable.....	<u>(XXX)</u>	<u>XXX</u>
Total liabilities		XXX

Stockholders' equity

Capital stock:		
Common stock	XXX	
Additional paid-in capital:		
Premium on common stock.....	<u>XXX</u>	
Total paid-in capital		XXX
Retained earnings	<u>XXX</u>	
Total paid-in capital and retained earnings	XXX	
Less: Treasury stock, at cost.....	<u>(XXX)</u>	
Total stockholders' equity.....		<u>XXX</u>
Total liabilities and stock- holders' equity		<u>\$XXX</u>

Note to instructor: An assumption made here is that cash included the cash restricted for plant expansion. If it did not, then a subtraction from cash would not be necessary or the cash balance would be “grossed up” and then the cash restricted for plant expansion deducted.

EXERCISE 5-5 (30–35 minutes)

**Uhura Company
Balance Sheet
December 31, 2007**

<u>Assets</u>			
<u>Current assets</u>			
Cash	\$230,000		
Trading securities—at fair value	120,000		
Accounts receivable	\$357,000		
Less: Allowance for doubtful accounts.....	17,000	340,000	
Inventories, at lower of average cost or market	401,000		
Prepaid expenses	12,000		
Total current assets			\$1,103,000
 <u>Long-term investments</u>			
Land held for future use.....	175,000		
Cash surrender value of life insurance	90,000	265,000	
 <u>Property, plant, and equipment</u>			
Building.....	\$730,000		
Less: Accum. depr.—building.....	160,000	570,000	
Office equipment	265,000		
Less: Accum. depr.—office equipment.....	105,000	160,000	730,000
 <u>Intangible assets</u>			
Goodwill.....			80,000
Total assets			\$2,178,000

EXERCISE 5-5 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable	\$ 135,000	
Notes payable (due next year)	125,000	
Rent payable	<u>49,000</u>	
Total current liabilities		\$309,000

Long-term liabilities

Bonds payable	\$500,000	
Add: Premium on bonds payable	<u>53,000</u>	\$553,000
Pension obligation	<u>82,000</u>	<u>635,000</u>
Total liabilities		944,000

Stockholders' equity

Common stock, \$1 par, authorized 400,000 shares, issued 290,000 shares	290,000	
Additional paid-in capital	<u>160,000</u>	450,000
Retained earnings	<u>784,000*</u>	
Total stockholders' equity		<u>1,234,000</u>
Total liabilities and stock- holders' equity		<u>\$2,178,000</u>

*\$2,178,000 – \$944,000 – \$450,000

EXERCISE 5-6 (30–35 minutes)

**Geronimo Company
Balance Sheet
July 31, 2007**

<u>Assets</u>		
<u>Current assets</u>		
Cash		\$60,000*
Accounts receivable	\$46,700**	
Less: Allowance for doubtful accounts	3,500	43,200
Inventories		<u>65,300***</u>
Total current assets		\$168,500
 <u>Long-term investments</u>		
Bond sinking fund		15,000
 <u>Property, plant, and equipment</u>		
Equipment		112,000
Less: Accumulated depreciation— equipment	<u>28,000</u>	84,000
 <u>Intangible assets</u>		
Patents		<u>21,000</u>
Total assets		<u>\$288,500</u>

*(\$69,000 – \$15,000 + \$6,000)

**(\$52,000 – \$5,300)

***(\$60,000 + \$5,300)

EXERCISE 5-6 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Notes and accounts payable	\$ 52,000****	
Taxes payable.....	<u>6,000</u>	
Total current liabilities.....		58,000

<u>Long-term liabilities</u>		<u>75,000</u>
Total liabilities		133,000

<u>Stockholders' equity</u>		<u>155,500</u>
Total liabilities and stock- holders' equity		<u>\$288,500</u>

****(\$44,000 + \$8,000)

EXERCISE 5-7 (15–20 minutes)

Current assets

Cash	\$ 87,000*	
Less: Cash restricted for plant expansion.....	<u>(50,000)</u>	\$ 37,000
Trading securities at fair value (cost, \$31,000)		29,000
Accounts receivable (of which \$50,000 is pledged as collateral on a bank loan)	161,000	
Less: Allowance for doubtful accounts	<u>(12,000)</u>	149,000
Interest receivable [(\$40,000 X 6%) X 8/12]		1,600
Inventories at lower of cost (determined using LIFO) or market		
Finished goods.....	52,000	
Work-in-process.....	34,000	
Raw materials.....	<u>207,000</u>	<u>293,000</u>
Total current assets		<u>\$509,600</u>

*An acceptable alternative is to report cash at \$37,000 and simply report the cash restricted for plant expansion in the investments section.

EXERCISE 5-8 (10–15 minutes)

- 1. Dividends payable of \$2,375,000 will be reported as a current liability [(1,000,000 – 50,000) X \$2.50].**
- 2. Bonds payable of \$25,000,000 and interest payable of \$3,000,000 (\$100,000,000 X 12% X 3/12) will be reported as a current liability. Bonds payable of \$75,000,000 will be reported as a long-term liability.**
- 3. Customer advances of \$17,000,000 will be reported as a current liability (\$12,000,000 + \$30,000,000 – \$25,000,000).**

EXERCISE 5-9 (30–35 minutes)

**(a) Alessandro Scarlatti Company
Balance Sheet (Partial)
December 31, 2007**

Current assets

Cash		\$ 34,396*
Accounts receivable	\$ 91,300**	
Less: Allowance for doubtful accounts	<u>7,000</u>	84,300
Inventories		159,000***
Prepaid expenses		<u>9,000</u>
Total current assets		<u>\$286,696</u>

*Cash balance		\$ 40,000
Add: Cash disbursement after discount [\$39,000 X 98%]		<u>38,220</u>
		78,220
Less: Cash sales in January (\$30,000 – \$21,500)		(8,500)
Cash collected on account		(23,324)
Bank loan proceeds (\$35,324 – \$23,324)		<u>(12,000)</u>
Adjusted cash		<u>\$ 34,396</u>

**Accounts receivable balance		\$ 89,000
Add: Accounts reduced from January collection (\$23,324 ÷ 98%)		<u>23,800</u>
		112,800
Deduct: Accounts receivable in January		<u>(21,500)</u>
Adjusted accounts receivable		<u>\$ 91,300</u>

***Inventories		\$171,000
Less: Inventory received on consignment		<u>12,000</u>
Adjusted inventory		<u>\$159,000</u>

EXERCISE 5-9 (Continued)

Current liabilities

Accounts payable		\$115,000^a
Notes payable.....		<u>55,000^b</u>
Total current liabilities.....		<u>\$170,000</u>

^a Accounts payable balance		\$61,000
Add: Cash disbursements	\$39,000	
Purchase invoice omitted		
(\$27,000 – \$12,000)	<u>15,000</u>	<u>54,000</u>
Adjusted accounts payable		<u>\$115,000</u>

^b Notes payable balance		\$ 67,000
Less: Proceeds of bank loan		<u>12,000</u>
Adjusted notes payable		<u>\$ 55,000</u>

(b) Adjustment to retained earnings balance:

Add: January sales discounts		
[($\$23,324 \div 98\%$) X .02].....		\$ 476
Deduct: January sales	\$30,000	
January purchase discounts		
(\$39,000 X 2%)	780	
December purchases.....	15,000	
Consignment inventory	<u>12,000</u>	<u>(57,780)</u>
Change (decrease) to retained earnings		<u>\$(57,304)</u>

EXERCISE 5-10 (15–20 minutes)

- (a) In order for a liability to be reported for threatened litigation, the amount must be probable and payment reasonably estimable. Since these conditions are not met an accrual is not required.**
- (b) A current liability of \$150,000 should be recorded.**
- (c) A current liability for accrued interest of \$4,000 ($\$600,000 \times 8\% \times 1/2$) should be reported. Also, the \$600,000 note payable should be a current liability if payable in one year. Otherwise, the \$600,000 note payable would be a long-term liability.**
- (d) Although bad debts expense of \$300,000 should be debited and the allowance for doubtful accounts credited for \$300,000, this does not result in a liability. The allowance for doubtful accounts is a valuation account (contra asset) and is deducted from accounts receivable on the balance sheet.**
- (e) A current liability of \$80,000 should be reported. The liability is recorded on the date of declaration.**
- (f) Customer advances of \$110,000 ($\$160,000 - \$50,000$) will be reported as a current liability.**

