Chapter 2
Investing and Financing Decisions and the Balance Sheet

ANSWERS TO QUESTIONS

1. The primary objective of financial reporting for external users is to provide useful economic information about a business to help external parties, primarily investors and creditors, make sound financial decisions. These users are expected to have a reasonable understanding of accounting concepts and procedures. Usually, they are interested in information to assist them in projecting future cash inflows and outflows of a business.

2. (a) An asset is a probable future economic benefit owned by the entity as a result of past transactions.

   (b) A current asset is an asset that will be used or turned into cash within one year; inventory is always considered a current asset regardless of how long it takes to produce and sell the inventory.

   (c) A liability is a probable debt or obligation of the entity as a result of a past transaction, which will be paid with assets or services.

   (d) A current liability is a liability that will be paid in cash (or other current assets) or satisfied by providing service within the coming year.

   (e) Contributed capital is the financing provided to the business by owners; usually owners provide cash and sometimes other assets such as equipment and buildings.

   (f) Retained earnings are the cumulative earnings of a company that are not distributed to the owners and are reinvested in the business.

3. (a) The separate-entity assumption requires that business transactions are separate from the transactions of the owners. For example, the purchase of a truck by the owner for personal use is not recorded as an asset of the business.

   (b) The unit-of-measure assumption requires information to be reported in the national monetary unit. That means that each business will account for and report its financial results primarily in terms of the national monetary unit, such as Yen in Japan and Australian dollars in Australia.

   (c) Under the continuity or going-concern assumption, businesses are assumed to operate into the foreseeable future. That is, they are not expected to liquidate.

   (d) The historical cost principle requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all noncash considerations.

4. Accounting assumptions are necessary because they reflect the scope of accounting and the expectations that set certain limits on the way accounting information is reported.

5. An account is a standardized format used by organizations to accumulate the dollar effects of transactions on each financial statement item. Accounts are necessary to keep track of all increases and decreases in the fundamental accounting model.

6. The fundamental accounting model is provided by the equation:

   Assets = Liabilities + Stockholders' Equity

7. A business transaction is (a) an exchange of resources (assets) and obligations (debts) between a business and one or more outside parties, and (b) certain events that directly affect the entity such as the use over time of rent that was paid prior to occupying space and the wearing out of equipment used to operate the business. An example of the first situation is (a) the sale of goods or services. An example of the second situation is (b) the use of insurance paid prior to coverage.

8. Debit is the left side of a T-account and credit is the right side of a T-account. A debit is an increase in assets and a decrease in liabilities and stockholders' equity. A credit is the opposite -- a decrease in assets and an increase in liabilities and stockholders' equity.

9. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation:

   Assets = Liabilities + Stockholders' Equity

   The two principles underlying the process are:
   * every transaction affects at least two accounts.
   * the accounting equation must remain in balance after each transaction.

   The two steps in transaction analysis are:
   (1) identify and classify accounts and the direction and amount of the effects.
   (2) determine that the accounting equation (A = L + SE) remains in balance.

10. The equalities in accounting are:
    (a) Assets = Liabilities + Stockholders' Equity
    (b) Debits = Credits

11. The journal entry is a method for expressing the effects of a transaction on accounts in a debits-equal-credits format. The title of the account(s) to be debited is (are) listed first and the title of the account(s) to be credited is (are) listed underneath the debited accounts. The debited amounts are placed in a left-hand column and the credited amounts are placed in a right-hand column.

12. The T-account is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities. It is a simplified representation of a ledger account with a debit column on the left and a credit column on the right.

13. The current ratio is computed as current assets divided by current liabilities. It measures the ability of the company to pay its short-term obligations with current assets. A high ratio normally suggests good liquidity, but a ratio that is too high may indicate inefficient use of resources. The rule of thumb was a ratio between 1.0 and 2.0 (twice as many current assets as current liabilities), but sophisticated cash management systems allow many companies to minimize funds invested in current assets and have a current ratio below 1.0.

14. Investing activities on the statement of cash flows include the buying and selling of productive assets and investments. Financing activities include borrowing and repaying debt, issuing and repurchasing stock, and paying dividends.

MULTIPLE CHOICE

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

Authors' Recommended Solution Time

(Time in minutes)

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

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

MINI-EXERCISES

M2–1.

C (1) Separate-entity assumption
H (2) Historical cost principle
G (3) Credits
A (4) Assets
I (5) Account

M2–2.

