CHAPTER 5

Balance Sheet and Statement of Cash Flows

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics		Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1.	Disclosure principles, uses of the balance sheet, financial flexibility.	1, 2, 3, 4, 5, 6, 7, 10, 18, 21, 30, 31				3, 4
2.	Classification of items in the balance sheet and other financial statements.	11, 12, 13, 14, 15, 16, 18, 19	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11	1, 2, 3, 8, 9, 10		1, 2
3.	Preparation of balance sheet; issues of format, terminology, and valuation.	4, 7, 8, 9, 16, 17, 20, 29, 32		4, 5, 6, 7, 11, 12, 17	1, 2, 3, 4, 5, 6, 7	2, 3, 4
4.	Statement of cash flows.	21, 22, 23, 24, 25, 26, 27, 28	12, 13, 14, 15, 16	13, 14, 15, 16, 17, 18	6, 7	5

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Explain the uses and limitations of a balance sheet.	1, 2, 3, 4, 5, 6, 7, 18			7	CA5-2, CA5-3
2. Identify the major classifications of the balance sheet.	6, 8, 9,11, 12, 13, 14, 15, 16, 17, 18, 19		1, 2, 3, 4, 6, 8, 9, 10		CA5-2, CA5-3
3. Prepare a classified balance sheet using the report and account formats.	9, 10, 14, 20	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11	1, 2, 3, 4, 5, 6, 7, 9, 10, 11, 12, 17	1, 2, 3, 4, 5, 6, 7	CA5-1
4. Indicate the purpose of the statement of cash flows.	21				CA5-4
5. Identify the content of the statement of cash flows.	22, 23, 24, 26		13		CA5-4, CA5-5
6. Prepare a basic statement of cash flows.	25	12, 13, 14, 15	14, 15, 16, 17, 18	6, 7	
7. Understand the usefulness of the statement of cash flows.	26, 27, 28	12, 16	15, 16, 18	6, 7	
8. Determine which balance sheet information requires supplemental disclosure.	30, 31, 32			4	
9. Describe the major disclosure techniques for the balance sheet.	29				

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E5-1	Balance sheet classifications.	Simple	15–20
E5-2	Classification of balance sheet accounts.	Simple	15–20
E5-3	Classification of balance sheet accounts.	Simple	15–20
E5-4	Preparation of a classified balance sheet.	Simple	30–35
E5-5	Preparation of a corrected balance sheet.	Simple	30–35
E5-6	Corrections of a balance sheet.	Complex	30–35
E5-7	Current assets section of the balance sheet.	Moderate	15–20
E5-8	Current vs. long-term liabilities.	Moderate	10–15
E5-9	Current assets and current liabilities.	Complex	30–35
E5-10	Current liabilities.	Moderate	15–20
E5-11	Balance sheet preparation.	Moderate	25–30
E5-12	Preparation of a balance sheet.	Moderate	30–35
E5-13	Statement of cash flows—classifications.	Moderate	15–20
E5-14	Preparation of a statement of cash flows.	Moderate	25–35
E5-15	Preparation of a statement of cash flows.	Moderate	25–35
E5-16	Preparation of a statement of cash flows.	Moderate	25–35
E5-17	Preparation of a statement of cash flows and a balance sheet.	Moderate	30–35
E5-18	Preparation of a statement of cash flows, analysis.	Moderate	25–35
P5-1	Preparation of a classified balance sheet, periodic inventory.	Moderate	30–35
P5-2	Balance sheet preparation.	Moderate	35–40
P5-3	Balance sheet adjustment and preparation.	Moderate	40–45
P5-4	Preparation of a corrected balance sheet.	Complex	40–45
P5-5	Balance sheet adjustment and preparation.	Complex	40–45
P5-6	Preparation of a statement of cash flows and a balance sheet.	Complex	35–45
P5-7	Preparation of a statement of cash flows and balance sheet.	Complex	40–50
CA5-1	Reporting for financial effects of varied transactions.	Moderate	20–25
CA5-2	Identifying balance sheet deficiencies.	Moderate	20–25
CA5-3	Critique of balance sheet format and content.	Simple	20–25
CA5-4	Presentation of property, plant, and equipment.	Simple	20–25
CA5-5	Cash flow analysis.	Complex	40–50

SOLUTIONS TO CODIFICATION EXERCISES

CE5-1

(a) Current assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

(b) Intangible assets are assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.) Clicking on the first link yields the following FASB ASC string: 350 Intangibles—Goodwill and Other > 10 Overall.

(c) Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

   a. Readily convertible to known amounts of cash

   b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

   Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three moths. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

(d) Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

CE5-2

See FASC ASC 210-10-45 (Other Presentation Matters)

Classification of Current Liabilities

45-5A Total of current liabilities shall be presented in classified balance sheets.

45-6 The concept of current liabilities shall include estimated or accrued amounts that are expected to be required to cover expenditures within the year for known obligations the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or where the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold).

CE5-2 (Continued)

45-7 Section 470-10-45 includes guidance on various debt transactions that may result in current liability classification. These transactions are the following:

a. Due on demand loan agreements
b. Callable debt agreements
c. Short-term obligations expected to be refinanced.

CE5-3

The following discussion is provided at 235-10-50 Disclosure

> Accounting Policies Disclosure

50-1 Information about the accounting policies adopted by an entity is essential for financial statement users. When financial statements are issued purporting to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles (GAAP), a description of all significant accounting policies of the entity shall be included as an integral part of the financial statements. In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with GAAP, statements so presented also shall include disclosure of the pertinent accounting policies.

> Accounting Policies Disclosure in Interim Periods

50-2 The provisions of the preceding paragraph are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (for example, each quarter) if the reporting entity has not changed its accounting policies since the end of its preceding fiscal year.

> What to Disclose

50-3 Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it shall encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives
b. Principles and methods peculiar to the industry in which the entity operations, even if such principles and methods are predominantly followed in that industry
c. Unusual or innovative applications of GAAP.

> Examples of Disclosures

50-4 Examples of disclosures by an entity commonly required with respect to accounting policies would include, among others, those relating to the following:

a. Basis of consolidation
b. Depreciation methods

CE5-3 (Continued)

c. Amortization of intangibles
d. Inventory pricing
e. Accounting for recognition of profit on long-term construction-type contracts
f. Recognition of revenue from franchising and leasing operations.

> Avoid Duplicate Details of Disclosures

50-5 Financial statement disclosure of accounting policies shall not duplicate details (for example, composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies shall refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period shall be described with cross-reference to the disclosure required by Topic 250.

> Format

50-6 This Subtopic recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with the provisions of this Subtopic. Disclosure is preferred in a separate summary of significant accounting policies preceding the notes to financial statements, or as the initial note, under the same or a similar title.

CE5-4

The following section: 230-10-05 Overview and Background provides a discussion of the objectives for the Statement of Cash Flows.

05-1 The Statement of Cash Flows Topic presents standards for reporting cash flows in general-purpose financial statements.

05-2 Specific guidance is provided on all of the following:

a. Classifying in the statement of cash flows of cash receipts and payments as either operating, investing, or financing activities
b. Applying the direct method and the indirect method of reporting cash flows
c. Presenting the required information about noncash investing and financing activity and other events
d. Classifying cash receipts and payments related to hedging activities.

230-10-10 Objectives

10-1 The primary objective of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during a period.

CE5-4 (Continued)

10-2 The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others (including donors) to do all of the following:

a. Assess the entity's ability to generate positive future net cash flows
b. Assess the entity's ability to meet its obligations, its ability to pay dividends, and its needs for external financing
c. Assess the reasons for differences between net income and associated cash receipts and payments
d. Assess the effects on an entity's financial position of both its cash and noncash investing and financing transactions during the period.

ANSWERS TO QUESTIONS

1. The balance sheet provides information about the nature and amounts of investments in enterprise resources, obligations to enterprise creditors, and the owners' equity in net enterprise resources. That information not only complements information about the components of income, but also contributes to financial reporting by providing a basis for (1) computing rates of return, (2) evaluating the capital structure of the enterprise, and (3) assessing the liquidity and financial flexibility of the enterprise.

2. Solvency refers to the ability of an enterprise to pay its debts as they mature. For example, when a company carries a high level of long-term debt relative to assets, it has lower solvency. Information on long-term obligations, such as long-term debt and notes payable, in comparison to total assets can be used to assess resources that will be needed to meet these fixed obligations (such as interest and principal payments).

3. Financial flexibility is the ability of an enterprise to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities. An enterprise with a high degree of financial flexibility is better able to survive bad times, to recover from unexpected setbacks, and to take advantage of profitable and unexpected investment opportunities. Generally, the greater the financial flexibility, the lower the risk of enterprise failure.

4. Some situations in which estimates affect amounts reported in the balance sheet include:
(a) allowance for doubtful accounts.
(b) depreciable lives and estimated salvage values for plant and equipment.
(c) warranty returns.
(d) determining the amount of revenues that should be recorded as unearned.

When estimates are required, there is subjectivity in determining the amounts. Such subjectivity can impact the usefulness of the information by reducing the faithful representation of the measures, either because of bias or lack of verifiability.

5. An increase in inventories increases current assets, which is in the numerator of the current ratio. Therefore, inventory increases will increase the current ratio. In general, an increase in the current ratio indicates a company has better liquidity, since there are more current assets relative to current liabilities.

Note to instructors—When inventories increase faster than sales, this may not be a good signal about liquidity. That is, inventory can only be used to meet current obligations when it is sold (and converted to cash). That is why some analysts use a liquidity ratio—the acid-test ratio—that excludes inventories from current assets in the numerator.

6. Liquidity describes the amount of time that is expected to elapse until an asset is converted into cash or until a liability has to be paid. The ranking of the assets given in order of liquidity is:
(1) (d) Short-term investments.
(2) (e) Accounts receivable.
(3) (b) Inventory.
(4) (c) Buildings.
(5) (a) Goodwill.

7. The major limitations of the balance sheet are:
(a) The values stated are generally historical and not at fair value.
(b) Estimates have to be used in many instances, such as in the determination of collectibility of receivables or finding the approximate useful life of long-term tangible and intangible assets.
(c) Many items, even though they have financial value to the business, presently are not recorded. One example is the value of a company's human resources.

8. Some items of value to technology companies such as Intel or IBM are the value of research and development (new products that are being developed but which are not yet marketable), the value of the “intellectual capital” of its workforce (the ability of the companies’ employees to come up with new ideas and products in the fast changing technology industry), and the value of the company reputation or name brand (e.g., the “Intel Inside” logo). In most cases, the reasons why the value of these items are not recorded in the balance sheet concern the lack of faithful representation of the estimates of the future cash flows that will be generated by these “assets” (for all three types) and the ability to control the use of the asset (in the case of employees). Being able to reliably measure the expected future benefits and to control the use of an item are essential elements of the definition of an asset, according to the Conceptual Framework.

9. Classification in financial statements helps users by grouping items with similar characteristics and separating items with different characteristics. Current assets are expected to be converted to cash within one year or the operating cycle, whichever is longer—property, plant and equipment will provide cash inflows over a longer period of time. Thus, separating long-term assets from current assets facilitates computation of useful ratios such as the current ratio.