EXERCISE 5-11 (25–30 minutes)

**Kelly Corporation
Balance Sheet
December 31, 2007**

<u>Assets</u>		
Current assets		
Cash.....	\$ 6,850	
Office supplies	1,200	
Prepaid insurance	<u>1,000</u>	
Total current assets		\$ 9,050
Equipment	48,000	
Less: Accumulated depreciation	<u>4,000</u>	44,000
Intangible assets—trademark.....		<u>950</u>
Total assets.....		<u>\$54,000</u>
<u>Liabilities and Stockholders' Equity</u>		
Current liabilities		
Accounts payable	\$10,000	
Wages payable.....	500	
Unearned service revenue	<u>2,000</u>	
Total current liabilities		\$12,500
Long-term liabilities		
Bonds payable		<u>9,000</u>
Total liabilities		<u>21,500</u>
Stockholders' equity		
Common stock.....		10,000
Retained earnings (\$25,000 – \$2,500*)		<u>22,500</u>
Total stockholders' equity.....		<u>32,500</u>
Total liabilities and stockholders' equity.....		<u>\$54,000</u>

*[\$10,000 – (\$9,000 + \$1,400 + \$1,200 + \$900)]

EXERCISE 5-12 (30–35 minutes)

**John Nalezny Corporation
Balance Sheet
December 31, 2007**

<u>Assets</u>		
<u>Current assets</u>		
Cash		\$197,000
Trading securities.....		153,000
Accounts receivable	\$435,000	
Less: Allowance for doubtful accounts	(25,000)	410,000
Inventories		<u>597,000</u>
Total current assets.....		1,357,000
 <u>Long-term investments</u>		
Investments in bonds.....		299,000
Investments in stocks		<u>277,000</u>
Total long-term investments.....		576,000
 <u>Property, plant, and equipment</u>		
Land		260,000
Buildings	1,040,000	
Less: Accum. depreciation.....	(152,000)	888,000
Equipment.....	600,000	
Less: Accum. depreciation.....	(60,000)	<u>540,000</u>
Total property, plant, and equipment.....		1,688,000
 <u>Intangible assets</u>		
Franchise		160,000
Patent.....		<u>195,000</u>
Total intangible assets.....		<u>355,000</u>
Total assets		<u>\$3,976,000</u>

EXERCISE 5-12 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable	\$ 455,000	
Short-term notes payable.....	90,000	
Dividends payable	136,000	
Accrued liabilities	<u>96,000</u>	
Total current liabilities		\$ 777,000

Long-term debt

Long-term notes payable.....	900,000	
Bonds payable	<u>1,000,000</u>	
Total long-term liabilities		<u>1,900,000</u>
Total liabilities		2,677,000

Stockholder's equity

Paid-in capital		
Common stock (\$5 par).....	\$1,000,000	
Additional paid-in capital.....	<u>80,000</u>	1,080,000
Retained earnings*		<u>410,000</u>
Total paid-in capital and retained earnings.....		1,490,000
Less: Treasury stock		<u>(191,000)</u>
Total stockholders' equity		<u>1,299,000</u>
Total liabilities and stockholders' equity		<u>\$3,976,000</u>

EXERCISE 5-12 (Continued)

*Computation of Retained Earnings:

Sales	\$8,100,000
Investment revenue	63,000
Extraordinary gain	80,000
Cost of goods sold	(4,800,000)
Selling expenses	(2,000,000)
Administrative expenses	(900,000)
Interest expense	<u>(211,000)</u>
Net income	<u>\$ 332,000</u>
Beginning retained earnings	\$ 78,000
Net income	<u>332,000</u>
Ending retained earnings	<u>\$410,000</u>

Or ending retained earnings can be computed as follows:

Total stockholders' equity	\$1,299,000
Add: Treasury stock	191,000
Less: Paid-in capital	<u>1,080,000</u>
Ending retained earnings	<u>\$ 410,000</u>

Note to instructor: There is no dividends account. Thus, the 12/31/07 retained earnings balance already reflects any dividends declared.

EXERCISE 5-13 (15–20 minutes)

(a) 4.	(f) 1.	(k) 1.
(b) 3.	(g) 5.	(l) 2.
(c) 4.	(h) 4.	(m) 2.
(d) 3.	(i) 5.	
(e) 1.	(j) 4.	

EXERCISE 5-14 (25–35 minutes)

**Constantine Cavamanlis Inc.
Statement of Cash Flows
For the Year Ended December 31, 2007**

Cash flows from operating activities		
Net income.....		\$44,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	\$ 6,000	
Increase in accounts receivable.....	(3,000)	
Increase in accounts payable	5,000	8,000
Net cash provided by operating activities		52,000
Cash flows from investing activities		
Purchase of equipment		(17,000)
Cash flows from financing activities		
Issuance of common stock.....	20,000	
Payment of cash dividends	(23,000)	
Net cash used by financing activities		(3,000)
Net increase in cash.....		32,000
Cash at beginning of year		13,000
Cash at end of year.....		<u>\$45,000</u>

EXERCISE 5-15 (25–35 minutes)

**(a) Zubin Mehta Corporation
Statement of Cash Flows
For the Year Ended December 31, 2007**

Cash flows from operating activities		
Net income		\$160,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense.....	\$17,000	
Loss on sale of investments.....	10,000	
Decrease in accounts receivable	5,000	
Decrease in current liabilities.....	(17,000)	<u>15,000</u>
Net cash provided by operating activities.....		175,000
Cash flows from investing activities		
Sale of investments	12,000	
[(\$74,000 – \$52,000) – \$10,000]		
Purchase of equipment	(58,000)	
Net cash used by investing activities		(46,000)
Cash flows from financing activities		
Payment of cash dividends.....		(30,000)
Net increase in cash		99,000
Cash at beginning of year.....		<u>78,000</u>
Cash at end of year		<u>\$177,000</u>

(b) Free Cash Flow Analysis

Net cash provided by operating activities	\$175,000
Less: Purchase of equipment	(58,000)
Dividends.....	<u>(30,000)</u>
Free cash flow	<u>\$ 87,000</u>

EXERCISE 5-16 (20–25 minutes)

**(a) Shabbona Corporation
Statement of Cash Flows
For the Year Ended December 31, 2007**

Cash flows from operating activities		
Net income.....		\$125,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	\$27,000	
Increase in accounts receivable.....	(16,000)	
Decrease in inventory	9,000	
Decrease in accounts payable.....	(13,000)	<u>7,000</u>
Net cash provided by operating activities		132,000
Cash flows from investing activities		
Sale of land.....	39,000	
Purchase of equipment	(60,000)	
Net cash used by investing activities.....		(21,000)
Cash flows from financing activities		
Payment of cash dividends		<u>(60,000)</u>
Net increase in cash.....		51,000
Cash at beginning of year		<u>22,000</u>
Cash at end of year.....		<u>\$ 73,000</u>
Noncash investing and financing activities		
Issued common stock to retire \$50,000 of bonds outstanding		

EXERCISE 5-16 (Continued)

(b) Current cash debt coverage ratio =

$$\begin{aligned} &= \frac{\text{Net cash provided by operating activities}}{\text{Average current liabilities}} \\ &= \frac{\$132,000}{(\$34,000 + \$47,000) / 2} \\ &= 3.26 \text{ to } 1 \end{aligned}$$

Cash debt coverage ratio =

$$\begin{aligned} &= \frac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}} \\ &= \$132,000 \div \frac{\$184,000 + \$247,000}{2} \\ &= .61 \text{ to } 1 \end{aligned}$$

Free Cash Flow Analysis

Net cash provided by operating activities	\$132,000
Less: Purchase of equipment	(60,000)
Dividends.....	<u>(60,000)</u>
Free cash flow	<u>\$ 12,000</u>

Shabbona has excellent liquidity. Its financial flexibility is good. It might be noted that it substantially reduced its long-term debt in 2007 which will help its financial flexibility.