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

M2–3.

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

M2–4.

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

M2–5.

	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Cash	+20,000		Notes payable	+20,000			
b.	Cash Notes receivable	–7,000 +7,000						
c.	Cash	+1,000					Contributed capital	+1,000
d.	Cash Equipment	–6,000 +15,000		Notes payable	+9,000			
e.	Cash	–2,000					Retained earnings	–2,000

M2–6.

	Debit	**Credit**
Assets	*Increases*	*Decreases*
Liabilities	*Decreases*	*Increases*
Stockholders' equity	*Decreases*	*Increases*

M2–7.

	Increase	**Decrease**
Assets	*Debit*	*Credit*
Liabilities	*Credit*	*Debit*
Stockholders' equity	*Credit*	*Debit*

M2–8.

		Debit	Credit
a.	Cash (+A)	20,000	
	Notes Payable (+L)		20,000
b.	Notes Receivable (+A)	7,000	
	Cash (–A)		7,000
c.	Cash (+A)	1,000	
	Contributed Capital (+SE)		1,000
d.	Equipment (+A)	15,000	
	Cash (–A)		6,000
	Notes Payable (+L)		9,000
e.	Retained Earnings (–SE)	2,000	
	Cash (–A)		2,000

M2–9.

Cash

	Debit	Credit	
Beg.	800		
(a)	20,000	7,000	(b)
(c)	1,000	6,000	(d)
		2,000	(e)
	6,800		

Notes Receivable

	Debit	Credit
Beg.	900	
(b)	7,000	
	7,900	

Equipment

	Debit	Credit
Beg.	15,000	
(d)	15,000	
	30,000	

Notes Payable

Debit	Credit	
	2,700	Beg.
	20,000	(a)
	9,000	(d)
	31,700	

Contributed Capital

Debit	Credit	
	5,000	Beg.
	1,000	(c)
	6,000	

Retained Earnings

	Debit	Credit	
		9,000	Beg.
(e)	2,000		
		7,000	

M2–10.

Pitt Inc.
Balance Sheet
At January 31, 2012

Assets		***Liabilities***	
Current assets:		*Current liabilities:*	
Cash	$ 6,800	Notes payable	$ 31,700
Notes receivable	7,900	Total current liabilities	31,700
Total current assets	14,700	***Stockholders' Equity***	
		Contributed capital	6,000
Equipment	30,000	Retained earnings	7,000
		Total stockholders' equity	13,000
Total Assets	$44,700	***Total Liabilities & Stockholders' Equity***	$44,700

M2–11.

Current Ratio =

	Current Assets	÷	Current Liabilities		
2007	240,000	÷	160,000	=	1.50
2008	260,000	÷	220,000	=	1.18

This ratio indicates that Sal's Pizza has sufficient current assets to settle current liabilities, but that the ratio has also decreased between 2007 and 2008 by .32 (21%). Sal's Pizza's ratio is higher than Papa John's 2008 ratio (of .75), indicating that Sal's Pizza appears to have stronger liquidity than Papa John's. However, given its size, Papa John's is likely to have a strong cash management system that can keep current asset levels low.

M2–12.

(a) F

(b) I

(c) F

(d) I

(e) F

EXERCISES

E2–1.

E (1) Transaction
F (2) Continuity assumption
B (3) Balance sheet
P (4) Liabilities
K (5) Assets = Liabilities + Stockholders' Equity
M (6) Note payable
S (7) Conservatism
H (8) Historical cost principle
I (9) Account
Q (10) Dual effects
O (11) Retained earnings
A (12) Current assets
C (13) Separate-entity assumption
W (14) Reliability
D (15) Debits
J (16) Accounts receivable
N (17) Unit-of-measure assumption
U (18) Materiality
T (19) Relevance
R (20) Stockholders' Equity

E2–2.