10. Separate amounts should be reported for accounts receivable and notes receivable. The amounts should be reported gross, and an amount for the allowance for doubtful accounts should be deducted. The amount and nature of any nontrade receivables, and any amounts designated or pledged as collateral, should be clearly identified.

11. No. Available-for-sale securities should be reported as a current asset only if management expects to convert them into cash as needed within one year or the operating cycle, whichever is longer. If available-for-sale securities are not held with this expectation, they should be reported as long-term investments.

12. The relationship between current assets and current liabilities is that current liabilities are those obligations that are reasonably expected to be liquidated either through the use of current assets or the creation of other current liabilities.

13. The total selling price of the season tickets is $20,000,000 (10,000 X $2,000). Of this amount, $8,000,000 has been earned by 12/31/14 (16/40 X $20,000,000). The remaining $12,000,000 should be reported as unearned revenue, a current liability in the 12/31/14 balance sheet (24/40 X $20,000,000).

14. Working capital is the excess of total current assets over total current liabilities. This excess is sometimes called net working capital. Working capital represents the net amount of a company’s relatively liquid resources. That is, it is the liquidity buffer available to meet the financial demands of the operating cycle.

15. (a) Stockholders’ Equity. “Treasury stock (at cost).”
Note: This is a reduction of total stockholders’ equity (reported as contra-equity).
(b) Current Assets. Included in “Cash.”
(c) Long-Term Investments. “Land held as an investment.”
(d) Long-Term Investments. “Sinking fund.”
(e) Long-term debt (adjunct account to bonds payable). “Unamortized premium on bonds payable.”
(f) Intangible Assets. “Copyrights.”
(g) Investments. “Employees’ pension fund,” with subcaptions of “Cash” and “Securities” if desired. (Assumes that the company still owns these assets.)
(h) Stockholders’ Equity. “Additional paid-in capital.”
(i) Investments. Nature of investments should be given together with parenthetical information as follows: “pledged to secure loans payable to banks.”

16. (a) Allowance for doubtful accounts should be deducted from accounts receivable in current assets.
(b) Merchandise held on consignment should not appear on the consignee's balance sheet except possibly as a note to the financial statements.
(c) Advances received on sales contract are normally a current liability and should be shown as such in the balance sheet.
(d) Cash surrender value of life insurance should be shown as a long-term investment.
(e) Land should be reported in property, plant, and equipment unless held for investment.
(f) Merchandise out on consignment should be shown among current assets under the heading of inventory.
(g) Franchises should be itemized in a section for intangible assets.
(h) Accumulated depreciation of plant and equipment should be deducted from the equipment account.
(i) Materials in transit should not be shown on the balance sheet of the buyer, if purchased f.o.b. destination.

17. (a) Trade accounts receivable should be stated at their estimated amount collectible, often referred to as net realizable value. The method most generally followed is to deduct from the total accounts receivable the amount of the allowance for doubtful accounts.
(b) Land is generally stated in the balance sheet at cost.
(c) Inventories are generally stated at the lower of cost or market.
(d) Trading securities (consisting of common stock of other companies) are stated at fair value.
(e) Prepaid expenses should be stated at cost less the amount apportioned to and written off over the previous accounting periods.

18. Assets are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. If a building is leased under a capital lease, the future economic benefits of using the building are controlled by the lessee (tenant) as the result of a past event (the signing of a lease agreement).

19. Battle is incorrect. Retained earnings is a **source** of assets, but is not an asset itself. For example, even though the funds obtained from issuing a note payable are invested in the business, the note payable is not reported as an asset. It is a **source** of assets, but it is reported as a liability because the company has an obligation to repay the note in the future. Similarly, even though the earnings are invested in the business, retained earnings is not reported as an asset. It is reported as part of shareholders' equity because it is, in effect, an investment by owners which increases the ownership interest in the assets of an entity.

20. The notes should appear as long-term liabilities with full disclosure as to their terms. Each year, as the profit is determined, notes of an amount equal to two-thirds of the year's profits should be transferred from the long-term liabilities to current liabilities until all of the notes have been liquidated.

21. The purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period. It differs from the balance sheet and the income statement in that it reports the sources and uses of cash by operating, investing, and financing activity classifications. While the income statement and the balance sheet are accrual basis statements, the statement of cash flows is a cash basis statement—noncash items are omitted.

22. The difference between these two amounts may be due to increases in current assets (e.g., an increase in accounts receivable from a sale on account would result in an increase in revenue and net income but have no effect yet on cash). Similarly a cash payment that results in a decrease in an existing current liability (e.g., accounts payable would decrease cash provided by operations without affecting net income).

23. The difference between these two amounts could be due to noncash charges that appear in the income statement. Examples of noncash charges are depreciation, depletion, and amortization of intangibles. Expenses recorded but unpaid (e.g., increase in accounts payable) and collection of previously recorded sales on credit (i.e., now decreasing accounts receivable) also would cause cash provided by operating activities to exceed net income.

24. **Operating activities** involve the cash effects of transactions that enter into the determination of net income. **Investing activities** include making and collecting loans and acquiring and disposing of debt and equity instruments; property, plant, and equipment and intangibles. **Financing activities** involve long-term liability and stockholders' equity items and include obtaining capital from owners and providing them with a return on (dividends) and a return of their investment and borrowing money from creditors and repaying the amounts borrowed.

25. (a) Net income is adjusted downward by deducting $5,000 from $90,000 and reporting cash provided by operating activities as $85,000.

(b) The issuance of the preferred stock is a financing activity. The issuance is reported as follows:

Cash flows from financing activities	
Issuance of preferred stock	$1,150,000

(c) Net income is adjusted as follows:

Cash flows from operating activities	
Net income	$90,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	14,000
Bond premium amortization	(5,000)
Net cash provided by operating activities	$99,000

(d) The increase of $20,000 reflects an investing activity. The increase in Land is reported as follows:

Cash flows from investing activities:	
Purchase Land	$(20,000)

26. The company appears to have good liquidity and reasonable financial flexibility. Its current cash debt coverage is 1.20 $\left(\frac{\$1,200,000}{\$1,000,000}\right)$, which indicates that it can pay off its current liabilities in a given year from its operations. In addition, its cash debt coverage is also good at 0.80 $\left(\frac{\$1,200,000}{\$1,500,000}\right)$, which indicates that it can pay off approximately 80% of its debt out of current operations.

27. Free cash flow = $860,000 – $75,000 – $30,000 = $755,000.

28. Free cash flow is net cash provided by operating activities less capital expenditures and dividends. The purpose of free cash flow analysis is to determine the amount of discretionary cash flow a company has for purchasing additional investments, retiring its debt, purchasing treasury stock, or simply adding to its liquidity and financial flexibility.

29. Some of the techniques of disclosure for the balance sheet are:
(a) Parenthetical explanations.
(b) Notes to the financial statements.
(c) Cross references and contra items.
(d) Supporting schedules.

30. A note entitled "Summary of Significant Accounting Policies" would indicate the basic accounting principles used by that enterprise. This note should be very useful from a comparative standpoint, since it should be easy to determine whether the company uses the same accounting policies as other companies in the same industry.

31. General debt obligations, lease contracts, pension arrangements and stock option plans are four items for which disclosure is mandatory in the financial statements. The reason for disclosing these contractual situations is that these commitments are of a long-term nature, are often significant in amount, and are very important to the company's well-being.

32. The profession has recommended that the use of the term "surplus" be discontinued in balance sheet presentations of stockholders' equity. This term has a connotation outside accounting that is quite different from its meaning in the accounts or in the balance sheet. The use of the terms capital surplus, paid-in surplus, and earned surplus is confusing to the nonaccountant and leads to misinterpretation.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 5-1

Current assets		
Cash		$ 30,000
Accounts receivable	$110,000	
Less: Allowance for doubtful accounts	8,000	102,000
Inventory		290,000
Prepaid insurance		9,500
Total current assets		$431,500

BRIEF EXERCISE 5-2

Current assets		
Cash		$ 7,000
Equity Investments (Trading)		11,000
Accounts receivable	$90,000	
Less: Allowance for doubtful accounts	4,000	86,000
Inventory		30,000
Prepaid insurance		5,200
Total current assets		$139,200

BRIEF EXERCISE 5-3

Long-term investments	
Debt investments	$ 56,000
Land held for investment	39,000
Note receivables (long-term)	42,000
Total investments	$137,000

BRIEF EXERCISE 5-4

Property, plant, and equipment		
Land		$ 71,000
Buildings	$207,000	
Less: Accumulated depreciation	45,000	162,000
Equipment	$190,000	
Less: Accumulated depreciation	19,000	171,000
Timberland		70,000
Total property, plant, and equipment		$474,000

BRIEF EXERCISE 5-5

Intangible assets	
Goodwill	$150,000
Patents	220,000
Franchises	130,000
Total intangible assets	$500,000

BRIEF EXERCISE 5-6

Intangible assets	
Goodwill	$ 50,000
Franchises	47,000
Patents	33,000
Trademarks	10,000
Total intangible assets	$140,000

BRIEF EXERCISE 5-7

Current liabilities	
Notes payable	$ 22,500
Accounts payable	72,000
Salaries and wages payable	4,000
Income taxes payable	7,000
Total current liabilities	$105,500

BRIEF EXERCISE 5-8

<u>Current liabilities</u>	
Accounts payable	$220,000
Unearned rent revenue	41,000
Salaries and wages payable	27,000
Interest payable	12,000
Income tax payable	29,000
Total current liabilities	$329,000

BRIEF EXERCISE 5-9

<u>Long-term liabilities</u>		
Bonds payable	$400,000	
Less: Discount on bonds payable	29,000	$371,000
Pension liability		375,000
Total long-term liabilities		$746,000

BRIEF EXERCISE 5-10

<u>Stockholders' equity</u>		
Common stock	$750,000	
Paid-in capital in excess of par	200,000	$950,000
Retained earnings		120,000
Accumulated other comprehensive loss		(150,000)
Stockholders' equity – Hawthorn Corporation		920,000
Noncontrolling interest		35,000
Total stockholders' equity		$955,000

BRIEF EXERCISE 5-11

Stockholders' equity	
Preferred stock	$152,000
Common stock	55,000
Additional paid-in capital	174,000
Retained earnings	114,000
Stockholders' equity – Stowe Company	495,000
Noncontrolling interest	63,000
Total stockholders' equity	$558,000

BRIEF EXERCISE 5-12

Cash Flow Statement

Operating Activities		
Net income		$40,000
Depreciation expense	$ 4,000	
Increase in accounts receivable	(10,000)	
Increase in accounts payable	7,000	1,000
Net cash provided by operating activities		41,000
Investing Activities		
Purchase of equipment		(8,000)
Financing Activities		
Issue notes payable	$20,000	
Property dividends	(5,000)	
Net cash flow from financing activities		15,000
Net increase in cash ($41,000 – $8,000 + $15,000)		$48,000

Free Cash Flow = $41,000 (Net cash provided by operating activities) – $8,000 (Purchase of equipment) – $5,000 (Dividends) = $28,000.

