CHAPTER 3

QUESTIONS

1. Three elements, as defined by the FASB, are contained in a balance sheet: *assets, liabilities,* and *equity*. These elements measure the worth of an enterprise at a given point in time. The balance sheet thus reports what resources an enterprise has and who has claim against those resources. Two other elements, *investments by owners* and *distribution to owners,* are related to the equity element. Information concerning the change in equity is often contained in a separate statement that supplements the balance sheet.

2. In order to meet the definition of an asset, an item need not be associated with certain future benefit. To acknowledge the uncertainty inherent in business, the definition of an asset stipulates that the future benefit need be only probable.

3. Some liabilities, such as accounts payable and long-term debt, are denominated in precise monetary terms. However, the amounts of many liabilities must be estimated based on expectations about future events.

4. The difference between current assets and current liabilities, referred to as *working capital,* is a commonly used measure of the liquidity of an enterprise. It helps to determine whether the company will be able to meet its current debts and obligations with available assets and still continue normal operations.

5. **a.** Assets are classified as current if

(1) the asset will be realized in cash during the normal operating cycle of the business or 1 year, whichever is longer, or

(2) the asset will be sold or consumed within a normal operating cycle or 1 year, whichever is longer.

b. Liabilities are classified as current if liquidation of the liability is expected to require

(1) the use of current assets or

(2) the creation of other current liabilities.

6. **a.** Cash is classified as noncurrent when it is a part of a fund that will be used to discharge noncurrent obligations. Such funds include bond retirement funds, pension funds, and preferred stock redemption funds. Cash to be used for the acquisition of land, buildings, and equipment or cash received on long-term deposits from customers would also be reported as noncurrent.

b. Receivables not reportable as current assets include those arising from unusual transactions, such as the sale of land, buildings, and equipment or advances to affiliates or employees that would not be collectible within 12 months.

7. If a short-term loan is expected to be refinanced or paid back with the proceeds of a replacement loan, the existing short-term loan is not classified as current. This is true as long as the intent of the company is to refinance the loan on a long-term basis and the company's intent is evidenced by an actual refinancing **after** the balance sheet date or by the existence of an explicit refinancing agreement.

8. **a.** A subjective acceleration clause is a provision in a debt instrument that specifies some general conditions permitting a lender to unilaterally accelerate the due date.

b. An objective acceleration clause is a provision in a debt instrument that specifies conditions that can cause the debt to be immediately callable, for example, failure to earn a certain return on the assets or to make an interest payment.

c. If a noncurrent debt instrument contains a subjective acceleration clause and the invoking of the clause is deemed probable, the liability should be classified as current. If invoking of the clause is deemed reasonably possible but not probable, the obligation should continue to be reported as a noncurrent liability with a note to describe the contingency. If a debt instrument contains an objective acceleration clause and the conditions that trigger the call have occurred, the debt should be classified as current. Exceptions are that (1) the creditor has waived the right to demand payment for a period that extends beyond the debtor's normal operating cycle or (2) the debtor has cured the deficiency after the balance sheet date but before the statements are issued, and the debt is not callable for a period that extends beyond the debtor's normal operating cycle.

9. *Contingent liabilities* could or could not give rise to actual obligations; *estimated liabilities* are known to exist but the amount is not definitely known. A company could, for example, win or lose a lawsuit, but it is actually liable for income tax. The exact amount of the income tax is unknown until the final tax return is completed. The tax liability could have to be estimated at the time financial statements are prepared.

10. With a proprietorship, owner's equity is reported with a single capital account. In a partnership, separate capital accounts are established for each partner. In a corporation, a distinction is made between contributed capital and retained earnings.

11. The three major categories in a corporation's Equity section are

(a) Contributed capital, including both capital stock at par and additional paid-in capital
(b) Retained earnings
(c) Other equity, such as treasury stock, unrealized gains and losses on available-for-sale securities, foreign currency translation adjustments, and unrealized gains and losses on derivatives

12. Offset balances are used to adjust the gross amount of balance sheet items to arrive at proper valuations. For example, allowance for bad debts is properly offset against the gross amount of accounts receivable to show the net amount estimated collectible. It is generally not proper to offset an asset account against a liability or owners' equity account because such an offset would not be for the purpose of correctly valuing either account but rather to condense financial data at the expense of adequate disclosure.

13. Assets are usually presented in the order of their liquidity, with the most liquid items listed first.

14. Financial ratios are mathematical relationships between financial statement amounts. For example, return on equity is net income divided by owners' equity.

15. Asset turnover ratio (total sales divided by total assets) is a measure of the number of dollars of sales generated by each dollar of assets. The higher the asset turnover ratio, the more efficient the company is in using its assets to generate sales.

16. Return on equity is an indicator of the overall performance of a company. Return on equity measures the percentage return on the stockholders' investment and is computed as net income divided by total equity.

17. There are at least four types of notes used by management to support the financial statements and provide users with additional relevant information. They can be classified as follows:

(a) Summary of significant accounting policies
(b) Additional information, both numerical and descriptive, to support summary totals included in the financial statements
(c) Information about items that does not meet the recognition criteria but that is still useful to decision makers
(d) Supplementary schedules required by the FASB or the SEC to fulfill the full disclosure principle

18. The FASB must maintain a balance between conceptual purity and business practicality. When a conceptually correct recognition standard is criticized as impractical, one FASB approach is to require only the disclosure of the information rather than its formal recognition. This sometimes mollifies businesses' complaints about impracticality. For example, in 1994 the FASB decided to temporarily require only note disclosure of stock option values in response to businesses' complaints about the proposed recognition of those values as compensation expense.

19. Separate supplementary information or schedules may be included to disclose segment information; details about property, plant, and equipment and short-term borrowing; and trend data for periods beyond those included in the basic statements.

20. If a subsequent event provides additional information about items included in the financial statements, especially those whose value has been estimated, the new information should be used to make adjustments to the amounts in the statements. The event itself does not actually change the value but merely provides additional information about conditions that existed at the balance sheet date. For example, the filing of a bankruptcy petition by a major customer provides additional data concerning the collectibility of accounts receivable. The conditions that led to the bankruptcy were probably present at the balance sheet date but may not have been known to the preparer of the statements until the bankruptcy filing took place. Under these circumstances, Allowance for Bad Debts may need adjustment to properly reflect the net realizable value of receivables.

21. Many assets are reported at historical cost, which is usually less than market value, and other assets (such as homegrown goodwill) are not included in the balance sheet at all. Accordingly, the balance sheet numbers are often a very poor reflection of what a company is worth. Typically, a going concern is worth significantly more than the reported book value of equity.

PRACTICE EXERCISES

PRACTICE 3–1 WORKING CAPITAL

Current assets:	
Cash	$ 700
Inventory	2,500
Total	$3,200
Current liabilities:	
Accounts payable	$2,400
Accrued wages payable	225
Total	$2,625

Working capital = Current assets – Current liabilities = $3,200 – $2,625 = $575

PRACTICE 3–2 CURRENT ASSETS

Current assets:	
Cash	$ 400
Investment securities (trading)	250
Accounts receivable	700
Inventory	4,000
Prepaid expenses	1,100
Total current assets	$6,450

PRACTICE 3–3 CURRENT LIABILITIES

Current liabilities:	
Accounts payable	$ 700
Unearned revenue	315
Accrued income taxes payable	9,000
Current portion of long-term debt	10,000
Total current liabilities	$20,015

PRACTICE 3–4 CLASSIFICATION OF SHORT-TERM LOANS TO BE REFINANCED

Current:

Loan A

Because the loan will be repaid, with cash, within one year of the balance sheet date, it should be classified as current.

Loan B

In order to classify the loan as noncurrent, the company must have both the intent to refinance *and* evidence of the intent in the form of actual refinancing or a contract to refinance *before* the issuance of the financial statements.

PRACTICE 3–4 (Concluded)

Noncurrent:

Loan C

The company intends to refinance Loan C, and the refinancing will be formalized *before* the financial statements for this year have been released. Of course, the actual formalization of the refinancing must be confirmed; this will occur before the issuance of the financial statements.

PRACTICE 3–5 CALLABLE OBLIGATIONS

Current:

Loan A

A loan is current if it is payable on demand or will become payable on demand within one year.

Noncurrent:

Loan B

The company is exceeding the current ratio constraint in the loan agreement; thus, the loan is not payable on demand.

Loan C

It is "reasonably possible" that the company will violate the subjective acceleration clause. The loan continues to be classified as noncurrent, and the possibility of the loan becoming payable on demand will be disclosed in a note.