Req. 1

	Received	Given
(a)	Cash (A)	Contributed capital (SE)
(b)	Equipment (A) *[or Delivery truck]*	Cash (A)
(c)	*No exchange transaction*	—
(d)	Equipment (A) *[or Computer equipment]*	Note payable (L)
(e)	Building (A) *[or Construction in progress]*	Cash (A)
(f)	Intangibles (A) *[or Copyright]*	Cash (A)
(g)	Retained earnings (SE) *[Received a reduction in the amount available for payment to stockholders]*	Cash (A)
(h)	Land (A)	Cash (A)
(i)	Intangibles (A) *[or Patents]*	Cash (A) and Note payable (L)
(j)	*No exchange transaction*	—
(k)	Investments (A)	Cash (A)
(l)	Cash (A)	Short-term note payable (L)
(m)	Note payable (L) *[Received a reduction in its promise to pay]*	Cash (A)

Req. 2
The truck in (b) would be recorded as an asset of $18,000. The land in (h) would be recorded as an asset of $50,000. These are applications of the historical cost principle.

Req. 3
The agreement in (c) involves no exchange or receipt of cash, goods, or services and thus is not a transaction. Since transaction (j) occurs between the owner and others, there is no effect on the business because of the separate-entity assumption.

E2–3.

	Account	***Balance Sheet Categorization***	***Debit or Credit Balance***
(1)	Accounts Receivable	CA	Debit
(2)	Retained Earnings	SE	Credit
(3)	Taxes Payable	CL	Credit
(4)	Prepaid Expenses	CA	Debit
(5)	Contributed Capital	SE	Credit
(6)	Long-Term Investments	NCA	Debit
(7)	Plant, Property, and Equipment	NCA	Debit
(8)	Accounts Payable	CL	Credit
(9)	Short-Term Investments	CA	Debit
(10)	Long-Term Debt	NCL	Credit

E2–4.

Event	**Assets**		**=**	**Liabilities**		**+**	**Stockholders' Equity**	
a.	Cash	+34,000					Contributed capital	+34,000
b.	Equipment	+8,000		Notes payable	+7,000			
	Cash	–1,000						
c.	Cash	+9,000		Notes payable	+9,000			
d.	Note receivable	+500						
	Cash	–500						
e.	Land	+15,000		Mortgage note payable	+11,000			
	Cash	–4,000						

E2–5.

Req. 1

Event	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Buildings	+212.0		Notes payable (long-term)	+199.2			
	Equipment	+30.4						
	Cash	– 43.2						
b.	Cash	+186.6					Contributed capital	+186.6
c.				Dividends payable	+121.4		Retained earnings	–121.4
d.	Short-term Investments	+2,908.7						
	Cash	– 2,908.7						
e.	No effects							
f.	Cash	+2,390.0						
	Short-term Investments	– 2,390.0						

Req. 2

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

E2–6.

		Debit	Credit
a.	Cash (+A)	34,000	
	Contributed capital (+SE)		34,000
b.	Equipment (+A)	8,000	
	Cash (–A)		1,000
	Notes payable (+L)		7,000
c.	Cash (+A)	9,000	
	Notes payable (+L)		9,000
d.	Notes receivable (+A)	500	
	Cash (–A)		500
e.	Land (+A)	15,000	
	Cash (–A)		4,000
	Mortgage notes payable (+L)		11,000

E2–7.

Req. 1

a.	Buildings (+A)	212.0	
	Equipment (+A)	30.4	
	Cash (–A)		43.2
	Note payable (+L)		199.2
b.	Cash (+A)	186.6	
	Contributed capital (+SE)		186.6
c.	Retained earnings (–SE)	121.4	
	Dividends payable (+L)		121.4
d.	Short-term investments (+A)	2,908.7	
	Cash (–A)		2,908.7
e.	No journal entry required.		
f.	Cash (+A)	2,390.0	
	Short-term investments (–A)		2,390.0

Req. 2

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

E2–8.

Req. 1

Cash

	Debit	Credit	
Beg.	0		
(a)	63,000	5,000	(b)
(d)	4,000	2,500	(e)
	59,500		

Note Receivable

	Debit	Credit	
Beg.	0		
(e)	2,500		
	2,500		

Equipment

	Debit	Credit	
Beg.	0		
(b)	20,000		
	20,000		

Land

	Debit	Credit	
Beg.	0		
(d)	13,000		
	13,000		

Note Payable

	Debit	Credit	
		0	Beg.
		15,000	(b)
		15,000	

Contributed Capital

	Debit	Credit	
		0	Beg.
		63,000	(a)
		17,000	(d)
		80,000	

Req. 2

Assets \$ 95,000 = Liabilities \$ 15,000 + Stockholders' Equity \$ 80,000

Req. 3

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

E2–9.

