

# CHAPTER 2

## A Further Look at Financial Statements

### Learning Objectives

1. Identify the sections of a classified balance sheet.
2. Use ratios to evaluate a company's profitability, liquidity, and solvency.
3. Discuss financial reporting concepts.

### Summary of Questions by Learning Objectives and Bloom's Taxonomy

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

## ASSIGNMENT CHARACTERISTICS TABLE

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

# ANSWERS TO QUESTIONS

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

LO 1 BT: K Diff: E TOT: 1 min. AACSB: None AICPA FC: Measurement

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

LO 1 BT: K Diff: E TOT: 1 min. AACSB: None AICPA FC: Reporting

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

LO 1 BT: C Diff: M TOT: 2 min. AACSB: None AICPA FC: Reporting

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

LO 1 BT: C Diff: M TOT: 1 min. AACSB: None AICPA FC: Reporting

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

LO 1 BT: K Diff: M TOT: 2 min. AACSB: None AICPA FC: Reporting

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

LO 2 BT: C Diff: M TOT: 3 min. AACSB: None AICPA FC: Reporting

7. (a) Liquidity ratios: Working capital and current ratio.  
(b) Solvency ratios: Debt to assets and free cash flow.  
(c) Profitability ratio: Earnings per share.

LO 2 BT: K Diff: E TOT: 2 min. AACSB: None AICPA FC: Reporting

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

LO 2 BT: C Diff: E TOT: 2 min. AACSB: None AICPA FC: Reporting

9. (a) Liquidity ratios measure the short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.
- (b) Profitability ratios measure the income or operating success of a company for a given period of time.
- (c) Solvency ratios measure the company's ability to survive over a long period of time.

LO 2 BT: K Diff: E TOT: 2 min. AACSB: None AICPA FC: Reporting

10. (a) The increase in earnings per share is good news because it means that profitability has improved.
- (b) An increase in the current ratio signals good news because the company improved its ability to meet maturing short-term obligations.
- (c) The increase in the debt to assets ratio is bad news because it means that the company has increased its obligations to creditors and has lowered its equity "buffer."
- (d) A decrease in free cash flow is bad news because it means that the company has become less solvent. The higher the free cash flow, the more solvent the company.

LO 2 BT: AN Diff: M TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

11. (a) The debt to assets ratio and free cash flow indicate the company's ability to repay the face value of the debt at maturity and make periodic interest payments.
- (b) The current ratio and working capital indicate a company's liquidity and short-term debt-paying ability.
- (c) Earnings per share indicates the earning power (profitability) of an investment.

LO 2 BT: C Diff: M TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

12. (a) Generally accepted accounting principles (GAAP) are a set of rules and practices, having substantial support, that are recognized as a general guide for financial reporting purposes.
- (b) The body that provides authoritative support for GAAP is the Financial Accounting Standards Board (FASB).

LO 3 BT: K Diff: E TOT: 2 min. AACSB: None AICPA FC: Measurement

13. (a) The primary objective of financial reporting is to provide information useful for decision making.
- (b) The fundamental qualitative characteristics are relevance and faithful representation. The enhancing qualities are comparability, consistency, verifiability, timeliness, and understandability.

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

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

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

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

- 18.** Accounting relies primarily on two measurement principles. Fair value is sometimes used when market price information is readily available. However, in many situations reliable market price information is not available. In these instances, accounting relies on historical cost as its basis.
- 19.** The economic entity assumption states that every economic entity can be separately identified and accounted for. This assumption requires that the activities of the entity be kept separate and distinct from (1) the activities of its owners (the shareholders) and (2) all other economic entities. A shareholder of a company charging personal living costs as expenses of the company is an example of a violation of the economic entity assumption.
- 20.** At September 27, 2014 Apple's largest current asset was Cash and cash equivalents of \$14,557 million, its largest current liability is Accounts payable of \$16,459 million and its largest item under "Assets" was Property and equipment, net of \$16,967 million.

# SOLUTIONS TO BRIEF EXERCISES

## BRIEF EXERCISE 2-1

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

LO 1 BT: K Difficulty: Easy TOT: 2 min. AACSB: None AICPA FC: Reporting

## BRIEF EXERCISE 2-2

### CHIN COMPANY Partial Balance Sheet

<b>Current assets</b>	
Cash.....	\$10,400
Debt investments.....	8,200
Accounts receivable.....	14,000
Supplies.....	3,800
Prepaid insurance.....	2,600
<b>Total current assets .....</b>	<b><u>\$39,000</u></b>

LO 1 BT: AP Difficulty: Medium TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## BRIEF EXERCISE 2-3

$$\begin{aligned}
 \text{Earnings per share} &= \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shares outstanding}} \\
 &= \frac{\$220 \text{ million} - \$0}{333 \text{ million shares}} = \$0.66 \text{ per share}
 \end{aligned}$$

LO 2 BT: AP Difficulty: Easy TOT: 2 min. AACSB: Analytic AICPA FC: Reporting

## BRIEF EXERCISE 2-4

Working capital = Current assets – Current liabilities

Current assets	\$102,500,000
Current liabilities	<u>201,200,000</u>
Working capital	<u>(\$ 98,700,000)</u>

Current ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$102,500,000}{\$201,200,000} = .51:1$$

LO 2 BT: AP Difficulty: Easy TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## BRIEF EXERCISE 2-5

- (a) Current ratio  $\frac{\$262,787}{\$293,625} = 0.89:1$   
 $\frac{\text{Current assets}}{\text{Current liabilities}}$
- (b) Debt to assets  $\frac{\$376,002}{\$439,832} = 85.5\%$   
 $\frac{\text{Total liabilities}}{\text{Total assets}}$
- (c) Free cash flow  $\$62,300 - \$24,787 - \$12,000 = \$25,513$   
(Net cash provided  
operating activities –  
capital expenditures –  
dividends paid)

LO 2 BT: AP Difficulty: Easy TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## BRIEF EXERCISE 2-6

- (a) True.  
(b) False.

LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: None AICPA FC: Measurement

## **BRIEF EXERCISE 2-7**

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

**LO 3 BT: K Difficulty: Easy TOT: 3 min. AACSB: None AICPA FC: Measurement**

## **BRIEF EXERCISE 2-8**

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

**LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: None AICPA FC: Measurement**

## **BRIEF EXERCISE 2-9**

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

**LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: None AICPA FC: Measurement**

## **BRIEF EXERCISE 2-10**

- (c)**

**LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: None AICPA FC: Measurement**



## SOLUTIONS TO DO IT! EXERCISES

### DO IT! 2-1a

#### MYLAR CORPORATION Balance Sheet (partial) December 31, 2017

Assets			
<b>Current assets</b>			
Cash .....	\$	13,000	
Accounts receivable .....		22,000	
Inventory .....		58,000	
Supplies .....		<u>7,000</u>	
<b>Total current assets</b> .....			<b>\$100,000</b>
<b>Property, plant, and equipment</b>			
Equipment.....		180,000	
Less: Accumulated depreciation— equipment.....		<u>50,000</u>	<u>130,000</u>
<b>Total assets</b> .....			<b><u>\$230,000</u></b>

LO 1 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Analytic AICPA FC: Reporting

### DO IT! 2-1b

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

LO 1 BT: AP Difficulty: Easy TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## DO IT! 2-2

(a)	2017	2016
	$\frac{(\$80,000 - \$6,000)}{(40,000 + 75,000)/2} = \$1.29$	$\frac{(\$40,000 - \$6,000)}{(30,000 + 40,000)/2} = \$0.97$

Nguoi's profitability, as measured by the amount of income available for each share of common stock, increased by 33 percent  $((\$1.29 - \$0.97)/\$0.97)$  during 2017. Earnings per share should not be compared across companies because the number of shares issued by companies varies widely. Thus, we cannot conclude that Nguoi Corporation is more profitable than Matisse Corporation based on its higher EPS in 2017.

$$\frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Common Shares Outstanding}}$$

(b)	2017	2016
Current ratio	$\frac{\$54,000}{\$22,000} = 2.45:1$	$\frac{\$36,000}{\$30,000} = 1.20:1$

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

Debt to assets ratio	$\frac{\$72,000}{\$240,000} = 30\%$	$\frac{\$100,000}{\$205,000} = 49\%$
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$$\frac{\text{Total liabilities}}{\text{Total assets}}$$

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

(c)	Free cash flow	2017: $\$90,000 - \$6,000 - \$3,000 - \$27,000 = \$54,000$
		2016: $\$56,000 - \$6,000 - \$1,500 - \$12,000 = \$36,500$

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

LO 1 BT: AP Difficulty: Easy TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## **DO IT! 2-3**

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

**LO 2 BT: K Difficulty: Hard TOT: 10 min. AACSB: Analytic AICPA FC: Reporting**

# SOLUTIONS TO EXERCISES

## EXERCISE 2-1

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

LO 1 BT: AP Difficulty: Easy TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## EXERCISE 2-2

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

LO 1 BT: AP Difficulty: Easy TOT: 3 min. AACSB: Analytic AICPA FC: Reporting

## EXERCISE 2-3

**THE BOEING COMPANY**  
**Partial Balance Sheet**  
**December 31, 2017**  
**(in millions)**

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<b>Assets</b>			
<b>Current assets</b>			
Cash.....	\$	9,215	
Debt investments.....		2,008	
Accounts receivable.....		5,785	
Notes receivable .....		368	
Inventory .....		<u>16,933</u>	
Total current assets .....			\$34,309
<b>Long-term investments</b>			
Notes receivable .....			5,466
<b>Property, plant, and equipment</b>			
Buildings .....		21,579	
Less: Accumulated depreciation—buildings.....		<u>12,795</u>	8,784
<b>Intangible assets</b>			
Patents .....			<u>12,528</u>
Total assets .....			<u>\$61,087</u>

LO 1 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Analytic AICPA FC: Reporting

**EXERCISE 2-4**

**H. J. HEINZ COMPANY**  
**Partial Balance Sheet**  
**April 30, 2017**  
**(in thousands)**

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<b>Assets</b>			
<b>Current assets</b>			
Cash .....		\$ 373,145	
Accounts receivable .....		1,171,797	
Inventory .....		1,237,613	
Prepaid insurance .....		<u>125,765</u>	
Total current assets .....			\$ 2,908,320
<b>Property, plant, and equipment</b>			
Land .....		76,193	
Buildings .....	\$4,033,369		
Less: Accumulated depreciation—			
Buildings .....	<u>2,131,260</u>	<u>1,902,109</u>	1,978,302
<b>Intangible assets</b>			
Goodwill .....		3,982,954	
Trademarks .....		<u>757,907</u>	<u>4,740,861</u>
Total assets .....			<u><u>\$ 9,627,483</u></u>

LO 1 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Analytic AICPA FC: Reporting