PRACTICE 3–6 CONTINGENT LIABILITIES

a. **This is an *estimated liability*. The company has a definite obligation that must be estimated and reported in the balance sheet.**

b. **It is possible that the company will have to make a payment under this contingent liability. The possibility is described in a financial statement note; nothing is recognized in the balance sheet.**

c. **It is probable that the company will have to make a payment under this contingent liability. Accordingly, the liability is recognized in the balance sheet if it can be reasonably estimated.**

PRACTICE 3–7 STOCKHOLDERS' EQUITY

a. **Total contributed capital:**

Preferred stock, at par	$ 3,450
Additional paid-in capital, preferred	150
Common stock, at par	170
Additional paid-in capital, common	8,200
Total contributed capital	$11,970

PRACTICE 3–7 (Concluded)

b. Ending retained earnings:

Retained earnings (beginning)	$6,500
Plus: Sales	9,700
Less: Total expenses	(5,650)
Dividends	(950)
Ending retained earnings	$9,600

c. Total stockholders' equity:

Total contributed capital	$11,970
Plus: Ending retained earnings	9,600
Less: Treasury stock	(375)
Total stockholders' equity	$21,195

PRACTICE 3–8 STOCKHOLDERS' EQUITY

a. Total contributed capital:

Common stock, at par	$ 400
Additional paid-in capital, common	9,000
Total contributed capital	$9,400

b. Total accumulated other comprehensive income:

Cumulative translation adjustment (equity reduction), ending	$(2,000)
Cumulative unrealized gain on available-for-sale securities, ending	1,100
Total accumulated other comprehensive income (equity reduction)	$ (900)

c. Total stockholders' equity:

Total contributed capital	$ 9,400
Plus: Retained earnings (post closing, or ending)	1,500
Total accumulated other comprehensive income (equity reduction)	(900)
Less: Treasury stock	(700)
Total stockholders' equity	$ 9,300

PRACTICE 3–9 FORMAT OF FOREIGN BALANCE SHEET

Noncurrent assets (or fixed assets):		
Property, plant, and equipment		$ 8,000
Long-term investments		1,700
Total noncurrent assets (or fixed assets)		$ 9,700
Current assets:		
Cash	$ 500	
Inventory	2,000	
Total current assets	$2,500	
Current liabilities:		
Accounts payable	$ 300	
Short-term loans payable	1,100	
Total current liabilities	$1,400	
Net current assets		1,100
Total assets less current liabilities		$10,800
Noncurrent liabilities:		
Long-term debt		$ 3,000
Stockholders' equity:		
Common stock, at par	$ 50	
Additional paid-in capital	2,000	
Retained earnings	5,750	
Total stockholders' equity		7,800
		$10,800

PRACTICE 3–10 CURRENT RATIO

Current assets:	
Cash	$ 750
Inventory	6,300
Total current assets	$7,050
Current liabilities:	
Accounts payable	$3,700
Accrued wages payable	615
Total current liabilities	$4,315

Current ratio = Current assets/Current liabilities = $7,050/$4,315= 1.63

PRACTICE 3–11 QUICK RATIO

“Quick” assets:	
Cash	$ 400
Accounts receivable	1,750
Total quick assets	$2,150
Current liabilities:	
Accrued wages payable	$ 315

Quick ratio = Quick assets/Current liabilities = $2,150/$315 = 6.83

PRACTICE 3–12 DEBT RATIO

Liabilities:	
Accounts payable	$ 700
Accrued income taxes payable	9,000
Unearned revenue	315
Current portion of long-term debt	10,000
Notes payable (due in 14 months)	1,100
Total liabilities	$21,115
Stockholders’ equity:	
Paid-in capital	$ 1,750
Additional paid-in capital	4,000
Retained earnings	1,000
Treasury stock	(400)
Total stockholders’ equity	$ 6,350

Total assets = Total liabilities + Stockholders’ equity = $21,115 + $6,350 = $27,465

Debt ratio = Total liabilities/Total assets = $21,115/$27,465 = 76.9%

PRACTICE 3–13 DEBT RATIO

Total liabilities = $1,300 because Accounts payable is the only liability item in the list.

Total contributed capital:

Preferred stock, at par	$ 3,450
Additional paid-in capital, preferred	150
Common stock, at par	170
Additional paid-in capital, common	8,200
Total contributed capital	$11,970

PRACTICE 3–13 (Concluded)

Ending retained earnings:

Retained earnings (beginning)	$ 6,500
Plus: Sales	9,700
Less: Total expenses	(5,650)
Dividends	(950)
Ending retained earnings	$ 9,600

Total stockholders' equity:

Total contributed capital	$11,970
Plus: Ending retained earnings	9,600
Less: Treasury stock	(375)
Total stockholders' equity	$21,195

Total assets = Total liabilities + Stockholders' equity = $1,300 + $21,195 = $22,495

Debt ratio = Total liabilities/Total assets = $1,300/$22,495 = 5.8%

PRACTICE 3–14 ASSET MIX

a. Inventory/Total assets = $2,000/$12,200 = 16.4%

b. Property, plant, and equipment/Total assets = $8,000/$12,200 = 65.6%

PRACTICE 3–15 ASSET MIX

Total Assets:

Cash	$ 400
Investment Securities (trading)	250
Accounts Receivable	700
Inventory	4,000
Prepaid Expenses	1,100
Property, Plant, and Equipment	10,000
Goodwill	9,000
Total assets	$25,450

a. Inventory/Total assets = $4,000/$25,450 = 15.7%

b. Property, plant, and equipment/Total assets = $10,000/$25,450 = 39.3%

PRACTICE 3–16 MEASURE OF EFFICIENCY

Asset turnover = Sales/Total assets = $50,000/$12,200 = 4.10

PRACTICE 3–17 RETURN ON ASSETS

Return on assets = Net income/Total assets = $3,600/$12,200 = 29.5%

PRACTICE 3–18 RETURN ON EQUITY

Return on equity = Net income/Total equity = $2,000/$7,800 = 25.6%

PRACTICE 3–19 ACCOUNTING FOR SUBSEQUENT EVENTS

The January 16 study results yield better information about conditions that existed on the December 31 balance sheet date. The study indicates that $215,000 is a better estimate of the December 31 warranty liability than is $150,000. Thus, the reported warranty liability should be $215,000.

PRACTICE 3–20 ACCOUNTING FOR SUBSEQUENT EVENTS

The additional $87,000 in warranty liability was created *after* the December 31 balance sheet date. There is no reason to question the $100,000 warranty liability estimate as of December 31. Thus, the reported warranty liability should be $100,000, with note disclosure outlining the problem with poor-quality materials that arose *after* the balance sheet date.

PRACTICE 3–21 BOOK-TO-MARKET RATIO

Book-to-market ratio = Stockholders' equity/Market value of equity = $7,800/$10,000 = 0.78

EXERCISES

3–22.

1.	(g) (–)	11.	(a)
2.	(b)	12.	(b)
3.	(f) or (g)*	13.	(d)
4.	(a)	14.	(a) (–)
5.	(f)	15.	(f)
6.	(f)	16.	(c) (–)
7.	(f) or (h)	17.	(a)
8.	(i)	18.	(a)
9.	(f)	19.	(a)
10.	(e)	20.	(e) As discussed in Chapter 16, can also be (a), current asset

*If bonds are expected to be refinanced and the necessary criteria are met.

3–23.

Account	Classification
(a) Treasury Stock	Other equity portion of the Owners' Equity section
(b) Retained Earnings	Retained earnings in the Owners' Equity section
(c) Vacation Pay Payable	Current liability
(d) Foreign Currency Translation Adjustment	Other equity portion of the Owners' Equity section
(e) Allowance for Bad Debts	Offset against receivables in the Current Asset section
(f) Liability for Pension Payments	Other noncurrent liability except for current portion
(g) Investment Securities (Trading)	Current asset
(h) Paid-In Capital in Excess of Stated Value	Additional paid-in capital in the Owners' Equity section
(i) Leasehold Improvements	Property, plant, and equipment
(j) Goodwill	Intangible asset
(k) Receivables—U.S. Government Contracts	Current asset
(l) Advances to Salespersons	Current asset
(m) Premium on Bonds Payable	Added to bonds payable in Long-Term Debt section
(n) Inventory	Current asset

3–23. (Concluded)

(o)	**Patents**	**Intangible asset**
(p)	**Unclaimed Payroll Checks**	**Current liability**
(q)	**Income Taxes Payable**	**Current liability**
(r)	**Subscription Revenue Received in Advance**	**Current liability**
(s)	**Interest Payable**	**Current liability**
(t)	**Deferred Income Tax Asset**	**Other noncurrent asset or, as discussed in Chapter 16, can also be a current asset**
(u)	**Tools**	**Property, plant, and equipment**
(v)	**Deferred Income Tax Liability**	**Other noncurrent liability or, as discussed in Chapter 16, can also be a current liability**

3–24. (a) Not an asset. No probable future economic benefits are associated with the mine.

(b) Not an asset. There certainly are future economic benefits associated with the geologists, but they are not controlled by Ingalls, because they always have the option of quitting.

(c) Not an asset. The probability of future economic benefit from the crater is low.

(d) Not an asset. The real estate is not currently controlled by Ingalls.

(e) Not an asset. The oil field has future economic benefit, but it is not yet controlled by Ingalls as a result of a past transaction.

3–25. (a) Not a liability. There was a liability, but since the payment was made, no further future sacrifice of assets will be required.

(b) Liability. Pauli is obligated to deliver services in the future as a result of events (receipt of the advertising) that have already occurred.

(c) Liability. It is probable that Pauli will have to sacrifice assets in the future (new carpets) as a result of events that have already occurred (past sales of guaranteed carpets).

(d) Not a liability. Although it is probable that Pauli will have to make payments in the future, the events necessitating those payments have not yet occurred.

