

***Financial Accounting Tools for Business Decision
Making 9th edition Kimmel Solutions Manual***

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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.

ASSIGNMENT CHARACTERISTICS TABLE

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

Questions Chapter 2 (Continued)

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

Questions Chapter 2 (Continued)

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.

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

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.

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

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.

LO 3 BT: C Diff: E TOT: 1 min. AACSB: None AICPA FC: Measurement

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.

LO 3 BT: K Diff: E TOT: 1 min. AACSB: None AICPA FC: Measurement

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.

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

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.

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

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.

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

Questions Chapter 2 (Continued)

- 20.** At September 30, 2017 Apple's largest current asset was short-term marketable securities of \$53,892 million, its largest current liability was accounts payable of \$49,049 million and its largest item under "Assets" was long-term marketable securities of \$194,714 million.

LO 1 BT: C Diff: M TOT: 5 min. AACSB: None AICPA FC: Reporting

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

Identify the order of asset classifications.

<u>2</u>	Long-term investments
<u>5</u>	Current liabilities
<u>7</u>	Stockholders' equity
<u>4</u>	Intangible assets
<u>1</u>	Current assets
<u>6</u>	Long-term liabilities
<u>3</u>	Property, plant, and equipment

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

BRIEF EXERCISE 2.3

CHIN COMPANY Partial Balance Sheet

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

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

BRIEF EXERCISE 2.4

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

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

BRIEF EXERCISE 2.5

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:

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

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

BRIEF EXERCISE 2.6

- (a) $\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$262,787}{\$293,625} = 0.89:1$
- (b) $\frac{\text{Total liabilities}}{\text{Total assets}} = \frac{\$376,002}{\$439,832} = 85.5\%$
- (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 2.7

- (a) True.
- (b) False. The primary standard-setting in the U.S. is the FASB.

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

BRIEF EXERCISE 2.8

- (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 2.9

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

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

BRIEF EXERCISE 2.10

- (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 2.11

- (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, 2022

Assets			
Current assets			
Cash	\$ 13,000		
Accounts receivable.....	22,000		
Inventory	58,000		
Supplies	<u>7,000</u>		
Total current assets			\$100,000
Long-term investments			
Stock-investments.....			1,900
Property, plant, and equipment			
Equipment.....	180,000		
Less: Accumulated depreciation— equipment.....	<u>50,000</u>		130,000
Intangible assets			
Goodwill			<u>4,100</u>
Total assets.....			<u>\$236,000</u>

(Current assets + L-T invest. + Prop., plant, & equip. + Intang. assets = Tot. assets)
 [(\$13,000 + \$22,000 + \$58,000 + \$7,000) + \$1,900 + (\$180,000 - \$50,000) + \$4,100 = \$236,000]
 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)	2022	2021
	$\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 2022. 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 2022.

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

(b)	2022	2021
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	2022: $\$90,000 - \$6,000 - \$3,000 - \$27,000 = \$54,000$ 2021: $\$56,000 - \$6,000 - \$1,500 - \$12,000 = \$36,500$
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The amount of cash generated by the company above its needs for dividends and capital expenditures increased from \$36,500 to \$54,000.

LO 2 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 3 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, 2022
(in millions)

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

[(Cash + Debt invest. + Accts. rec. + Notes rec. + Inv.) + Notes rec. + (Bldgs. – Accum. depr.-bldgs.) + Patents = Tot. assets]

[((\$9,215 + \$2,008 + \$5,785 + \$368 + \$16,933)) + \$5,466 + (\$21,579 - \$12,795) + \$12,528 = \$61,087]

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, 2022
(in thousands)

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

[(Cash + Accts. rec. + Inv. + Prepd. ins.) + (Land + (Bldgs. – Accum. depr.-bldgs.)) + (Goodwill + Trademarks) = Tot. assets]

[((\$373,145 + \$1,171,797 + \$1,237,613 + \$125,765) + (\$76,193 + (\$4,033,369 - \$2,131,260)) + (\$3,982,954 + \$757,907) = \$9,627,483]