## EXERCISE 2-5

### LONGHORN COMPANY Balance Sheet December 31, 2017

Assets			
<b>Current assets</b>			
Cash.....		\$11,840	
Accounts receivable.....		12,600	
Prepaid insurance.....		<u>3,200</u>	
Total current assets .....			\$ 27,640
<b>Property, plant, and equipment</b>			
Land.....		61,200	
Buildings .....	\$105,800		
Less: Accumulated depreciation— buildings .....	<u>45,600</u>	60,200	
Equipment.....	82,400		
Less: Accumulated depreciation— equipment .....	<u>18,720</u>	<u>63,680</u>	<u>185,080</u>
Total assets .....			<u>\$212,720</u>
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities</b>			
Accounts payable.....		\$ 9,500	
Current maturity of note payable .....		13,600	
Interest payable .....		<u>3,600</u>	
Total current liabilities .....			\$ 26,700
<b>Long-term liabilities</b>			
Note payable (\$93,600 – \$13,600) .....			<u>80,000</u>
Total liabilities .....			106,700
<b>Stockholders' equity</b>			
Common stock.....		60,000	
Retained earnings (\$40,000 + \$6,020*) .....		<u>46,020</u>	
Total stockholders' equity .....			<u>106,020</u>
Total liabilities and stockholders' equity .....			<u>\$212,720</u>

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

(Assets = Liabilities + Stockholders' Equity)

LO 1 BT: AP Difficulty: Medium TOT: 10 min. AACSB: Analytic AICPA FC: Reporting

**EXERCISE 2-6**

**TEXAS INSTRUMENTS, INC.**  
**Balance Sheet**  
**December 31, 2017**  
**(in millions)**

<b>Assets</b>			
<b>Current assets</b>			
Cash .....	\$ 1,182		
Debt investments .....	1,743		
Accounts receivable .....	1,823		
Inventory .....	1,202		
Prepaid rent.....	<u>164</u>		
<b>Total current assets .....</b>		<b>\$ 6,114</b>	
<b>Long-term investments</b>			
Stock investments .....			<b>637</b>
<b>Property, plant, and equipment</b>			
Equipment .....	6,705		
Less: Accumulated depreciation—equipment.....	<u>3,547</u>		<b>3,158</b>
<b>Intangible assets</b>			
Patents.....			<u><b>2,210</b></u>
<b>Total assets.....</b>			<u><b>\$12,119</b></u>
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities</b>			
Accounts payable .....	\$1,459		
Income taxes payable .....	<u>128</u>		
<b>Total current liabilities .....</b>		<b>\$ 1,587</b>	
<b>Long-term liabilities</b>			
Notes payable .....			<u><b>810</b></u>
<b>Total liabilities .....</b>			<b>2,397</b>
<b>Stockholders' equity</b>			
Common stock.....	2,826		
Retained earnings.....	<u>6,896</u>		
<b>Total stockholders' equity .....</b>		<b>9,722</b>	
<b>Total liabilities and stockholders' equity.....</b>			<u><b>\$12,119</b></u>

(Assets = Liabilities + Stockholders' Equity)

LO 1 BT: AP Difficulty: Medium TOT: 10 min. AACSB: Analytic AICPA FC: Reporting



## EXERCISE 2-7

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

2017 : 
$$\frac{\$66,176,000 - 0}{(66,282,000 + 64,507,000) / 2} = \$ 1.01$$

2016 : 
$$\frac{\$54,587,000 - 0}{(73,139,000 + 66,282,000) / 2} = \$ .78$$

- (b) Using net income (loss) as a basis to evaluate profitability, Callaway Golf's income improved by 21%  $[(\$66,176 - \$54,587) \div \$54,587]$  between 2016 and 2017. Its earnings per share increased by 29%  $[(\$1.01 - \$0.78) \div \$0.78]$ .
- (c) To determine earnings per share, dividends on preferred stock are subtracted from net income, but dividends on common stock are not subtracted.

LO 2 BT: AP Difficulty: Medium TOT: 7 min. AACSB: Analytic AICPA FC: Reporting

**EXERCISE 2-8**

(a) **FAIRVIEW CORPORATION**  
**Income Statement**  
**For the Year Ended July 31, 2017**

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

**FAIRVIEW CORPORATION**  
**Retained Earnings Statement**  
**For the Year Ended July 31, 2017**

Retained earnings, August 1, 2013.....		\$34,000
Less: Net loss .....	\$2,500	
Dividends .....	<u>4,000</u>	<u>6,500</u>
Retained earnings, July 31, 2014.....		<u><u>\$27,500</u></u>

[Revenues – Expenses = Net income or (loss)]

(Beginning retained earnings ± Changes in retained earnings = Ending retained earnings)

(b) **FAIRVIEW CORPORATION**  
**Balance Sheet**  
**July 31, 2017**

<b>Assets</b>		
<b>Current assets</b>		
Cash .....	\$29,200	
Accounts receivable .....	<u>9,780</u>	
Total current assets.....		\$38,980
<b>Property, plant, and equipment</b>		
Equipment.....	18,500	
Less: Accumulated depreciation— equipment.....	<u>6,000</u>	<u>12,500</u>
Total assets .....		<u><u>\$51,480</u></u>

**EXERCISE 2-8 (Continued)****(b)**

**FAIRVIEW CORPORATION**  
**Balance Sheet (Continued)**  
**July 31, 2017**

<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities</b>			
Accounts payable .....	\$ 4,100		
Salaries and wages payable .....	<u>2,080</u>		
Total current liabilities.....			\$ 6,180
<b>Long-term liabilities</b>			
Notes payable .....		<u>1,800</u>	
Total liabilities.....			<u>7,980</u>
<b>Stockholders' equity</b>			
Common stock.....	16,000		
Retained earnings .....	<u>27,500</u>		
Total stockholders' equity .....			<u>43,500</u>
<b>Total liabilities and stockholders' equity .....</b>			<u><b>\$51,480</b></u>

(Assets = Liabilities + Stockholders' equity)

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

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

(Current assets ÷ Current liabilities) and (Total liabilities ÷ Total assets)