Req. 1

Transaction	***Brief Explanation***
1	Issued capital stock to shareholders for $15,000 cash. (FastTrack Sports Inc. is a corporation.)
2	Borrowed $75,000 cash and signed a short-term note for this amount.
3	Purchased land for $16,000; paid $5,000 cash and gave an $11,000 short-term note payable for the balance.
4	Loaned $4,000 cash; borrower signed a short-term note for this amount (Note Receivable).
5	Purchased store fixtures for $9,500 cash.
6	Purchased land for $4,000, paid for by signing a short-term note.

Req. 2

FastTrack Sports Inc.
Balance Sheet
At January 7, 2011

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$71,500	Note payable	$90,000
Note receivable	4,000	*Total Current Liabilities*	90,000
Total Current Assets	75,500		
Store fixtures	9,500	***Stockholders' Equity***	
Land	20,000	Contributed capital	15,000
		Total Stockholders' Equity	15,000
Total Assets	$105,000	***Total Liabilities & Stockholders' Equity***	$105,000

E2–10.

Req. 1

Transaction	***Brief Explanation***
1	Issued capital stock to shareholders for $50,000 cash.
2	Purchased a delivery truck for $30,000; paid $6,000 cash and gave a $24,000 long-term note payable for the balance.
3	Loaned $4,000 cash; borrower signed a short-term note for this amount.
4	Purchased short-term investments for $7,000 cash.
5	Sold short-term investments at cost for $2,000 cash.
6	Issued capital stock to shareholders for $4,000 of computer equipment.

Req. 2

Volz Cleaning, Inc.
Balance Sheet
At March 31, 2011

Assets		***Liabilities***	
Current Assets		Notes payable	$24,000
Cash	$35,000	*Total Liabilities*	24,000
Investments	5,000		
Note receivable	4,000		
Total Current Assets	44,000		
		Stockholders' Equity	
Computer equipment	4,000	Contributed capital	54,000
Delivery truck	30,000	*Total Stockholders' Equity*	54,000
Total Assets	$78,000	***Total Liabilities & Stockholders' Equity***	$78,000

E2–11.

a.	Cash (+A)	65,000	
	Contributed capital (+SE)		65,000
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Cash (+A)	10,000	
	Notes payable (long-term) (+L)		10,000
d.	Equipment (+A)	13,000	
	Cash (–A)		1,500
	Notes payable (short-term) (+L)		11,500
e.	Notes receivable (short-term) (+A)	1,000	
	Cash (–A)		1,000
f.	Store fixtures (+A)	20,000	
	Cash (–A)		20,000

E2–12.

a.	Retained earnings (–SE)	197	
	Dividends payable (+L)		197
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Dividends payable (–L)	694	
	Cash (–A)		694
d.	Cash (+A)	2,655	
	Notes payable (+L)		2,655
e.	Cash (+A)	285	
	Equipment (–A)		285
f.	Equipment (+A)	1,255	
	Cash (–A)		970
	Notes payable (+L)		285
g.	Investments (+A)	2,220	
	Cash (–A)		2,220

E2–13.

Req. 1

Assets $ 8,500 = Liabilities $ 2,500 + Stockholders' Equity $ 6,000

Req. 2

Cash

	Debit	Credit	
Beg.	4,000		
(a)	3,000		
(b)	1,000		
(c)	1,250	300	(d)
End.	8,950		

Short-Term Investments

	Debit	Credit	
Beg.	2,000		
		1,000	(b)
End.	1,000		

Property & Equipment

	Debit	Credit	
Beg.	2,500		
		1,250	(c)
End.	1,250		

Short-Term Notes Payable

	Debit	Credit	
		2,200	Beg.
		2,200	End.

Long-Term Notes Payable

	Debit	Credit	
		300	Beg.
		3,000	(a)
		3,300	End.

Contributed Capital

	Debit	Credit	
		4,000	Beg.
		4,000	End.

Retained Earnings

	Debit	Credit	
		2,000	Beg.
(d)	300		
		1,700	End.

Req. 3

Assets $ 11,200 = Liabilities $ 5,500 + Stockholders' Equity $ 5,700

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$8{,}950+\$1{,}000}{\$2{,}200} = \frac{\$9{,}950}{\$2{,}200} = 4.52$$

This ratio indicates that, for every $1 of current liabilities, Zeber maintains $4.52 of current assets. Zeber's ratio is higher than the industry average of 1.50, indicating that Zeber maintains a lower level of short-term debt and has higher liquidity. However, maintaining such a high current ratio also suggests that the company may not be using its resources efficiently. Increasing short-term obligations would lower Zeber's current ratio, but this strategy alone would not help its efficiency. Zeber should consider investing more of its cash in order to generate future returns.