BRIEF EXERCISE 5-13

Cash flows from operating activities		
Net income		$151,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense	$44,000	
Increase in accounts payable	9,500	
Increase in accounts receivable	(13,000)	40,500
Net cash provided by operating activities		$191,500

BRIEF EXERCISE 5-14

Sale of land and building	$191,000
Purchase of land	(37,000)
Purchase of equipment	(53,000)
Net cash provided by investing activities	$101,000

BRIEF EXERCISE 5-15

Issuance of common stock	$147,000
Purchase of treasury stock	(40,000)
Payment of cash dividend	(95,000)
Retirement of bonds	(100,000)
Net cash used by financing activities	$ (88,000)

BRIEF EXERCISE 5-16

Free Cash Flow Analysis

Net cash provided by operating activities	$400,000
Purchase of equipment	(53,000)
Purchase of land*	(37,000)
Dividends	(95,000)
Free cash flow	$215,000

***If the land were purchased as an investment, it would be excluded in the computation of free cash flow.**

SOLUTIONS TO EXERCISES

EXERCISE 5-1 (15–20 minutes)

(a) **If the equity investment (preferred stock) is readily marketable and held primarily for sale in the near term to generate income on short-term price differences, then the account should appear as a current asset and be included with trading securities. If, on the other hand, the preferred stock is not a trading security, it should be classified as available-for-sale. Available-for-sale securities are classified as current or noncurrent depending upon the circumstances.**

(b) **If the company accounts for the treasury stock on the cost basis, the account should properly be shown as a reduction of total stockholders' equity.**

(c) **Stockholders' equity.**

(d) **Current liability.**

(e) **Property, plant, and equipment (as a deduction).**

(f) **If the warehouse in process of construction is being constructed for another party, it is properly classified as an inventory account in the current assets section. This account will be shown net of any billings on the contract. On the other hand, if the warehouse is being constructed for the use of this particular company, it should be classified as a separate item in the property, plant, and equipment section.**

(g) **Current asset.**

(h) **Current liability.**

(i) **Retained earnings.**

EXERCISE 5-1 (Continued)

(j) Current asset.

(k) Current liability.

(l) Current liability.

(m) Current asset (inventory).

(n) Current liability.

EXERCISE 5-2 (15–20 minutes)

1.	h.	11.	b.
2.	d.	12.	f.
3.	f.	13.	a.
4.	f.	14.	h.
5	c.	15.	c.
6.	a.	16.	b.
7.	f.	17.	a.
8.	g.	18.	a.
9.	a.	19.	g.
10.	a.	20.	f.

EXERCISE 5-3 (15–20 minutes)

1.	a.	10.	f.
2.	b.	11.	a.
3.	f.	12.	f.
4.	a.	13.	a. or e. (preferably a.)
5	f.	14.	c. and N.
6.	h.	15.	f.
7.	i.	16.	X.
8.	d.	17.	f.
9.	a.	18.	c.

EXERCISE 5-4 (30–35 minutes)

Denis Savard Inc.
Balance Sheet
December 31, 20–

Assets

Current assets			
Cash	$XXX		
Less: Cash restricted for plant expansion	XXX	$XXX	
Accounts receivable	XXX		
Less: Allowance for doubtful accounts	XXX	XXX	
Notes receivable		XXX	
Receivables—officers		XXX	
Inventories			
Finished goods	XXX		
Work in process	XXX		
Raw materials	XXX	XXX	
Total current assets			$XXX
Long-term investments			
Preferred stock investments		XXX	
Land held for future plant site		XXX	
Restricted cash (plant expansion)		XXX	
Total long-term investments			XXX
Property, plant, and equipment			
Buildings		XXX	
Less: Accum. depreciation—buildings		XXX	XXX
Intangible assets			
Copyrights			XXX
Total assets			$XXX

Liabilities and Stockholders' Equity

Current liabilities			
Salaries and wages payable	$XXX		
Notes payable, short-term	XXX		
Unearned subscriptions revenue	XXX		
Unearned rent revenue	XXX		
Total current liabilities			$XXX
Long-term debt			
Bonds payable, due in four years		$XXX	
Less: Discount on bonds payable		(XXX)	XXX
Total liabilities			XXX
Stockholders' equity			
Capital stock:			
Common stock	XXX		
Additional paid-in capital:			
Paid-in capital in excess of par (common stock)	XXX		
Total paid-in capital		XXX	
Retained earnings		XXX	
Total paid-in capital and retained earnings		XXX	
Less: Treasury stock, at cost		(XXX)	
Equity attributable to Denis Savard, Inc.			XXX
Equity attributed to noncontrolling interest			XXX
Total stockholders' equity			XXX
Total liabilities and stockholders' equity			$XXX

Note to instructor: An assumption made here is that cash included the restricted cash for plant expansion. If it did not, then a subtraction from cash would not be necessary or the cash balance would be "grossed up" and then the restricted cash for plant expansion deducted.

EXERCISE 5-5 (30–35 minutes)

Uhura Company
Balance Sheet
December 31, 2014

Assets

Current assets			
Cash		$230,000	
Equity investments (trading)		120,000	
Accounts receivable	$357,000		
Less: Allowance for doubtful accounts	17,000	340,000	
Inventory, at lower-of-average cost-or-market		401,000	
Prepaid expenses		12,000	
Total current assets			$1,103,000
Long-term investments			
Land held for future use		175,000	
Cash surrender value of life insurance		90,000	265,000
Property, plant, and equipment			
Buildings	$730,000		
Less: Accum. depr.—buildings	160,000	570,000	
Equipment	265,000		
Less: Accum. depr.—equipment	105,000	160,000	730,000
Intangible assets			
Goodwill			80,000
Total assets			$2,178,000

EXERCISE 5-5 (Continued)

Liabilities and Stockholders' Equity

Current liabilities			
Accounts payable		$ 135,000	
Notes payable (due next year)		125,000	
Rent payable		49,000	
Total current liabilities			$309,000
Long-term liabilities			
Bonds payable	$500,000		
Add: Premium on bonds payable	53,000	$ 553,000	
Pension obligation		82,000	635,000
Total liabilities			944,000
Stockholders' equity			
Common stock, $1 par, authorized 400,000 shares, issued 290,000 shares	290,000		
Additional paid-in capital	160,000	450,000	
Retained earnings		784,000*	
Total stockholders' equity			1,234,000
Total liabilities and stockholders' equity			$2,178,000

*$2,178,000 – $944,000 – $450,000

EXERCISE 5-6 (30–35 minutes)

Geronimo Company
Balance Sheet
July 31, 2014

Assets			
Current assets			
Cash		$60,000*	
Accounts receivable	$38,700**		
Less: Allowance for doubtful accounts	3,500	35,200	
Inventory		65,300***	
Total current assets			$160,500
Long-term investments			
Bond sinking fund			15,000
Property, plant, and equipment			
Equipment		112,000	
Less: Accumulated depreciation—equipment		28,000	84,000
Intangible assets			
Patents			21,000
Total assets			$280,500

*($69,000 – $15,000 + $6,000)
**($44,000 – $5,300)
***($60,000 + $5,300)

EXERCISE 5-6 (Continued)

Liabilities and Stockholders' Equity

Current liabilities		
Notes and accounts payable	$ 44,000	
Income taxes payable..................................	6,000	
Total current liabilities		$ 50,000
Long-term liabilities		75,000
Total liabilities...		125,000
Stockholders' equity		155,500
Total liabilities and stock-holders' equity		$280,500

EXERCISE 5-7 (15–20 minutes)

<u>Current assets</u>		
Cash	$ 87,000*	
Less: Restricted cash (plant expansion)	50,000	$ 37,000
Trading securities at fair value (cost, $31,000)		29,000
Accounts receivable (of which $50,000 is pledged as collateral on a bank loan)	161,000	
Less: Allowance for doubtful accounts	12,000	149,000
Interest receivable [($40,000 X 6%) X 8/12]		1,600
Inventories at lower of cost (determined using LIFO) or market		
Finished goods	52,000	
Work in process	34,000	
Raw materials	207,000	293,000
Total current assets		$509,600

*An acceptable alternative is to report cash at $37,000 and simply report the restricted cash (plant expansion) in the investments section.

EXERCISE 5-8 (10–15 minutes)

1. Dividends payable of $2,375,000 will be reported as a current liability [(1,000,000 – 50,000) X $2.50].

2. Bonds payable of $25,000,000 and interest payable of $3,000,000 ($100,000,000 X 12% X 3/12) will be reported as a current liability. Bonds payable of $75,000,000 will be reported as a long-term liability.

3. Customer advances of $17,000,000 will be reported as a current liability ($12,000,000 + $30,000,000 – $25,000,000).

EXERCISE 5-9 (30–35 minutes)

(a)

Allessandro Scarlatti Company
Balance Sheet (Partial)
December 31, 2014

Current assets		
Cash		$ 34,396*
Accounts receivable...............................	$ 91,300**	
Less: Allowance for doubtful accounts.................................	7,000	84,300
Inventory		159,000***
Prepaid expenses		9,000
Total current assets..........................		$286,696

*Cash balance	$ 40,000
Add: Cash disbursement after discount ($39,000 X 98%)	38,220
	78,220
Less: Cash sales in January ($30,000 – $21,500)	(8,500)
Cash collected on account	(23,324)
Bank loan proceeds ($35,324 – $23,324)	(12,000)
Adjusted cash	$ 34,396

**Accounts receivable balance	$ 89,000
Add: Accounts reduced from January collection ($23,324 ÷ 98%)	23,800
	112,800
Deduct: Accounts receivable in January	(21,500)
Adjusted accounts receivable	$ 91,300

***Inventory	$171,000
Less: Inventory received on consignment	12,000
Adjusted inventory	$159,000

EXERCISE 5-9 (Continued)

Current liabilities

Accounts payable		$115,000[a]
Notes payable		55,000[b]
Total current liabilities.............................		$170,000

[a]Accounts payable balance		$ 61,000
Add: Cash disbursements	$39,000	
Purchase invoice omitted		
($27,000 – $12,000)	15,000	54,000
Adjusted accounts payable		$115,000

[b]Notes payable balance		$ 67,000
Less: Proceeds of bank loan		12,000
Adjusted notes payable		$ 55,000

(b) Adjustment to retained earnings balance:

Add: January sales discounts		
[($23,324 ÷ 98%) X .02]		$ 476
Deduct: January sales	$30,000	
January purchase discounts		
($39,000 X 2%)..................................	780	
December purchases	15,000	
Consignment inventory.......................	12,000	(57,780)
Change (decrease) to retained earnings		$(57,304)

EXERCISE 5-10 (15–20 minutes)

(a) In order for a liability to be reported for threatened litigation, the amount must be probable and payment reasonably estimable. Since these conditions are not met an accrual is not required.

(b) A current liability of $150,000 should be recorded.

(c) A current liability for accrued interest of $4,000 ($600,000 X 8% X 1/12) should be reported. Also, the $600,000 note payable should be a current liability if payable in one year. Otherwise, the $600,000 notes payable would be a long-term liability.

(d) Although Bad Debt Expense of $300,000 should be debited and the Allowance for Doubtful Accounts credited for $300,000, this does not result in a liability. The allowance for doubtful accounts is a valuation account (contra asset) and is deducted from accounts receivable on the balance sheet.

(e) A current liability of $80,000 should be reported. The liability is recorded on the date of declaration.

(f) Customer advances of $110,000 ($160,000 – $50,000) will be reported as a current liability.