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

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

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

## EXERCISE 2-8 (Continued)

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

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

LO 1, 2 BT: AP Difficulty: Hard TOT: 20 min. AACSB: Analytic AICPA FC: Reporting

## EXERCISE 2-9

(a)	<u>Beginning of Year</u>	<u>End of Year</u>
Working capital	$\$3,361 - \$1,635 = \$1,726$	$\$3,217 - \$1,601 = \$1,616$
Current ratio	$\frac{\$3,361}{\$1,635} = 2.06:1$	$\frac{\$3,217}{\$1,601} = 2.01:1$

(Current assets – Current liabilities) and (Current assets ÷ Current liabilities)

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

(c) Nordstrom's current ratio at both the beginning and the end of the recent year exceeds Best Buy's current ratio for 2014 (and 2013). Nordstrom's end-of-year current ratio (2.01) exceeds Best Buy's 2014 current ratio (1.41\*). Nordstrom would be considered much more liquid than Best Buy for the recent year.

\*(see text, pg. 55)

LO 2 BT: AP Difficulty: Medium TOT: 10 min. Difficulty: Analytic AICPA FC: Reporting

## EXERCISE 2-10

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

$$\text{Working capital} = \$60,000 - \$30,000 = \$30,000$$

(Current assets ÷ Current liabilities) and (Current assets – Current liabilities)

## EXERCISE 2-10 (Continued)

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

$$\text{Working capital} = \$40,000 - \$10,000 = \$30,000$$

$$*\$60,000 - \$20,000$$

$$**\$30,000 - \$20,000$$

(Current assets ÷ Current liabilities) and (Current assets – Current liabilities)

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

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

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

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

LO 2 BT: AP Difficulty: Medium TOT: 15 min. Difficulty: Analytic AICPA FC: Reporting

## EXERCISE 2-11

	2017	2016
(a) Current ratio	$\frac{\$925,359}{\$401,763} = 2.30 : 1$	$\frac{\$1,020,834}{\$376,178} = 2.71 : 1$
(b) Earnings per share	$\frac{\$179,061}{205,169} = \$0.87$	$\frac{\$400,019}{216,119} = \$1.85$
(c) Debt to assets ratio	$\frac{\$554,645}{\$1,963,676} = 28.2\%$	$\frac{\$527,216}{\$1,867,680} = 28.2\%$
(d) Free cash flow	$\$302,193 - \$265,335 - \$82,394$ $= (\$45,536)$	$\$464,270 - \$250,407 - \$80,796$ $= \$133,067$
(e) Using the debt to assets ratio and free cash flow as measures of solvency produces deteriorating results for American Eagle Outfitters. Its debt to assets ratio remained constant from 2016 to 2017. However, its free cash flow decreased by 134% indicating a significant decline in solvency.		
(f) In 2016 American Eagle Outfitters's cash provided by operating activities was greater than the cash used for capital expenditures. It was generating plenty of cash from operations to cover its investing needs. In 2017, American Eagle Outfitters experienced negative free cash flow. This deficiency could have been covered by issuing stock or debt.		

LO 2 BT: AP Difficulty: Medium TOT: 15 min. Difficulty: Analytic AICPA FC: Reporting

## EXERCISE 2-12

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

LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: None AICPA FC: Measurement

## **EXERCISE 2-13**

- (a) This is a violation of the historical cost principle. The inventory was written up to its fair value when it should have remained at cost.**
- (b) This is a violation of the economic entity assumption. The treatment of the transaction treats Victor Lopez and Lopez Co. as one entity when they are two separate entities. The cash used to purchase the truck should have been treated as part of salaries and wages expense.**
- (c) This is a violation of the periodicity assumption. This assumption states that the economic life of a business can be divided into artificial time periods (months, quarters, or a year). By adding two more weeks to the year, Lopez Co. would be misleading financial statement readers. In addition, 2017 results would not be comparable to previous years' results. The company should use a 52 week year.**

**LO 3 BT: C Difficulty: Medium TOT: 5 min. AACSB: None AICPA FC: Measurement**

# SOLUTIONS TO PROBLEMS

## PROBLEM 2-1A

### YAHOO! INC. Balance Sheet December 31, 2017 (Amounts are in millions)

Assets		
<b>Current assets</b>		
Cash.....	\$2,292	
Debt investments.....	1,160	
Accounts receivable.....	1,061	
Prepaid rent.....	<u>233</u>	
<b>Total current assets</b> .....		<b>\$ 4,746</b>
<b>Long-term investments</b>		
Stock investments .....		<b>3,247</b>
<b>Property, plant, and equipment</b>		
Equipment .....	1,737	
Less: Accumulated depreciation— equipment.....	<u>201</u>	<b>1,536</b>
<b>Intangible assets</b>		
Goodwill .....	3,927	
Patents .....	<u>234</u>	<b>4,161</b>
<b>Total assets</b> .....		<b><u>\$13,690</u></b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable .....	\$ 152	
Unearned sales revenue .....	<u>413</u>	
<b>Total current liabilities</b> .....		<b>\$ 565</b>
<b>Long-term liabilities</b>		
Notes payable .....		<u>734</u>
<b>Total liabilities</b> .....		<b>1,299</b>
<b>Stockholders' equity</b>		
Common stock.....	6,283	
Retained earnings.....	<u>6,108</u>	
<b>Total stockholders' equity</b> .....		<b><u>12,391</u></b>
<b>Total liabilities and stockholders' equity</b> .....		<b><u>\$13,690</u></b>

(Assets = Liabilities + Stockholders' equity)

LO 1 BT: AP Difficulty: Medium TOT: 12 min. AACSB: Analytic AICPA FC: Measurement



