

***Financial Accounting 10th edition Libby Solutions
Manual***

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Chapter 2

Investing and Financing Decisions and the Accounting System

ANSWERS TO QUESTIONS

1. The primary objective of financial reporting for external users is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. These users are expected to have a reasonable understanding of accounting concepts and procedures. Usually, they are interested in information to assist them in projecting future cash inflows and outflows of a business.
2.
 - (a) An asset is a probable future economic benefit owned or controlled by the entity as a result of past transactions.
 - (b) A current asset is an asset that will be used or turned into cash within one year; inventory is always considered a current asset regardless of how long it takes to produce and sell the inventory.
 - (c) A liability is a probable future sacrifice of economic benefits of the entity arising from present obligations as a result of a past transaction.
 - (d) A current liability is a liability that will be settled by providing cash, goods, or other services within the coming year.
 - (e) Additional paid-in capital is the owner-provided financing to the business that represents the excess of the amount received when the common stock was issued over the par value of the common stock.
 - (f) Retained earnings are the cumulative earnings of a company that are not distributed to the owners and are reinvested in the business.

3.
 - (a) The separate entity assumption requires that business transactions are separate from the transactions of the owners. For example, the purchase of a truck by the owner for personal use is not recorded as an asset of the business.
 - (b) The monetary unit assumption requires information to be reported in the national monetary unit without any adjustment for changes in purchasing power. That means that each business will account for and report its financial results primarily in terms of the national monetary unit, such as Yen in Japan and Australian dollars in Australia.
 - (c) Under the going concern assumption, businesses are assumed to operate into the foreseeable future. That is, they are not expected to liquidate.
 - (d) Historical cost is a measurement model that requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all noncash considerations.
4. Accounting assumptions are necessary because they reflect the scope of accounting and the expectations that set certain limits on the way accounting information is reported.
5. An account is a standardized format used by organizations to accumulate the dollar effects of transactions on each financial statement item. Accounts are necessary to keep track of all increases and decreases in the fundamental accounting model.
6. The fundamental accounting model is provided by the equation:
$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$
7. A business transaction is (a) an exchange of resources (assets) and obligations (debts) between a business and one or more outside parties, and (b) certain events that directly affect the entity such as the use over time of rent that was paid prior to occupying space and the wearing out of equipment used to operate the business. An example of the first situation is (a) the sale of goods or services. An example of the second situation is (b) the use of insurance paid prior to coverage.
8. Debit is the left side of a T-account and credit is the right side of a T-account. A debit is an increase in assets and a decrease in liabilities and stockholders' equity. A credit is the opposite -- a decrease in assets and an increase in liabilities and stockholders' equity.

9. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation:
$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

The two principles underlying the process are:
- * every transaction affects at least two accounts.
 - * the accounting equation must remain in balance after each transaction.
- The two steps in transaction analysis are:
- (1) identify and classify accounts and the direction and amount of the effects.
 - (2) determine that the accounting equation ($A = L + SE$) remains in balance.
10. The equalities in accounting are:
- (a) $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$
 - (b) $\text{Debits} = \text{Credits}$
11. The journal entry is a method for expressing the effects of a transaction on accounts in a debits-equal-credits format. The title of the account(s) to be debited is (are) listed first and the title of the account(s) to be credited is (are) listed underneath the debited accounts. The debited amounts are placed in a left-hand column and the credited amounts are placed in a right-hand column.
12. The T-account is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities. It is a simplified representation of a ledger account with a debit column on the left and a credit column on the right.
13. The current ratio is computed as current assets divided by current liabilities. It measures a company's liquidity -- the ability of the company to pay its short-term obligations with current assets. A ratio above 1.0 normally suggests that the company has sufficient current assets to settle short-term obligations. Sophisticated cash management systems allow many companies to minimize funds invested in current assets and have a current ratio below 1.0. However, a ratio that is too high in relation to other competitors in the industry may indicate inefficient use of resources.
14. Investing activities on the statement of cash flows include the buying and selling of productive assets and investments. Financing activities include borrowing and repaying debt, issuing and repurchasing stock, and paying dividends.

MULTIPLE CHOICE

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

(Time in minutes)

<i>Mini-exercises</i>		<i>Exercises</i>		<i>Problems</i>		<i>Alternate Problems</i>		<i>Cases and Projects</i>	
<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>
1	3	1	8	1	20	1	20	1	15
2	3	2	15	2	25	2	25	2	15
3	4	3	8	3	40	3	40	3	15
4	4	4	10	4	15	4	15	4	20
5	5	5	10	5	40			5	15
6	3	6	10	6	20			6	20
7	3	7	10					7	30
8	6	8	15					8	20
9	6	9	20					9	*
10	6	10	20						
11	6	11	20						
12	4	12	20			<i>Continuing Problem</i>			
13	4	13	20			1	40		
		14	30						
		15	20						
		16	20						
		17	10						
		18	10						
		19	10						
		20	10						
		21	15						

* Due to the nature of these cases and projects, it is very difficult to estimate the amount of time students will need to complete the assignment. As with any open-ended project, it is possible for students to devote a large amount of time to these assignments. While students often benefit from the extra effort, we find that some become frustrated by the perceived difficulty of the task. You can reduce student frustration and anxiety by making your expectations clear. For example, when our goal is to sharpen research skills, we devote class time discussing research strategies. When we want the students to focus on a real accounting issue, we offer suggestions about possible companies or industries.

MINI-EXERCISES

M2-1.

- F (1) Going concern assumption
- H (2) Historical cost
- G (3) Credits
- A (4) Assets
- I (5) Account

M2-2.

- D (1) Journal entry
- C (2) $A = L + SE$, and Debits = Credits
- A (3) Assets = Liabilities + Stockholders' Equity
- I (4) Liabilities
- B (5) Income statement, balance sheet, statement of stockholders' equity, and statement of cash flows

M2-3.

- (1) N
- (2) N
- (3) Y
- (4) Y
- (5) Y
- (6) N

M2-4.

CL	(1) Accounts Payable
CA	(2) Accounts Receivable
NCA	(3) Buildings
CA	(4) Cash
SE	(5) Common Stock
NCA	(6) Land
CA	(7) Merchandise Inventory
CL	(8) Income Taxes Payable
NCA	(9) Long-Term Investments
NCL	(10) Notes Payable (due in three years)
CA	(11) Notes Receivable (due in six months)
CA	(12) Prepaid Rent
SE	(13) Retained Earnings
CA	(14) Supplies
CL	(15) Utilities Payable
CL	(16) Wages Payable

M2-5.

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
a.	Cash +30,000		Notes payable +30,000		
b.	Cash -10,000				
	Notes receivable +10,000				
c.	Cash +500			Common stock +10	
				Additional paid-in capital +490	
d.	Cash -5,000		Notes payable +10,000		
	Equipment +15,000				
e.			Dividends payable +2,000	Retained earnings -2,000	

M2-6.

	Debit	Credit
Assets	<i>Increase</i>	<i>Decrease</i>
Liabilities	<i>Decrease</i>	<i>Increase</i>
Stockholders' equity	<i>Decrease</i>	<i>Increase</i>

M2-7.

	Increase	Decrease
Assets	<i>Debit</i>	<i>Credit</i>
Liabilities	<i>Credit</i>	<i>Debit</i>
Stockholders' equity	<i>Credit</i>	<i>Debit</i>

M2-8.

a.	Cash (+A)	30,000	
	Notes payable (+L)		30,000
b.	Notes receivable (+A)	10,000	
	Cash (–A)		10,000
c.	Cash (+A)	500	
	Common stock (+SE)		10
	Additional paid-in capital (+SE)		490
d.	Equipment (+A)	15,000	
	Cash (–A)		5,000
	Notes payable (+L)		10,000
e.	Retained earnings (–SE)	2,000	
	Dividends payable (+L)		2,000

M2-9.