EXERCISE 5-11 (25–30 minutes)

Kelly Corporation
Balance Sheet
December 31, 2014

Assets		
Current assets		
Cash	$ 6,850	
Supplies	1,200	
Prepaid insurance	1,000	
Total current assets		$ 9,050
Equipment	48,000	
Less: Accumulated depreciation—equipment	4,000	44,000
Trademark		950
Total assets		$54,000
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$10,000	
Salaries and wages payable	500	
Unearned service revenue	2,000	
Total current liabilities		$12,500
Long-term liabilities		
Bonds payable		9,000
Total liabilities		21,500
Stockholders' equity		
Common stock	10,000	
Retained earnings ($25,000 – $2,500*)	22,500	
Total stockholders' equity		32,500
Total liabilities and stockholders' equity		$54,000

*[$10,000 – ($9,000 + $1,400 + $1,200 + $900)]

EXERCISE 5-12 (30–35 minutes)

Scott Butler Corporation
Balance Sheet
December 31, 2014

Assets

Current assets			
Cash		$197,000	
Debt investments (Trading)		153,000	
Accounts receivable	$435,000		
Less: Allowance for doubtful accounts	(25,000)	410,000	
Inventory		597,000	
Total current assets			1,357,000
Long-term investments			
Debt investments		299,000	
Equity investments		277,000	
Total long-term investments			576,000
Property, plant, and equipment			
Land		260,000	
Buildings	1,040,000		
Less: Accum. depreciation—building	(152,000)	888,000	
Equipment	600,000		
Less: Accum. depreciation—equipment	(60,000)	540,000	
Total property, plant, and equipment			1,688,000
Intangible assets			
Franchises		160,000	
Patents		195,000	
Total intangible assets			355,000
Total assets			$3,976,000

EXERCISE 5-12 (Continued)

Liabilities and Stockholders' Equity

Current liabilities			
Accounts payable		$ 455,000	
Notes payable (short-term)		90,000	
Dividends payable		136,000	
Accrued liabilities		96,000	
Total current liabilities			$ 777,000
Long-term debt			
Notes payable (long-term)		900,000	
Bonds payable		1,000,000	
Total long-term liabilities			1,900,000
Total liabilities			2,677,000
Stockholder's equity			
Paid-in capital			
Common stock ($5 par)	$1,000,000		
Additional paid-in capital	80,000	1,080,000	
Retained earnings*		410,000	
Total paid-in capital and retained earnings		1,490,000	
Less: Treasury stock		191,000	
Total stockholders' equity			1,299,000
Total liabilities and stockholders' equity			$3,976,000

EXERCISE 5-12 (Continued)

***Computation of Retained Earnings:**

Sales revenue	$8,100,000
Investment revenue	63,000
Extraordinary gain	80,000
Cost of goods sold	(4,800,000)
Selling expenses	(2,000,000)
Administrative expenses	(900,000)
Interest expense	(211,000)
Net income	$ 332,000

Beginning retained earnings	$ 78,000
Net income	332,000
Ending retained earnings	$410,000

Or ending retained earnings can be computed as follows:

Total stockholders' equity	$1,299,000
Add: Treasury stock	191,000
Less: Paid-in capital in excess of par	1,080,000
Ending retained earnings	$ 410,000

Note to instructor: There is no dividends account. Thus, the 12/31/14 retained earnings balance already reflects any dividends declared.

EXERCISE 5-13 (15–20 minutes)

(a)	4.	(f)	1.	(k)	1.
(b)	3.	(g)	5.	(l)	2.
(c)	4.	(h)	4.	(m)	2.
(d)	3.	(i)	5.		
(e)	1.	(j)	4.		

EXERCISE 5-14 (25–35 minutes)

Constantine Cavamanlis Inc.
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$44,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 6,000	
Increase in accounts receivable	(3,000)	
Increase in accounts payable	5,000	8,000
Net cash provided by operating activities		52,000
Cash flows from investing activities		
Purchase of equipment		(17,000)
Cash flows from financing activities		
Issuance of common stock	20,000	
Payment of cash dividends	(23,000)	
Net cash used by financing activities		(3,000)
Net increase in cash		32,000
Cash at beginning of year		13,000
Cash at end of year		$45,000

EXERCISE 5-15 (25–35 minutes)

(a)

Zubin Mehta Corporation
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$160,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$17,000	
Loss on sale of investments	10,000	
Decrease in accounts receivable	5,000	
Decrease in current liabilities	(17,000)	15,000
Net cash provided by operating activities		175,000
Cash flows from investing activities		
Sale of investments [($74,000 – $52,000) – $10,000]	12,000	
Purchase of equipment	(58,000)	
Net cash used by investing activities		(46,000)
Cash flows from financing activities		
Payment of cash dividends		(30,000)
Net increase in cash		99,000
Cash at beginning of year		78,000
Cash at end of year		$177,000

(b)

Free Cash Flow Analysis

Net cash provided by operating activities	$175,000
Less: Purchase of equipment	(58,000)
Dividends	(30,000)
Free cash flow	$ 87,000

EXERCISE 5-16 (20–25 minutes)

(a)

Shabbona Corporation
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$125,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$27,000	
Increase in accounts receivable	(16,000)	
Decrease in inventory	9,000	
Decrease in accounts payable	(13,000)	7,000
Net cash provided by operating activities		132,000
Cash flows from investing activities		
Sale of land	39,000	
Purchase of equipment	(60,000)	
Net cash used by investing activities		(21,000)
Cash flows from financing activities		
Payment of cash dividends		(60,000)
Net increase in cash		51,000
Cash at beginning of year		22,000
Cash at end of year		$ 73,000

Noncash investing and financing activities
Issued common stock to retire $50,000 of bonds outstanding

EXERCISE 5-16 (Continued)

(b) Current cash debt coverage =

$$= \frac{\text{Net cash provided by operating activities}}{\text{Average current liabilities}}$$

$$= \frac{\$132{,}000}{(\$34{,}000 + \$47{,}000) / 2}$$

$$= 3.26 \text{ to } 1$$

Cash debt coverage =

$$\frac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}} =$$

$$\$132{,}000 \div \frac{\$184{,}000 + \$247{,}000}{2} =$$

.61 to 1

Free Cash Flow Analysis

Net cash provided by operating activities........................	$132,000
Less: Purchase of equipment	(60,000)
Dividends	(60,000)
Free cash flow	$ 12,000

Shabbona has excellent liquidity. Its financial flexibility is good. It might be noted that it substantially reduced its long-term debt in 2014 which will help its financial flexibility.

EXERCISE 5-17 (30–35 minutes)

(a)

Grant Wood Corporation
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$55,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on sale of equipment	$ 2,000*	
Depreciation expense	13,000	
Patent amortization	2,500	
Increase in current assets (other than cash)	(29,000)	1,500
Increase in current liabilities	13,000	
Net cash provided by operating activities		56,500
Cash flows from investing activities		
Sale of equipment	10,000	
Addition to building	(27,000)	
Investment in stock	(16,000)	
Net cash used by investing activities		(33,000)
Cash flows from financing activities		
Issuance of bonds	50,000	
Payment of dividends	(30,000)	
Purchase of treasury stock	(11,000)	
Net cash provided by financing activities		9,000
Net increase in cash		$32,500[a]

*[$10,000 – ($20,000 – $8,000)]

[a]An additional proof to arrive at the increase in cash is provided as follows:

Total current assets—end of period	$296,500	[from part (b)]
Total current assets—beginning of period	235,000	
Increase in current assets during the period	61,500	
Increase in current assets other than cash	29,000	
Increase in cash during year	$ 32,500	

EXERCISE 5-17 (Continued)

(b)

Grant Wood Corporation
Balance Sheet
December 31, 2014

Assets			
Current assets			$296,500[b]
Equity investments (Long-term)			16,000
Property, plant, and equipment			
Land		$ 30,000	
Building ($120,000 + $27,000)	$147,000		
Less: Accum. depreciation—building ($30,000 + $4,000)	(34,000)	113,000	
Equipment ($90,000 – $20,000)	70,000		
Less: Accum. depreciation—equipment ($11,000 – $8,000 + $9,000)	(12,000)	58,000	
Total property, plant, and equipment			201,000
Intangible assets—patents ($40,000 – $2,500)			37,500
Total assets			$551,000

Liabilities and Stockholders' Equity

Current liabilities ($150,000 + $13,000)		$163,000
Long-term liabilities		
Bonds payable ($100,000 + $50,000)		150,000
Total liabilities		313,000
Stockholders' equity		
Common stock	$180,000	
Retained earnings ($44,000 + $55,000 – $30,000)	69,000	
Total paid-in capital and retained earnings	249,000	
Less: Cost of treasury stock	11,000	
Total stockholders' equity		238,000
Total liabilities and stockholders' equity		$551,000

[b] The amount determined for current assets could be computed last and then is a "plug" figure. That is, total liabilities and stockholders' equity is computed because information is available to determine this amount. Because the total assets amount is the same as total liabilities and stockholders' equity amount, the amount of total assets is determined. Information is available to compute all the asset amounts except current assets and therefore current assets can be determined by deducting the total of all the other asset balances from the total asset balance (i.e., $551,000 – $37,500 – $201,000 – $16,000). Another way to compute this amount, given the information, is that beginning current assets plus the $29,000 increase in current assets other than cash plus the $32,500 increase in cash equals $296,500.

EXERCISE 5-18 (25–35 minutes)

(a)

Madrasah Corporation
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$44,000
Adjustment to reconcile net income to net cash provided by operating activities:		
Depreciation	$ 6,000	
Increase in accounts payable	5,000	
Increase in accounts receivable	(18,000)	(7,000)
Net cash provided by operating activities		37,000
Cash flows from Investing activities		
Purchase of equipment		(17,000)
Cash flows from financing activities		
Issuance of stock	20,000	
Payment of dividends	(33,000)	
Net cash used by financing activities		(13,000)
Net increase in cash		7,000
Cash at beginning of year		13,000
Cash at end of year		$20,000

	2014	2013
(b) Current ratio	6.3	6.73
	$\frac{\$126,000}{\$\ 20,000}$	$\frac{\$101,000}{\$\ 15,000}$

Free Cash Flow Analysis

Net cash provided by operating activities	$ 37,000
Less: Purchase of equipment	(17,000)
Pay dividends	(33,000)
Free cash flow	$ (13,000)

(c) Although, Madrasah's current ratio has declined from 2013 to 2014, it is still in excess of 6. It appears the company has good liquidity and financial flexibility.

TIME AND PURPOSE OF PROBLEMS

Problem 5-1 (Time 30–35 minutes)
Purpose—to provide the student with the opportunity to prepare a balance sheet, given a set of accounts. No monetary amounts are to be reported.

Problem 5-2 (Time 35–40 minutes)
Purpose—to provide the student with the opportunity to prepare a complete balance sheet, involving dollar amounts. A unique feature of this problem is that the student must solve for the retained earnings balance.

Problem 5-3 (Time 40–45 minutes)
Purpose—to provide an opportunity for the student to prepare a balance sheet in good form. Emphasis is given in this problem to additional important information that should be disclosed. For example, an inventory valuation method, bank loans secured by long-term investments, and information related to the capital stock accounts must be disclosed.

Problem 5-4 (Time 40–45 minutes)
Purpose—to provide the student with the opportunity to analyze a balance sheet and correct it where appropriate. The balance sheet as reported is incomplete, uses poor terminology, and is in error. A challenging problem.

