

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 preset 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 the ability of the company to pay its short-term obligations with current assets. A ratio above 1.0 normally suggests good liquidity (that is, 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						
		14	20						
		15	20			1	40		
		16	20						
		17	20						
		18	10						
		19	10						
		20	10						
		21	10						
		22	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.	Cash	-2,000					Retained earnings	-2,000

M2-6.

	Debit	Credit
Assets	<i>Increases</i>	<i>Decreases</i>
Liabilities	<i>Decreases</i>	<i>Increases</i>
Stockholders' equity	<i>Decreases</i>	<i>Increases</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	
	Cash (-A).....		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)				
		2,000 (e)				
	<u>14,400</u>			<u>11,000</u>		<u>30,100</u>

Notes Payable	
	3,000 Beg.
	30,000 (a)
	10,000 (d)
	<u>43,000</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.

Dennen, Inc. Trial Balance January 31		
	Debit	Credit
Cash	\$14,400	
Notes receivable	11,000	
Equipment	30,100	
Notes payable		\$43,000
Common stock		1,010
Additional paid-in capital		3,490
Retained earnings		8,000
Totals	<u>\$55,500</u>	<u>\$55,500</u>

M2-11.

**Dennen Inc.
Balance Sheet
At January 31**

Assets*Current assets:*

Cash	\$ 14,400
Notes receivable	11,000
Total current assets	25,400

Equipment	30,100
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Total Assets	\$55,500
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Liabilities*Current liabilities:*

Notes payable	\$ 43,000
Total current liabilities	43,000

Stockholders' Equity

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

Total Liabilities & Stockholders' Equity	\$55,500
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M2-12.**Current Ratio =**

	Current Assets	÷	Current Liabilities	=	
2013	280,000	÷	155,000	=	1.806
2014	270,000	÷	250,000	=	1.080

This ratio indicates that Sal's Taco Company has sufficient current assets to settle current liabilities, but that the ratio has also decreased between 2013 and 2014 by .726 (40%). Sal's Taco Company ratio is lower than Chipotle's 2014 ratio (of 3.576), indicating that Sal's Taco Company appears to have weaker liquidity than Chipotle; Sal's has less liquidity to withstand an economic downturn.

M2-13.

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

EXERCISES

E2-1.

E

(1)

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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 (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 (L)
(j)	<i>No exchange transaction</i>	—
(k)	Investments (A)	Cash (A)
(l)	Cash (A)	Short-term notes payable (L)
(m)	Note 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 Categorization</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.

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

E2-5.

Req. 1

Event	Assets	=	Liabilities	+	Stockholders' Equity
a.	Buildings +172		Notes payable +1		
	Equipment +270		(long-term) 0		
	Cash - 432				
b.	Cash +345				Common stock +20
					Additional paid-in 0
					capital
					+145
c.			Dividends payable +145		Retained earnings -145
d.	Short-term Investments +7,616				
	Cash -7,616				
e.	No effects				
f.	Cash +4,313				
	Short-term Investments -4,313				

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
	Mortgage 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

a.	Buildings (+A).....	172	
	Equipment (+A)	270	
	Cash (–A).....		432
	Notes payable (+L)		10
b.	Cash (+A).....	345	
	Common stock (+SE).....		200
	Additional paid-in capital (+SE)		145
c.	Retained earnings (–SE).....	145	
	Dividends payable (+L).....		145
d.	Short-term investments (+A).....	7,616	
	Cash (–A).....		7,616
e.	No journal entry required.		
f.	Cash (+A).....	4,313	
	Short-term investments (–A).....		4,313

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 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		Liabilities	
Current Assets		Current Liabilities	
Cash	\$71,500	Note payable	\$90,000
Note receivable	4,000	Total Current Liabilities	<u>90,000</u>
Total Current Assets	<u>75,500</u>		
		Stockholders' Equity	
Store fixtures	9,500	Common stock	1,500
Land	20,000	Additional paid-in capital	13,500
		Total Stockholders' Equity	<u>15,000</u>
Total Assets	<u>\$105,000</u>	Total Liabilities & Stockholders' Equity	<u>\$105,000</u>