EXERCISE 5-17 (30–35 minutes)

**(a) Grant Wood Corporation
Statement of Cash Flows
For the Year Ended December 31, 2007**

Cash flows from operating activities		
Net income.....		\$55,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on sale of equipment.....	\$ 2,000*	
Depreciation expense	13,000	
Patent amortization.....	2,500	
Increase in current liabilities	13,000	
Increase in current assets (other than cash)	<u>(29,000)</u>	<u>1,500</u>
Net cash provided by operating activities		56,500
Cash flows from investing activities		
Sale of equipment	10,000	
Addition to building.....	(27,000)	
Investment in stock	<u>(16,000)</u>	
Net cash used by investing activities.....		(33,000)
Cash flows from financing activities		
Issuance of bonds	50,000	
Payment of dividends	(30,000)	
Purchase of treasury stock.....	<u>(11,000)</u>	
Net cash provided by financing activities.....		<u>9,000</u>
Net increase in cash.....		<u>\$32,500^a</u>

*[\$10,000 – (\$20,000 – \$8,000)]

^aAn additional proof to arrive at the increase in cash is provided as follows:

Total current assets—end of period	\$296,500 [from part (b)]
Total current assets—beginning of period	<u>235,000</u>
Increase in current assets during the period	61,500
Increase in current assets other than cash	<u>29,000</u>
Increase in cash during year	<u>\$ 32,500</u>

EXERCISE 5-17 (Continued)

**(b) Grant Wood Corporation
Balance Sheet
December 31, 2007**

Assets		
Current assets		\$296,500^b
Long-term investments		16,000
Property, plant, and equipment		
Land	\$ 30,000	
Building (\$120,000 + \$27,000).....	\$147,000	
Less: Accum. depreciation		
(\$30,000 + \$4,000).....	(34,000)	113,000
Equipment (\$90,000 – \$20,000)	70,000	
Less: Accum. depreciation		
(\$11,000 – \$8,000 + \$9,000)	(12,000)	58,000
Total property, plant, and equipment		201,000
Intangible assets—patents		
(\$40,000 – \$2,500).....		<u>37,500</u>
Total assets		<u>\$551,000</u>
Liabilities and Stockholders' Equity		
Current liabilities (\$150,000 + \$13,000)		\$163,000
Long-term liabilities		
Bonds payable (\$100,000 + \$50,000).....		<u>150,000</u>
Total liabilities.....		313,000
Stockholders' equity		
Common stock	\$180,000	
Retained earnings (\$44,000 + \$55,000 – \$30,000)	69,000	
Total paid-in capital and retained earnings	249,000	
Less: Cost of treasury stock.....	(11,000)	
Total stockholders' equity		<u>238,000</u>
Total liabilities and stockholders' equity.....		<u>\$551,000</u>

^b The amount determined for current assets could be computed last and then is a “plug” figure. That is, total liabilities and stockholders' equity is computed because information is available to determine this amount. Because the total assets amount is the same as total liabilities and stockholders' equity amount, the amount of total assets is determined. Information is available to compute all the asset amounts except current assets and therefore current assets can be determined by deducting the total of all the other asset balances from the total asset balance (i.e., \$551,000 – \$37,500 – \$201,000 – \$16,000). Another way to compute this amount, given the information, is that beginning current assets plus the \$29,000 increase in current assets other than cash plus the \$32,500 increase in cash equals \$296,500.

EXERCISE 5-18 (25–35 minutes)

(a) **Madrasah Corporation**
Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income.....		\$44,000
Adjustment to reconcile net income to net cash provided by operating activities:		
Depreciation.....	\$ 6,000	
Increase in accounts payable	5,000	
Increase in accounts receivable	<u>(18,000)</u>	<u>(7,000)</u>
Net cash provided by operating activities		37,000
Cash flows from Investing activities		
Purchase of equipment.....		(17,000)
Cash flows from financing activities		
Issuance of stock.....	20,000	
Payment of dividends	<u>(33,000)</u>	
Net cash used by financing activities		<u>(13,000)</u>
Net increase in cash.....		\$ 7,000
Cash at beginning of year		<u>13,000</u>
Cash at end of year.....		<u>\$20,000</u>

	<u>2007</u>	<u>2006</u>
(b) Current ratio	6.3	6.73
	<u>\$126,000</u>	<u>\$101,000</u>
	<u>\$ 20,000</u>	<u>\$ 15,000</u>

Free Cash Flow Analysis

Net cash provided by operating activities	\$ 37,000
Less: Purchase of equipment.....	(17,000)
Pay dividends	<u>(33,000)</u>
Free cash flow	<u>\$ (13,000)</u>

(c) Although, Madrasah's current ratio has declined from 2006 to 2007, it is still in excess of 6. It appears the company has good liquidity and financial flexibility.

TIME AND PURPOSE OF PROBLEMS

Problem 5-1 (Time 30–35 minutes)

Purpose—to provide the student with the opportunity to prepare a balance sheet, given a set of accounts. No monetary amounts are to be reported.

Problem 5-2 (Time 35–40 minutes)

Purpose—to provide the student with the opportunity to prepare a complete balance sheet, involving dollar amounts. A unique feature of this problem is that the student must solve for the retained earnings balance.

Problem 5-3 (Time 40–45 minutes)

Purpose—to provide an opportunity for the student to prepare a balance sheet in good form. Emphasis is given in this problem to additional important information that should be disclosed. For example, an inventory valuation method, bank loans secured by long-term investments, and information related to the capital stock accounts must be disclosed.

Problem 5-4 (Time 40–45 minutes)

Purpose—to provide the student with the opportunity to analyze a balance sheet and correct it where appropriate. The balance sheet as reported is incomplete, uses poor terminology, and is in error. A challenging problem.

Problem 5-5 (Time 40–45 minutes)

Purpose—to provide the student with the opportunity to prepare a balance sheet in good form. Additional information is provided on each asset and liability category for purposes of preparing the balance sheet. A challenging problem.

Problem 5-6 (Time 35–45 minutes)

Purpose—to provide the student with an opportunity to prepare a complete statement of cash flows. A condensed balance sheet is also required. The student is also required to explain the usefulness of the statement of cash flows. Because the textbook does not explain in Chapter 5 all of the steps involved in preparing the statement of cash flows, assignment of this problem is dependent upon additional instruction by the teacher or knowledge gained in elementary financial accounting.

Problem 5-7 (Time 40–50 minutes)

Purpose—to provide the student with an opportunity to prepare a balance sheet in good form and a more complex cash flow statement.

SOLUTIONS TO PROBLEMS

PROBLEM 5-1

Company Name
Balance Sheet
December 31, 20XX

Assets

Current assets

Cash on hand (including petty cash)	\$XXX		
Cash in bank	<u>XXX</u>	\$XXX	
Trading securities		XXX	
Accounts receivable	XXX		
Less: Allowance for doubtful accounts	<u>XXX</u>	XXX	
Interest receivable		XXX	
Advances to employees		XXX	
Inventory (ending)		XXX	
Prepaid rent		<u>XXX</u>	
Total current assets			\$XXX

Long-term investments

Bond sinking fund		\$XXX	
Cash surrender value of life insurance		XXX	
Land for future plant site		<u>XXX</u>	
Total long-term investments			\$XXX

Property, plant, and equipment

Land		\$XXX	
Buildings	\$XXX		
Less: Accum. depreciation—buildings	<u>XXX</u>	XXX	
Equipment	XXX		
Less: Accum. depreciation—equipment	<u>XXX</u>	<u>XXX</u>	
Total property, plant, and equipment			XXX

Intangible assets

Copyright		\$XXX	
Patent		<u>XXX</u>	
Total intangible assets			<u>XXX</u>
Total assets			<u>\$XXX</u>

PROBLEM 5-1 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Notes payable		\$XXX	
Payroll taxes payable		XXX	
Accrued wages		XXX	
Dividends payable		XXX	
Unearned subscriptions revenue		<u>XXX</u>	
Total current liabilities			\$XXX

Long-term debt

Bonds payable	\$XXX		
Add: Premium on bonds payable	<u>XXX</u>	XXX	
Pension obligations		<u>XXX</u>	
Total long-term liabilities			<u>XXX</u>
Total liabilities			XXX