Problem 5-5 (Time 40–45 minutes)
Purpose—to provide the student with the opportunity to prepare a balance sheet in good form. Additional information is provided on each asset and liability category for purposes of preparing the balance sheet. A challenging problem.

Problem 5-6 (Time 35–45 minutes)
Purpose—to provide the student with an opportunity to prepare a complete statement of cash flows. A condensed balance sheet is also required. The student is also required to explain the usefulness of the statement of cash flows. Because the textbook does not explain in Chapter 5 all of the steps involved in preparing the statement of cash flows, assignment of this problem is dependent upon additional instruction by the instructor or knowledge gained in elementary financial accounting.

Problem 5-7 (Time 40–50 minutes)
Purpose—to provide the student with an opportunity to prepare a balance sheet in good form and a more complex cash flow statement.

SOLUTIONS TO PROBLEMS

PROBLEM 5-1

COMPANY NAME
Balance Sheet
December 31, 20XX

Assets

Current assets			
Cash on hand (including petty cash)	$XXX		
Cash in bank	XXX	$XXX	
Debt investments (trading)		XXX	
Accounts receivable	XXX		
Less: Allowance for doubtful accounts	XXX	XXX	
Interest receivable		XXX	
Advances to employees		XXX	
Inventory (ending)		XXX	
Prepaid rent		XXX	
Total current assets			$XXX
Long-term investments			
Bond sinking fund		XXX	
Cash surrender value of life insurance		XXX	
Land for future plant site		XXX	
Total long-term investments			XXX
Property, plant, and equipment			
Land		XXX	
Buildings	XXX		
Less: Accum. depreciation—buildings	XXX	XXX	
Equipment	XXX		
Less: Accum. depreciation—equipment	XXX	XXX	
Total property, plant, and equipment			XXX
Intangible assets			
Copyrights		XXX	
Patents		XXX	
Total intangible assets			XXX
Total assets			$XXX

PROBLEM 5-1 (Continued)

Liabilities and Stockholders' Equity

Current liabilities			
Notes payable		$XXX	
Payroll taxes payable		XXX	
Salaries and wages payable		XXX	
Dividends payable		XXX	
Unearned subscriptions revenue		XXX	
Total current liabilities			$XXX
Long-term debt			
Bonds payable	$XXX		
Add: Premium on bonds payable	XXX	XXX	
Pension liability		XXX	
Total long-term liabilities			XXX
Total liabilities			XXX
Stockholders' equity			
Capital stock			
Preferred stock (description)	XXX		
Common stock (description)	XXX	XXX	
Paid-in capital in excess of par – Preferred stock		XXX	
Total paid-in capital		XXX	
Retained earnings		XXX	
Total paid-in capital and retained earnings		XXX	
Accumulated other comprehensive income		XXX	
Less: Treasury stock		XXX	
Equity attributable to Stockholders' equity – Company			XXX
Equity attributable to Noncontrolling interest			XXX
Total stockholders' equity			XXX
Total liabilities and stockholders' equity			$XXX

PROBLEM 5-2

MONTOYA, INC.
Balance Sheet
December 31, 2014

Assets

Current assets			
Cash		$ 360,000	
Equity investments (trading)		121,000	
Notes receivable		445,700	
Income taxes receivable		97,630	
Inventory		239,800	
Prepaid expenses		87,920	
Total current assets			$1,352,050
Property, plant, and equipment			
Land		480,000	
Buildings	$1,640,000		
Less: Accum. depreciation—buildings	270,200	1,369,800	
Equipment	1,470,000		
Less: Accum. depreciation—equipment	292,000	1,178,000	3,027,800
Intangible assets			
Goodwill			125,000
Total assets			$4,504,850

Liabilities and Stockholders' Equity

Current liabilities			
Accounts payable		$ 490,000	
Notes payable (to banks)		265,000	
Payroll taxes payable		177,591	
Income taxes payable		98,362	
Rent payable		45,000	
Total current liabilities			$1,075,953
Long-term liabilities			
Notes payable (long-term)		1,600,000	
Bonds payable	$300,000		
Less: Discount on bonds payable	15,000	285,000	
Rent payable (long-term)		480,000	2,365,000
Total liabilities			3,440,953
Stockholders' equity			
Capital stock			
Preferred stock, $10 par; 20,000 shares authorized, 15,000 shares issued	150,000		
Common stock, $1 par; 400,000 shares authorized, 200,000 issued	200,000	350,000	
Retained earnings ($1,063,897 – $350,000)		713,897	
Total stockholders' equity ($4,504,850 – $3,440,953)			1,063,897
Total liabilities and stockholders' equity			$4,504,850

PROBLEM 5-3

EASTWOOD COMPANY
Balance Sheet
December 31, 2014

Assets			
Current assets			
Cash		$ 41,000	
Accounts receivable	$163,500		
Less: Allowance for doubtful accounts	8,700	154,800	
Inventory (LIFO cost)		208,500	
Prepaid insurance		5,900	
Total current assets			$ 410,200
Long-term investments			
Equity investments ($120,000 have been pledged as security for notes payable)—at fair value			339,000
Property, plant, and equipment			
Cost of uncompleted plant facilities			
Land	85,000		
Construction in process (building)	124,000	209,000	
Equipment	400,000		
Less: Accum. depreciation—equipt.	240,000	160,000	369,000
Intangible assets			
Patents (less $4,000 amortization)			36,000
Total assets			$1,154,200

PROBLEM 5-3 (Continued)

Liabilities and Stockholders' Equity

Current liabilities			
Notes payable (secured by investments of $120,000)		$ 94,000	
Accounts payable		148,000	
Accrued liabilities		49,200	
Total current liabilities			$ 291,200
Long-term liabilities			
8% bonds payable, due January 1, 2025		200,000	
Less: Discount on bonds payable		20,000	180,000
Total liabilities			471,200
Stockholders' equity			
Common stock			
Authorized 600,000 shares of $1 par value; issued and outstanding, 500,000 shares	$500,000		
Paid in capital in excess of par—common stock	45,000	545,000	
Retained earnings		138,000	683,000
Total liabilities and stockholders' equity			$1,154,200

PROBLEM 5-4

KISHWAUKEE CORPORATION
Balance Sheet
December 31, 2014

Assets

Current assets			
Cash		$175,900	
Accounts receivable		170,000	
Inventory		312,100	
Total current assets			$ 658,000
Long-term investments			
Assets allocated to trustee for expansion:			
Cash in bank		70,000	
Debt investments (held-to-maturity)		138,000	208,000
Property, plant, and equipment			
Land		950,000	
Buildings	$1,070,000[a]		
Less: Accum. depreciation—buildings	410,000	660,000	1,610,000
Total assets			$2,476,000

Liabilities and Stockholders' Equity

Current liabilities			
Notes payable—current installment		$100,000	
Income taxes payable		75,000	
Total current liabilities			$ 175,000

PROBLEM 5-4 (Continued)

Long-term liabilities		
Notes payable		500,000[b]
Total liabilities		675,000
Stockholders' equity		
Common stock, no par; 1,000,000 shares authorized and issued; 950,000 shares outstanding	1,150,000	
Retained earnings	683,000[c]	
	1,833,000	
Less: Treasury stock, at cost (50,000 shares)	87,000	
Kishwankee stockholders'	1,746,000	
Equity attributable to Noncontrolling interest	55,000	
Total stockholders' equity		1,801,000
Total liabilities and stockholders' equity		$2,476,000

[a]$1,640,000 – $570,000 (to eliminate the excess of appraisal value over cost from the Buildings account. Note that the appreciation capital account is also deleted).

[b]$600,000 – $100,000 (to reclassify the currently maturing portion of the notes payable as a current liability).

[c]$803,000 – $120,000 (to remove the value of goodwill from retained earnings. Note 2 indicates that retained earnings was credited. Note that the goodwill account is also deleted).

Note: As an alternate presentation, the cash restricted for plant expansion would be added to the general cash account and then subtracted. The amount reported in the investments section would not change.

PROBLEM 5-5

SARGENT CORPORATION
Balance Sheet
December 31, 2014

Assets

Current assets			
Cash		$150,000	
Equity investments (Trading)		80,000	
Accounts receivable	$ 170,000		
Less: Allowance for doubtful accounts	10,000	160,000	
Inventory (lower-of-FIFO-cost-or-market)		180,000	
Total current assets			$ 570,000
Long-term investments			
Equity investments (available-for-sale) (at fair value)		270,000	
Bond sinking fund		250,000	
Cash surrender value of life insurance		40,000	
Land held for future use		270,000	830,000
Property, plant, and equipment			
Land		500,000	
Buildings	1,040,000		
Less: Accum. depreciation—buildings	360,000	680,000	
Equipment	450,000		
Less: Accum. depreciation—equipment	180,000	270,000	1,450,000
Intangible assets			
Franchise		165,000	
Goodwill		100,000	265,000
Total assets			$3,115,000

PROBLEM 5-5 (Continued)

Liabilities and Stockholders' Equity

Current liabilities			
Accounts payable		$ 140,000	
Notes payable		80,000	
Income taxes payable		40,000	
Unearned rent revenue		5,000	
Total current liabilities			$ 265,000
Long-term liabilities			
Notes payable		120,000	
7% bonds payable, due 2022	$1,000,000		
Less: Discount on bonds payable	40,000	960,000	1,080,000
Total liabilities			1,345,000
Stockholders' equity			
Capital stock			
Preferred stock, no par value; 200,000 shares authorized, 70,000 issued and outstanding	450,000		
Common stock, $1 par value; 400,000 shares authorized, 100,000 issued and outstanding	100,000		
Paid-in capital in excess of par—common stock [100,000 X ($10.00 – $1.00)]	900,000	1,450,000	
Retained earnings		320,000	
Total stockholders' equity			1,770,000
Total liabilities and stockholders' equity			$3,115,000

PROBLEM 5-6

(a)

LANSBURY INC.
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$32,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense	$ 11,000	
Gain on sale of investments	(3,400)	
Increase in account receivable ($41,600 – $21,200)	(20,400)	(12,800)
Net cash provided by operating activities		19,200
Cash flows from investing activities		
Sale of investments	15,000	
Purchase of land	(18,000)	
Net cash used by investing activities		(3,000)
Cash flows from financing activities		
Issuance of common stock	20,000	
Retirement of notes payable	(16,000)	
Payment of cash dividends	(8,200)	
Net cash used by financing activities		(4,200)
Net increase in cash		12,000
Cash at beginning of year		20,000
Cash at end of year		$32,000

Noncash investing and financing activities
Land purchased through issuance of $30,000 of bonds

(b)

LANSBURY INC.
Balance Sheet
December 31, 2014

Assets			Liabilities and Stockholders' Equity		
Cash	$32,000		Accounts payable	$30,000	
Accounts receivable	41,600		Notes payable (long-term)	25,000	(4)
Equity investments	20,400	(1)	Bonds payable	30,000	(5)
Plant assets (net)	70,000	(2)	Common stock	120,000	(6)
Land	88,000	(3)	Retained earnings	47,000	(7)
	$252,000			$252,000	

(1) $32,000 – ($15,000 – $3,400)
(2) $81,000 – $11,000
(3) $40,000 + $18,000 + $30,000
(4) $41,000 – $16,000
(5) $0 + $30,000
(6) $100,000 + $20,000
(7) $23,200 + $32,000 – $8,200

(c) Cash flow information is useful for assessing the amount, timing, and uncertainty of future cash flows. For example, by showing the specific inflows and outflows from operating activities, investing activities, and financing activities, the user has a better understanding of the liquidity and financial flexibility of the enterprise. Similarly, these reports are useful in providing feedback about the flow of enterprise resources. This information should help users make more accurate predictions of future cash flow. In addition, some individuals have expressed concern about the quality of the earnings because the measurement of the income depends on a number of accruals and estimates which may be somewhat subjective. As a result, the higher the ratio of cash provided by operating activities to net income, the more comfort some users have in the reliability of the earnings. In this problem the ratio of cash provided by operating activities to net income is 60% ($19,200 ÷ $32,000).