E2–14.

Zeber Company
Balance Sheet
At December 31, 2012

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$ 8,950	Short-term notes payable	$ 2,000
Short-term investments	1,000	*Total Current Liabilities*	2,200
Total Current Assets	9,950	Long-term notes payable	3,300
		Total Liabilities	5,500
		Stockholders' Equity	
		Contributed capital	4,000
Property and equipment	1,250	Retained earnings	1,700
		Total Stockholders' Equity	5,700
		Total Liabilities &	
Total Assets	$11,200	***Stockholders' Equity***	$11,200

E2–15.

Req. 1

Cash

Beg.	0	
(a)	40,000	4,000 (c)
		1,000 (d)
	35,000	

Short-Term Notes Receivable

Beg.	0	
(e)	4,000	
	4,000	

Land

Beg.	0	
(b)	16,000	4,000 (e)
	12,000	

Equipment

Beg.	0	
(c)	20,000	
(d)	1,000	
	21,000	

Short-Term Notes Payable

	0 Beg.
	16,000 (b)
	16,000

Long-Term Notes Payable

	0 Beg.
	16,000 (c)
	16,000

Contributed Capital

	0 Beg.
	40,000 (a)
	40,000

E2–15. (continued)

Req. 2

Strauderman Delivery Company, Inc.
Balance Sheet
At December 31, 2011

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$35,000	Short-term notes payable	$16,000
Short-term note receivable	4,000	*Total Current Liabilities*	16,000
Total Current Assets	39,000	Long-term notes payable	16,000
		Total Liabilities	32,000
Land	12,000		
Equipment	21,000	***Stockholders' Equity***	
		Contributed capital	40,000
		Total Stockholders' Equity	40,000
Total Assets	$72,000	***Total Liabilities & Stockholders' Equity***	$72,000

Req. 3

2011:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$39{,}000}{\$16{,}000} = 2.44$$

2012:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$52{,}000}{\$23{,}000} = 2.26$$

2013:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$47{,}000}{\$40{,}000} = 1.18$$

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

Req. 4

The management of Strauderman Delivery Company has already been financing the company's development through additional short-term debt, from $16,000 in 2011 to $40,000 in 2013. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. Based solely on the current ratio, the bank's vice president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

E2–16.

Transaction	***Brief Explanation***
(a)	Issued capital stock to shareholders in exchange for $16,000 cash and $4,000 tools and equipment.
(b)	Loaned $1,500 cash; borrower signed a note receivable for this amount.
(c)	Purchased a building for $50,000; paid $10,000 cash and gave a $40,000 note payable for the balance.
(d)	Sold $800 of tools and equipment for their original cost.

E2–17.

Req. 1

	Increases with…	**Decreases with…**
Equipment	Purchases of equipment	Sales of equipment
Notes receivable	Additional loans to others	Collection of loans
Notes payable	Additional borrowings	Payments of debt

Req. 2

Equipment

	Debit	Credit
1/1	500	
	250	$\boxed{650}$
12/31	100	

Notes Receivable

	Debit	Credit
1/1	150	
	$\boxed{245}$	225
12/31	170	

Notes Payable

Debit	Credit	
	100	1/1
$\boxed{110}$	170	
	160	12/31

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

E2–18.

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

E2–19.

Starwood Hotels & Resorts Worldwide, Inc.
Partial Statement of Cash Flows
For the Year Ended December 31, 2012
(in millions)

Investing Activities	
Purchase of investments	$ (37)
Sale of assets and investments	359
Purchase and renovation of properties	(476)
Receipt of payment from note receivable	172
Cash flow from investing activities	18
Financing Activities	
Additional borrowing from banks	986
Issuance of stock	120
Payment of debt	(574)
Cash flow from financing activities	$ 532

E2–20.

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

PROBLEMS

P2–1.