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

a.	Retained earnings (–SE).....	1,508	
	Dividends payable (+L).....		1,508
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Dividends payable (–L).....	852	
	Cash (–A).....		852
d.	Cash (+A).....	5,899	
	Notes payable (+L).....		5,899
e.	Cash (+A).....	53	
	Equipment (–A).....		53
f.	Equipment (+A).....	2,598	
	Cash (–A).....		2,250
	Notes payable (+L)		348
g.	Investments (+A).....	2,616	
	Cash (–A).....		2,616

E2-15.

Req. 1

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

Req. 2

Cash		Short-Term Investments		Property & 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				
	800 (d)				
End.	<u>11,200</u>	End.	<u>1,000</u>	End.	<u>1,500</u>

Short-Term Notes Payable		Long-Term Notes Payable	
	2,200 Beg.		800 Beg.
			4,000 (a)
	<u>2,200</u> End.		<u>4,800</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>

Req. 3

Assets \$ 13,700 = Liabilities \$ 7,000 + Stockholders' Equity \$ 6,700

Req. 4

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

This ratio indicates that, for every \$1 of current liabilities, Higgins maintains \$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 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.

Higgins Company
Balance Sheet
 At December 31

Assets

Current Assets

Cash	\$ 11,200
Short-term investments	1,000
Total Current Assets	12,200

Property and equipment	1,500
------------------------	-------

Total Assets	\$13,700
---------------------	-----------------

Liabilities

Current Liabilities

Short-term notes payable	\$ 2,200
Total Current Liabilities	2,200
Long-term notes payable	4,800
Total Liabilities	7,000

Stockholders' Equity

Common stock	500
Additional paid-in capital	4,000
Retained earnings	2,200
Total Stockholders' Equity	6,700

Total Liabilities & Stockholders' Equity	\$13,700
---	-----------------

E2-17.

Req. 1

Cash	
Beg.	0
(a)	40,000
	4,000 (c)
	1,000 (d)
	<u>35,000</u>

Short-Term Notes Receivable	
Beg.	0
(e)	4,000
	<u>4,000</u>

Land	
Beg.	0
(b)	16,000
	4,000 (e)
	<u>12,000</u>

Equipment	
Beg.	0
(c)	20,000
(d)	1,000
	<u>21,000</u>

Short-Term Notes Payable	
	0 Beg.
	16,000 (b)
	<u>16,000</u>

Long-Term Notes Payable	
	0 Beg.
	16,000 (c)
	<u>16,000</u>

Common Stock	
	0 Beg.
	10,000 (a)
	<u>10,000</u>

Additional Paid-in Capital	
	0 Beg.
	30,000 (a)
	<u>30,000</u>

E2-17. (continued)

Req. 2

Strauderman Delivery Company, Inc.		
Trial Balance		
December 31, 2016		
	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>

E2-17. (continued)

Req. 3

Strauderman Delivery Company, Inc.
Balance Sheet
At December 31, 2016

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

Req. 4

	<u>Current Assets</u>	÷	<u>Current Liabilities</u>	=	<u>Current Ratio</u>
2016	\$39,000	÷	\$16,000	=	2.44
2017	52,000	÷	23,000	=	2.26
2018	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 Strauderman Delivery Company has already been financing the company's development through additional short-term debt, from \$16,000 in 2016 to \$40,000 in 2018. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. 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.

E2-18.

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 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).

E2-19.

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>

E2-20.

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	—

E2-21.

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	+

E2-22.