Stockholders' equity

Capital stock			
Preferred stock (description)	\$XXX		
Common stock (description)	<u>XXX</u>	XXX	
Additional paid-in capital			
Premium on preferred stock		<u>XXX</u>	
Total paid-in capital		XXX	
Retained earnings		<u>XXX</u>	
Total paid-in capital and retained earnings		XXX	
Less: Treasury stock (description)		<u>(XXX)</u>	
Total stockholders' equity			<u>XXX</u>
Total liabilities and stockholders' equity			<u>\$XXX</u>

PROBLEM 5-2

**Letterman, Inc.
Balance Sheet
December 31, 2007**

Assets

Current assets

Cash.....	\$	360,000	
Trading securities		121,000	
Notes receivable		545,700	
Income taxes receivable		97,630	
Inventories.....		239,800	
Prepaid expenses.....		<u>87,920</u>	
Total current assets.....			\$1,452,050

Property, plant, and equipment

Land.....	\$	480,000	
Building	\$1,640,000		
Less: Accum. depreciation—			
building	<u>170,200</u>	1,469,800	
Equipment	1,470,000		
Less: Accum. depreciation—			
equipment.....	<u>292,000</u>	<u>1,178,000</u>	3,127,800

Intangible assets

Goodwill		<u>125,000</u>	
Total assets			<u>\$4,704,850</u>

PROBLEM 5-2 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable.....	\$ 590,000	
Notes payable to banks.....	265,000	
Payroll taxes payable.....	177,591	
Taxes payable.....	98,362	
Rent payable.....	<u>45,000</u>	
Total current liabilities.....		\$1,175,953

Long-term liabilities

Unsecured notes payable (long-term).....		\$1,600,000
Bonds payable.....	\$300,000	
Less: Discount on bonds payable.....	<u>15,000</u>	285,000
Long-term rental obligations.....	<u>480,000</u>	<u>2,365,000</u>
Total liabilities.....		3,540,953

Stockholders' equity

Capital stock

Preferred stock, \$10 par; 20,000 shares authorized, 15,000 shares issued.....		\$150,000
Common stock, \$1 par; 400,000 shares authorized, 200,000 issued.....	<u>200,000</u>	\$350,000
Retained earnings (\$1,163,897 – \$350,000).....	<u>813,897</u>	
Total stockholders' equity (\$4,704,850 – \$3,540,953).....		<u>1,163,897</u>
Total liabilities and stockholders' equity.....		<u>\$4,704,850</u>

PROBLEM 5-3

**Side Kicks Company
Balance Sheet
December 31, 2007**

<u>Assets</u>			
<u>Current assets</u>			
Cash.....		\$ 41,000	
Accounts receivable.....	\$163,500		
Less: Allowance for doubtful accounts	8,700	154,800	
Inventory—at LIFO cost		308,500	
Prepaid insurance.....		5,900	
Total current assets.....			\$ 510,200
 <u>Long-term investments</u>			
Investments in stocks and bonds, of which investments of \$120,000 have been pledged as security for notes payable—at fair value.....			339,000
 <u>Property, plant, and equipment</u>			
Cost of uncompleted plant facilities			
Land	85,000		
Building in process of construction	124,000	209,000	
Equipment	400,000		
Less: Accum. depreciation	140,000	260,000	469,000
 <u>Intangible assets</u>			
Patents—at cost less amortization			36,000
Total assets			\$1,354,200

PROBLEM 5-3 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Notes payable, secured by investments of \$120,000.....	\$ 94,000	
Accounts payable.....	148,000	
Accrued expenses.....	<u>49,200</u>	
Total current liabilities		\$ 291,200

Long-term liabilities

8% bonds payable, due January 1, 2018	400,000	
Less: Unamortized discount on bonds payable.....	<u>20,000</u>	<u>380,000</u>
Total liabilities.....		671,200

Stockholders' equity

Common stock			
Authorized 600,000 shares of \$1 par value; issued and outstanding, 500,000 shares	\$500,000		
Premium on common stock.....	<u>45,000</u>	545,000	
Retained earnings		<u>138,000</u>	<u>683,000</u>
Total liabilities and stockholders' equity.....			<u>\$1,354,200</u>

PROBLEM 5-4

**Russell Crowe Corporation
Balance Sheet
December 31, 2007**

<u>Assets</u>			
<u>Current assets</u>			
Cash.....	\$175,900		
Accounts receivable.....	170,000		
Inventories.....	<u>312,100</u>		
Total current assets.....			\$658,000
 <u>Long-term investments</u>			
Assets allocated to trustee for expansion:			
Cash in bank.....	70,000		
U.S. Treasury notes, at fair value.....	<u>138,000</u>		208,000
 <u>Property, plant, and equipment</u>			
Land.....	750,000		
Buildings.....	\$1,070,000 ^a		
Less: Accum. depreciation—			
buildings.....	<u>410,000</u>	<u>660,000</u>	<u>1,410,000</u>
Total assets.....			<u>\$2,276,000</u>

Liabilities and Stockholders' Equity

<u>Current liabilities</u>			
Notes payable—current installment.....	\$100,000		
Federal income taxes payable.....	<u>75,000</u>		
Total current liabilities.....			\$ 175,000

PROBLEM 5-4 (Continued)

Long-term liabilities

Notes payable	<u>500,000^b</u>
Total liabilities.....	<u>675,000</u>

Stockholders' equity

Common stock, no par; 1,000,000 shares authorized and issued; 950,000 shares outstanding.....	\$1,150,000	
Retained earnings	<u>538,000^c</u>	
	1,688,000	
Less: Treasury stock, at cost (50,000 shares)	<u>(87,000)</u>	
Total stockholders' equity		<u>1,601,000</u>
Total liabilities and stockholders' equity.....		<u>\$2,276,000</u>

^a\$1,640,000 – \$570,000 (to eliminate the excess of appraisal value over cost from the Buildings account. Note that the appreciation capital account is also deleted.)

^b\$600,000 – \$100,000 (to reclassify the currently maturing portion of the notes payable as a current liability.)

^c\$658,000 – \$120,000 (to remove the value of goodwill from retained earnings. Note 2 indicates that retained earnings was credited. Note that the goodwill account is also deleted.)

Note: As an alternate presentation, the cash restricted for plant expansion would be added to the general cash account and then subtracted. The amount reported in the investments section would not change.

PROBLEM 5-5

**Stephen King Corporation
Balance Sheet
December 31, 2007**

<u>Assets</u>			
<u>Current assets</u>			
Cash.....		\$114,000	
Trading securities—at fair value		80,000	
Accounts receivable.....	\$ 170,000		
Less: Allowance for doubtful accounts	10,000	160,000	
Inventories, at lower of cost (determined using FIFO) or market.....		180,000	
Total current assets.....			\$ 534,000
<u>Long-term investments</u>			
Investments in common stock (available for sale)—at fair value		270,000	
Bond sinking fund.....		250,000	
Cash surrender value of life insurance.....		40,000	
Land held for future use		270,000	830,000
<u>Property, plant, and equipment</u>			
Land.....		500,000	
Buildings.....	1,040,000		
Less: Accum. depreciation— building	360,000	680,000	
Equipment	450,000		
Less: Accum. depreciation— equipment.....	180,000	270,000	1,450,000
<u>Intangible assets</u>			
Franchise		165,000	
Goodwill		100,000	265,000
Total assets			\$3,079,000

PROBLEM 5-5 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable	\$ 104,000		
Notes payable	80,000		
Taxes payable	40,000		
Unearned revenue	<u>5,000</u>		
Total current liabilities			\$ 229,000

Long-term liabilities

Notes payable	\$ 120,000		
7% bonds payable, due 2015	\$1,000,000		
Less: Discount on bonds payable.....	<u>40,000</u>	<u>960,000</u>	<u>1,080,000</u>
Total liabilities.....			1,309,000

Stockholders' equity

Capital stock

Preferred stock, no par value; 200,000 shares authorized, 70,000 issued and outstanding	450,000		
Common stock, \$1 par value; 400,000 shares authorized, 100,000 issued and outstanding	100,000		
Paid-in capital in excess of par on common stock (100,000 X [\$10.00 – \$1.00])	<u>900,000</u>	<u>1,450,000</u>	
Retained earnings		<u>320,000</u>	
Total stockholders' equity			<u>1,770,000</u>
Total liabilities and stockholders' equity.....			<u>\$3,079,000</u>