		Balance Sheet Classification	Debit or Credit Balance
(1)	Notes and Loans Payable (short-term)	CL	Credit
(2)	Materials and Supplies	CA	Debit
(3)	Contributed Capital	SE	Credit
(4)	Patents (an intangible asset)	NCA	Debit
(5)	Income Taxes Payable	CL	Credit
(6)	Long-Term Debt	NCL	Credit
(7)	Marketable Securities (short-term)	CA	Debit
(8)	Property, Plant, and Equipment	NCA	Debit
(9)	Retained Earnings	SE	Credit
(10)	Notes and Accounts Receivable (short-term)	CA	Debit
(11)	Investments (long-term)	NCA	Debit
(12)	Cash and Cash Equivalents	CA	Debit
(13)	Accounts Payable	CL	Credit
(14)	Crude Oil Products and Merchandise	CA	Debit

P2–2.

Req. 1

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

Req. 2 (On next page)

Req. 3

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

Req. 4

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

(b) Total liabilities = \$100,000 + \$180,000
= \$280,000

(c) Total stockholders' equity = Total assets – Total liabilities
= \$870,000 – \$280,000 = \$590,000

(d) Cash balance = \$50,000 + \$90,000 – \$9,000 + \$3,500 – \$18,000 – \$5,000
= \$111,500

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

Req. 5

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

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

P2–2. (continued)

Req. 2

	Assets						=	Liabilities		+	Stockholders' Equity	
	Cash	**Short-Term Investments**	**Notes Receivable**	**Land**	**Buildings**	**Equipment**		**ST Notes Payable**	**LT Notes Payable**		**Contributed Capital**	**Retained Earnings**
Beg.	50,000			500,000	100,000	50,000	=	100,000	100,000		100,000	400,000
(a)	+90,000						=				+90,000	
(b)	–9,000			+14,000	+60,000	+15,000	=		+80,000			
(c)	+3,500			–3,500			=					
(d)	–18,000	+18,000					=					
(e)	No effect											
(f)	–5,000		+5,000				=					
	+111,500	+18,000	+5,000	+510,500	+160,000	+65,000	=	+100,000	+180,000		+190,000	+400,000

$870,000 $280,000 $590,000

P2–3.

Req. 1 and 2

Cash

Beg.	19,000	
(e)	12,000	9,000 (a)
(f)	12,000	7,000 (b)
(i)	1,000	6,000 (c)
		3,000 (g)
		9,000 (h)
End.	10,000	

Investments (short-term)

Beg.	2,000	
(a)	9,000	
End.	11,000	

Accounts Receivable

Beg.	3,000	
End.	3,000	

Inventory

Beg.	24,000	
End.	24,000	

Notes Receivable (long-term)

Beg.	1,000	
(b)	7,000	
End.	8,000	

Equipment

Beg.	48,000	
(c)	18,000	1,000 (i)
End.	65,000	

Factory Building

Beg.	90,000	
(h)	25,000	
End.	115,000	

Intangibles

Beg.	3,000	
(g)	3,000	
End.	6,000	

Accounts Payable

	15,000 Beg.
	15,000 End.

Accrued Liabilities Payable

	2,000 Beg.
	2,000 End.

Notes Payable (short-term)

	7,000 Beg.
	12,000 (c)
	12,000 (f)
	31,000 End.

Long-Term Notes Payable

	46,000 Beg.
	16,000 (h)
	62,000 End.

Contributed Capital

	90,000 Beg.
	12,000 (e)
	102,000 End.

Retained Earnings

	30,000 Beg.
	30,000 End.

P2–3. (continued)

Req. 3

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

Req. 4

Cougar Plastics Company
Balance Sheet
At December 31, 2012

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$ 10,000	Accounts payable	$ 15,000
Investments	11,000	Accrued liabilities payable	2,000
Accounts receivable	3,000	Notes payable	31,000
Inventory	24,000	*Total Current Liabilities*	48,000
Total Current Assets	48,000	Long-term notes payable	62,000
		Total Liabilities	110,000
Notes receivable	8,000		
Equipment	65,000	***Stockholders' Equity***	
Factory building	115,000	Contributed capital	102,000
Intangibles	6,000	Retained earnings	30,000
		Total Stockholders' Equity	132,000
Total Assets	$242,000	***Total Liabilities & Stockholders' Equity***	$242,000

Req. 5

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

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

P2–4.

Transaction	Type of Activity	Effect on Cash
(a)	I	–
(b)	I	–
(c)	I	–
(d)	NE	NE
(e)	F	+
(f)	F	+
(g)	I	–
(h)	I	–
(i)	I	+

P2–5.