(e) Not a liability for the same reasons in (d).

3–26.

Balance Sheet

Assets	Liabilities
Current assets:	Current liabilities:
Cash	Notes payable (current)
Investment securities (trading)	Accounts payable
Accounts receivable	Income taxes payable
Less allowance for bad debts	Salaries payable
Interest receivable	Estimated warranty expense payable
Inventory	Total current liabilities
Prepaid insurance	Noncurrent liabilities:
Total current assets	Long-term debt:
Investments:	Bonds payable
Investment in subsidiary	Premium on bonds payable
Net pension asset	Deferred income tax liability
Total investments	Total noncurrent liabilities
Property, plant, and equipment:	Total liabilities
Land	
Buildings	Stockholders' Equity
Less accumulated depreciation	Contributed capital:
Equipment	Common stock
Less accumulated depreciation	Paid-in capital in excess of stated value
Total property, plant, and equipment	Paid-in capital from sale of treasury stock
Intangible assets:	Total contributed capital
Patents	Retained earnings
Goodwill	Total stockholders' equity
Total intangible assets	
Total assets	Total liabilities and stockholders' equity

3–27.

Current assets:		
Cash in general checking account	$ 34,000	
Cash held to pay sales taxes	18,000	
Accounts receivable	113,000	
Inventory	111,000	
Prepaid insurance	15,000	
Used equipment to be sold	9,000	$300,000
Current liabilities:		
Accounts payable	$ 79,000	
Note payable—due July 2014	27,000	
Salaries payable	11,000	
Sales taxes payable	23,000	140,000
Working capital		$160,000

3–28.

Jared Corporation
Balance Sheet
December 31, 2013

Assets		Liabilities	
Current assets:		Current liabilities:	
Cash	$ 8,500	Accounts payable	$ 3,400
Investment securities	5,250	Current portion of bonds payable	2,500
Accounts receivable, net	21,350	Loan due on demand	7,000
Inventory	31,000	Dividends payable	15,000
Land held for resale	8,000	Other	2,000
Other current assets	10,200	Total current liabilities	$ 29,900
Total current assets	$ 84,300	Long-term liabilities:	
Noncurrent assets:		Bonds payable	$ 7,500
Investments	$ 2,750	Other liabilities	15,750
Property, plant, and equipment, net	56,800	Total long-term liabilities	$ 23,250
Restricted cash:		Total liabilities	$ 53,150
For preferred stock	19,000	Owners' Equity	
For equipment	4,000	Preferred stock	$ 19,000
Advance to company president	4,000	Common stock	50,000
Other noncurrent assets	13,600	Retained earnings	66,800
Total noncurrent assets	$100,150	Less treasury stock	(4,500)
		Total owners' equity	$131,300
Total assets	$184,450	Total liabilities and owners' equity	$184,450

COMPUTATIONS:

Cash: $12,500 – $4,000 (a)
Investment securities: $8,000 – $2,750 (b)
Land held for resale: $8,000 (h)
Other current assets: $14,200 – $4,000 (c)
Property, plant, and equipment: $64,800 – $8,000 (h)
Restricted cash: $19,000 (g)
$4,000 (a)
Investments: $2,750 (b)
Advance to company president: $4,000 (c)
Current portion of bonds payable: $2,500 (d)
Loan due on demand: $7,000 (e)
Dividends payable: $15,000 (f)
Bonds payable (long-term): $10,000 – $2,500 (d)
Other long-term liabilities: $32,750 – $2,500 (d) – $7,500 (d) – $7,000 (e)
Preferred stock: $19,000 (g)
Retained earnings: $81,800 – $15,000 (f)
Treasury stock: formerly shown incorrectly as a noncurrent asset

3–29.

(a)	22,642	(f)	145,372	(k)	78,145
(b)	129,515	(g)	159,991	(l)	468,770
(c)	380,465	(h)	21,842	(m)	441,732
(d)	295,772	(i)	43,911	(n)	792,514
(e)	88,484	(j)	65,753		

3–30. 1. (a) Current assets:

Cash		$ 43,700
Investment securities (trading)		15,000
Notes receivable		22,000
Accounts receivable	$79,500	
Less: Allowance for doubtful accounts	(4,600)	74,900
Accrued interest on notes receivable		2,100
Inventory		59,300
Prepaid expenses		8,200
Total current assets		$225,200

(b) Property, plant, and equipment:

	Cost	Accumulated Depreciation	Book Value
Land	$103,000		$103,000
Buildings	192,000	$21,000	171,000
Equipment	37,000	5,900	31,100
Total property, plant, and equipment	$332,000	$26,900	$305,100

(c) Intangible assets:

Patents	$ 85,000
Franchises	82,110
Total intangible assets	$167,110

(d) Total assets:

Current assets	$225,200
Property, plant, and equipment	305,100
Intangible assets	167,110
Total assets	$697,410

(e) Current liabilities:

Accounts payable	$ 57,600
Notes payable—trade creditors	11,000
Accrued interest on notes payable	950
Accrued interest on bonds payable	7,500
Accrued interest on mortgage payable	4,320
Total current liabilities	$ 81,370

3–30. (Concluded)

(f) Noncurrent liabilities:

Bonds payable, 8%—issue 1		$ 65,000	
Premium on bonds payable		2,500	$ 67,500
Bonds payable, 12%—issue 2		$125,000	
Discount on bonds payable		12,500	112,500
Mortgage payable			72,000
Total noncurrent liabilities			$252,000

(g) Owners' equity:

Contributed capital:			
Capital stock, par value $1, 10,000 shares authorized, 5,000 shares issued	$ 5,000		
Additional paid-in capital	123,700	$128,700	
Retained earnings		251,340	$380,040
Less: Treasury stock—at cost (500 shares)			(16,000)
Total owners' equity			$364,040

(h) Total liabilities and owners' equity:

Current liabilities	$ 81,370
Noncurrent liabilities	252,000
Owners' equity	364,040
Total liabilities and owners' equity	$697,410

2. (a) Current ratio = $225,200/$81,370 = 2.77

(b) Debt ratio = ($81,370 + $252,000)/$697,410 = 0.48

3–31.

The computation of Riverton Company's ratios is as follows:

Current ratio ($55,000/$25,000)	2.20
Debt ratio ($95,000/$150,000)	0.63
Asset turnover ($275,000/$150,000)	1.83
Return on assets ($18,000/$150,000)	12.0%
Return on equity [$18,000/($150,000 – $95,000)]	32.7%

3–32.

Schlofman Company has the following assets and asset mix:

	Asset Amount	Total Assets (%)	Industry Asset Mix
Cash	$ 20,000	4.9%	7.0%
Accounts receivable	60,000	14.8	15.0
Inventory	105,000	25.9	18.0
Property, plant, and equipment	220,000	54.3	60.0
Total assets	$405,000	100.0%	100.0%

Note: **Items do not total to 100% due to rounding.**

Schlofman Company holds 25.9% of its total assets in the form of inventory, whereas the corresponding percentage for the industry is just 18%. Schlofman has too much inventory compared to other companies in its industry.

3–33.

(a) (1) The customer's financial condition was deteriorating at the end of the year, and the bankruptcy confirmed the doubtful nature of the account. An increased allowance adjustment would be required.

(b) (2) Since the event occurred after the year-end, it would not be recorded in the financial statements. However, because damage to the plant was extensive, the event should be disclosed in the notes to the statements.

(c) (1) The event that caused the loss occurred in a previous period. The settlement of the case confirmed the amount of the loss and should be recorded in the financial statements. Depending on the facts of the case, the loss will be recorded either as an extraordinary item or as a separate item in the operating income section.

(d) (3) The U.S. trade deficit is a well-publicized fact. Unless some specific regulation or event created an unusual impact on the company, this information would not require disclosure in the notes.

(e) (2) A major change in equity during the subsequent event period should be disclosed in the notes. This event will affect the statements to be issued at the close of the subsequent period.

(f) (1) If $25,000 is considered material, the income tax expense and tax liability should be adjusted for the new information. Because the liability relates to the financial statements currently being issued, an adjustment should be made to the accounts.

(g) (3) The information would probably be conveyed through a source other than the financial statements, such as a press release.

3–34. (a) Report the amount as a subtraction in the Equity section of the balance sheet.

(b) Note disclosure.

(c) Report the detail in the income statement or as a note disclosure.

(d) Report the amount in the balance sheet as Allowance for Bad Debts.

(e) Contingent liability mentioned in the note disclosure, but no amount recognized because the contingency is not described as being probable.

(f) Report the amount in the income statement.

(g) Report the amount as a long-term asset.

(h) Note disclosure.

(i) No financial statement disclosure.

(j) Note disclosure.

(k) No financial statement disclosure.

3–35. Note 1. Summary of Significant Accounting Policies

Receivables. An allowance account is provided for the estimated uncollectible accounts.

Inventories. Inventory is valued using the LIFO method. If the Company had used the FIFO inventory method, the ending inventory would be reduced by $50,000 and net income for the year would be reduced by $35,000 after taxes. Consignment inventory is carried as an asset by Delta until it is sold by the consignee.