PROBLEM 5-6

(a) **Alistair Cooke, Inc.**
Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income.....		\$32,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense	12,000	
Gain on sale of investments	(3,400)	
Increase in account receivable (\$41,600 – \$21,200)	<u>(20,400)</u>	<u>(11,800)</u>
Net cash provided by operating activities		20,200
Cash flows from investing activities		
Sale of investments	17,000	
Purchase of land	<u>(18,000)</u>	
Net cash used by investing activities.....		(1,000)
Cash flows from financing activities		
Issuance of common stock.....	24,000	
Retirement of notes payable	(16,000)	
Payment of cash dividends	<u>(8,200)</u>	
Net cash used by financing activities		<u>(200)</u>
Net increase in cash.....		19,000
Cash at beginning of year		<u>20,000</u>
Cash at end of year.....		<u>\$39,000</u>
Noncash investing and financing activities		
Land purchased through issuance of \$30,000 of bonds		

PROBLEM 5-6 (Continued)

(b)

**Alistair Cooke Inc.
Balance Sheet
December 31, 2007**

<u>Assets</u>		<u>Liabilities and Stockholders' Equity</u>	
Cash	\$39,000	Accounts payable	\$30,000
Accounts receivable	41,600	Long-term notes payable	25,000 (4)
Investments	18,400 (1)	Bonds payable	30,000 (5)
Plant assets (net)	69,000 (2)	Common stock	124,000 (6)
Land	88,000 (3)	Retained earnings	47,000 (7)
	<u>\$256,000</u>		<u>\$256,000</u>

(1) $\$32,000 - (\$17,000 - \$3,400)$

(2) $\$81,000 - \$12,000$

(3) $\$40,000 + \$18,000 + \$30,000$

(4) $\$41,000 - \$16,000$

(5) $\$0 + \$30,000$

(6) $\$100,000 + \$24,000$

(7) $\$23,200 + \$32,000 - \$8,200$

(c) Cash flow information is useful for assessing the amount, timing, and uncertainty of future cash flows. For example, by showing the specific inflows and outflows from operating activities, investing activities, and financing activities, the user has a better understanding of the liquidity and financial flexibility of the enterprise. Similarly, these reports are useful in providing feedback about the flow of enterprise resources. This information should help users make more accurate predictions of future cash flow. In addition, some individuals have expressed concern about the quality of the earnings because the measurement of the income depends on a number of accruals and estimates which may be somewhat subjective. As a result, the higher the ratio of cash provided by operating activities to net income, the more comfort some users have in the reliability of the earnings. In this problem the ratio of cash provided by operating activities to net income is 63% ($\$20,200 \div \$32,000$).

PROBLEM 5-6 (Continued)

An analysis of Cooke's free cash flow indicates it is negative as shown below:

Free Cash Flow Analysis

Net cash provided by operating activities	\$20,200
Less: Purchase of land	(18,000)
Dividends	<u>(8,200)</u>
Free cash flow	<u>\$ (6,000)</u>

Its current cash debt coverage ratio is .67 to 1 $\left(\frac{\$20,200}{\$30,000} \right)$ and its cash debt coverage ratio is .26 to 1 $\left(\$20,200 \div \frac{\$71,000 + \$85,000}{2} \right)$, which are reasonable.

Overall, it appears that its liquidity position is average and overall financial flexibility should be improved.

PROBLEM 5-7

(a) **Jay Leno Inc.**
Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income		\$35,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense.....	\$12,000	
Loss on sale of investments.....	3,000	
Increase in accounts payable (\$40,000 – \$30,000)	10,000	
Increase in accounts receivable (\$42,000 – \$21,200)	<u>(20,800)</u>	<u>4,200</u>
Net cash provided by operating activities.....		39,200
Cash flows from investing activities		
Sale of investments	29,000	
Purchase of land	<u>(38,000)</u>	
Net cash used by investing activities		(9,000)
Cash flows from financing activities		
Issuance of common stock	26,000	
Payment of cash dividends.....	<u>(10,000)</u>	
Net cash provided by financing activities.....		<u>16,000</u>
Net increase in cash		46,200
Cash at beginning of year.....		<u>20,000</u>
Cash at end of year		<u>\$66,200</u>
Noncash investing and financing activities		
Land purchased through issuance of \$30,000 of bonds		

PROBLEM 5-7 (Continued)

(b)

**Jay Leno Inc.
Balance Sheet
December 31, 2007**

<u>Assets</u>		<u>Liabilities and Stockholders' Equity</u>	
Cash	\$66,200	Accounts payable	\$40,000
Accounts receivable	42,000	Bonds payable	71,000 (3)
Plant assets (net)	69,000 (1)	Common stock	126,000 (4)
Land	<u>108,000 (2)</u>	Retained earnings	<u>48,200 (5)</u>
	<u>\$285,200</u>		<u>\$285,200</u>

(1) \$81,000 – \$12,000

(2) \$40,000 + \$38,000 + \$30,000

(3) \$41,000 + \$30,000

(4) \$100,000 + \$26,000

(5) \$23,200 + \$35,000 – \$10,000

(c) An analysis of Leno's free cash flow indicates it is negative as shown below:

Free Cash Flow Analysis

Net cash provided by operating activities	\$39,200
Less: Purchase of land	(38,000)
Dividends	<u>(10,000)</u>
Free cash flow	<u>\$(8,800)</u>

PROBLEM 5-7 (Continued)

Its current cash debt coverage is 1.12 to 1 $\left(\frac{\$39,200}{\$35,000^*} \right)$. Overall, it appears that its liquidity position is average and overall financial flexibility should be improved.

$$*(\$30,000 + \$40,000) \div 2$$

- (d) This type of information is useful for assessing the amount, timing, and uncertainty of future cash flows. For example, by showing the specific inflows and outflows from operating activities, investing activities, and financing activities, the user has a better understanding of the liquidity and financial flexibility of the enterprise. Similarly, these reports are useful in providing feedback about the flow of enterprise resources. This information should help users make more accurate predictions of future cash flow. In addition, some individuals have expressed concern about the quality of the earnings because the measurement of the income depends on a number of accruals and estimates which may be somewhat subjective. As a result, the higher the ratio of cash provided by operating activities to net income, the more comfort some users have in the reliability of the earnings.

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 5-1 (Time 20–25 minutes)

Purpose—to provide a varied number of financial transactions and then determine how each of these items should be reported in the financial statements. Accounting changes, additional assessments of income taxes, prior period adjustments, and changes in estimates are some of the financial transactions presented.

CA 5-2 (Time 25–30 minutes)

Purpose—to present the student with the opportunity to determine whether certain accounts should be classified as current asset and current liability items. Borderline cases are included in which the student is required to state the reasons for the questionable classifications. The number of items to be classified is substantial and provides a good review to assess whether students understand what items should be classified in the current section of the balance sheet.

CA 5-3 (Time 30–35 minutes)

Purpose—to present the asset section of a partial balance sheet that must be analyzed to assess its deficiencies. Items such as improper classifications, terminology, and disclosure must be considered.

CA 5-4 (Time 20–25 minutes)

Purpose—to present a balance sheet that must be analyzed to assess its deficiencies. Items such as improper classification, terminology, and disclosure must be considered.

CA 5-5 (Time 20–25 minutes)

Purpose—to present the student an ethical issue related to the presentation of balance sheet information. The reporting involves “net presentation” of property, plant and equipment.

CA 5-6 (Time 40–50 minutes)

Purpose—to present a cash flow statement that must be analyzed to explain differences in cash flow and net income, and sources and uses of cash flow and ways to improve cash flow.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 5-1

1. The new estimate would be used in computing depreciation expense for 2007. No adjustment of the balance in accumulated depreciation at the beginning of the year would be made. Instead, the remaining depreciable cost would be divided by the estimated remaining life. This is a change in an estimate and is accounted for prospectively (in the current and future years). Disclosure in the notes to the financial statements is appropriate, if material.
2. The additional assessment should be shown on the current period's income statement. If material it should be shown separately; if immaterial it could be included with the current year's tax expense. This transaction does not represent a prior period adjustment.
3. The effect of the error at December 31, 2006, should be shown as an adjustment of the beginning balance of retained earnings on the retained earnings statement. The current year's expense should be adjusted (if necessary) for the possible carryforward of the error into the 2007 expense computation.
4. Generally, an entry is made for a cash dividend on the date of declaration. The appropriate entry would be a debit to Retained Earnings (or Dividends) for the amount to be paid, with a corresponding credit to Dividends Payable. Dividends payable is reported as a current liability.