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

EXERCISE 2.5

LONGHORN COMPANY
Balance Sheet
December 31, 2022

Assets			
Current assets			
Cash.....		\$11,840	
Accounts receivable		12,600	
Prepaid insurance.....		<u>3,200</u>	
Total current assets			\$ 27,640
Property, plant, and equipment			
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>
Liabilities and Stockholders' Equity			
Current liabilities			
Accounts payable		\$ 9,500	
Current maturity of note payable		13,600	
Interest payable		<u>3,600</u>	
Total current liabilities			\$ 26,700
Long-term liabilities			
Note payable (\$93,600 – \$13,600).....			<u>80,000</u>
Total liabilities			106,700
Stockholders' equity			
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**

[(Current assets + Prop., plant & equip.) = Current liabl. + Long-term liabl. + SE]

[(((\$11,840 + \$12,600 + \$3,200) + (\$61,200 + (\$105,800 - \$45,600) + (\$82,400 - \$18,720))) = ((\$9,500 + \$13,600 + \$3,600) + \$80,000 + (\$60,000 + \$46,020))]

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

EXERCISE 2.6

CARMEN CO.
Balance Sheet
December 31, 2022

Assets			
Current assets			
Cash.....		\$11,840	
Debt Investments.....		4,100	
Accounts receivable.....		21,700	
Notes receivable		5,300	
Supplies		<u>9,200</u>	
Total current assets			\$52,140
Long-term investments			
Stock investments			71,500
Property, plant, and equipment			
Land.....		195,600	
Buildings	\$261,200		
Less: Accumulated			
depreciation—buildings	<u>32,600</u>	228,600	
Equipment.....	82,400		
Less: Accumulated			
depreciation—equipment	<u>18,720</u>	63,680	
Land improvements.....	45,780		
Less: Accumulated			
depreciation—land improvements		<u>12,600</u>	<u>33,180</u>
Total property, plant and			
equipment			521,060
Intangible assets			
Patents		<u>46,700</u>	
Total assets			<u><u>\$691,400</u></u>

EXERCISE 2-6 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Accounts payable	\$ 9,500
Current portion of mortgage payable	9,100
Income taxes payable	14,700
Interest payable	<u>3,600</u>

Long-term liabilities \$36,900

Mortgage payable 84,500

Total liabilities 121,400

Stockholders' equity

Common stock 75,000

Retained earnings** 495,000

Total stockholders' equity* 570,000

Total liabilities and stockholders' equity \$691,400

*($\$691,400 - \$121,400 = \$570,000$)

**($\$570,000 - \$75,000$)

[(Current assets + L-T invest. + Prop., plant, & equip. + Intang. assets) = (Current liabl. + L-T liabl. + SE)]

[(($\$11,840 + \$4,100 + \$21,700 + \$5,300 + \$9,200$) + $\$71,500 + (\$195,600 + (\$261,200 - \$32,600) + (\$82,400 - \$18,720) + (\$45,780 - \$12,600)) + \$46,700$) = (($\$9,500 + \$9,100 + \$14,700 + \$3,600$) + $\$84,500 + (\$75,000 + \$495,000)$)]

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

EXERCISE 2.7

TEXAS INSTRUMENTS, INC.
Balance Sheet
December 31, 2022
(in millions)

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

[(Current assets + L-T invest. + Prop., plant, & equip. + Intang. assets) = (Current liabl. + L-T liabl. + SE)]
[(((\$1,182 + \$1,743 + \$1,823 + \$1,202 + \$164) + \$637 + (\$6,705 - \$3,547) + \$2,210) = ((\$1,459 + \$128) + \$810 + (\$2,826 + \$6,896))]

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

EXERCISE 2.8

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

2022 :
$$\frac{\$66,176,000 - 0}{(66,282,000 + 64,507,000) / 2} = \$ 1.01$$

2021 :
$$\frac{\$54,587,000 - 0}{(73,139,000 + 66,282,000) / 2} = \$.78$$

(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 2021 and 2022. 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 2.9

(a)