PROBLEM 5-6 (Continued)

An analysis of Lansbury's free cash flow indicates it is negative as shown below:

Free Cash Flow Analysis

Net cash provided by operating activities	**$19,200**
Less: Purchase of land	**18,000**
Dividends	**8,200**
Free cash flow	**$ (7,000)**

Its current cash debt coverage is 0.64 to 1 $\left(\frac{\$19,200}{\$30,000}\right)$ **and its cash debt coverage is 0.25 to 1** $\left(\$19,200 \div \frac{\$71,000 + \$85,000}{2}\right)$**, which are reasonable.**

Overall, it appears that its liquidity position is average and overall financial flexibility and solvency should be improved.

PROBLEM 5-7

(a)

AERO INC.
Statement of Cash Flows
For the Year Ended December 31, 2014

Cash flows from operating activities		
Net income		$35,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense	$12,000	
Loss on sale of investments	5,000	
Increase in accounts payable ($40,000 – $30,000)	10,000	
Increase in accounts receivable ($42,000 – $21,200)	(20,800)	6,200
Net cash provided by operating activities		41,200
Cash flows from investing activities		
Sale of investments	27,000	
Purchase of land	(38,000)	
Net cash used by investing activities		(11,000)
Cash flows from financing activities		
Issuance of common stock	30,000	
Payment of cash dividends	(10,000)	
Net cash provided by financing activities		20,000
Net increase in cash		50,200
Cash at beginning of year		20,000
Cash at end of year		$70,200

Noncash investing and financing activities
Land purchased through issuance of $30,000 of bonds

PROBLEM 5-7 (Continued)

(b)

AERO INC.
Balance Sheet
December 31, 2014

Assets			Liabilities and Stockholders' Equity		
Cash	$ 70,200		Accounts payable	$ 40,000	
Accounts receivable	42,000		Bonds payable	71,000	(3)
Plant assets (net)	69,000	(1)	Common stock	130,000	(4)
Land	108,000	(2)	Retained earnings	48,200	(5)
	$289,200			$289,200	

(1) $81,000 – $12,000
(2) $40,000 + $38,000 + $30,000
(3) $41,000 + $30,000
(4) $100,000 + $30,000
(5) $23,200 + $35,000 – $10,000

(c) An analysis of Aero's free cash flow indicates it is negative as shown below:

Free Cash Flow Analysis

Net cash provided by operating activities	$41,200
Less: Purchase of land	38,000
Dividends	10,000
Free cash flow	$ (6,800)

PROBLEM 5-7 (Continued)

Its current cash debt coverage is 1.18 to 1 $\left(\frac{\$41,200}{\$35,000^*}\right)$. Overall, it appears that its liquidity position is average and overall financial flexibility should be improved.

***($30,000 + $40,000) ÷ 2**

(d) This type of information is useful for assessing the amount, timing, and uncertainty of future cash flows. For example, by showing the specific inflows and outflows from operating activities, investing activities, and financing activities, the user has a better understanding of the liquidity and financial flexibility of the enterprise. Similarly, these reports are useful in providing feedback about the flow of enterprise resources. This information should help users make more accurate predictions of future cash flow. In addition, some individuals have expressed concern about the quality of the earnings because the measurement of the income depends on a number of accruals and estimates which may be somewhat subjective. As a result, the higher the ratio of cash provided by operating activities to net income, the more comfort some users have in the reliability of the earnings.

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 5-1 (Time 20–25 minutes)
Purpose—to provide a varied number of financial transactions and then determine how each of these items should be reported in the financial statements. Accounting changes, additional assessments of income taxes, prior period adjustments, and changes in estimates are some of the financial transactions presented.

CA 5-2 (Time 30–35 minutes)
Purpose—to present the asset section of a partial balance sheet that must be analyzed to assess its deficiencies. Items such as improper classifications, terminology, and disclosure must be considered.

CA 5-3 (Time 20–25 minutes)
Purpose—to present a balance sheet that must be analyzed to assess its deficiencies. Items such as improper classification, terminology, and disclosure must be considered.

CA 5-4 (Time 20–25 minutes)
Purpose—to present the student an ethical issue related to the presentation of balance sheet information. The reporting involves “net presentation” of property, plant and equipment.

CA 5-5 (Time 40–50 minutes)
Purpose—to present a cash flow statement that must be analyzed to explain differences in cash flow and net income, and sources and uses of cash flow and ways to improve cash flow.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 5-1

1. The new estimate would be used in computing depreciation expense for 2014. No adjustment of the balance in accumulated depreciation at the beginning of the year would be made. Instead, the remaining depreciable cost would be divided by the estimated remaining life. This is a change in an estimate and is accounted for prospectively (in the current and future years). Disclosure in the notes to the financial statements is appropriate, if material.

2. The additional assessment should be shown on the current period's income statement. If material it should be shown separately; if immaterial it could be included with the current year's tax expense. This transaction does not represent a prior period adjustment.

3. The effect of the error at December 31, 2013, should be shown as an adjustment of the beginning balance of retained earnings on the retained earnings statement. The current year's expense should be adjusted (if necessary) for the possible carryforward of the error into the 2014 expense computation.

4. Generally, an entry is made for a cash dividend on the date of declaration. The appropriate entry would be a debit to Retained Earnings (or Dividends) for the amount to be paid, with a corresponding credit to Dividends Payable. Dividends payable is reported as a current liability.

CA 5-2

1. Unclaimed payroll checks should be shown as a current liability if these are claims by employees.

2. Debt investments (trading) should be reported at fair value, not cost.

3. Bad Debt Reserve is an improper terminology; Allowance for Doubtful Accounts is considered more appropriate. The amount of estimated uncollectibles should be disclosed.

4. Next-in, First-out (NIFO) is not an acceptable inventory valuation method.

5. Heading "Tangible assets" should be changed to "Property, Plant and Equipment"; also label for corresponding $630,000 should be changed to "net property, plant, and equipment."

6. Land should not be depreciated.

7. Buildings and equipment and their related accumulated depreciation balances should be separately disclosed.

8. The valuation basis for stocks should be disclosed (fair value or equity) and the description should be Equity investment (Available-for-Sale) or Equity investment in X Company.

9. Treasury stock is not an asset and should be shown in the stockholders' equity section as a deduction.

10. Discount on bonds payable is not an asset and should be shown as a deduction from bonds payable.

11. Sinking fund should be reported in the long-term investments section.

CA 5-3

Criticisms of the balance sheet of the Sameed Brothers Corporation:

1. The basis for the valuation of marketable securities should be shown. Marketable securities are valued at fair value. In addition, they should be classified as either trading securities, available-for-sale securities, or held-to-maturity securities.

2. An allowance for doubtful accounts receivable is not indicated.

3. The basis for the valuation and the method of pricing for Inventory are not indicated.

4. A stock investment in a subsidiary company is not ordinarily held to be sold within one year or the operating cycle, whichever is longer. As such, this account should not be classified as a current asset, but rather should be included under the heading "Investments." The basis of valuation of the investment should be shown.

5. Treasury stock is not an asset. It should be presented as a deduction in the shareholders' equity section of the balance sheet. The class of stock, number of shares, and basis of valuation should be indicated.

6. Buildings and land should be segregated. The Reserve for Depreciation should be shown as a subtraction from the Buildings account only. Also, the term "reserve for" should be replaced by "accumulated."

7. Cash Surrender Value of Life Insurance would be more appropriately shown under the heading of "Investments."

8. Reserve for Income Taxes should appropriately be entitled Income Tax Payable.

9. Customers' Accounts with Credit Balances is an immaterial amount. As such, this account need not be shown separately. The $1,000 credit could readily be netted against Accounts Receivable without any material misstatement.

10. Unamortized Premium on Bonds Payable should be appropriately shown as an addition to the related Bonds Payable in the long-term liability section. The use of the term deferred credits is inappropriate.

11. Bonds Payable is inadequately disclosed. The interest rate, interest payment dates, and maturity date should be indicated.

12. Additional disclosure relative to the Common Stock account is needed. This disclosure should include the number of shares authorized, issued, and outstanding.

13. Earned Surplus should appropriately be entitled Retained Earnings. Also, a separate heading should be shown for this account; it should not be shown under the heading "Common Stock." A more appropriate heading would be "Shareholders' Equity."

14. Cash Dividends Declared should be disclosed on the retained earnings statement as a reduction of retained earnings. Dividends Payable, in the amount of $8,000, should be shown on the balance sheet among the current liabilities, assuming payment has not occurred.

CA 5-4

(a). The ethical issues involved are integrity and honesty in financial reporting, full disclosure, and the accountant's professionalism.

(b). While presenting property, plant, and equipment net of depreciation on the balance sheet may be acceptable under GAAP, it is inappropriate to attempt to hide information from financial statement users. Information must be useful, and the presentation Keene is considering would not be. Users would not grasp the age of plant assets and the company's need to concentrate its future cash outflows on replacement of these assets. This information could be provided in a note disclosure.

Because of the significant impact on the financial statements of the depreciation method(s) used, the following disclosures should be made.

a. Depreciation expense for the period.
b. Balances of major classes of depreciable assets, by nature and function.
c. Accumulated depreciation, either by major classes of depreciable assets or in total.
d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

CA 5-5

Date

President Kappeler, CEO
Kappeler Corporation
125 Wall Street
Middleton, Kansas 67458

Dear Mr. Kappeler:

I have good news and bad news about the financial statements for the year ended December 31, 2014. The good news is that net income of $100,000 is close to what we predicted in the strategic plan last year, indicating strong performance this year. The bad news is that the cash balance is seriously low. Enclosed is the Statement of Cash Flows, which best illustrates how these situations occurred simultaneously.

If you look at the operating activities, you can see that no cash was generated by operations due to the increase in accounts receivable and inventory and reduction in accounts payable. In effect, these events caused net cash flow provided by operating activities to be lower than net income; they reduced your cash balance by $116,000.

The corporation made significant investments in equipment and land. These were paid from cash reserves. These purchases used 75% of the company's cash. In addition, the redemption of the bonds improved the equity of the corporation and reduced interest expense. However, it also used 25% of the corporation's cash. It is normal to use cash for investing and financing activities. But when cash is used, it must also be replenished.

Operations normally provide the cash for investing and financing activities. Since there is a finite amount of assets to sell and funds to borrow or raise from the sale of capital stock, operating activities are the only renewable source of cash. That is why it is important to keep the operating cash flows positive. Cash management requires careful and continuous planning.