CA 5-2

Current Assets

Interest accrued on U.S. government securities.
Notes receivable.
Petty cash fund.
U.S. government securities.
Cash in bank.
Inventory of operating parts and supplies.
Inventory of raw materials.
Accounts receivable.
 U.S. government contracts.
 Regular (less allowance for doubtful accounts).
 Installments—due next year.
Inventory of finished goods.
Inventory of work in process.

Current Liabilities

Preferred cash dividend, payable Nov. 1, 2007.
Federal income taxes payable.
Customers' advances (on contracts to be completed next year).
Premium on bonds redeemable in 2007.
Officers' 2007 bonus accrued.
Accrued payroll.
Notes payable.
Accrued interest on bonds.
Accounts payable.
Accrued interest on notes payable.
8% First mortgage bonds to be redeemed in 2007.

CA 5-2 (Continued)

Borderline cases that have been classified on the basis of assumptions are:

1. Notes receivable are assumed to be collectible within one year or the operating cycle.
2. U.S. government securities are assumed to be a temporary investment of current funds.
3. Accounts receivable—government contracts are assumed to be collectible within one year or the operating cycle.
4. Notes payable are assumed to be due within one year or the operating cycle.

(Note to instructor: Allowance for doubtful accounts receivable is not a current asset. It, however, would appear in the current asset section.)

CA 5-3

- (1) Unclaimed payroll checks should be shown as a current liability if these are claims by employees.
- (2) Trading securities should be reported at fair value, not cost.
- (3) Bad Debt Reserve is an improper terminology; Allowance for Doubtful Accounts is considered more appropriate. The amount of estimated uncollectibles should be disclosed.
- (4) Next-in, First-out (NIFO) is not an acceptable inventory valuation method.
- (5) Heading “Tangible assets” should be changed to “Property, Plant and Equipment” also label for corresponding \$630,000 should be changed to “net property, plant, and equipment.”
- (6) Land should not be depreciated.
- (7) Buildings and equipment and their related accumulated depreciation balances should be separately disclosed.
- (8) The valuation basis for stocks should be disclosed (fair value or equity) and the description should be Available for Sale Securities or Investment in X Company.
- (9) Treasury stock is not an asset and should be shown in the stockholders’ equity section as a deduction.
- (10) Discount on bonds payable is not an asset and should be shown as a deduction from bonds payable.
- (11) Sinking fund should be reported in the long-term investments section.

CA 5-4

Criticisms of the balance sheet of the Bellemy Brothers Corporation:

- (1) The basis for the valuation of marketable securities should be shown. Marketable securities are valued at fair value. In addition, they should be classified as either trading securities, available-for-sale securities, or held-to-maturity securities.
- (2) An allowance for doubtful accounts receivable is not indicated.

CA 5-4 (Continued)

- (3) The basis for the valuation and the method of pricing for Merchandise Inventory are not indicated.
- (4) A stock investment in a subsidiary company is not ordinarily held to be sold within one year or the operating cycle, whichever is longer. As such, this account should not be classified as a current asset, but rather should be included under the heading "Investments." The basis of valuation of the investment should be shown.
- (5) Treasury stock is not an asset. It should be presented as a deduction in the stockholders' equity section of the balance sheet. The class of stock, number of shares, and basis of valuation should be indicated.
- (6) Buildings and land should be segregated. The Reserve for Depreciation should be shown as a subtraction from the Buildings account only. Also, the term "reserve for" should be replaced by "accumulated."
- (7) Cash Surrender Value of Life Insurance would be more appropriately shown under the heading of "Investments."
- (8) Reserve for Income Taxes should appropriately be entitled Income Taxes Payable.
- (9) Customers' Accounts with Credit Balances is an immaterial amount. As such, this account need not be shown separately. The \$1,000 credit could readily be netted against Accounts Receivable without any material misstatement.
- (10) Unamortized Premium on Bonds Payable should be appropriately shown as an addition to the related Bonds Payable in the long-term liability section. The use of the term deferred credits is inappropriate.
- (11) Bonds Payable are inadequately disclosed. The interest rate, interest payment dates, and maturity date should be indicated.
- (12) Additional disclosure relative to the Common Stock account is needed. This disclosure should include the number of shares authorized, issued, and outstanding.
- (13) Earned Surplus should appropriately be entitled Retained Earnings. Also, a separate heading should be shown for this account; it should not be shown under the heading "Capital Stock." A more appropriate heading would be "Stockholders' Equity."
- (14) Cash Dividends Declared should be disclosed on the retained earnings statement as a reduction of retained earnings. Dividends Payable, in the amount of \$8,000, should be shown on the balance sheet among the current liabilities, assuming payment has not occurred.

CA 5-5

- (a) The ethical issues involved are integrity and honesty in financial reporting, full disclosure, and the accountant's professionalism.
- (b) While presenting property, plant, and equipment net of depreciation on the balance sheet may be acceptable under GAAP, it is inappropriate to attempt to hide information from financial statement users. Information must be useful, and the presentation Pafko is considering would not be. Users would not grasp the age of plant assets and the company's need to concentrate its future cash outflows on replacement of these assets. This information could be provided in a note disclosure.

CA 5-5 (Continued)

Because of the significant impact on the financial statements of the depreciation method(s) used, the following disclosures should be made.

- a. Depreciation expense for the period.
- b. Balances of major classes of depreciable assets, by nature and function.
- c. Accumulated depreciation, either by major classes of depreciable assets or in total.
- d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

CA 5-6

Date

James Spencer, III, CEO
James Spencer Corporation
125 Wall Street
Middleton, Kansas 67458

Dear Mr. Spencer:

I have good news and bad news about the financial statements for the year ended December 31, 2007. The good news is that net income of \$100,000 is close to what we predicted in the strategic plan last year, indicating strong performance this year. The bad news is that the cash balance is seriously low. Enclosed is the Statement of Cash Flows, which best illustrates how both of these situations occurred simultaneously.

If you look at the operating activities, you can see that no cash was generated by operations due to the increase in accounts receivable and inventory and reduction in accounts payable. In effect, these events caused net cash flow provided by operating activities to be lower than net income, they reduced your cash balance by \$116,000.

The corporation made significant investments in equipment and land. These were paid from cash reserves. These purchases used 75% of the company's cash. In addition, the redemption of the bonds improved the equity of the corporation and reduced interest expense. However, it also used 25% of the corporation's cash. It is normal to use cash for investing and financing activities. But when cash is used, it must also be replenished.

Operations normally provide the cash for investing and financing activities. Since there is a finite amount of assets to sell and funds to borrow or raise from the sale of capital stock, operating activities are the only renewable source of cash. That is why it is important to keep the operating cash flows positive. Cash management requires careful and continuous planning.

There are several possible remedies for the current cash problem. First, prepare a detailed analysis of monthly cash requirements for the next year. Second, investigate the changes in accounts receivable and inventory and work to return them to more normal levels. Third, look for more favorable terms with suppliers to allow the accounts payable to increase without loss of discounts or other costs. Finally, since the land represents a long-term commitment without immediate plans for use, consider shopping for a low interest loan to finance the acquisition for a few years and return the cash balance to a more normal level.

If you have additional questions or need one of our staff to address this problem, please contact me at your convenience.

Sincerely yours,

Partner in Charge

FINANCIAL REPORTING PROBLEM

- (a) P&G could use the account form or report form. P&G uses the report form.
- (b) The techniques of disclosing pertinent information include (1) parenthetical explanations, (2) notes, (3) cross-reference and contra items, and (4) supporting schedules. P&G uses parenthetical explanations and notes (see notes to financial statements section) and supporting schedules.
- (c) Investments are reported on P&G's balance sheet as current assets. Note 1 (Significant Accounting Policies) states that Investments are readily available marketable debt and equity securities. These securities are reported at fair value. Unrealized gains and losses on trading securities are recognized in income. Unrealized gains and losses relating to investments classified as available-for-sale are recorded as a component of accumulated other comprehensive income in stockholders' equity. As of June 30, 2004, P&G had negative working capital (current assets less than current liabilities) of \$5,032,000,000. At June 30, 2003, P&G's positive working capital was \$2,862,000,000.
- (d) The following table summarizes P&G's cash flows from operating, investing, and financing activities in the 2002–2004 time period (in millions).