Cash			Notes Receivable			Equipment		
Beg.	900		Beg.	1,000		Beg.	15,100	
(a)	30,000	10,000 (b)	(b)	10,000		(d)	15,000	
(c)	500	5,000 (d)						
	<u>16,400</u>			<u>11,000</u>			<u>30,100</u>	
Notes Payable			Dividends Payable					
	3,000 Beg.			0 Beg.				
	30,000 (a)			2,000 (e)				
	10,000 (d)							
	<u>43,000</u>			<u>2,000</u>				
Common Stock			Additional Paid-in Capital			Retained Earnings		
	1,000 Beg.			3,000 Beg.			10,000 Beg.	
	10 (c)			490 (c)		(e)	2,000	
	<u>1,010</u>			<u>3,490</u>			<u>8,000</u>	

M2-10.

JonesSpa Corporation Trial Balance January 31		
	Debit	Credit
Cash	16,400	
Notes receivable	11,000	
Equipment	30,100	
Notes payable		43,000
Dividends payable		2,000
Common stock		1,010
Additional paid-in capital		3,490
Retained earnings		8,000
Totals	<u>57,500</u>	<u>57,500</u>

M2-11.

**JonesSpa Corporation
Balance Sheet
At January 31**

Assets*Current assets:*

Cash	\$ 16,400
Notes receivable	11,000
Total current assets	<u>27,400</u>

Equipment	30,100
	<u> </u>

Total Assets \$ 57,500

Liabilities*Current liabilities:*

Notes payable	\$ 43,000
Dividends payable	2,000
Total current liabilities	<u>45,000</u>

Stockholders' Equity

Common stock	1,010
Additional paid-in capital	3,490
Retained earnings	8,000
Total stockholders' equity	<u>12,500</u>

Total Liabilities &

Stockholders' Equity \$ 57,500

M2-12.**Current Ratio =**

	<u>Current Assets</u>	÷	<u>Current Liabilities</u>	=	
2016	<u>280,000</u>	÷	<u>155,000</u>	=	<u>1.806</u>
2017	<u>270,000</u>	÷	<u>250,000</u>	=	<u>1.080</u>

This ratio indicates that Sal's Taco Company has sufficient current assets to settle current liabilities, but that the ratio has also decreased between 2016 and 2017 by .726 (40%). Sal's Taco Company ratio of 1.080 is lower than Chipotle's 2017 ratio of 1.944, indicating that Sal's Taco Company appears to have weaker liquidity than Chipotle. Because the restaurant industry typically has high cash inflows from customers, both companies can maintain a lower current ratio.

M2-13.

- (a) F
- (b) I
- (c) F
- (d) I

Transaction (e) for the declaration of cash dividends creates an obligation. Thus, it would not be included on the statement of cash flows because no cash was paid in January.

EXERCISES

E2-1.

- E (1) Transaction
- F (2) Going concern assumption
- B (3) Balance sheet
- P (4) Liabilities
- K (5) $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$
- M (6) Notes payable
- L (7) Common stock
- H (8) Historical cost
- I (9) Account
- Q (10) Dual effects
- O (11) Retained earnings
- A (12) Current assets
- C (13) Separate entity assumption
- X (14) Par value
- D (15) Debits
- J (16) Accounts receivable
- N (17) Monetary unit assumption
- W (18) Faithful representation
- T (19) Relevance
- R (20) Stockholders' equity

E2-2.

Req. 1

	<u>Received</u>	<u>Given</u>
(a)	Cash (A)	Common stock and Additional paid-in capital (SE)
(b)	Equipment (A) <i>[or Delivery truck]</i>	Cash (A)
(c)	<i>No exchange transaction</i>	—
(d)	Equipment (A) <i>[or Computer equipment]</i>	Notes payable (<i>current</i>) (L)
(e)	Building (A) <i>[or Construction in progress]</i>	Cash (A)
(f)	Intangibles (A) <i>[or Copyright]</i>	Cash (A)
(g)	Retained earnings (SE) <i>[Received a reduction in the amount available for payment to stockholders]</i>	Dividends payable (L)
(h)	Land (A)	Cash (A)
(i)	Intangibles (A) <i>[or Patents]</i>	Cash (A) and Notes payable (<i>current</i>) (L)
(j)	<i>No exchange transaction</i>	—
(k)	Investments (A)	Cash (A)
(l)	Cash (A)	Notes payable (<i>current</i>) (L)
(m)	Notes payable (L) <i>[Received a reduction in its promise to pay]</i>	Cash (A)

Req. 2

The truck in (b) would be recorded as an asset of \$18,000. The land in (h) would be recorded as an asset of \$50,000. These are applications of the historical cost principle.

Req. 3

The agreement in (c) involves no exchange or receipt of cash, goods, or services and thus is not a transaction. Since transaction (j) occurs between the owner and others, there is no effect on the business because of the separate entity assumption.

E2-3.

<u>Account</u>	<u>Balance Sheet Classification</u>	<u>Debit or Credit Balance</u>
(1) Accounts Receivable	CA	Debit
(2) Retained Earnings	SE	Credit
(3) Accrued Expenses Payable	CL	Credit
(4) Prepaid Expenses	CA	Debit
(5) Common Stock	SE	Credit
(6) Long-Term Investments	NCA	Debit
(7) Plant, Property, and Equipment	NCA	Debit
(8) Accounts Payable	CL	Credit
(9) Short-Term Investments	CA	Debit
(10) Long-Term Debt	NCL	Credit

E2-4.

<u>Event</u>	<u>Assets</u>		=	<u>Liabilities</u>		+	<u>Stockholders' Equity</u>	
a.	Cash	+40,000					Common stock	+1,000
							Additional paid-in capital	+39,000
b.	Equipment	+15,000		Accounts payable	+12,000			
	Cash	-3,000						
c.	Cash	+10,000		Notes payable	+10,000			
d.	Note receivable	+800						
	Cash	-800						
e.	Land	+13,000		Notes payable	+9,000			
	Cash	-4,000						

E2-5.

Req. 1 (dollars in millions)

<u>Event</u>	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
a.	Buildings +303		Notes payable		
	Equipment +1,202		(long-term) +1,073		
	Cash - 432				
b.	Cash +695				Common stock +10
					Additional paid-in capital +685
c.			Dividends payable +1,159		Retained earnings -1,159
d.	Short-term investments +5,928				
	Cash -5,928				
e.	No effects				
f.	Cash +2,423				
	Short-term investments -2,423				

Req. 2

The separate entity assumption states that transactions of the business are separate from transactions of the owners. Since transaction (e) occurs between the owners and others in the stock market, there is no effect on the business.

E2-6.

a.	Cash (+A)	40,000	
	Common stock (+SE)*		1,000
	Additional paid-in capital (+SE)		39,000
b.	Equipment (+A)	15,000	
	Cash (-A)		3,000
	Accounts payable (+L)		12,000
c.	Cash (+A)	10,000	
	Notes payable (+L)		10,000
d.	Notes receivable (+A)	800	
	Cash (-A)		800
e.	Land (+A)	13,000	
	Cash (-A)		4,000
	Notes payable (+L)		9,000

*Common stock at par value: 1,000 shares x \$1 par value = \$1,000

Additional paid-in capital is the excess over market: 1,000 shares x \$39 excess = \$39,000

E2-7.

Req. 1 (dollars in millions)

a.	Buildings (+A)	303	
	Equipment (+A)	1,202	
	Cash (–A)		432
	Notes payable (+L)		1,073
b.	Cash (+A)	695	
	Common stock (+SE)		10
	Additional paid-in capital (+SE)		685
c.	Retained earnings (–SE)	1,159	
	Dividends payable (+L)		1,159
d.	Short-term investments (+A)	5,928	
	Cash (–A)		5,928
e.	No journal entry required.		
f.	Cash (+A)	2,423	
	Short-term investments (–A)		2,423

Req. 2

The separate entity assumption states that transactions of the business are separate from transactions of the owners. Since transaction (e) occurs between the owners and others in the stock market, there is no effect on the business.

E2-8.