Equipment. The Company depreciates its equipment using the straight-line method. The current value of the equipment is $525,000.

Note 2. Receivables

The receivables amount of $126,000 includes the following balances:

Customers' accounts	$ 70,000
Customers' notes	30,000
Advances to sales representatives	10,000
Advance to president of company	25,000
Total	$135,000
Less allowance for bad debts	(9,000)
Net receivables	$126,000

Note 3. Anticipated Merger

The Board of Directors is discussing a merger with another chemical company. No final decision has been made as of the date these statements are being issued; however, it is anticipated that additional shares of stock will be issued as part of any merger.

3–35. (Concluded)

Note 4. Notes Payable

The Company borrowed $350,000 on a 10-year note at 14% interest. The note is due on July 1, 2020. Equipment has been pledged as collateral for the loan. The terms of the note prohibit any additional long-term borrowing without the express permission of the note holders. Because of a need for additional financing next year, management is planning to make such a request.

3–36.

	Reported Stockholders' Equity	Total Market Value of Equity	Book-to-Market Ratio
Company A	$15,000	$82,000	0.18
Company B	15,000	11,000	1.36

It is more likely that Company A is the successful Internet retailer and Company B is the traditional steel manufacturer. Most of the economic assets of the steel manufacturer would be included in the company's balance sheet, suggesting that the book-to-market ratio would be close to 1.00. For the successful Internet retailer, most of the economic assets are intangibles not included in the balance sheet; this would lead to a very low book-to-market ratio.

PROBLEMS

3–37.

1. Working capital = \$180,000 – \$88,000 = \$92,000

Current assets:	
Accounts receivable	\$ 40,000
Advances to salespersons	10,000
Allowance for bad debts	(10,000)
Cash	22,000
Certificates of deposit	16,000
Inventory	75,000
Investment in Siebert Co. stock	21,000
Prepaid insurance	6,000
Total current assets	\$180,000

Total assets:	
Current assets	\$180,000
Equipment	215,500
Tools	52,000
Accumulated depreciation	(44,000)
Investment in Rowe Oil Co. stock	76,500
Total assets	\$480,000

Current liabilities:	
Accounts payable	\$ 66,000
Rent revenue received in advance	12,000
Taxes payable	10,000
Total current liabilities	\$ 88,000

Total liabilities:	
Current liabilities	\$ 88,000
Bonds payable	100,000
Premium on bonds payable	6,000
Deferred income tax liability	46,000
Total liabilities	\$240,000

Owners' equity:	
Common stock (par)	\$100,000
Paid-in capital in excess of par	42,500
Retained earnings	97,500
Total owners' equity	\$240,000

Owners' equity per share of stock:
\$240,000 ÷ 75,000 = \$3.20

2. Current ratio = \$180,000/\$88,000 = 2.05
   Debt ratio = \$240,000/\$480,000 = 0.50
   Return on equity = \$20,000/\$240,000 = 8.33%

3–38.

1.

Pennington Investment Corporation
Balance Sheet
January 31, 2013

Assets			
Current assets:			
Cash on hand		$ 96,250	
Cash in banks		8,320	
Investment securities (trading)		83,750	
Notes receivable	$ 32,960		
Accounts receivable	158,200		
	$ 191,160		
Less allowance for doubtful notes and accounts receivable	(24,700)	166,460	
Interest receivable		2,700	
Claim for income tax refund		4,000	
Inventory		201,500	
Prepaid expenses:			
Prepaid insurance	$ 3,900		
Miscellaneous supplies inventory	4,200	8,100	$ 571,080
Long-term investments:			
Cash fund for stock redemption		$ 17,500	
Investments in undeveloped properties		193,500	211,000
Property, plant, and equipment:			
Land		$213,000	
Buildings	$ 320,000		
Less accumulated depreciation	(139,500)	180,500	
Machinery and equipment	$ 165,500		
Less: Accumulated depreciation	(116,300)	49,200	442,700
Total assets			$1,224,780
Liabilities			
Current liabilities:			
Notes payable		$ 68,320	
Accounts payable		92,400	
Salaries and wages payable		15,700	
Income taxes payable		18,000	
Interest payable		5,790	
Employees' income taxes payable		4,360	$ 204,570
Noncurrent liabilities:			
Notes payable (due 2016)			63,800
Total liabilities			$ 268,370
Owners' Equity			
Contributed capital:			
Preferred stock, $5 par, 57,000 shares	$ 285,000		
Common stock, $1 par, 55,000 shares	55,000		
Additional paid-in capital—common stock	605,000	$945,000	
Retained earnings		11,410	
Total owners' equity			956,410
Total liabilities and owners' equity			$1,224,780

2. Current ratio = $571,080/$204,570 = 2.79
Debt ratio = $268,370/$1,224,780 = 0.219
Asset turnover = $7,000,000/$1,224,780 = 5.72

3–39.

Brockbank Research Corp.
Balance Sheet
December 31, 2013

Assets

Current assets:			
Cash		$ 25,600	
Accounts receivable—trade	$ 57,731		
Less: Allowance for bad debts	(1,731)	56,000	
Insurance claims receivable (Note 2)		80,000	
Inventories (Note 1a)		201,620	
Prepaid insurance		5,500	$368,720
Investments:			
Cash fund for bond retirement		$ 3,600	
Investment in unconsolidated subsidiary		80,000	83,600
Property, plant, and equipment:			
Land		$ 6,000	
Leasehold improvements (Note 3)	$ 65,800		
Furniture, fixtures, and store equipment	769,000		
Automotive equipment	132,800		
	$967,600		
Less: Accumulated depreciation (Note 1b)	(579,472)	388,128	394,128
Intangible assets (Note 1c):			
Franchises		$ 12,150	
Patent licenses		57,402	69,552
Other noncurrent assets:			
Insurance claims receivable (Note 2)			40,000
Total assets (Note 4)			$956,000

Liabilities

Current liabilities:			
Notes payable—trade		$ 63,540	
Notes payable—banks		12,000	
Accounts payable		32,160	
Dividends payable		37,500	
Profit sharing, payroll, and vacation payable		40,000	$185,200
Long-term debt:			
7½%–12% Mortgage notes payable			200,000
Deferred income tax liability			45,000
Total liabilities			$430,200

Owners' Equity

Contributed capital:			
Common stock, $1 par, 100,000 shares authorized, 35,000 shares issued and outstanding	$ 35,000		
Additional paid-in capital	265,000	$300,000	
Retained earnings		225,800	
Total owners' equity			525,800
Total liabilities and owners' equity			$956,000

See accompanying notes to financial statements.

3–39. (Concluded)

BROCKBANK RESEARCH CORP.
NOTES TO FINANCIAL STATEMENTS—YEAR ENDED DECEMBER 31, 2013

1. Summary of significant accounting policies
   (a) Inventories are stated at the lower of cost or market. Cost is calculated by the specific identification method.
   (b) Depreciation is computed using the straight-line method over the estimated useful lives of the assets.
   (c) The costs of an exclusive franchise to import a foreign company's ball bearings and a related patent license are being amortized on the straight-line method over their remaining lives of 10 years and 15 years, respectively.
2. Insurance claims, based on the opinion of an independent insurance adjustor, are for property damages at the central warehouse. These claims have been classified as current and noncurrent based on the company's estimate of probable settlement dates.
3. The company leases all of its buildings. Rental lease commitments are $50,000 per year for the next 10 years. All leases are operating leases.
4. The company is currently in litigation over a $13,000 overpayment of income taxes. In the opinion of counsel, the claim is valid, but no legal right to the overpayment exists as of the date of the report.
5. The company is contingently liable for $12,000 of guaranteed notes.

3–40.

Sierra Corp.
Liabilities
December 31, 2013

Current liabilities:		
Notes payable—trade	$ 19,000	
Notes payable—bank (Note 1)	30,000	
Accounts payable	85,000	
Wages and salaries payable	1,500	
Interest payable	14,300	
Mortgage note payable (Note 2)	64,000	
Bonds payable (Note 3)	200,000	
Total current liabilities		$413,800
Noncurrent liabilities:		
Mortgage note payable (Note 2)	$146,000	
Notes payable—bank (Note 4)	50,000	
Total noncurrent liabilities		196,000
Total liabilities		$609,800

3–40. (Concluded)

Note 1. **This is an 8% note to First Interstate Bank issued March 1, 2011. Payable on demand.**

Note 2. **Sierra has two mortgage notes outstanding. (1) $60,000, 10%, 10-year note due October 1, 2020. Terms of this note give the holder the right to demand immediate payment if the company fails to make a monthly interest payment within 10 days of the date the payment is due. Because Sierra is three months in arrears on these payments, this $60,000 note is classified as a current liability. (2) 12%, 20-year note, current balance $150,000. Payments of principal and interest due annually until 2027. $4,000 of the April 30, 2014, payment applies to principal and is classified as a current liability. The remaining principal balance of $146,000 is classified as a noncurrent liability.**

Note 3. **The 10-year, 8% bonds mature on June 30, 2014.**

Note 4. **The 1-year, $50,000, 11½% note to First Interstate Bank matures on January 2, 2014. On December 30, 2013, a written agreement was entered into with First Interstate Bank to replace this note with a new, 2-year, $50,000, 10% note to be issued January 2, 2014. Because of this agreement, the note is properly classified as noncurrent.**

3–41.