- | | |
|---|---|
| 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 on sale 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)	Patents (an intangible asset)	NCA	Debit
(5)	Income Taxes Payable	CL	Credit
(6)	Long-Term Debt	NCL	Credit
(7)	Marketable Securities (short-term)	CA	Debit
(8)	Property, Plant, and Equipment	NCA	Debit
(9)	Retained Earnings	SE	Credit
(10)	Notes and Accounts Receivable (short-term)	CA	Debit
(11)	Investments (long-term)	NCA	Debit
(12)	Cash and Cash Equivalents	CA	Debit
(13)	Accounts Payable	CL	Credit
(14)	Crude Oil Products and Merchandise	CA	Debit
(15)	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 capital 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 \$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 (short-term)		
	7,000 Beg.	
	13,000 (c)	
	9,000 (f)	
	<u>29,000</u>	

Long-Term Notes Payable		
	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

Cougar 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

Cougar 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 Cougar Plastics has relatively low liquidity; for every \$1 of current liabilities, Cougar 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.

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.	13,844	Beg.	11,233	Beg.	17,460
(a)	18,266	(b)	16,800		
(d)	1,469		18,810 (e)		
(e)	18,810		<u>9,223</u>		<u>17,460</u>
	<u>21,818</u>				
Long-Term Investments		Inventories		Other Current Assets	
Beg.	130,162	Beg.	2,111	Beg.	23,883
(b)	4,200		<u>2,111</u>		<u>23,883</u>
	<u>134,362</u>				
Accounts Payable		Property, Plant, and Equipment		Other Noncurrent Assets	
	30,196 Beg.	Beg.	20,624	Beg.	12,522
	<u>30,196</u>	(c)	10,981		<u>12,522</u>
			<u>31,605</u>		
Short-term Notes Payable		Accrued Expenses		Unearned Revenue	
	6,308		18,453 Beg.		8,491 Beg.
	1,410 (c)		<u>18,453</u>		<u>8,491</u>
	<u>7,718</u>				
Dividends Payable		Other Noncurrent Liabilities		Common Stock	
	0 Beg.		27,857 Beg.		1 Beg
	11,126 (f)		<u>27,857</u>		1 (d)
	<u>11,126</u>				<u>2</u>
Additional Paid-in Capital		Retained Earnings			
	23,312 Beg.	(f)	11,126		88,234 Beg.
	1,468 (d)				<u>77,108</u>
	<u>24,780</u>				

P2–5. (continued)

Req. 3

Apple, Inc.
Balance Sheet
At September 26, 2015
(in millions)

ASSETS

Current Assets:

Cash	\$ 21,818
Short-term investments	9,223
Accounts receivable	17,460
Inventories	2,111
Other current assets	23,883

Total current assets	74,495
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Long-term investments	134,362
Property, plant and equipment	31,605
Other noncurrent assets	12,522

Total assets	<u>\$252,984</u>
---------------------	-------------------------

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:

Accounts payable	\$30,196
Accrued expenses	18,453
Unearned revenue	8,491
Dividends payable	11,126
Short-term notes payable	7,718

Total current liabilities	75,984
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Long-term debt	47,253
Other noncurrent liabilities	27,857

Total liabilities	151,094
-------------------	---------

Stockholders' Equity:

Common stock	2
Additional paid-in capital	24,780
Retained earnings	77,108

Total stockholders' equity	101,890
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Total liabilities and stockholders' equity	<u>\$252,984</u>
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P2-5. (continued)

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$74,495}{\$75,984} = 0.980$$

For every \$1 of short-term liabilities, Apple Inc. has \$0.98 of current assets. This suggests that Apple almost has sufficient current resources to pay current liabilities. This may appear to suggest a liquidity problem. What is more likely, however, is that Apple has a very efficient cash management system and keeps its current resources at lower levels to maximize investment opportunities.

P2-6.

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

Adamson Incorporated was organized as a corporation. Only a corporation issues shares of capital stock to its owners in exchange for their investment, as Adamson 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

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$35,000 + \$2,000}{\$169,000} = \frac{\$37,000}{\$169,000} = 0.22$$

This suggests that Adamson may not have sufficient liquidity to cover its current obligations. Adamson 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	Building		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		

AP2-3.