Req. 1

a.	Cash (+A)	30,000	
	Notes payable (+L)		30,000
b.	Cash (+A) (500 shares x \$30 market value per share)	15,000	
	Common stock (+SE) (500 shares x \$0.10 par value) ..		50
	Additional paid-in capital (+SE) (difference)		14,950
c.	Buildings (+A)	115,000	
	Cash (-A)		23,000
	Notes payable (+L)		92,000
d.	Equipment (+A)	20,000	
	Cash (-A)		4,000
	Accounts payable (+L)		16,000
e.	Notes receivable (+A)	1,000	
	Cash (-A)		1,000
f.	Accounts payable (-L)	2,000	
	Cash (-A)		2,000
g.	Short-term investments (+A)	10,000	
	Cash (-A)		10,000

E2-9.

Req. 1

Cash		Notes Receivable		Equipment	
Beg.	0	Beg.	0	Beg.	0
(a)	70,000	(e)	2,500	(b)	18,000
(d)	3,000				
	<u>66,000</u>		<u>2,500</u>		<u>18,000</u>

Land		Notes Payable		Common Stock	
Beg.	0		0 Beg.		0 Beg.
(d)	15,000		13,500 (b)		5,040 (a)*
	<u>15,000</u>		<u>13,500</u>		100 (d)
					<u>5,140</u>

Additional Paid-in Capital	
	0 Beg.
	64,960 (a)
	17,900 (d)
	<u>82,860</u>

*6 investors x 8,400 shares each = 50,400 shares issued

50,400 shares issued x \$0.10 par value per share = \$5,040 for common stock

Req. 2

Assets \$ 101,500 = Liabilities \$ 13,500 + Stockholders' Equity \$ 88,000

Req. 3

The agreement in (c) involves no exchange or receipt of cash, goods, or services and thus is not a transaction. Since transaction (f) occurs between the owner and others, there is no effect on the business due to the separate entity assumption.

E2-10.

Req. 1

Cash		Notes Receivable		Equipment	
Beg.	0	Beg.	0	Beg.	0
(a)	60,000	(c)	2,500	(b)	36,000
	9,000 (b)				
	2,500 (c)				
	12,000 (e)				
	<u>36,500</u>		<u>2,500</u>		<u>36,000</u>

Land		Notes Payable		Common Stock	
Beg.	0		0 Beg.		0 Beg.
(a)	35,000	(e)	12,000		300 (a)*
			27,000 (b)		
	<u>35,000</u>		<u>15,000</u>		<u>300</u>

Additional Paid-in Capital	
	0 Beg.
	94,700 (a)*
	<u>94,700</u>

* Common Stock: 3 investors x 1,000 shares each = 3,000 shares issued
 3,000 shares issued x \$0.10 par value per share = \$300 for common stock
 Additional Paid-in Capital: \$95,000 received - \$300 par value = \$94,700

Req. 2

Assets \$ 110,000 = Liabilities \$ 15,000 + Stockholders' Equity \$ 95,000

Req. 3

Since transaction (d) is a personal purchase, not purchased by Precision Builders, there is no effect on the business due to the separate entity assumption.

Req. 4

Market value per share = Total assets received ÷ Number of shares issued
 = \$95,000 ÷ 3,000 shares issued
 = \$31.67 per share

E2-11.

Req. 1

Transaction**Brief Explanation**

- | | |
|---|---|
| 1 | Issued common stock to shareholders for \$15,000 cash. (FastTrack Sports Inc. is a corporation because it issues stock. Par value of the stock was \$0.10 per share because \$1,500 common stock amount divided by 15,000 shares issued equals \$0.10 per share). |
| 2 | Borrowed \$75,000 cash and signed a short-term note for this amount. |
| 3 | Purchased land for \$16,000; paid \$5,000 cash and gave an \$11,000 short-term note payable for the balance. |
| 4 | Loaned \$4,000 cash; borrower signed a short-term note for this amount (Note Receivable). |
| 5 | Purchased store fixtures for \$9,500 cash. |
| 6 | Purchased land for \$4,000; paid for by signing a short-term note. |

Req. 2

FastTrack Sports Inc.
Balance Sheet
At January 7

Assets*Current Assets*

Cash	\$71,500
Notes receivable	4,000
Total Current Assets	<u>75,500</u>

Store fixtures

9,500

Land

20,000**Total Assets**\$105,000**Liabilities***Current Liabilities*

Notes payable	\$90,000
Total Current Liabilities	<u>90,000</u>

Stockholders' Equity

Common stock	1,500
Additional paid-in capital	13,500
Total Stockholders' Equity	<u>15,000</u>

Total Liabilities &**Stockholders' Equity**\$105,000

E2-12.

Req. 1

Transaction	Brief Explanation
1	Issued common stock to shareholders for \$45,000 cash. (Volz Cleaning is a corporation because it issues stock. Par value is \$2.00 per share; \$6,000 common stock amount divided by 3,000 shares issued equals \$2.00 per share).
2	Purchased a delivery truck for \$35,000; paid \$8,000 cash and gave a \$27,000 long-term note payable for the balance.
3	Loaned \$2,000 cash; borrower signed a short-term note for this amount.
4	Purchased short-term investments for \$7,000 cash.
5	Sold short-term investments at cost for \$3,000 cash.
6	Purchased computer equipment for \$4,000 cash.

Req. 2

**Volz Cleaning, Inc.
Balance Sheet
At March 31**

Assets		Liabilities	
<i>Current Assets</i>		Notes payable	\$27,000
Cash	\$27,000	<i>Total Liabilities</i>	<u>27,000</u>
Investments	4,000		
Notes receivable	<u>2,000</u>		
<i>Total Current Assets</i>	33,000	<i>Stockholders' Equity</i>	
Computer equipment	4,000	Common stock	6,000
Delivery truck	<u>35,000</u>	Additional paid-in capital	<u>39,000</u>
		<i>Total Stockholders' Equity</i>	<u>45,000</u>
<i>Total Assets</i>	<u>\$72,000</u>	<i>Total Liabilities & Stockholders' Equity</i>	<u>\$72,000</u>

E2-13.

a.	Cash (+A)	70,000	
	Common stock (+SE)		5,000
	Additional paid-in capital (+SE).....		65,000
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Cash (+A)	18,000	
	Notes payable (long-term) (+L)		18,000
d.	Equipment (+A)	11,000	
	Cash (–A)		1,500
	Notes payable (short-term) (+L)		9,500
e.	Notes receivable (short-term) (+A)	2,000	
	Cash (–A)		2,000
f.	Store fixtures (+A)	15,000	
	Cash (–A)		15,000

E2-14.

		(in millions of Euros)	
a.	Retained earnings (–SE)	2,106	
	Dividends payable (+L)		2,106
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Dividends payable (–L)	2,212	
	Cash (–A)		2,212
d.	Cash (+A)	8,952	
	Notes payable (+L)		8,952
e.	Cash (+A)	753	
	Equipment (–A)		753
f.	Equipment (+A)	8,410	
	Cash (–A)		5,823
	Notes payable (+L)		2,587
g.	Investments (+A)	3,592	
	Cash (–A)		3,592

E2-15.