**PROBLEM 2-2A**

**MARTIN CORPORATION**  
**Income Statement**  
**For the Year Ended December 31, 2017**

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

**MARTIN CORPORATION**  
**Retained Earnings Statement**  
**For the Year Ended December 31, 2017**

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Retained earnings, January 1, 2017 .....	<b>\$31,000</b>
Add: Net income .....	<b><u>21,400</u></b>
	<b>52,400</b>
Less: Dividends.....	<b><u>12,000</u></b>
Retained earnings, December 31, 2017 .....	<b><u>\$40,400</u></b>

**PROBLEM 2-2A (Continued)**

**MARTIN CORPORATION**  
**Balance Sheet**  
**December 31, 2017**

<b>Assets</b>			
<b>Current assets</b>			
Cash.....	\$10,100		
Accounts receivable .....	11,700		
Prepaid insurance.....	<u>3,500</u>		
Total current assets .....		\$25,300	
<b>Property, plant, and equipment</b>			
Equipment .....	66,000		
Less: Accumulated depreciation—equipment...	<u>17,600</u>	<u>48,400</u>	
Total assets.....		<u>\$73,700</u>	
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities</b>			
Accounts payable .....	\$18,300		
Salaries and wages payable.....	<u>3,000</u>		
Total current liabilities .....		\$21,300	
<b>Stockholders' equity</b>			
Common stock.....	12,000		
Retained earnings.....	<u>40,400</u>		
Total stockholders' equity .....		<u>52,400</u>	
Total liabilities and stockholders' equity.....		<u>\$73,700</u>	

[Revenues – Expenses = Net income or (loss)]

(Beginning retained earnings ± Changes in retained earnings = Ending retained earnings)

(Assets = Liabilities + Stockholders' equity)

LO 1 BT: AP Difficulty: Medium TOT: 15 min. AACSB: Analytic AICPA FC: Measurement

<b>PROBLEM 2-3A</b>
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(a)

**LAZURIS ENTERPRISES**  
**Income Statement**  
**For the Year Ended April 30, 2017**

Sales revenue .....		\$5,100
Expenses		
Cost of goods sold .....	\$1,060	
Salaries and wages expense .....	700	
Interest expense .....	400	
Depreciation expense .....	335	
Insurance expense .....	210	
Income tax expense .....	165	
Total expenses .....		<u>2,870</u>
Net income .....		<u>\$2,230</u>

**LAZURIS ENTERPRISES**  
**Retained Earnings Statement**  
**For the Year Ended April 30, 2017**

Retained earnings, May 1, 2013 .....		\$1,600
Add: Net income .....		<u>2,230</u>
		3,830
Less: Dividends .....		<u>325</u>
Retained earnings, April 30, 2014 .....		<u>\$3,505</u>

[Revenues – Expenses = Net income or (loss)]

(Beginning retained earnings ± Changes in retained earnings = Ending retained earnings)

**PROBLEM 2-3A (Continued)**

**(b)**

**LAZURIS ENTERPRISES**  
**Balance Sheet**  
**April 30, 2017**

<b>Assets</b>			
<b>Current assets</b>			
Cash .....	\$1,270		
Stock investments.....	1,200		
Accounts receivable.....	810		
Inventory .....	967		
Prepaid insurance .....	<u>60</u>		
<b>Total current assets.....</b>			<b>\$4,307</b>
<b>Property, plant, and equipment</b>			
Land.....	3,100		
Equipment.....	\$2,420		
Less: Accumulated depreciation—equipment.....	<u>670</u>	<u>1,750</u>	<u>4,850</u>
<b>Total assets.....</b>			<b><u>\$9,157</u></b>

**Liabilities and Stockholders' Equity**

<b>Current liabilities</b>			
Notes payable.....	\$ 61		
Accounts payable .....	834		
Salaries and wages payable.....	222		
Income taxes payable .....	<u>135</u>		
<b>Total current liabilities .....</b>			<b>\$1,252</b>
Mortgage payable.....			<u>3,500</u>
<b>Total liabilities.....</b>			<b>4,752</b>
<b>Stockholders' equity</b>			
Common stock .....	900		
Retained earnings .....	<u>3,505</u>		
<b>Total stockholders' equity .....</b>			<b><u>4,405</u></b>
<b>Total liabilities and stockholders' equity .....</b>			<b><u>\$9,157</u></b>

**(Assets = Liabilities + Stockholders' equity)**

**LO 1 BT: AP Difficulty: Medium TOT: 15 min. AACSB: Analytic AICPA FC: Measurement**

## PROBLEM 2-4A

- (a) Loeb Company's net income for 2017 is \$248,000 ( $\$1,800,000 - \$1,175,000 - \$283,000 - \$9,000 - \$85,000$ ). Its earnings per share is \$3.10 ( $\$248,000 \div 80,000$  shares outstanding). Bowsh's net income for 2017 is \$142,200 ( $\$620,000 - \$340,000 - \$98,000 - \$3,800 - \$36,000$ ). Its earnings per share is \$2.84 ( $\$142,200 \div 50,000$  shares outstanding).
- (b) Loeb appears to be more liquid. Loeb's 2017 working capital of \$340,875 ( $\$407,200 - \$66,325$ ) is more than twice as high as Bowsh's working capital of \$156,620 ( $\$190,336 - \$33,716$ ). In addition, Loeb's 2017 current ratio of 6.1:1 ( $\$407,200 \div \$66,325$ ) is higher than Loeb's current ratio of 5.6:1 ( $\$190,336 \div \$33,716$ ).
- (c) Loeb appears to be slightly more solvent. Loeb's 2017 debt to total assets ratio of 18.6% ( $\$174,825 \div \$939,200$ )<sup>a</sup> is lower than Bowsh's ratio of 22.5% ( $\$74,400 \div \$330,064$ )<sup>b</sup>. The lower the percentage of debt to assets, the lower the risk is that a company may be unable to pay its debts as they come due.