FAIRVIEW CORPORATION Income Statement For the Year Ended July 31, 2022

Revenues		
Service revenue.....	\$66,100	
Rent revenue	<u>8,500</u>	
Total revenues		\$74,600
Expenses		
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>

(Tot. rev. – Tot. exp. = Net loss)

[($\$66,100 + \$8,500$) – ($\$57,500 + \$15,600 + \$4,000$) = ($\$2,500$)]

FAIRVIEW CORPORATION Retained Earnings Statement For the Year Ended July 31, 2022

Retained earnings, August 1, 2021.....		\$34,000
Less: Net loss	\$2,500	
Dividends	<u>4,000</u>	<u>6,500</u>
Retained earnings, July 31, 2022.....		<u><u>\$27,500</u></u>

(Beg. ret. earn. - (Net loss + Div.)= End. ret. earn.)

[\$34,000 – ($\$2,500 + \$4,000$) = \$27,500]

EXERCISE 2.9 (Continued)

(b) **FAIRVIEW CORPORATION**
Balance Sheet
July 31, 2022

Assets			
Current assets			
Cash	\$29,200		
Accounts receivable	<u>9,780</u>		
Total current assets.....			\$38,980
Property, plant, and equipment			
Equipment.....	18,500		
Less: Accumulated depreciation— equipment.....	<u>6,000</u>	<u>12,500</u>	
Total assets			<u>\$51,480</u>
Liabilities and Stockholders' Equity			
Current liabilities			
Accounts payable	\$ 4,100		
Salaries and wages payable	<u>2,080</u>		
Total current liabilities.....			\$ 6,180
Long-term liabilities			
Notes payable		<u>1,800</u>	
Total liabilities.....			7,980
Stockholders' equity			
Common stock.....	16,000		
Retained earnings.....	<u>27,500</u>		
Total stockholders' equity.....			<u>43,500</u>
Total liabilities and stockholders' equity			<u>\$51,480</u>

[(Current assets + Prop., plant, & equip.) = (Current liabl. + L-T liabl. + SE)]

[((\$29,200 + \$9,780) + (\$18,500 - \$6,000)) = ((\$4,100 + \$2,080) + \$1,800 + (\$16,000 + \$27,500))]

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

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

EXERCISE 2.9 (Continued)

(Current assets ÷ Current liabl.) and (Tot. liabl. ÷ Tot. assets)

(\$38,980 ÷ \$6,180) and (\$7,980 ÷ \$51,480)

- (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 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.

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 2.10

(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 liabl.) and (Current assets ÷ Current liabl.)

[Beg. of yr.: (\$3,361 - \$1,635) and (\$3,361 ÷ \$1,635)]; [End of yr.: (\$3,217 - \$1,601) and (\$3,217 ÷ \$1,601)]

- (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.

EXERCISE 2.10 (Continued)

- (c) Nordstrom's current ratio at both the beginning and the end of the recent year exceeds Best Buy's current ratio for 2017 (and 2016). Nordstrom's end-of-year current ratio (2.01) exceeds Best Buy's 2017 current ratio (1.48) as shown in the chapter. Nordstrom would be considered much more liquid than Best Buy for the recent year.

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

EXERCISE 2.11

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

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

(Current assets ÷ Current liabl.) and (Current assets – Current liabl.)

(\$60,000 ÷ \$30,000) and (\$60,000 - \$30,000)

(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 liabl.) and (Current assets – Current liabl.)

[(\$60,000 - \$20,000) ÷ (\$30,000 - \$20,000)] and (\$40,000 - \$10,000)

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

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

EXERCISE 2.11 (Continued)

Payment of current obligations frequently requires cash. Neither working capital nor the current ratio indicate the composition of current assets. If a company's current assets are largely comprised of items such as inventory and prepaid expenses it may have difficulty paying current obligations even though its working capital and current ratio are large enough to indicate favorable liquidity. In 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 2.12

	2022	2021
(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 2021 to 2022. However, its free cash flow decreased by 134% indicating a significant decline in solvency.		