Req. 1

Assets \$ 10,500 = Liabilities \$ 3,000 + Stockholders' Equity \$ 7,500

Req. 2

a.	Cash (+A)	4,000	
	Notes payable (+L)		4,000
b.	Cash (+A)	1,500	
	Investments (-A)		1,500
c.	Cash (+A)	1,500	
	Property and Equipment (-A)		1,500
d.	Retained earnings (-SE)	800	
	Dividends payable (+L)		800
e.	Dividends payable (-L)	800	
	Cash (-A)		800

Req. 3

Cash		Short-Term Investments		Property and Equipment	
Beg.	5,000	Beg.	2,500	Beg.	3,000
(a)	4,000		1,500 (b)		1,500 (c)
(b)	1,500				
(c)	1,500				
End.	<u>11,200</u>	End.	<u>1,000</u>	End.	<u>1,500</u>
Notes Payable (current)		Notes Payable (noncurrent)		Dividends Payable	
	2,200 Beg.		800 Beg.		0 Beg.
			4,000 (a)	(e)	800 (d)
	<u>2,200</u> End.		<u>4,800</u> End.		<u>0</u> End.
Common Stock		Additional Paid-in Capital		Retained Earnings	
	500 Beg.		4,000 Beg.		3,000 Beg.
				(d)	800
	<u>500</u>		<u>4,000</u>		<u>2,200</u>

E2-15. (continued)

Req. 4

Higgins Company Trial Balance For the Year Ended December 31		
	Debit	Credit
Cash	11,200	
Short-term investments	1,000	
Property and equipment	1,500	
Notes payable (<i>current</i>)		2,200
Notes payable (<i>noncurrent</i>)		4,800
Dividends payable		0
Common stock		500
Additional paid-in capital		4,000
Retained earnings		2,200
Totals	13,700	13,700

Req. 5

Higgins Company Balance Sheet At December 31	
Assets	
<i>Current Assets:</i>	
Cash	\$11,200
Short-term investments	1,000
Total current assets	12,200
Property and equipment	1,500
Total assets	\$13,700
Liabilities and Stockholders' Equity	
<i>Current Liabilities:</i>	
Notes payable	\$ 2,200
Total current liabilities	2,200
Notes payable	4,800
Total liabilities	7,000
<i>Stockholders' Equity</i>	
Common stock	500
Additional paid-in capital	4,000
Retained earnings	2,200
Total stockholders' equity	6,700
Total liabilities and stockholders' equity	\$13,700

E2-15. (continued)

Req. 6

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$11,200 + \$1,000}{\$2,200} = \frac{\$12,200}{\$2,200} = \mathbf{5.55}$$

This ratio indicates that, for every \$1 of current liabilities, Higgins maintains approximately \$5.55 of current assets. Higgins' ratio is higher than the industry average of 1.50, indicating that Higgins maintains a lower level of short-term debt compared to its current assets and has higher liquidity. However, maintaining such a high current ratio also suggests that the company may not be using its resources efficiently. Increasing short-term obligations would lower Higgins' current ratio, but this strategy alone would not help its efficiency. Higgins should consider investing more of its cash in order to generate future returns.

E2-16.

Req. 1

Cash		Short-Term Notes Receivable		Land	
Beg.	0	Beg.	0	Beg.	0
(a)	40,000	(e)	4,000	(b)	16,000
	4,000 (c)				4,000 (e)
	1,000 (d)				
	<u>35,000</u>		<u>4,000</u>		<u>12,000</u>
Equipment		Short-Term Notes Payable		Long-Term Notes Payable	
Beg.	0		0 Beg.		0 Beg.
(c)	20,000		16,000 (b)		16,000 (c)
(d)	1,000				
	<u>21,000</u>		<u>16,000</u>		<u>16,000</u>
Common Stock		Additional Paid-in Capital			
	0 Beg.		0 Beg.		
	10,000 (a)		30,000 (a)		
	<u>10,000</u>		<u>30,000</u>		

Req. 2

Bailey Delivery Company, Inc. Trial Balance December 31, 2018		
	Debit	Credit
Cash	\$35,000	
Short-term notes receivable	4,000	
Land	12,000	
Equipment	21,000	
Short-term notes payable		\$16,000
Long-term notes payable		16,000
Common stock		10,000
Additional paid-in capital		30,000
Totals	<u>\$72,000</u>	<u>\$72,000</u>

E2-16. (continued)

Req. 3

Bailey Delivery Company, Inc.
Balance Sheet
At December 31, 2018

Assets		Liabilities	
<i>Current Assets</i>		<i>Current Liabilities</i>	
Cash	\$35,000	Short-term notes payable	\$16,000
Short-term notes receivable	<u>4,000</u>	<i>Total Current Liabilities</i>	<u>16,000</u>
<i>Total Current Assets</i>	39,000	Long-term notes payable	16,000
		<i>Total Liabilities</i>	<u>32,000</u>
Land	12,000	Stockholders' Equity	
Equipment	<u>21,000</u>	Common stock	10,000
		Additional paid-in capital	<u>30,000</u>
		<i>Total Stockholders' Equity</i>	<u>40,000</u>
Total Assets	<u>\$72,000</u>	Total Liabilities & Stockholders' Equity	<u>\$72,000</u>

Req. 4

	<u>Current Assets</u>	÷	<u>Current Liabilities</u>	=	<u>Current Ratio</u>
2018	\$39,000	÷	\$16,000	=	2.44
2019	52,000	÷	23,000	=	2.26
2020	47,000	÷	40,000	=	1.18

The current ratio has decreased over the years, suggesting that the company's liquidity is decreasing. Although the company still maintains sufficient current assets to settle the short-term obligations, this steep decline in the ratio may be of concern – it may be indicative of more efficient use of resources or it may suggest the company is having cash flow problems.

Req. 5

The management of Bailey Delivery Company has already been financing the company's development through additional short-term debt, from \$16,000 in 2018 to \$40,000 in 2020. This suggests the company is taking on increasing risk. Additional lending to the company, particularly short-term, may be too much risk for the bank to absorb. Should the bank lend the \$50,000, Bailey Delivery Company's current ratio would be 1.08 (97,000 ÷ 90,000) immediately after the financing. Based solely on the current ratio, the bank's vice president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

E2-17.

Transaction	Brief Explanation
(a)	Issued 100,000 shares of common stock (par value \$0.02 per share) to shareholders in exchange for \$20,000 cash and \$5,000 of tools and equipment.
(b)	Loaned \$1,800 cash; borrower signed a note receivable for this amount.
(c)	Purchased a building for \$40,000; paid \$10,000 cash and signed a \$30,000 note payable for the balance.
(d)	Sold tools and equipment for \$900 cash (their original cost).

E2-18.

Req. 1

	<u>Increases with...</u>	<u>Decreases with...</u>
Equipment	Purchases of equipment	Sales of equipment
Notes receivable	Additional loans to others	Collection of loans
Notes payable	Additional borrowings	Payments of debt

Req. 2

Equipment			Notes Receivable			Notes Payable		
1/1	500		1/1	150			100	1/1
	250	<u>650</u>		<u>245</u>	225	<u>110</u>	170	
12/31	<u>100</u>		12/31	<u>170</u>			<u>160</u>	12/31

	Beginning balance	+	"+"	–	"–"	=	Ending balance
Equipment	\$500	+	250	–	?	=	\$100
					?	=	<u>650</u>
Notes receivable	150	+	?	–	225	=	170
					?	=	<u>245</u>
Notes payable	100	+	170	–	?	=	160
					?	=	<u>110</u>

E2-19.

Activity	Type of Activity	Effect on Cash
(a) Capital expenditures (for property, plant, and equipment)	I	–
(b) Repurchases of common stock from investors	F	–
(c) Sale of short-term investments	I	+
(d) Issuance of common stock	F	+
(e) Purchases of short-term investments	I	–
(f) Dividends paid on common stock.	F	–

E2-20.

Activity	Type of Activity	Effect on Cash
(a) Additional borrowing from banks	F	+
(b) Purchase of investments	I	–
(c) Sale of assets and investments (assume sold at cost)	I	+
(d) Issuance of stock	F	+
(e) Purchases of property, plant, and equipment	I	–
(f) Payment of debt principal	F	–
(g) Dividends paid	F	–
(h) Receipt of principal payment on a note receivable	I	+

E2-21.

- | | |
|--|---|
| 1. Current assets | In the asset section of a classified balance sheet. |
| 2. Debt principal repaid | In the financing activities section of the statement of cash flows. |
| 3. Significant accounting policies | Usually the first note after the financial statements. |
| 4. Cash received from sales of noncurrent assets | In the investing activities section of the statement of cash flows. |
| 5. Dividends paid | In the financing activities section of the statement of cash flows. |
| 6. Short-term obligations | In the current liabilities section of a classified balance sheet. |
| 7. Date of the statement of financial position | In the heading of the balance sheet. |

PROBLEMS

P2-1.