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

<sup>a</sup>\$174,825 ( $\$66,325 + \$108,500$ ) is Loeb's 2017 total liabilities.  
\$939,200 ( $\$407,200 + \$532,000$ ) is Loeb's 2017 total assets.

<sup>b</sup>\$74,400 ( $\$33,716 + \$40,684$ ) is Bowsh's 2017 total liabilities.  
\$330,064 ( $\$190,336 + \$139,728$ ) is Bowsh's 2017 total assets.

LO 2 BT: AN Difficulty: Hard TOT: 20 min. AACSB: Analytic AICPA FC: Reporting

<b>PROBLEM 2-5A</b>
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(a) (i) Working capital = \$458,900 – \$195,500 = \$263,400.

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

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

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

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

(b) During 2017, the company's current ratio increased from 1.65:1 to 2.35:1 and its working capital increased from \$160,500 to \$263,400. Both measures indicate an improvement in liquidity during 2017.

The company's debt to assets ratio increased from 31.0% in 2016 to 38.2% in 2017 indicating that the company is less solvent in 2017. Another measure of solvency, free cash flow, increased from \$48,700 to \$67,800. This suggests an improvement in solvency, thus we have conflicting measures of solvency.

Earnings per share decreased from \$3.15 in 2016 to \$3.06 in 2017. This indicates a decline in profitability during 2017.

LO 2 BT: AP Difficulty: Medium TOT: 15 min. AACSB: Analytic AICPA FC: Reporting

## PROBLEM 2-6A

	<u>2016</u>	<u>2017</u>
(a) Earnings per share.	$\frac{\$60,000}{30,000 \text{ shares}} = \$2.00$	$\frac{\$70,000}{33,000 \text{ shares}} = \$2.12$
(b) Working capital.	$(\$20,000 + \$62,000 + \$73,000) - \$70,000 = \$85,000$	$(\$28,000 + \$70,000 + \$90,000) - \$75,000 = \$113,000$
(c) Current ratio.	$\frac{\$155,000}{\$70,000} = 2.2:1$	$\frac{\$188,000}{\$75,000} = 2.5:1$
(d) Debt to assets ratio.	$\frac{\$160,000}{\$685,000} = 23.4\%$	$\frac{\$155,000}{\$760,000} = 20.4\%$
(e) Free cash flow.	$\$56,000 - \$38,000 - \$15,000 = \$3,000$	$\$82,000 - \$45,000 - \$20,000 = \$17,000$
(f) Net income and earnings per share have increased, indicating that the underlying profitability of the corporation has improved. The liquidity of the corporation as shown by the working capital and the current ratio has improved slightly. Also, the corporation improved its solvency by improving its debt to assets ratio as well as free cash flow.		

LO 2 BT: AP Difficulty: Medium TOT: 20 min. AACSB: Analytic AICPA FC: Reporting

## PROBLEM 2-7A

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

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

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

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

LO 2 BT: AP Difficulty: Medium TOT: 20 min. AACSB: Analytic AICPA FC: Reporting



## PROBLEM 2-8A

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

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

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

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

**LO 3 BT: E Difficulty: Medium TOT: 15 min. AACSB: Reflective Thinking AICPA FC: Measurement and Reporting**

- (a) Total current assets were \$68,531,000 at September 27, 2014, and \$73,286,000 at September 28, 2013.
- (b) Current assets are properly listed in the order of liquidity. As you will learn in a later chapter, inventories are considered to be less liquid than receivables. Thus, they are listed below receivables and before prepaid expenses.
- (c) The asset classifications are similar to the text: (a) current assets, (b) Long-term marketable securities, (c) property, plant, and equipment, and (d) intangibles.
- (d) Total current liabilities were \$63,448,000 at September 27, 2014, and \$43,658,000 at September 28, 2013.

LO 1 BT: AP Difficulty: Medium TOT: 8 min. AACSB: Analytic AICPA FC: Reporting

(a)	(\$ in thousands)	Columbia Sports wear	VFC
1. Working capital		$\$1,266,041 - \$373,120 = \$892,921$	$\$4,185,854 - \$1,620,241 = \$2,565,613$
2. Current ratio		$\$1,266,041 \div \$373,120 = 3.4:1$	$\$4,185,854 \div \$1,620,241 = 2.6:1$
3. Debt to assets ratio		$\frac{\$436,975}{\$1,792,209} = 24.4\%$	$\frac{\$4,349,258^*}{\$9,980,140} = 43.6\%$
4. Free cash flow		$\$185,783 - \$60,283 - \$39,836 = \$85,664$	$\$1,697,629 - \$234,077 - \$478,933 = \$984,619$

\* $\$1,620,241 + \$1,423,581 + \$1,305,436$

(b) **Liquidity**

VFC Company appears much more liquid since it has about \$1,673 million more working capital than Columbia. But, looking at the current ratios, we see that Columbia's ratio is more than 1.3 times as large as VFC's.

**Solvency**

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

Comparing free cash flow, VFC generates much more excess cash than Columbia—\$984.6 million versus \$85.7 million.