Midway Company
Balance Sheet
June 30, 2013

Assets			
Current assets:			
Cash		$ 44,500	
Investment securities—trading		53,700	
Inventories		635,100	
Prepaid expenses		41,000	$ 774,300
Investments:			
Bahen Builders			275,000
Property, plant, and equipment		$330,000	
Less: Accumulated depreciation		(150,000)	180,000
Other noncurrent assets:			
Deposit made on future delivery of special inventories			25,000
Total assets			$1,254,300
Liabilities			
Current liabilities:			
Notes payable		$ 55,000	
Accounts payable		240,000	
Taxes payable		37,000	$ 332,000
Long-term debt:			
Notes payable		$ 95,000	
Bonds payable	$325,000		
Less discount on bonds payable	(25,000)	300,000	395,000
Other noncurrent liabilities:			
Deferred income tax liability		$ 71,000	
Liability under pension plan		49,000	120,000
Total liabilities			$ 847,000
Owners' Equity			
Contributed capital:			
Common stock, $1 par, 15,000 shares issued and outstanding	$ 15,000		
Additional paid-in capital	227,200	$242,200	
Retained earnings:			
Restricted for building expansion	$112,000		
Unrestricted	53,100*	165,100	
Total owners' equity			407,300
Total liabilities and owners' equity			$1,254,300

*$138,100 – $85,000 unrecognized goodwill = $53,100.

3–42.

St. Charles Ranch
Balance Sheet
December 31, 2013

Assets			
Current assets:			
Cash on hand		$ 10,640	
Cash in bank		34,505	
Accounts receivable	$ 40,500		
Less: Allowance for bad debts	(2,430)	38,070	
Claim for income tax refund		2,800	
Feed inventory (at cost) ($37,000 × 25%)		9,250	
Grain inventory (at market)		42,500	$137,765
Property, plant, and equipment:			
Land		$490,000	
Buildings and equipment	$176,400		
Less: Accumulated depreciation	(70,560)	105,840	595,840
Total assets			$733,605
Liabilities			
Current liabilities:			
Accounts payable		$ 37,000	
Mortgage payable—current portion		25,000	
Income taxes payable		18,500	
Bonus payable		9,000	
Dividends payable		30,000	$119,500
Noncurrent liabilities:			
Mortgage payable			225,000
Total liabilities			$344,500
Owners' Equity			
Contributed capital:			
Common stock, $1 par value, 14,000 shares issued and outstanding	$ 14,000		
Additional paid-in capital	276,000	$290,000	
Retained earnings*		99,105	
Total owners' equity			389,105
Total liabilities and owners' equity			$733,605

*Amount needed to balance the statement.

Note: The question of when to recognize a liability for property taxes—when the taxes are assessed or as the tax year elapses—is actually quite complicated. This solution assumes that the liability is recognized as the tax year (2014) elapses. Thus, no liability is recorded at the end of 2013.

3–43. **A work sheet is not required, but it facilitates the preparation of a corrected balance sheet.**

Chordwise Music, Inc.
Work Sheet for Corrected Balance Sheet
June 30, 2013

	Balance Sheet		Corrections		Corrected Balance Sheet	
Account Title	Debit	Credit	Debit	Credit	Debit	Credit
Current Assets	286,800	....	....	(a) 286,800	....	....
Other Assets.......................	630,600	....	....	(b) 630,600	....	....
Current Liabilities................	....	158,920	(c) 158,920	....	....	....
Other Liabilities...................	....	200,000	(d) 200,000	....	....	....
Owners' Equity....................	....	558,480	(e) 558,480	....	....	....
	917,400	917,400				
Cash	....	....	(a) 51,000	....	51,000	....
Investment Securities— Trading.............................	....	....	(a) 40,000	....	40,000	....
Accounts Receivable	....	....	(a) 68,300	....	68,300	....
Inventory.............................	....	....	(a) 124,000	....	124,000	....
Advertising Supplies...........	....	....	(a) 3,500	....	3,500	....
Property, Plant, and Equipment........................	....	....	(b) 775,000	....	775,000	....
Accumulated Depreciation— Buildings and Equipment	....	....	....	(b) 220,500	....	220,500
Retained Earnings..............	....	....	(b) 65,400	....	....	....
	....	....	(f) 236,520	....	301,920	....
Deposit with Supplier..........	....	....	(b) 10,700	....	10,700	....
Payroll Payable....................	....	....	....	(c) 4,050	....	4,050
Taxes Payable	....	....	....	(c) 8,870	....	8,870
Rent Payable.......................	....	....	....	(c) 7,700	....	7,700
Accounts Payable	....	....	....	(c) 111,300	....	111,300
Notes Payable......................	....	....	....	(c) 32,000	....	32,000
Note Receivable	....	....	(c) 5,000	....	5,000	....
Mortgage Payable (current portion)	....	....	....	(d) 40,000	....	40,000
Mortgage Payable (noncurrent portion)	....	....	....	(d) 160,000	....	160,000
Preferred Stock (15,000 shares at $20 par)............	....	....	....	(e) 300,000	....	300,000
Common Stock (175,000 shares at $1 stated value)	....	....	....	(e) 175,000	....	175,000
Paid-In Capital in Excess				(e) 83,480		
of Stated Value	....	....	....	(f) 236,520	....	320,000
			2,296,820	2,296,820	1,379,420	1,379,420

Corrections:

(a) To establish current asset balances
(b) To establish other asset balances and eliminate goodwill
(c) To establish current liability balances
(d) To establish mortgage payable balances
(e) and (f) To establish owners' equity balances

3–43. (Concluded)

Chordwise Music, Inc.
Balance Sheet
June 30, 2013

Assets			
Current assets:			
Cash		$ 51,000	
Investment securities—trading		40,000	
Note receivable		5,000	
Accounts receivable		68,300	
Inventory		124,000	
Deposit with supplier		10,700	
Advertising supplies		3,500	$302,500
Property, plant, and equipment		$775,000	
Less: Accumulated depreciation		(220,500)	554,500
Total assets			$857,000
Liabilities			
Current liabilities:			
Notes payable		$ 32,000	
Accounts payable		111,300	
Mortgage payable (current portion)		40,000	
Accrued expenses:			
Payroll payable	$ 4,050		
Taxes payable	8,870		
Rent payable	7,700	20,620	$203,920
Mortgage payable			160,000
Total liabilities			$363,920
Owners' Equity			
Contributed capital:			
Preferred stock, $20 par, 15,000 shares issued and outstanding	$300,000		
Common stock, $1 stated value, 175,000 shares issued and outstanding	175,000		
Paid-in capital in excess of stated value	320,000	$795,000	
Less: Accumulated deficit		(301,920)	
Total owners' equity			493,080
Total liabilities and owners' equity			$857,000

3–44. **A work sheet is not required, but it facilitates the preparation of a corrected balance sheet.**

Appalachian Freight Company
Work Sheet for Corrected Balance Sheet
December 31, 2013

Account Title	Balance Sheet Debit	Balance Sheet Credit		Corrections Debit		Corrections Credit	Corrected Balance Sheet Debit	Corrected Balance Sheet Credit
Cash	45,050	....		....		....	45,050	....
Accounts Receivable	112,500	....		....		....	112,500	....
Inventory	204,000	....		....	(b)	45,000	159,000	....
Prepaid Insurance	8,800	....		....		....	8,800	....
Property, Plant, and Equipment	376,800	....	(c)	180,000	(c)	85,000	471,800	....
Miscellaneous Liabilities	....	3,600	(d)	3,600		....	....	....
Loan Payable	....	76,200		....		....	....	76,200
Accounts Payable	....	75,250		....	(b)	16,250	....	91,500
Capital Stock	....	134,000	(h)	134,000		....	....	....
Paid-In Capital	....	458,100	(i)	458,100		....	....	....
	747,150	747,150						
Retained Earnings	....	....	(a)	4,800	(i)	308,500	....	....
	....	....	(b)	61,250		....	....	179,650
	....	....	(f)	18,250		....	....	....
	....	....	(g)	44,550		....	....	....
Allowance for Bad Debts	....	....		....	(a)	4,800	....	4,800
Accumulated Depreciation—Buildings and Equipment	....	....	(c)	85,000	(c)	180,000	....	95,000
Salaries Payable	....	....		....	(d)	9,500	....	9,500
Advances to Officers	....	....	(d)	5,900		....	5,900	....
Deferred Income Tax Liability	....	....		....	(g)	44,550	....	44,550
Taxes Payable	....	....		....	(f)	18,250	....	18,250
6% Preferred Stock, $20 Par	....	....		....	(h)	125,000	....	125,000
Common Stock, $1 Stated Value	....	....		....	(h)	9,000	....	9,000
Paid-In Capital in Excess of Par and Stated Values on Preferred and Common Stock	....	....		....	(i)	149,600	....	149,600
				995,450		995,450	803,050	803,050

3–44. (Concluded)