	Balance Sheet Classification	Debit or Credit Balance
(1) Notes and Loans Payable (short-term)	CL	Credit
(2) Materials and Supplies	CA	Debit
(3) Common Stock	SE	Credit
(4) Intangible Assets	NCA	Debit
(5) Income Taxes Payable	CL	Credit
(6) Long-Term Debt	NCL	Credit
(7) Property, Plant, and Equipment	NCA	Debit
(8) Retained Earnings	SE	Credit
(9) Notes and Accounts Receivable (short-term)	CA	Debit
(10) Investments (long-term)	NCA	Debit
(11) Cash and Cash Equivalents	CA	Debit
(12) Accounts Payable and Accrued Liabilities	CL	Credit
(13) Crude Oil, Products and Merchandise	CA	Debit
(14) Additional Paid-in Capital	SE	Credit

P2-2.

Req. 1

East Hill Home Healthcare Services was organized as a corporation. Only a corporation issues shares of common stock to its owners in exchange for their investment, as in transaction (a).

Req. 2 (On next page)

Req. 3

The transaction between the two stockholders (Event e) was not included in the tabulation. Since the transaction in (e) occurs between the owners, there is no effect on the business due to the separate entity assumption.

Req. 4

$$(a) \quad \text{Total assets} = \$111,500 + \$18,000 + \$5,000 + \$510,500 + \$160,000 + \$65,000 \\ = \$870,000$$

$$(b) \quad \text{Total liabilities} = \$100,000 + \$180,000 \\ = \$280,000$$

$$(c) \quad \text{Total stockholders' equity} = \text{Total assets} - \text{Total liabilities} \\ = \$870,000 - \$280,000 = \$590,000$$

$$(d) \quad \text{Cash balance} = \$50,000 + \$90,000 - \$9,000 + \$3,500 - \$18,000 - \$5,000 \\ = \$111,500$$

$$(e) \quad \text{Total current assets} = \text{Cash } \$111,500 + \text{Short-Term Investments } \$18,000 + \text{Notes} \\ \text{Receivable } \$5,000 = \$134,500$$

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$111,500 + \$18,000 + \$5,000}{\$100,000} = \frac{\$134,500}{100,000} = 1.35$$

This suggests that for every \$1 in current liabilities, East Hill maintains approximately \$1.35 in current assets. The ratio suggests that East Hill is likely maintaining adequate liquidity and using resources efficiently.

P2-2. (continued)

Req. 2

	Assets						=	Liabilities		+	Stockholders' Equity		
	Cash	Short-Term Investments	Notes Receivable	Land	Buildings	Equipment		ST Notes Payable	LT Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
Beg.	50,000			500,000	100,000	50,000	=	100,000	100,000		20,000	80,000	400,000
(a)	+90,000						=				+9,000	+81,000	
(b)	-9,000			+14,000	+60,000	+15,000	=		+80,000				
(c)	+3,500			-3,500			=						
(d)	-18,000	+18,000					=						
(e)	No effect												
(f)	-5,000		+5,000				=						
	+111,500	+18,000	+5,000	+510,500	+160,000	+65,000	=	+100,000	+180,000		+29,000	+161,000	+400,000
	\$870,000							\$280,000			\$590,000		

P2-3.

Req. 1 and 2

Cash		
Beg.	22,000	
(e)	11,000	10,000 (a)
(f)	9,000	5,000 (b)
(i)	1,000	5,000 (c)
		3,000 (g)
		8,000 (h)
	<u>12,000</u>	

Investments (short-term)		
Beg.	3,000	
(a)	10,000	
	<u>13,000</u>	

Accounts Receivable		
Beg.	3,000	
	<u>3,000</u>	

Inventory		
Beg.	20,000	
	<u>20,000</u>	

Notes Receivable (long-term)		
Beg.	1,000	
(b)	5,000	
	<u>6,000</u>	

Equipment		
Beg.	50,000	
(c)	18,000	1,000 (i)
End.	<u>67,000</u>	

Factory Building		
Beg.	90,000	
(h)	24,000	
End.	<u>114,000</u>	

Intangibles		
Beg.	5,000	
(g)	3,000	
End.	<u>8,000</u>	

Accounts Payable		
	15,000 Beg.	
	<u>15,000</u>	

Accrued Liabilities Payable		
	4,000 Beg.	
	<u>4,000</u>	

Notes Payable (current)		
	7,000 Beg.	
	13,000 (c)	
	9,000 (f)	
	<u>29,000</u>	

Notes Payable (noncurrent)		
	47,000 Beg.	
	16,000 (h)	
	<u>63,000</u>	

Common Stock		
	10,000 Beg.	
	1,000 (e)	
	<u>11,000</u>	

Additional Paid-in Capital		
	80,000 Beg.	
	10,000 (e)	
	<u>90,000</u>	

Retained Earnings		
	31,000 Beg.	
	<u>31,000</u>	

P2-3. (continued)

Req. 3

No effect was recorded for (d). The agreement in (d) involves no exchange or receipt of cash, goods, or services and thus is not a transaction.

Req. 4

Jaguar Plastics Company Trial Balance At December 31		
	Debit	Credit
Cash	12,000	
Investments (short-term)	13,000	
Accounts receivable	3,000	
Inventory	20,000	
Notes receivable (long-term)	6,000	
Equipment	67,000	
Factory building	114,000	
Intangibles	8,000	
Accounts payable		15,000
Accrued liabilities payable		4,000
Notes payable (short-term)		29,000
Notes payable (long-term)		63,000
Common stock		11,000
Additional paid-in capital		90,000
Retained earnings		31,000
Totals	<u>243,000</u>	<u>243,000</u>

P2-3. (continued)

Req. 5

Jaguar Plastics Company
Balance Sheet
At December 31

Assets		Liabilities	
<i>Current Assets</i>		<i>Current Liabilities</i>	
Cash	\$ 12,000	Accounts payable	\$ 15,000
Investments	13,000	Accrued liabilities payable	4,000
Accounts receivable	3,000	Notes payable	29,000
Inventory	20,000	<i>Total Current Liabilities</i>	48,000
<i>Total Current Assets</i>	48,000	Long-term notes payable	63,000
		<i>Total Liabilities</i>	111,000
Notes receivable	6,000		
Equipment	67,000	<i>Stockholders' Equity</i>	
Factory building	114,000	Common stock	11,000
Intangibles	8,000	Additional paid-in capital	90,000
		Retained earnings	31,000
		<i>Total Stockholders' Equity</i>	132,000
<i>Total Assets</i>	<u>\$243,000</u>	<i>Total Liabilities & Stockholders' Equity</i>	<u>\$243,000</u>

Req. 6

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$48,000}{\$48,000} = 1.00$$

This ratio indicates that Jaguar Plastics has relatively low liquidity; for every \$1 of current liabilities, Jaguar Plastics maintains only \$1 of current assets.

P2-4.

<u>Transaction</u>	<u>Type of Activity</u>	<u>Effect on Cash</u>
(a)	I	—
(b)	I	—
(c)	I	—
(d)	NE	NE
(e)	F	+
(f)	F	+
(g)	I	—
(h)	I	—
(i)	I	+

P2-5. (dollars in millions)

Req. 1

a.	Cash (+A)	18,266	
	Long-term debt (+L)		18,266
b.	Long-term investments (+A)	4,200	
	Short-term investments (+A)	16,800	
	Cash (–A)		21,000
c.	Property, plant, and equipment (+A)	10,981	
	Cash (–A)		9,571
	Short-term notes payable (+L)		1,410
d.	Cash (+A)	1,469	
	Common stock (+SE)		1
	Additional paid-in capital (+SE)		1,468
e.	Cash (+A)	18,810	
	Short-term investments (–A)		18,810
f.	Retained earnings (–SE)	11,126	
	Dividends payable (+L)		11,126

P2-5. (continued)