Req. 1 and 2

Cash and Cash Equivalents		
Beg.	78,519	
(a)	1,020	3,400 (b)
(d)	4,020	2,980 (e)
(g)	310	1,830 (f)
	<u>75,659</u>	

Short-Term Investments		
Beg.	12,909	
(e)	2,980	
	<u>15,889</u>	

Accounts Receivable		
Beg.	15,036	
	<u>15,036</u>	

Inventories		
Beg.	141,692	
	<u>141,692</u>	

Prepaid Expenses and Other Current Assets		
Beg.	20,372	
	<u>20,372</u>	

Property, Plant, and Equipment		
Beg.	294,853	
(f)	11,230	4,020 (d)
	<u>302,063</u>	

Intangible Assets		
Beg.	45,128	
(b)	3,400	
	<u>48,528</u>	

Other Assets		
Beg.	19,816	
		310 (g)
	<u>19,506</u>	

Accounts Payable		
		26,958 Beg.
	<u>26,958</u>	

Accrued Expenses Payable		
		127,639 Beg.
		<u>127,639</u>

Dividends Payable		
		0 Beg
		300 (h)
		<u>300</u>

Long-Term Debt*		
		165,032 Beg.
		9,400 (f)
		<u>174,432</u>

Other Long-Term Liabilities		
		27,009 Beg.
		<u>27,009</u>

Common Stock		
		484 Beg.
		16 (a)
		<u>500</u>

Additional Paid-in Capital		
		359,728 Beg.
		1,004 (a)
		<u>360,732</u>

Retained Earnings		
		501,908 Beg.
(h)	300	
		<u>501,608</u>

Other Stockholders' Equity Items		
Beg.	580,433	
	<u>580,433</u>	

* Current portion is \$19.

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	\$ 75,659	
Short-term investments	15,889	
Accounts receivable	15,036	
Inventories	141,692	
Prepaid expenses and other current assets	20,372	
Property, plant, and equipment	302,063	
Intangibles	48,528	
Other assets	19,506	
Accounts payable		\$ 26,958
Accrued expenses payable		127,639
Dividends payable		300
Long-term debt (current portion, \$19)		174,432
Other long-term liabilities		27,009
Common stock		500
Additional paid-in capital		360,732
Retained earnings		501,608
Other stockholders' equity items	580,433	
Totals	<u>\$1,219,178</u>	<u>\$1,219,178</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	\$ 75,659
Short-term investments	15,889
Accounts receivable	15,036
Inventories	141,692
Prepaid expenses and other current assets	20,372

<i>Total current assets</i>	268,648
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Property, plant, and equipment	302,063
--------------------------------	---------

Intangibles	48,528
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Other assets	19,506
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Total Assets	\$638,745
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Liabilities*Current liabilities*

Accounts payable	\$ 26,958
Accrued expenses payable	127,639
Dividends payable	300
Current portion of long-term debt	19

<i>Total current liabilities</i>	154,916
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Long-term debt	174,413
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Other long-term liabilities	27,009
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Total Liabilities	356,338
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Stockholders' Equity

Common stock (\$0.01 par value)	500
Additional paid-in capital	360,732
Retained earnings	501,608
Other stockholders' equity items	(580,433)

Total Stockholders' Equity	282,407
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Total Liabilities and Stockholders' Equity	\$638,745
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Req. 6

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}} = \frac{\$268,648}{\$154,916} = 1.73$$

Ethan Allen maintains a relatively high current ratio, indicating that they are highly liquid. Initially, this seems to suggest that they are not investing their resources efficiently. However, a closer look reveals that a significant portion of their current assets are invested in inventory, which often necessitates a higher current ratio.

AP2-4.