Appalachian Freight Company
Balance Sheet
December 31, 2013

Assets			
Current assets:			
Cash		$ 45,050	
Accounts receivable	$112,500		
Less: Allowance for bad debts	(4,800)	107,700	
Inventory		159,000	
Prepaid insurance		8,800	$320,550
Property, plant, and equipment		$471,800	
Less: Accumulated depreciation		(95,000)	376,800
Other noncurrent assets:			
Advances to officers			5,900
Total assets			$703,250
Liabilities			
Current liabilities:			
Loan payable to bank, current portion		$ 25,000	
Accounts payable		91,500	
Salaries payable		9,500	
Taxes payable		18,250	$144,250
Loan payable to bank			51,200
Deferred income tax liability			44,550
Total liabilities			$240,000
Owners' Equity			
Contributed capital:			
6% Preferred stock, $20 par, 6,250 shares	$125,000		
Common stock, $1 stated value, 9,000 shares	9,000		
Paid-in capital in excess of par and stated values on preferred and common stock	149,600	$283,600	
Retained earnings		179,650	
Total owners' equity			463,250
Total liabilities and owners' equity			$703,250

3–45. **A work sheet is not required, but it facilitates the preparation of a corrected balance sheet.**

Delicious Bakery
Work Sheet for Corrected Balance Sheet
December 31, 2013

Account Title	Balance Sheet Debit	Balance Sheet Credit	Corrections Debit	Corrections Credit	Corrected Balance Sheet Debit	Corrected Balance Sheet Credit
Current Assets	53,415	....	....	(a) 53,415	....	....
Current Liabilities	....	29,000	(c) 29,000	....	....	....
Other Assets	75,120	....	....	(b) 75,120	....	....
Other Liabilities	....	3,600	(d) 3,600	....	....	....
Investment in Business	....	95,935	(e) 95,935	....	....	....
	128,535	128,535	....	....	....	....
Cash	....	....	(a) 10,600	....	10,600	....
Investment Securities— Trading (at market value)	....	....	(a) 2,575	....	2,575	....
Accounts Receivable	....	....	(a) 12,500	....	12,500	....
Inventory	....	....	(a) 8,040	....	8,040	....
Supplies Inventory	....	....	(a) 425	....	425	....
Delivery Truck	....	....	(a) 2,100	....	2,100	....
Fixtures	....	....	(a) 12,500	....	12,500	....
Accumulated Depreciation— Fixtures	....	....	....	(a) 2,100	....	2,100
Cash Surrender Value of Insurance on Officers' Lives	....	....	(a) 4,100	....	4,100	....
Retained Earnings	....	....	(a) 2,675	....	....	....
	....	....	(b) 7,750	....	....	....
	....	....	(d) 350	....	....	30,160
	....	....	....	(e) 40,935	....	....
Land	....	....	(b) 30,000	....	30,000	....
Buildings	....	....	(b) 62,000	....	62,000	....
Accumulated Depreciation— Buildings [2½ × ($62,000 ÷ 20)]	....	....	....	(b) 7,750	....	7,750
11% Mortgage Payable (noncurrent portion)	....	....	....	(b) 12,000	....	12,000
11% Mortgage Payable (current portion)	....	....	....	(b) 4,000	....	4,000
Interest Payable	....	....	....	(b) 880	....	880
Trade Accounts Payable	....	....	....	(c) 29,000	....	29,000
Miscellaneous Liabilities	....	....	....	(d) 3,950	....	3,950
Capital Stock, $5 Stated Value, 5,000 Shares	....	....	....	(e) 25,000	....	25,000
Paid-In Capital in Excess of Stated Value	....	....	....	(e) 30,000	....	30,000
			284,150	284,150	144,840	144,840

Corrections:
(a) To restate current assets
(b) To restate other assets
(c) To restate current liabilities
(d) To restate other liabilities
(e) To restate owners' equity accounts

3–45. (Concluded)

Delicious Bakery
Balance Sheet
December 31, 2013

Assets			
Current assets:			
Cash		$10,600	
Investment securities—trading (reported at market; cost $4,250)		2,575	
Accounts receivable (fully collectible)		12,500	
Inventory		8,040	
Supplies inventory		425	$ 34,140
Investments:			
Cash surrender value of life insurance			4,100
Property, plant, and equipment:			
Land		$30,000	
Buildings	$62,000		
Less: Accumulated depreciation	(7,750)	54,250	
Fixtures	$12,500		
Less: Accumulated depreciation	(2,100)	10,400	
Delivery truck		2,100	96,750
Total assets			$134,990
Liabilities			
Current liabilities:			
Mortgage payable, current portion		$ 4,000	
Trade accounts payable		29,000	
Interest payable		880	
Miscellaneous liabilities		3,950	$ 37,830
11% Mortgage payable (noncurrent portion)			12,000
Total liabilities			$ 49,830
Owners' Equity			
Contributed capital:			
Capital stock, $5 stated value, 5,000 shares	$25,000		
Paid-in capital in excess of stated value	30,000	$55,000	
Retained earnings		30,160	
Total owners' equity			85,160
Total liabilities and owners' equity			$134,990

3–46. **A work sheet is not required, but it facilitates the preparation of the December 31, 2013, balance sheet.**

Looseleaf Corporation
Work Sheet for Balance Sheet
December 31, 2013

Account Title	Balance Sheet January 1, 2013		Transactions 2013		Balance Sheet December 31, 2013	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	15,000	....	(e) 350,000	(b) 295,000	....	....
	....	....	(g) 150,000	(a) 82,000	24,500	....
	....	....		(c) 8,500	....	....
	....	....		(f) 105,000	....	....
Accounts Receivable	55,000	....	(d) 390,000	(e) 350,000	95,000	....
Inventory	105,000	....	(a) 395,000	(d) 320,000	180,000	....
Equipment	110,000	....	(f) 245,000	(f) 140,000	215,000	....
Accounts Payable	....	85,000	(b) 295,000	(a) 307,000	....	97,000
Capital Stock, $1 par	....	5,000	....	(g) 15,000	....	20,000
Additional Paid-In Capital	....	195,000	....	(g) 135,000	....	330,000
	285,000	285,000	....	....	....	....
Retained Earnings	....	....	(c) 8,500	(d) 70,000	....	....
	....	....	(h) 35,000	....	22,500	....
	....	....	(i) 45,000	....	....	....
	....	....	(j) 4,000	....	....	....
Wages Payable	....	....	....	(a) 6,000	....	6,000
Dividends Payable	....	....	....	(h) 35,000	....	35,000
Accumulated Depreciation—Equipment	....	....	....	(i) 45,000	....	45,000
Allowance for Bad Debts	....	....	....	(j) 4,000	....	4,000
			1,917,500	1,917,500	537,000	537,000

Transactions:

(a) To record costs of production
(b) To record payment to suppliers
(c) To record payment of other expenses
(d) To record gross profit for the year
(e) To record collections on receivables
(f) To record acquisition and retirement of equipment
(g) To record issuance of additional stock
(h) To record dividend declaration
(i) To record depreciation expense
(j) To record the allowance for bad debts

3–46. (Concluded)

Looseleaf Corporation
Balance Sheet
December 31, 2013

Assets		Liabilities	
Current assets:		Current liabilities:	
Cash	$ 24,500	Accounts payable	$ 97,000
Accounts receivable (net of allowance for bad debts of $4,000)	91,000	Wages payable	6,000
Inventory	180,000	Dividends payable	35,000
Total current assets	$295,500	Total current liabilities	$138,000
		Owners' Equity	
		Contributed capital:	
Equipment	$215,000	Capital stock, $1 par, 20,000 shares issued and outstanding	$ 20,000
Less: Accumulated depreciation	(45,000)	Additional paid-in capital	330,000
	$170,000	Retained earnings (deficit)	(22,500)
		Total owners' equity	$327,500
Total assets	$465,500	Total liabilities and owners' equity	$465,500

3–47.

1. The correct answer is a. The purpose of information presented in notes to the financial statements is to enhance the information included in the statements. This may include providing further detail of amounts that are included in totals on the statements. Information should not be improperly presented in the financial statements, and management's responses to auditor comments would not be presented in the statements or the notes to them.

2. The correct answer is a. Although all of the items listed may be disclosed, the summary of significant accounting policies is used to disclose the selection of accounting policies when the company is choosing among acceptable alternatives. Since a company may select among a variety of acceptable depreciation methods, the selection of straight-line would be an accounting policy.

CASES

Discussion Case 3–48

1. The equity shown on the balance sheet (assets – liabilities) can be thought of as a rough measure of the worth of the company. Accordingly, a company's net worth can never exceed the amount of its assets. However, many assets are reported at their historical cost, which in some cases differs greatly from the market value of the assets. Land purchased 30 years ago for $10,000 will still be shown on the balance sheet at $10,000 even though its market value may be many times as great. In addition, assets not acquired in a transaction are not recorded on the balance sheet at all. For example, a company's reputation and customer network may have great value, but this goodwill is not reported.

2.