CA 5-5 (Continued)

There are several possible remedies for the current cash problem. First, prepare a detailed analysis of monthly cash requirements for the next year. Second, investigate the changes in accounts receivable and inventory and work to return them to more normal levels. Third, look for more favorable terms with suppliers to allow the accounts payable to increase without loss of discounts or other costs. Finally, since the land represents a long-term commitment without immediate plans for use, consider shopping for a low interest loan to finance the acquisition for a few years and return the cash balance to a more normal level.

If you have additional questions or need one of our staff to address this problem, please contact me at your convenience.

Sincerely yours,

Partner in Charge

FINANCIAL REPORTING PROBLEM

(a) **P&G could use the account form or report form. P&G uses the account form.**

(b) **The techniques of disclosing pertinent information include (1) parenthetical explanations, (2) notes, (3) cross-reference and contra items, and (4) supporting schedules. P&G uses parenthetical explanations and notes (see notes to financial statements section) and supporting schedules.**

(c) **While there are no Investments reported on P&G's balance sheet, Note 1 (Significant Accounting Policies) states that Investments are readily marketable debt and equity securities. These securities are reported at fair value. Unrealized gains and losses on trading securities are recognized in income. Unrealized gains and losses relating to investments classified as available-for-sale are recorded as a component of accumulated other comprehensive income in shareholders' equity. As of June 30, 2011, P&G had negative working capital (current assets less than current liabilities) of $5,323 million. At June 30, 2010, P&G's negative working capital was $5,500 million.**

(d) **The following table summarizes P&G's cash flows from operating, investing, and financing activities in the 2009–2011 time period (in millions).**

	2011	2010	2009
Net cash provided by operating activities	$ 13,231	$16,072	$ 14,919
Net cash used in investing activities	(3,482)	(597)	(2,353)
Net cash used in financing activities	(10,023)	(17,255)	(10,814)

P&G's net cash provided by operating activities increased slightly from 2009 to 2010, and increased by 18% from 2010 to 2011. When accounts payable, accrued and other liabilities increase, cost of goods sold and operating expenses are higher on an accrued basis than they are on a cash basis. To convert to net cash provided by operating activities, the increase in accounts payable, and accrued and other liabilities must be added to net income.

(e) 1. Net Cash Provided by Operating Activities ÷ Average Current Liabilities = Current Cash Debt Coverage

$$\$13{,}231 \div \frac{(\$27{,}293 + \$24{,}282)}{2} = \underline{\underline{.51:1}}$$

2. Net Cash Provided by Operating Activities ÷ Average Total Liabilities = Cash Debt Coverage

$$\$13{,}231 \div \frac{(\$70{,}353 + \$66{,}733)}{2} = \underline{\underline{0.19:1}}$$

3. Net cash provided by operating activities less capital expenditures and dividends

Net cash provided by operating activities		$13,231
Less: Capital expenditures	$3,306	
Dividends	5,767	9,073
Free cash flow		$ 4,158

Note that P&G also used cash ($7,039 million) to repurchase common stock, which reduces its free cash flow to negative $2,881 million. P&G's financial position appears adequate. 19% of its total liabilities can be covered by the current year's operating cash flow and its free cash flow position indicates it is easily meeting its capital investment and financing demands from current free cash flow.

COMPARATIVE ANALYSIS CASE

(a) Both the Coca-Cola Company and PepsiCo, Inc. use the report form.

(b) The Coca-Cola Company has working capital of $1,214 million ($25,497 million – $24,283 million): PepsiCo, Inc. has working capital of $(713) million ($17,441 million – $18,154 million). The Coca-Cola Company indicates in its management discussion and analysis section that its ability to generate cash from operating activities is one of its fundamental financial strengths. This posture, coupled with use debt financing lowers the overall cost of capital and increases the return on shareowners' equity. PepsiCo has a similar strategy (see discussion in "Liquidity and Capital Resources.")

(c) The most significant difference relates to intangible assets. The Coca-Cola Company has Trademarks, Goodwill, and Other Intangible Assets of $27,669 million (35% of assets); PepsiCo, Inc. has Intangible Assets, net of amortization of $31,357 million (or 43% of assets). PepsiCo carries higher levels of property, plant, and equipment (27% of assets), while Coca-Cola's property, plant, and equipment is just 18.7% of assets. Coca-Cola has higher investments in unconsolidated subsidiaries (10.5% > 2% of assets).

(d)

Total assets	Annual	Five-Year
The Coca-Cola Company	49.81%	84.8%
PepsiCo, Inc.	10.7%	25.6%
Long-term debt		
The Coca-Cola Company	177.54%	316.7
PepsiCo, Inc.	170.26%	389.4%

(e) The Coca-Cola Company has increased net cash provided by operating activities from 2009 to 2011 by $1,288 million or 15.73%. PepsiCo, Inc. has increased net cash provided by operating activities by $2,148 million or 31.6%. Coca-Cola has a favorable trend in the generation of internal funds from operations. PepsiCo is more level.

(f) The Coca-Cola Company

Current Cash Debt Ratio

$$\$9,474 \div \frac{\$24,283 + \$18,508}{2} = \underline{\underline{0.44:1}}$$

Cash Debt Coverage Ratio

$$\$9,474 \div \frac{\$48,053 + \$41,604}{2} = \underline{\underline{0.21:1}}$$

($ millions)
Free cash flow

Net cash provided by operating activities................	$9,474
Less: Capital expenditures......................................	2,920
Dividends...	4,300
Free cash flow	$2,254

Coca-Cola Company's free cash flow is $2,254. Note that Coca-Cola is also using cash to repurchase shares ($4,513 million in 2011).

PepsiCo, Inc.

Current Cash Debt Coverage

$$\$8,944 \div \frac{\$18,154 + \$15,892}{2} = \underline{\underline{0.53:1}}$$

Cash Debt Coverage

$$\$8,944 \div \frac{\$51,983 + \$46,667}{2} = \underline{\underline{0.18:1}}$$

COMPARATIVE ANALYSIS CASE (Continued)

Free cash flow

Net cash provided by operating activities	$8,944
Less: Capital spending	3,339
Dividends	3,157
Free cash flow	$2,448

PepsiCo also used cash to repurchase shares (only $2.5 million in 2011).

Both companies have strong liquidity and financial flexibility.

FINANCIAL STATEMENT ANALYSIS CASE 1

(a) The raw materials price increase is not a required disclosure. However, the company might well want to inform shareholders in the management discussion and analysis section, especially as a means for company management to point out an area of success. If the company had not been able to successfully meet the challenge, then the reporting in the discussion and analysis section would be for the purpose of explaining poorer than expected operating results.

(b) The information in item (2) should be reported as follows: The $4,000,000 outstanding should, of course, be included in the balance sheet as a part of liabilities (current- or long-term, depending on the terms of the loan). The fact that an additional $11,000,000 or so is available for borrowing should be disclosed in the notes to the financial statements, as also should the fact that the loan is based on the accounts receivable.

FINANCIAL STATEMENT ANALYSIS CASE 2

(a) These accounts are shown in the order in which Sherwin-Williams actually presented the accounts. The order shown may be modified somewhat; however, cash should certainly be listed first and other current assets last within the current assets category; common stock should be listed first and retained earnings last in the stockholders' equity category. For the remaining items, the order may be different than that shown.

CURRENT ASSETS
Cash and cash equivalents
Short-term investments
Accounts receivable, less allowance
Finished goods inventories
Work in process and raw materials inventories
Other current assets

LONG-TERM ASSETS
Land
Buildings
Machinery and equipment
Intangibles and other assets

CURRENT LIABILITIES
Accounts payable
Employee compensation payable
Taxes payable
Other accruals
Accrued taxes

LONG-TERM LIABILITIES
Long-term debt
Postretirement obligations other than pensions
Other long-term liabilities

STOCKHOLDERS' EQUITY
Common stock
Other capital
Retained earnings

(b) There is some latitude for judgment in this question. The general answer is that the assets and liabilities specific to the automotive division will decrease and that cash will increase. Some students may be aware that retained earnings will increase or decrease, depending upon whether the assets were sold above or below historical cost.

- ***Cash and cash equivalents*—increase from the sale of the assets**
- ***Accounts receivable, less allowance*—decrease from the sale of the Automotive Division's receivables**
- ***Finished goods inventories*—decrease**
- ***Work in process and raw materials inventories*—decrease**
- ***Land*—decrease**
- ***Buildings*—decrease**
- ***Machinery and equipment*—decrease**
- ***Long-term debt*—decrease**
- ***Retained earnings*—increase or decrease, depending on whether the assets were sold above or below cost**

FINANCIAL STATEMENT ANALYSIS CASE 3

(a) Working Capital, Current Ratio

Without Contractual Obligations

Working Capital	**Current Ratio**
$27,208 – $15,922 = $11,286	**$27,208 ÷ $15,922 = 1.71**

With Contractual Obligations

Off-balance sheet current obligations = $3,275 ($3,172 + $100 + $3)

Working Capital	**Current Ratio**
$27,208 – ($15,922 + $3,275) = $8,011	**$27,208 ÷ ($15,922 + $3,275) = 1.42**

Without information on contractual obligations, an analyst would overstate Deere's liquidity, as measured by working capital and the current ratio.

(b)

1. **Based on the analysis in Part (a), Deere has a pretty good liquidity cushion. It would be able to pay a loan of up $8,011 billion, if due in one year.**

2. **Additional contractual obligations of $8,600 in years 2 and 3 and $3,631 in years 4 and 5 are relevant to assessing whether Deere can repay a loan maturing in 5 years. In evaluating a longer term loan, an analyst would need to develop a prediction of Deere's cash flows over the next 5 years that would be used to repay a longer term loan.**

   In summary, the schedule of contractual obligations provides information about off-balance sheet obligations—both the amounts and when due. This helps the analyst assess both liquidity and solvency of a company.

FINANCIAL STATEMENT ANALYSIS CASE 4

(a)

($ in millions)	Current Year	Prior Year
Current assets	$3,373	$2,929
Total assets	4,363	3,696
Current liabilities	2,532	1,899
Total liabilities	3,932	3,450
(1) Cash provided by operations	702	733
(2) Capital expenditures	216	204
(3) Dividends paid	0	0
Net Income (loss)	190	359
Sales	10,711	8,490
Free Cash Flow (1) – (2) – (3)	486	529

As indicated above, Amazon's free cash flow in the current and prior year was $486 million and $529 million respectively. Amazon shows a declining trend in profitability and cash provided by operations. Depending on the investment required to build the warehouses, it appears they might not be able to finance the warehouses with internal funds.