LO 2 BT: AN Difficulty: Hard TOT: 10 min. AACSB: Analytic AICPA FC: Reporting

(a)	(\$ in millions)	Amazon	Wal-Mart
1.	Working capital	$\$31,327 - \$28,089 = \$3,238$	$\$63,278 - \$65,272 = \$(-1,994)$
2.	Current ratio	$\$31,327 \div \$28,089 = 1.1:1$	$\$63,278 \div \$65,272 = .97:1$
3.	Debt to assets ratio	$\frac{\$43,764^*}{\$54,505} = 80.3\%$	$\frac{\$122,312}{\$203,706} = 60.0\%$
4.	Free cash flow	$\$6,842 - \$4,893 - \$0 = \$1,949$	$\$28,564 - \$12,174 - \$6,785 = \$9,605$

\*\$28,089 + \$8,265 + \$7,410

**(b) Liquidity**

Amazon appears more liquid since it has \$5,232 million more working capital than Wal-Mart. Also, Amazon's current ratio is slightly better than Wal-Mart's.

**Solvency**

Based on the debt to assets ratio, Wal-Mart is more solvent. Wal-Mart's debt to assets ratio is significantly lower than Amazon's and, therefore, Wal-Mart would be considered better able to pay its debts as they come due. Comparing free cash flow, Wal-Mart generates much more excess cash than Amazon.

LO 2 BT: AN Difficulty: Hard TOT: 10 min. AACSB: Analytic AICPA FC: Reporting

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

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

The average decrease per year can be approximated as:

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

- (b) Gap's working capital and current ratio decreased (2014), increased (2015 and 2016) and then decreased (2017) during this period, indicating a decline, an improvement and then another decline in liquidity. The current ratio is a better measure of liquidity because it provides a relative measure; that is, current assets compared to current liabilities. Working capital only tells us the net amount of current assets less current liabilities. It is hard to say whether a given amount of working capital is adequate or inadequate without knowing the size of the company.
- (c) The debt to assets ratio suggests that Gap's solvency didn't change much during the period. Debt to assets was .39 in 2013, rose to .45 in 2014 and then came back down to .42 in 2017.
- (d) The earnings per share suggests that Gap's profitability improved significantly from 2013 to 2017, increasing from \$0.94 to \$1.89. However, based on the years shown, it appears that earnings varied a great deal during this period.

LO 2 BT: AN Difficulty: Hard TOT: 15 min. AACSB: Analytic AICPA FC: Reporting

## REAL-WORLD FOCUS

### CT 2-5

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

LO 2 BT: AN Difficulty: Hard TOT: 20 min. AACSB: Analytic and Technology AICPA FC: Reporting

### CT 2-6

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

LO 1, 2 BT: E Difficulty: Hard TOT: 25 min. AACSB: Analytic, Technology, and Reflective Thinking  
AICPA FC: Reporting AICPA BB: Critical Thinking

- (a) Many large companies, big accounting firms, and accounting standard setters tend to favor a switch to IFRS because they believe that global accounting standards would save companies money by consolidating their bookkeeping. They also believe it would make it easier to raise capital around the world. In addition, investors would have less trouble comparing companies from different countries. They also feel that having international accounting standards would lead to an improvement in the enforcement of securities laws.
- (b) Many small companies are opposed to switching to IFRS because (1) they say that the switch would be very costly, and (2) because they don't have operations outside of the U.S., so they see any benefit to their company of using international standards.
- (c) It has been suggested that IFRS lacks standards that are specific to utility companies that U.S. GAAP contains.
- (d) Condorsement (a word invented by the SEC) represents a combination of convergence and endorsement. Under condorsement, U.S. standard setters would continue to work with international standard setters to try to reduce differences in standards. In addition, as new international standards are issued, U.S. standard setters would review those standards and consider whether to endorse them by absorbing them into U.S. GAAP.

LO 3 BT: AN Difficulty: Medium TOT: 20 min. AACSB: Analytic AICPA FC: Reporting

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

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

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

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

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

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

LO 2 BT: E Difficulty: Hard TOT: 20 min. AACSB: Communication and Reflective Thinking AICPA PC: Interaction, Leadership, and Communication



**To:** B. P. Palmer  
**From:** Accounting Major  
**Subject:** Financial Statement Analysis

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

1. **Liquidity ratios**—These measure a company's ability to pay its current obligations.
2. **Solvency ratios**—These measure a company's ability to pay its long-term obligations and survive over the long-term.
3. **Profitability ratios**—These measure the ability of the company to generate a profit.

(b) 1. Examples of liquidity measures are:

**Working capital = Current assets – Current liabilities**

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

2. Examples of solvency measures are:

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

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

## CT 2-9 (Continued)

### 3. Example of profitability measure:

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

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

The bases of comparison are:

1. **Intracompany**—This basis compares an item or financial relationship within a company in the current year with the same item or relationship in one or more prior years.
2. **Industry averages**—This basis compares an item or financial relationship of a company with industry averages (or norms).
3. **Intercompany**—This basis compares an item or financial relationship of one company with the same item or relationship in one or more competing companies.

LO 2 BT: AP Difficulty: Medium TOT: 18 min. AACSB: Communication AICPA PC: Communication

- (a) The stakeholders in this case are: Boeing's management; CEO, public relations manager, Boeing's stockholders, McDonnell Douglas stockholders, other users of the financial statements; especially potential investors of the new combined company.
- (b) The ethical issues center around full disclosure of financial information. Management attempted to "time" the release of bad news in order to complete a merger that would have been revoked if cost overruns had been disclosed as soon as management became aware of them.
- (c) The periodicity assumption requires that financial results be reported on specific, pre-determined dates.  
The full disclosure principle requires that all circumstances and events that make a difference to financial statement users must be disclosed.
- (d) It is not ethical to "time" the release of bad news. GAAP requires that all significant financial information be released to allow users to make informed decisions.
- (e) Answers will vary. One possibility: Release the information regarding cost overruns as it became available. Describe the causes of such overruns and explain how Boeing would address them (probably by improving production methods to eliminate the inefficiencies alluded to in the text).
- (f) Investors and analysts should be aware that Boeing's management will probably "manage" information in the future in ways that will interfere with full disclosure.