	2004	2003	2002
Net cash provided by operating activities	\$ 9,362	\$ 8,700	\$ 7,742
Net cash used in investing activities	(9,391)	(1,507)	(6,835)
Net cash used in financing activities	(368)	(5,095)	197

P&G's net cash provided by operating activities increased by 12% from 2002 to 2003, and by 8% from 2003 to 2004. When accounts payable, accrued and other liabilities increase, cost of goods sold and operating expenses are higher on an accrued basis than they are on a cash basis. To convert to net cash provided by operating activities, the increase in accounts payable, accrued and other liabilities must be added to net income.

FINANCIAL REPORTING PROBLEM (Continued)

- (e) (1) **Net Cash Provided by Operating Activities ÷ Average Current Liabilities = Current Cash Debt Ratio**

$$\$9,362 \div \frac{(\$22,147 + \$12,358)}{2} = \underline{.54:1}$$

- (2) **Net Cash Provided by Operating Activities ÷ Average Total Liabilities = Cash Debt Coverage Ratio**

$$\$9,362 \div \frac{(\$39,770 + \$27,520)}{2} = \underline{.28:1}$$

- (3) **Net cash provided by operating activities less capital expenditures and dividends**

Net cash provided by operating activities		\$9,362
Less: Capital expenditures	\$2,024	
Dividends	<u>2,539</u>	<u>4,563</u>
Free cash flow		<u>\$4,799</u>

Note that P&G also used cash (\$4,070 million) to repurchase common stock, which reduces its free cash flow to \$729 million. P&G's financial position appears adequate. Over 25% of its total liabilities can be covered by the current year's operating cash flow and its free cash flow position indicates it is easily meeting its capital investment and financing demands from current free cash flow.

FINANCIAL STATEMENT ANALYSIS CASE 1

- (a) The raw materials price increase is not a required disclosure. However, the company might well want to inform shareholders in the management discussion and analysis section, especially as a means for company management to point out an area of success. If the company had not been able to successfully meet the challenge, then the reporting in the discussion and analysis section would be for the purpose of explaining poorer than expected operating results.
- (b) The information in item (2) should be reported as follows: The \$4,000,000 outstanding should, of course, be included in the balance sheet as a part of liabilities (short- or long-term, depending on the terms of the loan). The fact that an additional \$11,000,000 or so is available for borrowing should be disclosed in the notes to the financial statements, as also should the fact that the loan is based on the accounts receivable.

FINANCIAL STATEMENT ANALYSIS CASE 2

- (a) These accounts are shown in the order in which Sherwin-Williams actually presented the accounts. The order shown may be modified somewhat; however, cash should certainly be listed first and other current assets last within the current asset category; common stock should be listed first and retained earnings last in the shareholders' equity category. For the remaining items, the order may be different than that shown.

CURRENT ASSETS

Cash and cash equivalents

Short-term investments

Accounts receivable, less allowance

Finished goods inventories

Work in process and raw materials inventories

Other current assets

LONG-TERM ASSETS

Land

Buildings

Machinery and equipment

Intangibles and other assets

CURRENT LIABILITIES

Accounts payable

Employee compensation payable

Taxes payable

Other accruals

Accrued taxes

LONG-TERM LIABILITIES

Long-term debt

Postretirement benefits other than pensions

Other long-term liabilities

FINANCIAL STATEMENT ANALYSIS CASE 2 (Continued)

SHAREHOLDERS' EQUITY

Common stock

Other capital

Retained earnings

(b) There is some latitude for judgment in this question. The general answer is that the assets and liabilities specific to the automotive division will decrease and that cash will increase. Some students may be aware that retained earnings will increase or decrease, depending upon whether the assets were sold above or below historical cost.

- ◆ *Cash and cash equivalents*—increase from the sale of the assets
- ◆ *Accounts receivable, less allowance*—decrease from the sale of the Automotive Division's receivables
- ◆ *Finished goods inventories*—decrease
- ◆ *Work in process and raw materials inventories*—decrease
- ◆ *Land*—decrease
- ◆ *Buildings*—decrease
- ◆ *Machinery and equipment*—decrease
- ◆ *Long-term debt*—decrease
- ◆ *Retained earnings*—increase or decrease, depending on whether the assets were sold above or below cost

FINANCIAL STATEMENT ANALYSIS CASE 3

a. Working Capital, Current Ratio

Without Contractual Obligations

Working Capital

$$\$17,855 - \$7,888 = \$9,997$$

Current Ratio

$$\$17,855 \div \$7,888 = 2.27$$

With contractual Obligations*

Off-balance sheet current obligations = \$2,351 (\$2,274 + \$75 + \$2)

Working Capital

$$\$17,855 - (\$7,888 + \$2,351) = \$7,616$$

Current Ratio

$$\$17,855 \div (\$7,888 + \$2,351) = 1.74$$

***Note:** The Total debt of \$3,458 is included in the current liabilities on the balance sheet.

Without information on contractual obligations, an analyst would overstate Deere's liquidity, as measured by working capital and the current ratio.

- b. 1) Based on the analysis in part a., Deere has a pretty good liquidity cushion. It would be able to pay a loan of up \$7.6 billion, if due in one year.
- 2) Additional contractual obligations of \$4,839 in years 1–3 and \$1,610 in years 3–5 are relevant to assessing whether Deere can repay a loan maturing in 5 years. In evaluating a longer term loan, an analyst would need to develop a prediction of Deere's cash flows over the next 5 years that would be used to repay a longer term loan.

In summary, the schedule of contractual obligations provides information about off-balance sheet obligations—both the amounts and when due. This helps the analyst assess both liquidity and solvency of a company.

FINANCIAL STATEMENT ANALYSIS CASE 4

(a) (\$ in millions)	<u>2003</u>	<u>2002</u>
Current assets	\$1,821	\$1,616
Total assets	2,162	1,990
Current liabilities	1,253	1,066
Total liabilities	3,198	3,343
(1) Cash provided by operations	392	174
(2) Capital expenditures	46	39
(3) Dividends paid	0	0
Net Income (loss)	35	(149)
Sales	5,264	3,933
Free Cash Flow	346	135
(1) – (2) – (3)		

As indicated above, Amazon's free cash flow in 2003 and 2002 was \$346 million and \$135 million respectively. Amazon shows a positive trend in profitability and cash flow from operations. Depending on the investment required to build the warehouses, it appears they could finance the warehouses with internal funds.

- (b) Cash from operations has increased in 2003 relative to 2002 by \$218 million. This is due in part to increased profitability (increase of \$184 million) from a loss of \$149 in 2002 to its first profit in 2003. If the company can turn in another year like this in 2004, it would appear they are on the way to more stable performance.
- (c) Prior to 2003, most would agree that Amazon was over-priced. It is hard to justify high market valuations in the face of operating losses and barely positive cash flow from operations. However, the results posted in 2003 indicate that Amazon may have turned the corner financially. However, it may be awhile before investors can expect any dividends.