Req. 2

Cash		Short-Term Investments		Accounts Receivable	
Beg.	20,289	Beg.	53,892	Beg.	17,874
(a)	18,266	(b)	16,800		
(d)	1,469		18,810 (e)		
(e)	18,810		<u>51,882</u>		<u>17,874</u>
	<u>28,263</u>				
Long-Term Investments		Inventories		Other Current Assets	
Beg.	194,714	Beg.	4,855	Beg.	31,735
(b)	4,200		<u>4,855</u>		<u>31,735</u>
	<u>198,914</u>				
Accounts Payable		Property, Plant, and Equipment		Other Noncurrent Assets	
	49,049 Beg.	Beg.	33,783	Beg.	18,177
	<u>49,049</u>	(c)	10,981		
			<u>44,764</u>		<u>18,177</u>
Short-term Notes Payable		Accrued Expenses		Unearned Revenue	
	18,473		25,744 Beg.		7,548 Beg.
	1,410 (c)		<u>25,744</u>		<u>7,548</u>
	<u>19,883</u>				
Dividends Payable		Other Noncurrent Liabilities		Common Stock	
	0 Beg.		43,251 Beg.		1 Beg
	11,126 (f)				1 (d)
	<u>11,126</u>		<u>43,251</u>		<u>2</u>
Long-term Debt		Additional Paid-in Capital		Retained Earnings	
	97,207 Beg.		35,866 Beg.		98,180 Beg.
	18,266 (a)		1,468 (d)	(f)	11,126
	<u>115,473</u>		<u>37,334</u>		<u>87,054</u>

P2-5. (continued)

Req. 3

Apple, Inc. Trial Balance For the Year Ended September 29, 2018 (in millions)		
	Debit	Credit
Cash	28,263	
Short-term Investments	51,882	
Accounts receivable	17,874	
Inventories	4,855	
Other current assets	31,735	
Long-term investments	198,914	
Property, plant, and equipment	44,764	
Other noncurrent assets	18,177	
Accounts payable		49,049
Accrued expenses		25,744
Unearned revenue		7,548
Short-term notes payable		19,883
Dividends payable		11,126
Long-term debt		115,473
Other noncurrent liabilities		43,251
Common stock		2
Additional paid-in capital		37,334
Retained earnings		87,054
Totals	<u>396,464</u>	<u>396,464</u>

P2-5. (continued)

Req. 4

Apple, Inc.
Balance Sheet
At September 29, 2018
(in millions)

ASSETS

Current Assets:

Cash	\$ 28,263
Short-term investments	51,882
Accounts receivable	17,874
Inventories	4,855
Other current assets	31,735
Total current assets	134,609
Long-term investments	198,914
Property, plant, and equipment	44,764
Other noncurrent assets	18,177
Total assets	\$396,464

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:

Accounts payable	\$49,049
Accrued expenses	25,744
Unearned revenue	7,548
Dividends payable	11,126
Short-term notes payable	19,883
Total current liabilities	113,350
Long-term debt	115,473
Other noncurrent liabilities	43,251
Total liabilities	272,074

Stockholders' Equity:

Common stock	2
Additional paid-in capital	37,334
Retained earnings	87,054
Total stockholders' equity	124,390
Total liabilities and stockholders' equity	\$396,464

P2-5. (continued)

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$134,609}{\$113,350} = 1.19$$

For every \$1 of short-term liabilities, Apple Inc. has approximately \$1.19 of current assets. This suggests that Apple has sufficient current resources to pay current liabilities. Apple has a very efficient cash management system and keeps its current resources at lower levels to maximize investment opportunities.

P2-6. (dollars in millions)

Activity	Type of Activity	Effect on Cash
(a) Borrowed from banks	F	+ 18,266
(b) Purchased investments	I	– 21,000
(c) Purchased property, plant, and equipment	I	– 9,571
(d) Issued additional stock	F	+ 1,469
(e) Sold short-term investments	I	+ 18,810
(f) Declared dividends (does not affect cash flows)	NE	NE

ALTERNATE PROBLEMS

AP2-1.

	Balance Sheet Classification	Debit or Credit Balance
(1) Prepaid Expenses	CA	Debit
(2) Inventories	CA	Debit
(3) Accounts Receivable	CA	Debit
(4) Long-Term Debt	NCL	Credit
(5) Cash and Equivalents	CA	Debit
(6) Goodwill (an intangible asset)	NCA	Debit
(7) Accounts Payable	CL	Credit
(8) Income Taxes Payable	CL	Credit
(9) Property, Plant, and Equipment	NCA	Debit
(10) Retained Earnings	SE	Credit
(11) Additional Paid-in Capital	SE	Credit
(12) Short-Term Borrowings	CL	Credit
(13) Accrued Liabilities	CL	Credit
(14) Common Stock	SE	Credit

AP2-2.

Req. 1

Russeck Incorporated was organized as a corporation. Only a corporation issues shares of common stock to its owners in exchange for their investment, as Russeck did in transaction (c).

Req. 2 (On next page)

Req. 3

Since the transaction in (i) occurs between the owners and others outside the company, there is no effect on the business due to the separate entity assumption.

Req. 4

(a) Total assets = \$35,000 + \$2,000 + \$85,000 + \$107,000 + \$510,000 = \$739,000

(b) Total liabilities = \$169,000 + \$170,000 = \$339,000

(c) Total stockholders' equity = Total assets – Total liabilities
= \$739,000 – \$339,000 = \$400,000

(d) Cash balance = \$120,000 + \$110,000 – \$3,000 + \$100,000 – \$5,000 – \$2,000
– \$200,000 – \$85,000 = \$35,000

(e) Total current assets = \$35,000 + \$2,000 = \$37,000

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$35,000 + \$2,000}{\$169,000} = \frac{\$37,000}{\$169,000} = 0.219$$

This suggests that Russeck may not have sufficient liquidity to cover its current obligations. Russeck should consider increasing its current assets or seeking to convert some of its short-term debt to long-term debt.

AP2-2. (continued)

Req. 2

	Assets					=	Liabilities		+	Stockholders' Equity		
	Cash	Notes Receivable	Long-Term Investments	Equipment	Buildings		Short-Term Notes Payable	Long-Term Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
Beg.	120,000			70,000	310,000	=	140,000	60,000		20,000	200,000	80,000
(a)	+110,000					=		+110,000				
(b)	-3,000			+30,000		=	+27,000					
(c)	+100,000					=				+10,000	+90,000	
(d)	-5,000			+10,000		=	+5,000					
(e)	-2,000	+2,000				=						
(f)	-200,000				+200,000	=						
(g)	-85,000		+85,000			=						
(h)				-3,000		=	-3,000					
(i)	No effect					=						
	+35,000	+2,000	+85,000	+107,000	+510,000	=	+169,000	+170,000		+30,000	+290,000	+80,000
	\$739,000						\$339,000			\$400,000		

Req. 1 and 2

		Retained Earnings
(h)	300	657,845 Beg.
		657,545

* Reported as a reduction in Stockholders' Equity (similar to Chipotle in Exhibit 2.2).

AP2-3. (continued)

Req. 3

No effect was recorded for (c). Ordering goods involves no exchange or receipt of cash, goods, or services and thus is not a transaction.

Req. 4

Ethan Allen Interiors Inc. Trial Balance At September 30 (in thousands of dollars)		
	Debit	Credit
Cash and cash equivalents	54,841	
Accounts receivable	12,293	
Inventories	149,483	
Prepaid expenses and other current assets	23,621	
Property, plant and equipment	277,408	
Intangible assets	48,528	
Long-term investments	10,310	
Other assets	2,158	
Accounts payable		16,961
Unearned revenue		62,960
Accrued expenses payable		43,793
Dividends payable		300
Long-term debt (current portion, \$2,731)		23,739
Other long-term liabilities		29,273
Common stock		506
Additional paid-in capital		378,744
Treasury stock	635,179	
Retained earnings		657,545
Totals	<u>1,213,821</u>	<u>1,213,821</u>

AP2-3. (continued)

Req. 5

Ethan Allen Interiors Inc.
Balance Sheet
At September 30
(in thousands of dollars)

Assets*Current assets*

Cash and cash equivalents	\$ 54,841
Accounts receivable	12,293
Inventories	149,483
Prepaid expenses and other current assets	23,621

Total current assets 240,238

Property, plant, and equipment	277,408
Intangible assets	48,528
Long-term investments	10,310
Other assets	2,158

Total Assets \$578,642

Liabilities*Current liabilities*

Accounts payable	\$ 16,961
Unearned revenue	62,960
Accrued expenses payable	43,793
Dividends payable	300
Current portion of long-term debt	2,731

Total current liabilities 126,745

Long-term debt	21,008
Other long-term liabilities	29,273

Total Liabilities 177,026

Stockholders' Equity

Common stock (\$0.01 par value)	506
Additional paid-in capital	378,744
Treasury stock	(635,179)
Retained earnings	657,545

Total Stockholders' Equity 401,616

Total Liabilities and Stockholders' Equity \$578,642

Req. 6

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}} = \frac{\$240,238}{\$126,745} = 1.895$$

Ethan Allen maintains a relatively high current ratio, indicating that the company has almost \$2 in current assets to pay each dollar of current obligations.