EXERCISE 2.12 (Continued)

- (f) In 2021 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 2022, 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 2.13

- (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 2.14

- a. 5 Whether an item is large enough to likely influence the decision of an investor or creditor.
- b. 6 Constraint that weighs the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available.
- c. 12 Obligations that a company expects to pay within the next year or operating cycle, whichever is longer.
- d. 7 Information that is complete, neutral, and free from error.
- e. 4 The primary accounting standard-setting body in the United States.
- f. 1 Net cash provided by operating activities after adjusting for capital expenditures and cash dividends paid.
- g. 11 A set of accounting standards that have substantial authoritative support and which guide accounting professionals.
- h. 8 The ability of a company to pay obligations that are expected to become due within the next year or operating cycle.
- i. 10 The average time required to purchase inventory, sell it on account, and then collect cash from customers – that is, go from cash to cash.
- j. 13 The quality of information that indicates the information makes a difference in a decision.
- k. 2 The agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies.
- l. 14 The quality of information that occurs when independent observers, using the same methods, obtains similar results.
- m. 9 The difference between the amounts of current assets and current liabilities.
- n. 3 The ability of a company to pay interest as it comes due and to repay the balance of a debt due at its maturity.

LO 1, 2, 3 BT: K Difficulty: Easy TOT: 10 min. AACSB: None AICPA FC: Measurement

EXERCISE 2.15

- (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, 2022 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, 2022 (Amounts are in millions)

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

[(Current Assets + L-T invest. + Prop., plant, & equip. + Intang. assets) = (Current liabl. + L-T libal. + SE)]

PROBLEM 2.1A (Continued)

$$[((\$2,292 + \$1,160 + \$1,061 + \$233) + \$3,247 + (\$1,737 - \$201) + (\$3,927 + \$234)) = ((\$152 + \$413) + \$734 + (\$6,283 + \$6,108))]$$

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, 2022

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

(Serv. rev. – Tot. exp. = Net inc.)

[\$68,000 – (\$37,000 + \$3,600 + \$2,200 + \$2,000 + \$1,800) = \$21,400]

MARTIN CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2022

Retained earnings, January 1, 2022.....	\$31,000
Add: Net income	<u>21,400</u>
	52,400
Less: Dividends.....	<u>12,000</u>
Retained earnings, December 31, 2022	<u><u>\$40,400</u></u>

(Beg. Ret. earn. + Net inc. – Div. = End. ret. earn.)

(\$31,000 + \$21,400 - \$12,000 = \$40,400)

PROBLEM 2. 2A (Continued)

MARTIN CORPORATION
Balance Sheet
December 31, 2022

Assets			
Current assets			
Cash.....	\$10,100		
Accounts receivable	11,700		
Supplies.....	3,100		
Prepaid insurance.....	<u>3,500</u>		
Total current assets			\$28,400
Long-term investments			
Debt investments			5,700
Property, plant, and equipment			
Equipment	66,000		
Less: Accumulated depreciation—equipment...	<u>17,600</u>		48,400
Intangible assets			
Trademarks			<u>2,000</u>
Total assets.....			<u>\$84,500</u>

Liabilities and Stockholders' Equity

Current liabilities			
Accounts payable	\$18,300		
Salaries and Wages payable	<u>3,000</u>		
Total current liabilities			\$21,300
Stockholders' equity			
Common stock.....	22,800		
Retained earnings.....	<u>40,400</u>		
Total stockholders' equity			<u>63,200</u>
Total liabilities.....			<u>\$84,500</u>

[(Current Assets + L-T invest. + Prop., plant, & equip. + Intang. assets) = (Current liabl. + SE)]

[((\$10,100 + \$11,700 + \$3,100 + \$3,500) + \$5,700 + (\$66,000 - \$17,600) + \$2,000) = ((\$18,300 + \$3,000) + (\$22,800 + \$40,400))]

LO 1 BT: AP Difficulty: Medium TOT: 25 min. AACSB: Analytic AICPA FC: Measurement

PROBLEM 2.3A

(a)

LAZURIS ENTERPRISES
Income Statement
For the Year Ended April 30, 2022

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><u>\$2,230</u></u>

(Sales rev. – Tot. exp. = Net inc.)