(b) **Cash provided by operations has decreased in current year relative to the prior year by $31 million. This is due to lower profitability combined with a net increase in working capital and other non-cash income adjustments.**

ACCOUNTING, ANALYSIS, AND PRINCIPLES

Accounting

Hopkins Company
Balance Sheet
December 31, 2014

Assets		
Current assets		
Cash ($75,000 – $15,000)		$ 60,000
Accounts receivable ($52,000 – $9,000)	$ 43,000	
Less: Allowance for doubtful accounts ($13,500 – $9,000)	4,500	38,500
Inventory		65,300
Total current assets		163,800
Long-term investments		
Bond sinking fund		15,000
Property, plant, and equipment		
Equipment	112,000	
Less: Accumulated depreciation—equipment	28,000	84,000
Intangible assets		
Patents		15,000
Total assets		$277,800
Liabilities and Stockholders' Equity		
Current liabilities		
Notes and accounts payable		$ 52,000
Long-term liabilities		
Notes payable (due 2016)		75,000
Total liabilities		127,000
Stockholders' equity		
Common stock	$100,000	
Retained earnings	50,800	
Total stockholders' equity		150,800
Total liabilities and stockholders' equity		$277,800

Analysis

The classified balance sheet provides subtotals for current assets and current liabilities, which are assets expected to be converted to cash (or liabilities expected to be paid from cash) in the next year or operating cycle (also referred to as liquidity). Thus, an analysis of current assets relative to current liabilities provides information relevant to assessing Hopkins' ability to repay a loan within the next year. Specifically, current assets in excess of current liabilities (working capital) is $111,800 ($163,800 – $52,000.) This seems to be a safe liquidity cushion relative to an additional loan of $45,000. Of course, the loan officer also would evaluate Hopkins' earnings and cash flows in the analysis.

Principles

The primary objection that the bank is likely to raise about this supplemental information is the subjectivity (which reduces faithful representation) of the estimates of fair values for the long-lived assets and the internally generated intangibles. In addition, the loan officer might not consider information about these long-term assets to be that relevant to the loan decision, because the loan is short-term.

PROFESSIONAL RESEARCH

(a) Codification String: FASB ASC 235-10-05—Presentation > 235 Notes to Financial Statements > 10 Overall > 05 Background (Predecessor Standard – [APB 22])

(b) Codification String: Presentation > 235 Notes to Financial Statements > 10 Overall > 05 Background

05-3 The accounting policies of an entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles (GAAP) and that, accordingly, have been adopted for preparing the financial statements.

(c) Codification String: Presentation > 235 Notes to Financial Statements > 10 Overall > 50 Disclosure

50-3 Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it shall encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.
b. Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry.
c. Unusual or innovative applications of GAAP.

(d) 50-4 Codification String: Presentation > 235 Notes to Financial Statements > 10 Overall > 05 Background

Examples of disclosures by an entity commonly required with respect to accounting policies would include, among others, those relating to the following:

a. Basis of consolidation
b. Depreciation methods
c. Amortization of intangibles
d. Inventory pricing
e. Accounting for recognition of profit on long-term construction-type contracts
g. Recognition of revenue from franchising and leasing operations.

PROFESSIONAL SIMULATION

FINANCIAL STATEMENT

SOLO HOPE COMPANY
Balance Sheet
December 31, 2014

Assets

Current assets		
Cash ($50,000 – $20,000)		$ 30,000
Accounts receivable ($38,500 + $13,500)	$ 52,000	
Less: Allowance for doubtful accounts	13,500	38,500
Inventory		65,300
Total current assets		133,800
Long-term investments		
Plant expansion fund		20,000
Property, plant, and equipment		
Equipment	132,000	
Less: Accumulated depreciation—equipment	28,000	104,000
Intangible assets		
Patents		25,000
Total assets		$282,800

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable	17,000	
Accounts payable	$ 32,000	
Income taxes payable	8,000	
Total current liabilities		$ 57,000

PROFESSIONAL SIMULATION (Continued)

Long-term liabilities		
Bonds payable (9%, due June 30, 2022)		100,000
Total liabilities		157,000
Stockholders' equity		
Common stock ($1 par)	50,000	
Additional paid-in capital	55,000	
Retained earnings..	20,800	125,800
Total liabilities and stockholders' equity..........		$282,800

ANALYSIS

$$Z = \frac{\text{Working capital}}{\text{Total assets}} \text{ X } 1.2 + \frac{\text{Retained earnings}}{\text{Total assets}} \text{ X } 1.4 + \frac{\text{EBIT}}{\text{Total assets}} \text{ X } 3.3$$

$$+ \frac{\text{Sales}}{\text{Total assets}} \text{ X } 0.99 + \frac{\text{MV equity}}{\text{Total liabilities}} \text{ X } 0.6$$

$$= \frac{(\$133{,}800 - \$57{,}000)}{\$282{,}800} \text{ X } 1.2 + \frac{\$20{,}800}{\$282{,}800} \text{ X } 1.4 + \frac{\$14{,}000}{\$282{,}800} \text{ X } 3.3$$

$$+ \frac{\$210{,}000}{\$282{,}800} \text{ X } 0.99 + \frac{\$225{,}000}{\$157{,}000} \text{ X } 0.6$$

$$= .3259 + .1030 + .1634 + .7351 + .8599 = 2.1873$$

PROFESSIONAL SIMULATION (Continued)

Hope's Z-Score is above the "likely-to-fail" level of 1.81 but also below the unlikely-to-fail value of 3.0. Hope should be concerned about his company's situation.

RESEARCH

Search string: "accounting policies" and disclosure

APB 22: Disclosure of Accounting Policies

12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, changes in financial position, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives;

b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;

c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.

IFRS CONCEPTS AND APPLICATION

IFRS5-1

In general, the disclosure requirements related to the statement of financial position (balance sheet) and the statement of cash flows are much more extensive and detailed in the U.S. *IAS 1*, "Presentation of Financial Statements," provides the overall IFRS requirements for balance sheet information. *IAS 7*, "Cash Flow Statements," provides the overall IFRS requirements for cash flow information.

IFRS5-2

Among the similarities between IFRS and U.S. GAAP related to statement of financial position presentation are as follows:

- **IAS 1 specifies minimum note disclosures. These must include information about (1) accounting policies followed, (2) judgments that management has made in the process of applying the entity's accounting policies, (3) and the key assumptions and estimation uncertainty that could result in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.**
- **Comparative prior-period information must be presented and financial statements must be prepared annually.**
- **Current/non-current classification for assets and liabilities is normally required. In general, post-financial statement events are not considered in classifying items as current or non-current.**

Differences include (1) IFRS statements may report property, plant, and equipment first in the statement of financial position. Some companies report the sub-total "net assets", which equals total assets minus total liabilities; (2) While the use of the term "reserve" is discouraged in U.S. GAAP, there is no such prohibition in IFRS.

IFRS5-3

The IASB and the FASB are working on a project to converge their standards related to financial statement presentation. This joint project will establish a common, high-quality standard for presentation of information in the financial statements, including the classification and display of line items. A key feature of the proposed framework for financial statement presentation is that each of the statements will be organized in the same format to separate an entity's financing activities from its operating and other activities (investing) and further separates financing activities into transactions with owners and creditors. Thus, the same classifications used in the statement of financial position would also be used in the income statement and the statement of cash flows.

IFRS5-4

Rainmaker Company will report a net revaluation gain of $165,000 ($200,000 – $35,000), which will be recoded as an adjustment to these assets with the net gain recorded in equity. Each reporting period the property and equipment are revalued to approximate fair value. The use of revaluations is prohibited in GAAP.

IFRS5-5

(a) Some of the differences are:

1. ***Report form and subtotals*—Tomkins uses a modified report form with current liabilities deducted from current assets to determine net current assets and remaining liabilities deducted from total assets less current liabilities to arrive at "net assets". This amount balances with total "Capital and Reserves".**
2. ***Classifications*—the classifications are not arranged according to decreasing liquidity. For example, "Fixed assets" are listed first, then "Current assets". Cash is not listed as the first current asset.**
3. ***Terminology*—For example, Contributed capital is referred to as "Ordinary share capital" and "Share premium" account, rather than Common Stock and Additional paid-in capital. "Accumulated deficit" is used instead of Retained Earnings.**
4. ***Units of currency*—Tomkins reports in pounds sterling.**

IFRS5-5 (Continued)

(b) Although there are differences in terminology and some groupings and subtotals are different, the British balance sheet does group assets and liabilities with similar characteristics together (Fixed assets, Current assets and Current liabilities). For the most part, the classifications are similar in that they are related to the liquidity of the balance sheet items. By netting liabilities against assets, a measure of solvency is provided.

<u>Note to instructors</u>: A final difference not mentioned above is the "Capital redemption reserve" account in the Capital and reserves section of Tomkins' Balance sheet. This account in the U.K. corresponds to "Additional Paid-in Capital—Treasury Stock in the U.S. setting.

IFRS5-6

(a) International Accounting Standard 8 covers the disclosure of accounting policies.

(b) Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (para. 5).

(c) An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category. (para. 13)

An entity shall change an accounting policy only if the change:

a. is required by an IFRS; or
b. results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. (para. 14)

IFRS5-6 (Continued)

(d) Disclosure

When initial application of an IFRS has an effect on the current period or any prior period, or would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

a. the title of the IFRS;
b. when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
c. the nature of the change in accounting policy;
d. when applicable, a description of the transitional provisions;
e. when applicable, the transitional provisions that might have an effect on future periods;
f. for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
   (i) for each financial statement line item affected; and
   (ii) if IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;
g. the amount of the adjustment relating to periods before those presented, to the extent practicable; and
h. if retrospective application required by paragraph 19(a) or (b) is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures. (para. 28)

IFRS5-6 (Continued)

When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

a. **the nature of the change in accounting policy;**
b. **the reasons why applying the new accounting policy provides reliable and more relevant information;**
c. **for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:**
   (i) **for each financial statement line item affected; and**
   (ii) **if IAS 33 applies to the entity, for basic and diluted earnings per share;**
d. **the amount of the adjustment relating to periods before those presented, to the extent practicable; and**
e. **if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.**

Financial statements of subsequent periods need not repeat these disclosures (para. 29).

IFRS5-7

(a) **M&S could have adopted the account form or report form. M&S uses the report form.**

(b) **The techniques of disclosing pertinent information include (1) parenthetical explanations, (2) cross-reference and contra items, and (3) notes to the financial statements. M&S uses notes.**

(c) **Investments are reported on M&S's statement of financial position as non-current assets. Note 1 (Accounting Policies) states that Investments are classified as either available-for-sale, or fair value through profit or loss. These securities are valued at fair value. On March 31, 2012, M&S had negative working capital (current assets less than current liabilities) of £545.3 million. On April 2, 2011, M&S's negative working capital was £568.5 million.**

(d) **The following table summarizes M&S's cash flows from operating, investing, and financing activities in 2012 and 2011 (in millions).**

	2012	2011
Net cash provided by operating activities	£1.203.0	£1,199.9
Net cash used in investing activities	757.8	490.5
Net cash used in financing activities	511.0	647.4

M&S's net cash provided by operating activities increased by 3% from 2011 to 2012. Changes in accounts payable and in accrued and other liabilities is added to net income because these changes reduce income but not cash flow.

(e) **Current Cash Debt**

$$£1,203 \div \frac{£2,005.4 + £2,210.2}{2} = \underline{\underline{0.57:1}}$$

Cash Debt Coverage

$$£1,203 \div \frac{£4,494.5 + £4,666.7}{2} = \underline{\underline{0.26:1}}$$

Free cash flow

Net cash provided by operating activities.................	£1,203.0
Less: Capital expenditures.......................................	564.3
Dividends..	267.8
Free cash flow	£ 370.9

M&S's financial position appears adequate. Over 26% of its total liabilities can be covered by the current year's operating cash flow and its free cash flow position indicates it is easily meeting its capital investment demands and the current level of dividends from current free cash flow.