AP2-4. (dollars in thousands)

<u>Transaction</u>	<u>Type of Activity</u>	<u>Effect on Cash</u>
(a)	F	+1,020
(b)	I	−3,400
(c)	NE	NE
(d)	I	+4,020
(e)	I	−2,980
(f)	I	−1,830
(g)	I	+310
(h)	NE	NE

CONTINUING PROBLEM

CON2-1.

Req. 1

	<u>Debit</u>	<u>Credit</u>
a. Cash (+A)	25,000	
Equipment (+A)	36,000	
Common stock (+SE).....		200
Additional paid-in capital (+SE).....		60,800
b. Land (+A).....	18,000	
Buildings (+A).....	72,000	
Cash (–A).....		10,000
Notes payable (<i>noncurrent</i>) (+L).....		80,000
c. Equipment (+A).....	6,500	
Cash (–A).....		2,500
Notes payable (<i>current</i>) (+L).....		4,000
d. No transaction – no exchange; just a promise of service by the receptionist for a promise to pay cash for the service by PPSS.		
e. Notes payable (<i>noncurrent</i>) (–L).....	1,000	
Cash (–A).....		1,000
f. Short-term investments (+A).....	5,000	
Cash (–A).....		5,000
g. No transaction – ordering goods involves no exchange or receipt of cash, goods, or services (a promise to deliver for a promise to pay when delivered – an exchange of promises is not a transaction).		

CON2-1. (continued)

Req. 2

Cash		
Beg.	0	
(a)	25,000	10,000 (b)
		2,500 (c)
		1,000 (e)
		5,000 (f)
	<u>6,500</u>	

Short-term Investments		
Beg.	0	
(f)	5,000	
	<u>5,000</u>	

Equipment		
Beg.	0	
(a)	36,000	
(c)	6,500	
	<u>42,500</u>	

Land		
Beg.	0	
(b)	18,000	
	<u>18,000</u>	

Buildings		
Beg.	0	
(b)	72,000	
	<u>72,000</u>	

Notes Payable (current)		
	0 Beg.	
	4,000 (c)	
	<u>4,000</u>	

Notes Payable (noncurrent)		
	0 Beg.	
(e)	1,000	80,000 (b)
		<u>79,000</u>

Common Stock		
	0 Beg.	
	200 (a)	
	<u>200</u>	

Additional Paid-in Capital		
	0 Beg.	
	60,800 (a)	
	<u>60,800</u>	

CON2–1. (continued)

Req. 3

Penny's Pool Service & Supply, Inc. Trial Balance March 31		
	Debit	Credit
Cash	\$ 6,500	
Short-term investments	5,000	
Equipment	42,500	
Land	18,000	
Buildings	72,000	
Notes payable (<i>current</i>)		\$ 4,000
Notes payable (<i>noncurrent</i>)		79,000
Common stock		200
Additional paid-in capital		60,800
Totals	<u>\$144,000</u>	<u>\$144,000</u>

CON2-1. (continued)

Req. 4

Penny's Pool Service & Supply, Inc.
Balance Sheet
March 31

Assets*Current Assets:*

Cash	\$ 6,500
Short-term investments	5,000
Total current assets	11,500
Equipment	42,500
Land	18,000
Buildings	72,000
Total assets	<u>\$144,000</u>

Liabilities and Stockholder's Equity*Current Liabilities:*

Notes payable	\$4,000
Total current liabilities	4,000
Notes payable	79,000
Total liabilities	83,000

Stockholder's Equity:

Common stock (\$0.05 par value)	200
Additional paid-in capital	60,800
Total stockholder's equity	61,000
Total liabilities and stockholder's equity	<u>\$144,000</u>

Req. 5

	Type of Activity (I, F, or NE)	Effect on Cash Flows (+ or - and amount)
(a)	F	+ 25,000
(b)	I	- 10,000
(c)	I	- 2,500
(d)	NE	NE
(e)	F	- 1,000
(f)	I	- 5,000
(g)	NE	NE

CON2-1. (continued)

Req. 6

	<u>Current Assets</u>	÷	<u>Current Liabilities</u>	=	<u>Current Ratio</u>
On March 31	\$11,500	÷	\$4,000	=	2.875

With a current ratio of 2.875, PPSS has liquidity with sufficient current assets to settle short-term obligations. However, this may change as the inventory is received in April and operations begin requiring paying cash for inventory purchases from suppliers, advertising, utilities, employee salary, and other operating needs, and paying notes payable when due. One of the most significant problems for new small businesses is generating sufficient cash from operations to pay obligations and maintain liquidity.

CASES AND PROJECTS

ANNUAL REPORT CASES

CP2–1. (dollars in thousands)

1. The company is a corporation since it maintains common stock and contributed capital and its owners are referred to as “stockholders.” (Refer to the stockholders’ equity section of the balance sheet).
2. The amount listed on the balance sheet for inventories does not represent the expected selling price. It represents the historical cost of acquiring the inventory, as required by the cost principle.
3. The company’s current obligations include: Accounts payable, Accrued compensation and payroll taxes, Accrued rent, Accrued income and other taxes, Unredeemed gift cards and gift certificates, Current portion of deferred lease credits, and Other liabilities and accrued expenses.
4. Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$968,530}{\$485,221} = 2.00$

The current ratio measures the ability of the company to settle short-term obligations with current assets. American Eagle Outfitters’ current ratio of 2.00 suggests strong liquidity with \$2.00 in current assets for every \$1.00 in current liabilities.

5. The company spent \$169,469 to purchase property and equipment in the fiscal year ended 2/3/2018; \$161,494 in the fiscal year ended 1/28/2017; and \$153,256 in the fiscal year ended 1/30/2016. This information is listed as *Capital expenditures for property and equipment* in the investing activities section of the Consolidated Statement of Cash Flows.

CP2-2. (in thousands)

$$\begin{array}{rclclcl} 1. & \text{Assets} & = & \text{Liabilities} & + & \text{Shareholders' Equity} \\ & \$1,187,607 & = & \$533,607 & + & \$654,000 \end{array}$$

2. No – shareholders' equity is a residual balance, which means the shareholders will receive what remains in cash and assets after the creditors have been satisfied. It is unlikely that shareholders would receive the retained earnings of \$710,081 or total stockholders' equity of \$654,000. In addition, nearly all assets on the balance sheet are stated at historical cost, not at market value (the amount that could be received if the assets are sold at the end of the year).
3. The company's noncurrent liabilities are Deferred lease credits of \$137,618 and Other long-term liabilities of \$105,125.
4. Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$565,136}{\$290,864} = 1.94$
5. The company had a net cash outflow from investing activities of \$66,667, primarily because the company acquired additional property, plant, and equipment (capital expenditures) for \$57,435. It did not have any sales of assets during the year.

CP2–3. (dollars in thousands)

1.		Industry Average	American Eagle Outfitters	Express, Inc.
	Current Ratio =	2.43	2.00	1.94

Both the American Eagle Outfitters' and Express, Inc.'s current ratios are lower than the industry average of 2.43. However, because both have a current ratio near or at 2.00, both companies are able to satisfy their current obligations with current assets.