<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	
Building (+A).....	72,000	
Cash (–A).....		10,000
Mortgage notes payable (+L).....		80,000
c. Equipment (+A).....	6,500	
Cash (–A).....		2,500
Short-term notes payable (+L).....		4,000
d. No transaction		
e. Mortgage notes payable (–L).....	1,000	
Cash (–A).....		1,000
f. Short-term investments (+A).....	5,000	
Cash (–A).....		5,000
g. No 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>	

Short-term Notes Payable		
	0 Beg.	
	4,000 (c)	
	<u>4,000</u>	

Mortgage Notes Payable		
	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 and 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	
Short-term notes payable		\$ 4,000
Mortgage notes payable		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 and Supply, Inc.
Balance Sheet
On March 31

Assets*Current Assets:*

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

Liabilities and Stockholder's Equity*Current Liabilities:*

Short-term notes payable	<u>\$4,000</u>
Total current liabilities	4,000
Mortgage notes payable	<u>79,000</u>
Total liabilities	<u>83,000</u>

Stockholder's Equity:

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

	Current Assets	÷	Current Liabilities	=	Current Ratio
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.

1. The company is a corporation since it maintains share 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.
$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$890,513}{\$459,093} = 1.94$$

The current ratio measures the ability of the company to settle short-term obligations with current assets. American Eagle Outfitters’ current ratio of 1.94 suggests strong liquidity with \$1.94 in current assets for every \$1 in current liabilities. In the most recent year presented, the company had a significant amount of cash, partly from selling short-term investments.

5. The company spent \$245,002,000 on purchasing property and equipment in the year ended 1/31/15; \$278,499,000 in the year ended 2/1/14; and \$93,939,000 in the year ended 2/2/13. This information is listed as Capital Expenditures on the Statement of Cash Flows in the investing activities section.

CP2-2.

1.

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Shareholders' Equity</u>
\$1,888,741,000	=	\$560,772,000	+	\$1,327,969,000
2. No – shareholders' equity is a residual balance, meaning that the shareholders will receive what remains in cash and assets after the creditors have been satisfied. It is likely that shareholders would receive less than \$1,327,969,000. 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 only noncurrent liability is Deferred Rent and Other Liabilities.
4.

Current	=	<u>Current Assets</u>	=	<u>\$809,117,000</u>	=	2.29
Ratio		<u>Current Liabilities</u>		<u>\$353,740,000</u>		
5. The company had a net cash inflow from investing activities of \$194,834,000, primarily because the company sold investments (sold marketable securities for \$830,297,000). The company also purchased property and equipment for \$229,804,000 and additional marketable securities for \$405,659,000.

CP2-3.

1.	Industry Average	American Eagle Outfitters	Urban Outfitters
Current Ratio =	2.03	1.94	2.29

American Eagle Outfitters' current ratio of 1.94 is lower than the industry average, but Urban Outfitters' current ratio of 2.29 is higher the industry average of 2.03. For the year ended January 31, 2015, Urban Outfitters is more able and American Eagle is less able to meet current obligations compared to the industry average.

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.

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 \$7,464,000 repurchasing common stock from employees and did not repurchase any common stock from investors. Urban Outfitters spent \$611,475,000 repurchasing shares.
3. As indicated in the statement of cash flows, American Eagle Outfitters paid \$97,224,000 in dividends. Urban Outfitters did not pay any dividends during the year. Refer to the financing activities section of the statement of cash flows.
4. American Eagle reports "Property and equipment, at cost, net of accumulated depreciation" and Urban Outfitters reports "Property and equipment, net." 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, for example in accounts such as: "Land," "Buildings and building improvements," Furniture, fixtures and equipment," and "Rental property and equipment."

FINANCIAL REPORTING AND ANALYSIS CASES

CP2-4.

Dollars are in thousands:

1. (a) Chipotle's total assets reported for the quarter ended September 30, 2014 are \$2,437,053.
- (b) Current liabilities increased over nine months from \$199,228 at December 31, 2013, to \$264,986 on June 30, 2014.
- (c) Current Ratio at 9/30/14 = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$873,870}{\$264,986} = 3.298$

Chipotle's current ratio increased from the level of 3.298 at the end of September 2014 up to 3.576 on December 31, 2014 (as discussed in the chapter). This indicates that, between September 30, 2014, and December 31, 2014, Chipotle increased its liquidity. Current assets increased by approximately \$4 million while current liabilities decreased by about \$19 million.