COMPARATIVE ANALYSIS CASE

- (a) The Coca-Cola Company uses the account form; PepsiCo, Inc. uses the report form.
- (b) The Coca-Cola Company had a working capital of \$1,123,000,000 (\$12,094,000,000 – \$10,971,000,000); PepsiCo, Inc. has working capital of \$1,877,000,000 (\$8,639,000,000 – \$6,752,000,000). The Coca-Cola Company indicates in its management discussion and analysis section that its global presence and strong capital position afford it easy access to key financial markets around the world, enabling it to raise funds with a low effective cost. This posture, coupled with active management of its short-term and long-term debt, results in a lower overall cost of borrowing. As a result, its debt management policies, in conjunction with its share repurchase program and investment activity, can result in current liabilities exceeding current assets. PepsiCo has a similar strategy (see discussion in “Liquidity and Capital Resources.”)
- (c) The most significant difference relates to intangible assets. The Coca-Cola Company has Trademarks, Goodwill, and Other Intangible Assets of \$3,836 million; PepsiCo, Inc. has Intangible Assets, net of amortization of \$5,440,000,000. PepsiCo, Inc. has substantial intangible assets due to the reacquiring of franchise rights and trademarks. In addition, a substantial amount of goodwill is recorded in these reacquisitions which represents the residual purchase price after allocation to all identifiable assets. In addition, PepsiCo carries higher levels of property, plant, and equipment (29.1% of assets), while Coca-Cola’s property, plant, and equipment is just 19% of assets. Coca-Cola has much higher investments in unconsolidated subsidiaries (20%* > 11.7% of assets).

$$*(\$9,306 - \$3,054) \div \$31,327$$

COMPARATIVE ANALYSIS CASE (Continued)

(d)

Total assets	<u>Annual</u>	<u>Five-Year</u>
The Coca-Cola Company	14.6%	50.4%
PepsiCo, Inc.	10.5%	34.8%
Long-term debt		
The Coca-Cola Company	(54.0%)	38.6%
PepsiCo, Inc.	40.8%	(20.3%)

(e) The Coca-Cola Company has increased net cash provided by operating activities from 2002 to 2004 by \$1,226 million or 25.9%. PepsiCo, Inc. has increased net cash provided by operating activities by \$427 million or 9.2%. Both companies have favorable trends in the generation of internal funds from operations.

(f) The Coca-Cola Company

Current Cash Debt Ratio

$$\$5,968 \div \frac{\$10,971 + \$7,886}{2} = \underline{.63:1}$$

Cash Debt Coverage Ratio

$$\$5,968 \div \frac{\$15,392 + \$13,252}{2} = \underline{.42:1}$$

COMPARATIVE ANALYSIS CASE (Continued)

Free cash flow		
Net cash provided by operating activities		\$5,968,000,000
Less: Business reinvestment		<u>755,000,000</u>
Free cash flow		<u>\$5,213,000,000</u>

The Coca-Cola Company defines free cash flow as the cash remaining from operations after satisfying business reinvestment opportunities. We have defined it to also reduce dividends. In that case, the Coca-Cola Company's free cash flow would be reduced by an additional \$2,429,000,000, which would reduce its free cash flow to \$2,784,000,000. Note that Coca-Cola is also using cash to repurchase shares (\$1,739 million in 2004).

PepsiCo, Inc.

Current Cash Debt Ratio

$$\$5,054 \div \frac{\$6,752 + \$6,415}{2} = \underline{\underline{.77:1}}$$

Cash Debt Coverage Ratio

$$\$5,054 \div \frac{\$14,464 + \$13,453}{2} = \underline{\underline{.36:1}}$$

Free cash flow

Net cash provided by operating activities		\$5,054,000,000
Less: Capital spending	\$1,387,000,000	
Dividends	<u>1,329,000,000</u>	<u>2,716,000,000</u>
Free cash flow		<u>\$2,338,000,000</u>

PepsiCo also is using significant cash balances to repurchase shares (\$3.1 billion in 2004).

Both companies have strong liquidity and financial flexibility.

COMPARATIVE ANALYSIS CASE (Continued)

- (g) The Coca-Cola Company uses the following ratios: Net debt to net capital; interest coverage ratio; and ratio of earnings to fixed charges.**

PepsiCo, Inc. does not use any ratios to explain its financial position related to debt financing. Thus, users must construct their own ratios for this purpose.

RESEARCH CASE 1

- (a) **Ford Motor Co. = 0000037996
Wisconsin Electric = 0000107815**

- (b) **Ford separately presents the assets and liabilities of its automotive and financial services operations due to their heterogeneity. Wisconsin Electric presents its plant assets first due to their importance. Note that common equity is listed before liabilities for Wisconsin Electric, which is a common practice for utilities.**

INTERNATIONAL REPORTING CASE

(a) Some of the differences are:

- 1. Report form and subtotals—Tomkins uses a modified report form with current liabilities deducted from current assets to determine net current assets and remaining liabilities deducted from total assets less current liabilities to arrive at “net assets”. This amount balances with total “Capital and Reserves”.**
- 2. Classifications—the classifications are not arranged according to decreasing liquidity. For example, “Fixed assets” are listed first, then “Current assets”. Cash is not listed as the first current asset.**
- 3. Terminology—For example, “Stock” is used instead of inventory. The term “Debtors” is used instead of accounts receivable. Contributed capital is referred to as “Called up share capital” and “Share premium”, rather than Common Stock and Additional paid-in capital. “Profit and loss account” is used instead of Retained Earnings.**
- 4. Units of currency—Tomkins reports in pounds sterling.**

(b) Although there are differences in terminology and some groupings and subtotals are different, the British balance sheet does group assets and liabilities with similar characteristics together (Fixed assets, Current assets and current liabilities). For the most part, the classifications are similar in that they are related to the liquidity of the balance sheet items. By netting liabilities against assets, a measure of solvency is provided.

Note to instructors: A final difference not mentioned above is the “Capital redemption reserve” account in the Capital and reserves section of Tomkins’ Balance sheet. This account in the U.K. corresponds to “Additional Paid-in Capital—Treasury Stock in the U.S. setting.

PROFESSIONAL RESEARCH: ACCOUNTING AND FINANCIAL REPORTING

Search string: “accounting policies” and disclosure

- (a) APB 22: Disclosure of Accounting Policies.
- (b) 6. The accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, changes in financial position, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing the financial statements.
- (c) 12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, changes in financial position, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:
 - a. A selection from existing acceptable alternatives;
 - b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;
 - c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).
- (d) Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.

PROFESSIONAL SIMULATION

Financial Statement

Lance Livestrong Company Balance Sheet December 31, 2007

Assets

Current assets

Cash (\$50,000 – \$20,000).....		\$30,000
Accounts receivable (\$38,500 + \$13,500).....	\$ 52,000	
Less: Allowance for doubtful accounts	<u>13,500</u>	38,500
Inventories		<u>65,300</u>
Total current assets.....		133,800

Long-term investments

Plant expansion fund.....		20,000
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Property, plant, and equipment

Equipment	132,000	
Less: Accumulated depreciation— equipment	<u>28,000</u>	104,000

Intangible assets

Patents.....		<u>20,000</u>
Total assets		<u>\$277,800</u>

PROFESSIONAL SIMULATION (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable.....	\$32,000	
Taxes payable.....	3,000	
Note payable	<u>17,000</u>	
Total current liabilities.....		\$ 52,000

Long-term liabilities

Bonds payable (9%, due June 30, 2015).....		<u>100,000</u>
Total liabilities.....		<u>152,000</u>

Stockholders' equity

Common stock (\$1 par).....	50,000	
Additional paid in capital	55,000	
Retained earnings	<u>20,800</u>	<u>125,800</u>
Total liabilities and stockholders' equity.....		<u>\$277,800</u>

Analysis

$$\begin{aligned}
 Z &= \frac{\text{Working capital}}{\text{Total assets}} \times 1.2 + \frac{\text{Retained earnings}}{\text{Total assets}} \times 1.4 + \frac{\text{EBIT}}{\text{Total assets}} \times 3.3 \\
 &\quad + \frac{\text{Sales}}{\text{Total assets}} \times 0.99 + \frac{\text{MV equity}}{\text{Total liabilities}} \times 0.6 \\
 &= \frac{(\$133,800 - \$52,000)}{\$277,800} \times 1.2 + \frac{\$20,800}{\$277,800} \times 1.4 + \frac{\$14,000}{\$277,800} \times 3.3 \\
 &\quad + \frac{\$210,000}{\$277,800} \times 0.99 + \frac{\$225,000}{\$152,000} \times 0.6 \\
 &= .3533 + .1048 + .1663 + .7484 + .8882 = 2.2610
 \end{aligned}$$

PROFESSIONAL SIMULATION (Continued)

Livestrong's Z-Score is above the "likely-to-fail" level of 1.81 but also below the unlikely-to-fail value of 3.0. Livestrong should be concerned about his company's situation.

Research

Search string: "accounting policies" and disclosure

APB 22: Disclosure of Accounting Policies

12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, changes in financial position, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

- a. A selection from existing acceptable alternatives;**
- b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;**
- c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).**

Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.