Many retailers, such as American Eagle Outfitters, choose to rent space rather than purchase buildings for stores. Acquiring buildings often requires borrowing long-term (mortgages). Thus, the choice of renting or purchasing buildings does not have an effect on the numerator or denominator of the current ratio.

Note: The retail industry has been struggling for some time and is quite susceptible to volatile changes in the economy. When the economy is weak, these companies need a cushion of current assets to be able to continue to pay employees and suppliers when sales and cash flows are lower. Both American Eagle Outfitters and Express, Inc., appear to follow this pattern with a higher current ratio than other industries such as restaurants.

2. As indicated in the financing activities section of each company's statement of cash flows, during the most recent year, American Eagle Outfitters spent \$87,682 repurchasing common stock from publicly announced repurchase programs, and spent \$12,513 repurchasing stock from employees. Express, Inc., spent \$17,264 repurchasing shares as part of its repurchase program and \$1,599 for tax withholding obligations.
3. As indicated in the statement of cash flows in the financing activities section, American Eagle Outfitters paid \$88,548 in dividends. Express, Inc., did not pay any dividends during the year.
4. On the balance sheet:

American Eagle reports → Property and equipment, at cost, net of accumulated depreciation (all on one line).

Express, Inc., reports → Property and equipment on one line at cost, Accumulated depreciation on the next line, and Property and equipment, net below that.

Details of the amount of land, building, and equipment are reported by each in the notes to the financial statements. Other companies sometimes choose to report these assets separately on the balance sheet, using captions such as: Land; Buildings and building improvements; Furniture, fixtures and equipment; and Leased property and equipment.

FINANCIAL REPORTING AND ANALYSIS CASES

CP2-4.

Dollars are in thousands:

1. (a) Chipotle's total assets for the quarter ended September 30, 2017 are \$2,064,377 in thousands of dollars.
- (b) Current liabilities increased over nine months from \$281,793 thousand at December 31, 2016, to \$323,402 thousand on September 30, 2017.
- (c) Current Ratio at 9/30/17 = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$655,936}{\$323,402} = 2.028$

Chipotle's current ratio decreased from the level of 2.028 on September 30, 2017 to 1.944 on December 31, 2017 (as discussed in the chapter). This indicates that, between September 30, 2017, and December 31, 2017, Chipotle decreased its liquidity slightly. Current assets decreased by approximately \$26 million while current liabilities increased by about \$1 million.

2. (a) For the nine months ended September 30, 2017, Chipotle spent \$165,506 on the purchase of leasehold improvements, property, and equipment.
- (b) The total cash flows used in financing activities was a cash outflow of \$209,575, mostly from the \$209,585 repurchase of Chipotle's stock from investors (called "treasury stock").

CP2-5.

The major deficiency in this balance sheet is the inclusion of the owner's personal residence as a business asset. Under the separate entity assumption, each business must be accounted for as an individual organization, separate and apart from its owners. The improper inclusion of this asset as part of Frances Sabatier's business:

- Overstates total assets by \$300,000; total assets should be \$105,000 rather than \$405,000, and
- Overstates stockholders' equity that should be only \$5,000, rather than \$305,000.

Since current assets and current liabilities were not affected, the current ratio remains the same. However, other ratios involving long-term assets and/or stockholders' equity will be affected.

CP2-6.

Dollars are in thousands:

1. The company is a corporation because its owners are referred to as “stockholders.”

$$\begin{array}{rclcl} 2. & \text{Assets} & = & \text{Liabilities} & + & \text{Stockholders' Equity} \\ & \$7,412,477 & = & \$2,365,259 & + & \$5,047,218 \end{array}$$

$$\begin{array}{rclcl} 3. & \text{Current Assets} & \div & \text{Current Liabilities} & = & \text{Current Ratio} \\ 2017 & \$5,321,884 & & \$583,278 & & 9.124 \\ 2016 & 4,652,196 & & 584,021 & & 7.966 \end{array}$$

In 2017, for every \$1 of current liabilities, Twitter maintained approximately \$9.12 of current assets, suggesting that Twitter is highly liquid and has the ability to pay its short-term obligations with current assets in the upcoming year. Since 2016, the current ratio has increased from 7.966. The interpretation of this ratio would be more useful given information on the company's current ratio compared to the current ratio for the industry and/or competitors and additional years of data to observe trends.

$$\begin{array}{rcl} 4. & \text{Accounts payable (-L)} & \dots\dots\dots 170,969 \\ & \text{Cash (-A)} & \dots\dots\dots 170,969 \end{array}$$

5. Over its years in business, it appears that Twitter has been unprofitable, based on a negative amount in Accumulated Deficit of \$2,703,308. The Accumulated Deficit account represents the cumulative losses of the firm since the business began, assuming no dividends were declared (unlikely given its deficit position).

In addition, Twitter appears unprofitable in the most recent year because Accumulated Deficit increased (due to further losses). It is possible to determine the amount of net loss by using the following equation, assuming no dividends were declared:

(in thousands)

$$\begin{array}{rclcl} & \text{Beginning} & & \text{For the Year} & & \text{Ending} \\ \text{Accum. Deficit} & + & \text{Net Income(Loss)} & - & \text{Dividends declared} & = & \text{Accum. Deficit} \\ \$ (2,619,063) & + & ? & - & \$ 0 & = & \$ (2,703,308) \end{array}$$

Thus, net loss for the most recent year was \$(83,705).

CRITICAL THINKING CASES

CP2-7.

Req. 1

**LettuceDoThis.Com, Inc.
Balance Sheet
December 31**

Assets

Current Assets:

Cash	\$ 1,000
Accounts receivable	8,000
Inventory	8,000

Total current assets 17,000

Furniture and fixtures 52,000

Delivery truck (net) 12,000

Buildings (net) 60,000

Total assets \$141,000

Liabilities

Current Liabilities:

Accounts payable	\$ 16,000
Payroll taxes payable	13,000

Total current liabilities 29,000

Notes payable (due in three years) 15,000

Mortgage payable 50,000

Total liabilities 94,000

Stockholders' Equity

Common stock 4,000

Additional paid-in capital 76,000

Accumulated deficit (33,000)

Total stockholders' equity 47,000

Total liabilities and stockholders' equity \$141,000

CP2-7. (continued)

Req. 2

Dear _____,

I corrected the balance sheet for LettuceDoThis.Com, Inc. Primarily, I reduced the amount reported for buildings to \$60,000, which is the historical cost less any depreciation. Estimated market value is not a generally accepted accounting principle for recording property, plant, and equipment. The \$38,000 difference (\$98,000 – \$60,000) reduces total assets and reduces retained earnings. In fact, retained earnings becomes negative suggesting that there may have been several years of operating losses.

Before making a final decision on investing in this company, you should examine the past three years of *audited* income statements and the past two years of *audited* balance sheets to identify positive and negative trends for this company. You can also compare this company's current ratio to that of the industry to assess trends in liquidity, and compare how this company's long-term debt as a proportion of stockholders' equity has changed over time. You should also learn as much about the industry as you can by reviewing recent articles on economic and technological trends that may have an impact on this company.

CP2–8.

1. The most obvious parties harmed by the fraud at Biovail Corporation were the stockholders and creditors. Stockholders were purchasing shares of stock that were inflated due to the fraud. Creditors were lending funds to the company based on inflated income statement and balance sheet information. When the fraud was discovered, the stock price dropped causing the stockholders to lose money on their investments. In addition, the creditors have a lower probability of receiving full payment on their loans. The vendors who assisted in verifying false promotional allowances were also investigated.

Those who were helped by the fraud included the former executives who were able to receive substantial bonuses based on the inflated results of operations.

2. Biovail set certain financial goals and tied the former executives' bonuses to meeting the goals. Adopting targets is a good tool for monitoring progress toward goals and identifying problem areas, such as rising costs or sagging sales. Better decision making can result by heading off potential problems before they grow too large. However, setting unrealistic financial targets, especially in poor economic times, can result in those responsible for meeting the targets circumventing appropriate procedures and policies for their own benefit.

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

CP2–9.

The solution to this team project will depend on the companies and/or accounting period selected for analysis.