ExxonMobil	0.76
Microsoft	0.32
Wal-Mart Stores	0.83
Berkshire Hathaway	1.56
Apple	0.28
Procter & Gamble	0.73
Johnson & Johnson	0.54
General Electric	4.61
Google	0.24
Bank of America	13.26

Clearly, the market value for most of these companies is more than their total of balance sheet assets. The two exceptions are the companies with large financial operations; for such companies, almost all of the economic assets (investments, loans receivable, and so forth) are reported in the financial statements at their current market value. The market values factors such as customers, historical performance, future expectations, and contributions of management and employees. None of these factors is presented as an account on a company's balance sheet, yet the market factors them into valuation.

3.

ExxonMobil	16.02
Microsoft	15.65
Wal-Mart Stores	14.32
Berkshire Hathaway	23.68
Apple	20.25
Procter & Gamble	14.14
Johnson & Johnson	14.25
General Electric	15.38
Google	25.98
Bank of America	26.69

Discussion Case 3–48 (Concluded)

In general, the following types of firms have *higher* P/E ratios than average:

- Firms with strong future growth possibilities
- Firms with earnings for the year lower than average because of a nonrecurring event (e.g., a large write-off, a natural disaster)
- Firms with substantial unrecorded assets (e.g., appreciated land, unrecorded goodwill)

In general, the following types of firms have *lower* P/E ratios than average:

- Firms with earnings for the year higher than average because of a nonrecurring event (e.g., a one-time gain)
- Firms perceived as being very risky

Discussion Case 3–49

BankAmerica	D
Kelly Services	A
Yahoo!	C
McDonald's	E
Consolidated Edison	B

The power-generating facilities of utilities form a large portion of their assets and are shown on the balance sheet as plant and equipment. However, McDonald's also has a great deal of plant and equipment. In fact, the balance sheets of a utility company and of a fast-food company look similar. In this instance, Consolidated Edison is B and McDonald's is E.

Kelly Services is A. Because service companies have low levels of fixed assets and low levels of inventory, company A matches this profile. Also because service companies typically don't have many tangible long-term assets to serve as collateral, they also don't have high levels of long-term debt and equity percentage is high. Also note that the amount of receivable is greater than the amount of short-term payables. Kelly Services basically makes its money on the difference in that spread.

BankAmerica is recognizable by its high level of other current liabilities (D). Far and away the largest liability of a bank is its deposit liability. A bank borrows money from its depositors (deposit liability) and loans it to its borrowers (loans receivables).

The Internet company Yahoo! is company C. It has no long-term debt and few long-term assets. The bulk of Yahoo's assets is invested in other current assets.

Discussion Case 3–50

The claim against ATC represents a contingent liability. Contingent liabilities are accounted for according to management's estimate of the probability that the contingent obligation will become an actual obligation.

- Probable: The liability (and a corresponding loss or expense) should be recognized.
- Possible: The contingent loss is disclosed in a note to the financial statements.
- Remote: No accounting action is necessary.

Because ATC has offered to settle out of court, management may view the likelihood of losing the case as probable. If so, a liability should be recognized. Because ATC has offered $500,000 to settle the case, the recognized liability should be at least that much. Alternatively, the settlement offer may be just a legal strategy, and ATC's management may not think that loss of the case is probable. If so, only note disclosure is necessary.

Discussion Case 3–51

1. Steps to avoid violating the current ratio constraint:

- Use FIFO instead of LIFO, causing current assets to increase by $50,000.
- Cancel plans to declare and pay cash dividends next year.

Current ratio without changes:
($1,200,000/$900,000) = 1.33

Current ratio with FIFO and cancellation of the planned dividend:
($1,290,000/$900,000) = 1.43

Other steps might include issuing new stock and converting some of the short-term debt into long-term debt.

2. Steps to avoid violating the debt ratio constraint:

- Use FIFO instead of LIFO, causing current assets to increase by $50,000.
- Lease the building instead of buying it. This will decrease long-term liabilities and long-term assets by $100,000.
- Cancel plans to declare and pay cash dividends next year.

Debt ratio without changes:
($1,700,000/$3,000,000) = 0.567

Debt ratio with FIFO, operating lease, and cancellation of the planned dividend:
($1,600,000/$2,990,000) = 0.535

Other steps might include issuing new stock.

The banks probably anticipated the cancellation of dividends, the issuance of new stock, and the transformation of short-term debts into long-term debts.

One way to eliminate accounting changes as a way to bypass loan covenants is to write the covenant in terms of a certain set of accounting principles. For example, for purposes of determining whether the covenant is violated or not, the current ratio would be computed using the LIFO inventory valuation method whether the borrowing company was still using LIFO or not.

A lender might also wish to stipulate that all long-term leases are to be treated as capital leases for purposes of the ratio computation.

Discussion Case 3–52

As a banker, you are concerned that the change in valuation requirements will limit your ability to borrow and lend monies, the primary function you are in business to accomplish. Regulations limit the amount that can be lent based on a percentage of the asset carrying value. If the total asset value is reduced because of a decline in security values, the bank cannot lend as much money and thus cannot be as profitable as it would be using a higher value. Of course, the opposite condition occurs when the valuation of the securities increases.

You are also concerned about the effect the rule can have on the income statement. Revaluing securities under current U.S. GAAP also requires recognizing unrealized gains and losses—if the securities are classified as trading securities. The recognition of these unrealized gains and losses can add volatility to the pattern of yearly earnings. To most investors, increased volatility indicates increased risk. A banker (or any other business leader) avoids the appearance of increased risk whenever possible.

The FASB and SEC are very concerned when economic conditions cause a loss in asset value and it is not reported in a timely manner on the financial statements. Some current values are very objective and can be readily measured. These include marketable equity securities and, to a lesser extent, marketable debt securities. If these securities are valued at current amounts, statement users can make more informed decisions.

Discussion Case 3–53

Note to Technology Unlimited, Inc., financial statements:

Subsequent Events

On August 15, 2013, Technology Unlimited, Inc., split its common stock 2 for 1. After the split, Technology has 200,000 shares of $0.50 par common stock outstanding.

Technology completed negotiations for the purchase of Liston Development Labs on July 18, 2013. The purchase price was $775,000, $525,000 in cash and $250,000 in a 10%, 4-year note. The acquisition was recorded in July 2013 and will be reflected in the financial statements for the year ending June 30, 2014.

A $750,000 lawsuit was filed against Technology on August 15, 2013. Technology intends to defend itself against the lawsuit; however, the probability of a favorable settlement is unknown as of September 8, 2013, the date of the auditors' report.

Events not included in subsequent events note:

Diatride Company bankruptcy. The loss from this receivable should be estimated and recorded in the 2013 fiscal year. Even though its bankruptcy didn't occur until after year-end, the underlying conditions that caused the bankruptcy were in place at the end of the fiscal year. A sufficient allowance for bad debts must be established to cover the potential loss.

General decline in stock market technology stock values. Declines in market values are generally available information and therefore do not require disclosure in a subsequent events note. To include the information might attach more importance to it than is justified. Users of the financial statements should be aware that financial statements do not contain all relevant economic information.

Discussion Case 3–54

1. Differences:

(1) Both group and individual company balances are shown side by side. Seldom is this information disclosed this way in the United States.
(2) The balance sheet begins with fixed assets rather than current assets. Current assets are listed in reverse order of liquidity, with cash being shown last. In the United States, current assets are listed in accordance to their liquidity, with cash being itemized first.
(3) Current assets less current liabilities is shown as a separate section. Some U.S. companies do this, but they include this section as the first one on the balance sheet. Also included is a line item where total assets are shown net of current liabilities. This is not done in the United States.
(4) Minority interests are shown as the last item on the balance sheet. They are shown before the equity section in most U.S. balance sheets.
(5) *Common stock* is referred to as "Called-up share capital" on the British statement.
(6) *Retained earnings* is referred to as "Profit and loss account."
(7) A significant revaluation reserve is included in the British company's Equity section. This arises from use of current values for some assets. This type of reserve is not common in U.S. statements.
(8) The British company does not identify the amount of accumulated depreciation balances on the face of the balance sheet.
(9) *Inventory* is referred to as "Stock" in the British statement.
(10) *Accounts receivable* is referred to as "Debtors" in the British statement.

Discussion Case 3–54 (Concluded)

2. Many of the differences arise from terminology differences. For instance, a few British terms would be confusing if used in the United States (e.g., stock is seldom used to mean inventory because it confuses reference to investments in common stock). Accountants should use terms that are understandable to the reader. Other differences are related to a different order of disclosure in the balance sheets of the two countries. In the United States, some companies consider the fixed assets to be more important than current assets, and they list them first. Utilities follow this principle in the United States while most other industries follow the more common liquidity approach.

Minority interest totals are often a significant item on the credit side of the balance sheet. By showing it last, readers are more likely to see the item and consider it in evaluating the impact of items on the majority shareholders. The U.S. disclosure in the midst of the liabilities and equities is often not seen by the reader.

The inclusion of both company and group totals is useful for readers who are concerned both with a consolidated group of companies and the individual company balances. U.S. companies often show only consolidated statements and do not show how the individual companies are doing. The additional information provided by the British company might be of great use to investors and creditors.