LO 3 BT: E Difficulty: Hard TOT: 20 min. AACSB: Ethics AICPA FC: Measurement AICPA PC: Personal Demeanor

**Answers will vary.**

**LO - BT: S Difficulty: Hard TOT: 30 min. AACSB: Communication and Reflective Thinking AICPA CC: Critical Thinking AICPA PC: Communication**

- (a) 1. **Current assets** is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.
2. **Current liabilities** is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

(b) **Access FASB Codification 210-20-45**

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

- 1. Each of two parties owes the other determinable amounts.**
- 2. The reporting party has the right to set off the amount owed with the amount owed by the other party.**
- 3. The reporting party intends to set off.**
- 4. The right of set off is enforceable at law. As a result, a company may not offset accounts payable against cash on its balance sheet.**

**LO 1 BT: C Difficulty: Medium TOT: 15 min. AACSB: Analytic and Technology AICPA FC: Measurement**

- (a) The existence of three different forms of certification would most likely create confusion for coffee purchasers. It would difficult to know what aspects of the coffee growing process each certification covered. Similarly, if there were multiple groups that certified financial statements, each with different criteria, it would be difficult for financial statement users to know what each certification promised.
- (b) The Starbucks certification appears to be the most common in that area. It has the advantage of having a direct link to the Starbucks coffee market. Although it does not guarantee that Starbucks will buy its coffee, it is a requirement that must be met before Starbucks will buy somebody's coffee. Note that the article states that the Starbucks certification "incorporates elements of social responsibility and environmental leadership, but quality of coffee is the first criteria." The Smithsonian Bird Friendly is considered to have the strictest requirements and, as a result, appears to be the least common.
- (c) The certifications have multiple objectives including organic farming as a means to protect bird species, biodiversity and wildlife habitat. Some included requirements are to improve workers' living conditions, such as providing running water in worker housing, child labor regulations and education requirements. As mentioned above, the Starbucks certification has the potential financial benefit of making Starbucks a potential customer, which can stabilize farmers' earnings. Certifications can also be financially beneficial because companies can benefit from the positive public relations effects of either producing or buying coffee produced using sustainable practices.

LO - BT: S Difficulty: Hard TOT: 30 min. AACSB: Technology and Reflective Thinking AICPA FC: Measurement and Reporting AICPA BB: Critical Thinking and Resource Management

## IFRS 2-1

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

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

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

LO 4 BT: C Difficulty: Easy TOT: 5 min. AACSB: Diversity AICPA FC: Reporting AICPA BB: International/Global

## IFRS 2-2

IFRS uses statement of financial position rather than balance sheet.

LO 4 BT: K Difficulty: Easy TOT: 3 min. AACSB: Diversity AICPA FC: Measurement AICPA BB: International/Global

**SUNDELL COMPANY**  
**Partial Statement of Financial Position**

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**Current assets**

Prepaid insurance.....	£ 3,600
Supplies.....	5,200
Accounts receivable .....	12,500
Debt investments .....	6,700
Cash.....	<u>15,400</u>
<b>Total .....</b>	<b><u>£43,400</u></b>

LO 1 BT: K Difficulty: Easy TOT: 2 min. AACSB: Diversity AICPA FC: Reporting AICPA BB: International/Global



**LESSILA BOWLING ALLEY**  
**Statement of Financial Position**  
**December 31, 2017**

<b>Assets</b>			
<b>Property, plant, and equipment</b>			
Land.....		\$64,000	
Buildings .....	\$128,800		
Less: Acc. depr.—buildings.....	<u>42,600</u>	86,200	
Equipment.....	62,400		
Less: Acc. depr.—equipment .....	<u>18,720</u>	<u>43,680</u>	\$193,880
<b>Current assets</b>			
Prepaid insurance.....		4,680	
Accounts receivable.....		14,520	
Cash.....		<u>18,040</u>	<u>37,240</u>
<b>Total assets .....</b>			<b><u>\$231,120</u></b>
<b>Equity and Liabilities</b>			
<b>Equity</b>			
Share capital—ordinary .....	\$100,000		
Retained earnings (\$15,000 + \$3,440*) .....	<u>18,440</u>		\$118,440
<b>Non-current liabilities</b>			
Notes payable .....			83,880
<b>Current liabilities</b>			
Current portion of notes payable .....	13,900		
Accounts payable .....	12,300		
Interest payable .....	<u>2,600</u>		<u>28,800</u>
<b>Total equity and liabilities .....</b>			<b><u>\$231,120</u></b>

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

**(Assets = Equity + Liabilities)**

**LO 1 BT: AP Difficulty: Medium TOT: 3 min. AACSB: Diversity AICPA FC: Reporting AICPA BB: International/Global**

## IFRS 2-5 INTERNATIONAL COMPARATIVE ANALYSIS PROBLEM

Differences in the format of the statement of financial position (balance sheet) used by Vuitton and Apple include the following:

	Vuitton	Apple
1.	Non-current assets listed first	Current assets listed first
2.	Goodwill listed before property, plant and equipment	Property, plant, and equipment listed before goodwill
3.	Current assets are shown in reverse order of liquidity with cash being last	Current assets are shown in order of liquidity with cash being first
4.	The equity section is shown before liabilities	Liabilities are shown before the equity section
5.	Long-term liabilities are shown before current liabilities	Current liabilities are shown before long-term liabilities
6.	The equity section uses Share capital and Share premium	The equity section uses Common stock and additional paid-in capital
7.	Reporting currency is € (euros)	Reporting currency is \$ (dollars)

LO 1 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Diversity AICPA FC: Reporting AICPA BB: International/Global

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