[\$5,100 – (\$1,060 + \$700 + \$400 + \$335 + \$210 + \$165) = \$2,230]

LAZURIS ENTERPRISES
Retained Earnings Statement
For the Year Ended April 30, 2022

Retained earnings, May 1, 2021		\$1,600
Add: Net income		<u>2,230</u>
		3,830
Less: Dividends		<u>325</u>
Retained earnings, April 30, 2022		<u><u>\$3,505</u></u>

(Beg. ret. earn. + net inc. – Div. = End. ret. earn.)

(\$1,600 + \$2,230 - \$325 = \$3,505)

PROBLEM 2.3A (Continued)

(b) LAZURIS ENTERPRISES
Balance Sheet
April 30, 2022

Assets			
Current assets			
Cash	\$1,270		
Stock investments	1,200		
Accounts receivable	810		
Inventory	967		
Prepaid insurance	<u>60</u>		
Total current assets			\$4,307
Long-term investments			
Investment in land			14,200
Property, plant, and equipment			
Land	3,100		
Equipment	\$2,420		
Less: Accumulated depreciation—equipment	<u>670</u>	<u>1,750</u>	4,850
Intangible assets			
Goodwill			<u>1,800</u>
Total assets			<u>\$25,157</u>

PROBLEM 2.3A (Continued)

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable	\$ 61	
Accounts payable	834	
Salaries and wages payable.....	222	
Income taxes payable	<u>135</u>	
Total current liabilities		\$1,252
Long-term liabilities		
Mortgage payable		<u>3,500</u>
Total liabilities		4,752
Stockholders' equity		
Common stock.....	16,900	
Retained earnings.....	<u>3,505</u>	
Total stockholders' equity		<u>20,405</u>
Total liabilities and stockholders' equity		<u>\$25,157</u>

[(Current assets + L-T invest. + Prop., plant, & equip. + Intang. assets) = (Current liabl. + L-T liabl. + SE)]

$$[(\$1,270 + \$1,200 + \$810 + \$967 + \$60) + \$14,200 + (\$3,100 + (\$2,420 - \$670)) + \$1,800] = ((\$61 + \$834 + \$222 + \$135) + \$3,500 + (\$16,900 + \$3,505))$$

LO 1 BT: AP Difficulty: Medium TOT: 25 min. AACSB: Analytic AICPA FC: Measurement

PROBLEM 2.4A

- (a) Loeb Company's net income for 2022 is \$248,000 (\$1,800,000 – \$1,175,000 – \$283,000 – \$9,000 – \$85,000). Its earnings per share is \$3.10 (\$248,000 ÷ 80,000 shares outstanding). Bowsh's net income for 2022 is \$142,200 (\$620,000 – \$340,000 – \$98,000 – \$3,800 – \$36,000). Its earnings per share is \$2.84 (\$142,200 ÷ 50,000 common shares outstanding).
- (b) Loeb appears to be more liquid. Loeb's 2022 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 2022 current ratio of 6.1:1 (\$407,200 ÷ \$66,325) is higher than Bowsh's current ratio of 5.6:1 (\$190,336 ÷ \$33,716).
- (c) Loeb appears to be slightly more solvent. Loeb's 2022 debt to total assets ratio of 18.6% ($\$174,825 \div \$939,200$)^a is lower than Bowsh's ratio of 22.5% ($\$74,400 \div \$330,064$)^b. The lower the percentage of debt to assets, the lower the risk is that a company may be unable to pay its debts as they come due.

Another measure of solvency, free cash flow, also indicates that 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).

^a\$174,825 (\$66,325 + \$108,500) is Loeb's 2022 total liabilities.
\$939,200 (\$407,200 + \$532,000) is Loeb's 2022 total assets.

^b\$74,400 (\$33,716 + \$40,684) is Bowsh's 2022 total liabilities.
\$330,064 (\$190,336 + \$139,728) is Bowsh's 2022 total assets.

LO 2 BT: AN Difficulty: Hard TOT: 25 min. AACSB: Analytic AICPA FC: Reporting

PROBLEM 2.5A

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

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

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

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

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

(b) During 2022, 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 2022.