Discussion Case 3–55

First, you should explain to the stockholders that comparing any company's book-to-market ratio to the average of the 10 most valuable companies in the United States is an unfair comparison. By definition, these companies are extremely successful and will therefore have very low book values of equity compared to their high market values. Also, you should explain that many of the economic assets of these companies are intangibles such as brand names (Microsoft, IBM, Intel, and so forth). Your company is successful in your market niche, but the sale of plumbing pipes does not create a huge amount of intangibles. Finally, high market values are usually associated with companies with high growth prospects. Your company has a solid market position, but the plumbing pipe business as a whole is unlikely to see double-digit growth rates in the future.

Case 3–56

1. Disney reports a current ratio of 1.33 ($11,889/$8,934). This ratio has increased moderately from 2008 when it was 1.01 ($11,666/$11,591). The higher current ratio in 2009 resulted in part from an increase in the amount of "cash and cash equivalents."

2. Disney's asset turnover in 2009 was 0.57 ($36,149/$63,117). This was slightly less than the asset turnover in 2008 of 0.61 ($37,843/$62,497), indicating that the company was slightly less efficient in 2009.

3. In Note 2, Disney states that it uses the moving average cost basis for computing the cost of inventories and that the inventories are stated at lower-of-cost-or-market.

4. Note 2 discloses that parks, resorts, and other property are carried at historical cost. Depreciation is computed on the straight-line method based upon estimated useful lives ranging from 3 to 40 years.

5. In Note 15, Disney states that it is committed to the payment of $21.1 billion for broadcast rights, primarily for sports programming. The company is also obligated to pay $28.1 billion in the future relating to noncancelable operating leases. In addition, Disney reports that it is involved in several lawsuits but believes it is not possible to estimate the impact they will have on the operations of the company, cash flows, or financial position.

6. In Note 1, Disney reveals that of total 2009 operating income of $6,672 million, 73.8%, or $4,923 million, was generated in the United States and Canada.

Case 3–57

1. The bulk of the $5 million decrease in assets came from decreases in cash and accounts receivable. These two categories accounted for $4,918,994 of the $4,949,585 decrease in total assets. The largest corresponding reductions were in the following liabilities: accounts payable and accrued expenses, deferred game revenues, and deferred compensation—noncurrent portion.

2. The original value recorded for the NBA franchise can be computed by adding the reported book value and the accumulated amortization:

Book value of NBA franchise	$3,393,263
Accumulated amortization	2,776,318
Original recorded value of franchise	$6,169,581

The annual amortization charge is computed by observing the change in accumulated amortization from 2000 to 2001: $2,776,318 – $2,622,078 = $154,240 annual amortization

The amortization period can be computed by comparing the original recorded value of the franchise and the annual amortization charge: $6,169,581/$154,240 = 40 years

The accumulated amortization of $2,776,318 on June 30, 2001, represents 18 years of amortization ($2,776,318/$154,240 = 18). Therefore, the NBA franchise asset was originally recognized on June 30, 1983.

3. Partners' capital can become negative in two ways: The partnership can experience losses large enough to wipe out the partners' original investments, or the partnership can pay out cash distributions in excess of the partners' original investments. The Celtics have paid out excess distributions to partners. One reason for this is that the NBA franchise asset analyzed in Question 2 is reported in the balance sheet at far less than its current market value, which probably exceeds $200 million.

4. The Celtics report that the $6.4 million deferred compensation liability relates to amounts that have been earned but not yet been paid in cash. Accordingly, this reported liability is for amounts to be paid in the future for services already rendered. The $254.585 million amount is for services that have not yet been provided. Thus, even though the payments have to be made whether the player plays or not, the amount is not recognized as a liability because it does not stem from a "past transaction," that is, from services already provided. In this case, you can see that the information from the financial statement notes is extremely important in understanding the total economic obligations currently borne by the Celtics.

Case 3–58

1.

	Kroger	Safeway	Supervalue
Current Ratio	0.97	0.90	0.89
Debt Ratio	0.79	0.67	0.82
Asset Turnover	3.32	2.73	2.47
Return on Equity	1%	–22%	14%

2. Evaluation of how efficiently specific assets are used can be done by computing asset turnover ratios for specific assets.

	Kroger	Safeway	Supervalue
Inventory Turnover (Cost of goods sold/Inventory)	12.03	11.15	13.43
Fixed Asset Turnover (Sales/PPE)	5.51	3.97	5.78

Case 3–58 (Concluded)

It appears that Supervalue is the most efficient at using inventory—each dollar of inventory measured at cost generates $13.43 of sales volume during a year. Supervalue also appears to be the most efficient at using property, plant, and equipment—each dollar of PPE generates $5.78 of sales during the year.

3. Ratio comparisons can be invalid when the companies being compared use different accounting methods. For example, comparisons of inventory efficiency may be misleading if one company uses LIFO and another uses FIFO. Comparative property, plant, and equipment efficiency is impacted by what fraction of a company's fixed assets are leased under operating leases and therefore do not appear on the balance sheet.

Case 3–59

Diageo
Consolidated Balance Sheet
30 June 2009
(In millions of £)

Assets	
Current assets:	
Cash	£ 914
Accounts receivable	2,031
Inventory	3,162
Other current assets	98
Total current assets	£ 6,205
Investments (£2,045 + £231)	2,276
Property, plant, and equipment	2,268
Biological assets	37
Long-term receivables	18
Other financial assets	364
Deferred tax assets	672
Post employment benefit assets	41
Intangible assets	6,215
Total assets	£18,096
Liabilities	
Current liabilities:	
Accounts payable and accrued liabilities	£ 2,173
Short-term debt	890
Income tax payable	532
Short-term provisions	172
Other current liabilities	220
Total current liabilities	£ 3,987
Long-term debt	7,685
Other noncurrent liabilities (£99 + £30 + £1,424)	1,553
Long-term provisions	314
Deferred tax liabilities	621
Total liabilities	£14,160
Stockholders' Equity	
Contributed capital:	
Common stock (£797 + £3,282)	£ 4,079
Additional paid-in capital	1,342
Retained earnings (deficit)	(2,200)
Minority interest	715
Total stockholders' equity	£ 3,936
Total liabilities and stockholders' equity	£18,096

Case 3–60

1. **a.** Debt ratio: ($33,498 – $9,698 – $213)/$33,498 = 70.4%
   b. Current ratio: $3,319/$3,205 = 1.04
   c. Long-term debt as a percentage of total capitalization: $9,232/$19,143 = 48.2%
   d. Long-term debt as a percentage of "net plant": $9,232/$20,874 = 44.2%
2. The least informative ratio for Consolidated Edison of the four computed is probably the current ratio. The essence of the company is its long-term plant and equipment, financed by long-term debt; short-term items are not crucial to the company's operating strategy as they would be for, say, a retailer. Because the company's focus is on plant and equipment and on financing these assets with long-term debt, the most important ratios are probably the long-term debt as a percentage of total capitalization and long-term debt as a percentage of "net plant."

Case 3–61

TO: The militant economics student group

No, it isn't the balance sheet that is stupid and outdated; it is your knowledge of the business information environment. The financial statements do not pretend to report everything that is useful in making decisions about a company. Yes, the value of the reputation of Coca-Cola is a useful thing to know. But so are the health of Coca-Cola's CEO and the announced marketing strategies of Coke's competitors. The financial statements include only a subset, albeit an important one, of the value-relevant information available about a company.

In order to be recognized in the financial statements, information must be both relevant and reliable. The art of accounting involves correctly trading off these two characteristics of information. Some market value information is considered to be sufficiently reliable to include in the financial statements—the market value of investment securities is a good example. Accountants have decided that other classes of market value information do not meet the reliability test. For example, market information may suggest that the value of Coca-Cola's reputation is $60 billion. However, the value of Coke's stock can change by 5% to 10% in one day—are these changes a result of changes in Coke's reputation, or do they stem from macroeconomic factors?

Financial statement information is both relevant and reliable. As such, it comprises an important part of the information investors and creditors need to make informed decisions about companies.

Case 3–62

Depending on the attitude of your senior colleagues on the accounting staff, it may be time for you to plan your departure from the firm. If you find yourself working for unethical superiors, you inevitably will be placed in situation after situation where you are faced with compromising your principles. If you think you will have to leave the firm eventually, you are better off to make it an orderly departure.

If your senior colleagues are ethical people who are also troubled by the options facing the firm, then you might suggest the following approach. Action 1 (lying about management's intent concerning the property in order to reclassify it as a current asset) is clearly unethical and unacceptable. All of the emphasis should be placed on Action 2, which has a chance of being made to comply with the accounting rules. The presentation to the board of directors might include the following points:

- A loan covenant violation would be very costly (give details).
- One way to avoid violation is to *accelerate* the negotiations on the refinancing plan.
- If a formal refinancing deal can be signed by the date the financial statements are finalized, the short-term loans can be properly classified as long-term, thus improving the current ratio and avoiding the covenant violation.
- If refinancing negotiations are not accelerated, the only other option is very unattractive and involves outright lying (briefly describe Action 1).

Case 3–62 (Concluded)

A presentation focusing on these points is ethical, gives the board of directors a concrete action to consider (i.e., getting to work on the refinancing negotiations), and points out the unsuitability of the only alternative action.

Case 3–63

Solutions to this problem can be found on the Instructor's Resource CD-ROM or downloaded from the Web at www.cengage.com/accounting/stice.