2. (a) For the three months ended September 30, 2014, Chipotle spent \$160,400 on the purchase of leasehold improvements, property, and equipment.
- (b) The total cash flows used in financing activities was \$50,503, mostly from the acquisition of the company's stock from investors (\$60,405) 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.”

$$\begin{array}{rclcl} 2. & \text{Assets} & = & \text{Liabilities} & + & \text{Stockholders' Equity} \\ & \$5,583,082 & = & \$1,956,679 & + & \$3,626,403 \end{array}$$

$$\begin{array}{rclcl} 3. & \text{Current Assets} & \div & \text{Current Liabilities} & = & \text{Current Ratio} \\ 2014 & \$4,255,853 & & \$393,794 & & 10.81 \\ 2013 & 2,574,679 & & 225,430 & & 11.42 \end{array}$$

In 2014, for every \$1 of current liabilities, Twitter maintains \$10.81 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 2013, the current ratio has dropped slightly from 11.42. 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.

$$\begin{array}{rcl} 4. & \text{Accounts Payable (-L)} & \dots\dots\dots 53,241 \dots\dots \\ & \text{Cash (-A)} & \dots\dots\dots 53,241 \end{array}$$

5. Over its years in business, it appears that Twitter has been unprofitable, based on a negative amount in Accumulated Deficit of \$1,582,470. The Accumulated Deficit account represents the cumulative losses of the firm since the business began.

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

(in thousands)

$$\begin{array}{rclcl} & \text{Beginning} & & \text{For the Year} & & \text{Ending} \\ \text{Accum.. Deficit} & + & \text{Net Income(Loss)} - \text{Dividends declared} & = & \text{Accum. Deficit} \\ \$ (994,949) & + & ? - \$ 0 & = & \$ (1,582,470) \end{array}$$

Thus, net loss for the most recent year was \$(587,521).

CRITICAL THINKING CASES

CP2-7.

Req. 1

Dewey, Cheetum, and Howe, Inc.
Balance Sheet
December 31

Assets

Current Assets:

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

Total current assets	<u>17,000</u>
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Furniture and fixtures	52,000
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Delivery truck (net)	12,000
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Buildings (net)	60,000
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Total assets	<u><u>\$141,000</u></u>
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Liabilities

Current Liabilities:

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

Total current liabilities	<u>29,000</u>
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Notes payable (due in three years)	15,000
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Mortgage payable	50,000
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Total liabilities	<u>94,000</u>
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Stockholders' Equity

Common stock	4,000
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Additional paid-in capital	76,000
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Accumulated deficit	(33,000)
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Total stockholders' equity	<u>47,000</u>
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Total liabilities and stockholders' equity	<u><u>\$141,000</u></u>
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CP2-7. (continued)

Req. 2

Dear _____,

I corrected the balance sheet for Dewey, Cheetum, and Howe, 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 which may have an impact on this company.

CP2–8.

1. The most obvious parties harmed by the fraud at Ahold's U.S. Foodservice, Inc., 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. The SEC also charged two individuals with insider trading for trading on a tip illegally.

2. U.S. Foodservice 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.
3. In many cases of fraudulent activity, auditors are named in lawsuits along with the company. If the auditors are found to be negligent in performing their audit, then they are liable. However, in many frauds, the management at multiple levels of the organization are so involved in covering the fraud that it becomes nearly impossible for the auditors to detect the fraudulent activity. In this case, it appears that top executives concocted a scheme to induce vendors to confirm false promotional allowance income by signing audit letters agreeing to the false amounts. In audits, confirming balances or amounts with external parties usually provides evidence for the auditors on potential problem areas. The auditors appropriately relied on this external evidence in performing their audit, not knowing it to be tainted or fraudulent.

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.