The company's debt to assets ratio increased from 31.0% in 2021 to 38.2% in 2022 indicating that the company is less solvent in 2022. 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 2021 to \$3.06 in 2022. This indicates a decline in profitability during 2022.

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

PROBLEM 2.6A

- | | 2021 | | 2022 |
|-----|---|--|---|
| (a) | Earnings per share. | | |
| | $\frac{\$60,000}{30,000 \text{ common shares}} = \2.00 | | $\frac{\$70,000}{33,000 \text{ common 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) | <p>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.</p> | | |

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% ($\$30,394 \div \$44,106$)	60.1% ($\$98,144 \div \$163,429$)
(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 \$128,645 million at September 30, 2017, and \$106,869 million at September 24, 2016.**
- (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 accounts receivable. 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 \$100,814 million at September 30, 2017, and \$79,006 million at September 24, 2016.**

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

(a)	(\$ in thousands)	Columbia Sportswear	VFC
1. Working capital		$\$1,412,023 - \$362,851 = \$1,049,172$	$\$4,293,098 - \$1,785,400 = \$2,507,698$
2. Current ratio		$\$1,412,023 \div \$362,851 = 3.9:1$	$\$4,293,098 \div \$1,785,400 = 2.4:1$
3. Debt to assets ratio		$\frac{\$432,383}{\$2,013,894} = 21.5\%$	$\frac{\$4,798,366}{\$9,739,287} = 49.3\%$
4. Free cash flow		$\$275,167 - \$49,987 - \$48,122 = \$177,058$	$\$1,477,919 - \$175,840 - \$635,994 = \$666,085$

(b) Liquidity

VFC Company appears much more liquid since it has about \$1,459 million more working capital than Columbia. But, looking at the current ratios, we see that Columbia's ratio is more than 1.6 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—\$666.1 million versus \$177.1 million.

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

(a)	(\$ in millions)	Amazon	Wal-Mart
1.	Working capital	$\$45,781 - \$43,816 = \$1,965$	$\$57,689 - \$66,928 = \$ (9,239)$
2.	Current ratio	$\$45,781 \div \$43,816 = 1.04$	$\$57,689 \div \$66,928 = .86$
3.	Debt to assets ratio	$\frac{\$64,117^*}{\$83,402} = 76.9\%$	$\frac{\$118,290^{**}}{\$198,825} = 59.5\%$
4.	Free cash flow	$\$16,443 - \$6,737 - \$0 = \$9,706$	$\$31,530 - \$10,619 - \$6,695 = \$14,216$

*\$43,816 + \$7,694 + \$12,607

**\$66,928 + \$36,015 + \$6,003 + \$9,344

(b) **Liquidity**

Amazon appears more liquid since it has \$11,204 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 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 (2019), increased (2020 and 2021) and then decreased (2022) 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 2018, rose to .45 in 2019 and then came back down to .42 in 2022.
- (d) The earnings per share suggest that Gap's profitability improved significantly from 2018 to 2022, increasing from \$0.94 to \$1.89.

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

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

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

2. Examples of solvency measures are:

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

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

CT 2.8 (Continued)

3. Example of profitability measure:

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

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

The bases of comparison are:

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

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 CONCEPTS AND APPLICATION

IFRS 2.1

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

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

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

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

IFRS 2.3

SUNDELL COMPANY
Partial Statement of Financial Position

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

(Prepd. ins. + Supp. + Accts. rec. + Debt invest. + Cash = Tot. current assets)
(£3,600 + £5,200 + £12,500 + £6,700 + £15,400 = £43,400)
LO 4 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, 2022

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

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

[(Prop., plant, & equip. + Current assets) = (Equity + Non-current liabl. + Current liabl.)]

[(((\$64,000 + (\$128,800 - \$42,600) + (\$62,400 - \$18,720)) + (\$4,680 + \$14,520 + \$18,040)) = ((\$100,000 + \$18,440) + \$83,880 + (\$13,900 + \$12,300 + \$2,600))]

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