Req. 1

a.	Cash (+A)	30	
	Long-term liabilities (+L)		30
b.	Receivables and other assets (+A)	250	
	Cash (–A)		250
c.	Long-term investments (+A)	2,600	
	Short-term investments (+A)	10,400	
	Cash (–A)		13,000
d.	Property, plant, and equipment (+A)	2,285	
	Cash (–A)		875
	Long-term liabilities (+L)		1,410
e.	Cash (+A)	200	
	Contributed capital (+SE)		200
f.	Cash (+A)	10,000	
	Short-term investments (–A)		10,000
g.	Retained earnings (–SE)	52	
	Cash (–A)		52

P2–5. (continued)

Req. 2

Cash

Beg.	8,352		
(a)	30	250	(b)
(e)	200	13,000	(c)
(f)	10,000	875	(d)
		52	(g)
	4,405		

Short-Term Investments

Beg.	740		
(c)	10,400	10,000	(f)
	1,140		

Receivables and Other Assets

Beg.	6,443	
(b)	250	
	6,693	

Inventories

Beg.	867	
	867	

Other Current Assets

Beg.	3,749	
	3,749	

Property, Plant, and Equipment

Beg.	2,277	
(d)	2,285	
	4,562	

Long-Term Investments

Beg.	454	
(c)	2,600	
	3,054	

Other Noncurrent Assets

Beg.	3,618	
	3,618	

Accounts Payable

	8,309	Beg.
	8,309	

Other Short-term Obligations

	6,550	Beg.
	6,550	

Long-Term Liabilities

	7,370	Beg.
	30	(a)
	1,410	(d)
	8,810	

Contributed Capital

	11,189	
	200	(e)
	11,389	

Other Stockholders' Equity Items

Beg.	27,904	
	27,904	

Retained Earnings

		20,986	Beg.
(g)	52		
		20,934	

P2–5. (continued)

Req. 3

Dell, Inc.
Balance Sheet
At January 29, 2010
(in millions)

ASSETS	
Current Assets	
Cash	$ 4,405
Short-term investments	1,140
Receivables and other assets	6,693
Inventories	867
Other current assets	3,749
	16,854
Noncurrent Assets	
Property, plant and equipment	4,562
Long-term investments	3,054
Other noncurrent assets	3,618
Total assets	**$28,088**
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 8,309
Other short-term obligations	6,550
	14,859
Long-term Liabilities	**8,810**
Stockholders' Equity	
Contributed capital	11,389
Retained earnings	20,934
Other stockholders' equity items	(27,904)
Total liabilities and stockholders' equity	**$28,088**

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$16{,}854}{\$14{,}859} = 1.13$$

For every $1 of short-term liabilities, Dell has $1.13 of current assets. This low current ratio suggests that Dell is using its resources efficiently and has sufficient liquidity.

P2–6.

Dell, Inc.
Partial Statement of Cash Flows
For the Year Ended January 29, 2010
(in millions of dollars)

INVESTING ACTIVITIES	
Purchase of property, plant, and equipment	$ (875)
Purchase of investments	(13,000)
Loan of funds to affiliates	(250)
Sale of investments	10,000
Cash flow used in investing activities	**(4,125)**
FINANCING ACTIVITIES	
Borrowings	30
Issuance of stock	200
Payment of dividends	(52)
Cash flow provided by financing activities	**178**
Net change in cash	(3,947)
Beginning balance of cash	8,352
Cash balance on January 29, 2010	**$ 4,405**

ALTERNATE PROBLEMS

AP2–1.

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

AP2–2.

Req. 1

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

Req. 2 (On next page)

Req. 3

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

Req. 4

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

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

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

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

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

Req. 5

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

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

AP2–2. (continued)

Req. 2

	Assets					=	Liabilities		+	Stockholders' Equity	
	Cash	**Notes Receivable**	**Long-Term Investments**	**Equipment**	**Building**		**Short-Term Notes Payable**	**Long-Term Notes Payable**		**Contributed Capital**	**Retained Earnings**
Beg.	120,000			70,000	310,000	=	140,000	60,000		220,000	80,000
(a)	+110,000					=		+110,000			
(b)	–3,000			+30,000		=	+27,000				
(c)	+100,000					=				+100,000	
(d)	–5,000			+10,000		=	+5,000				
(e)	–2,000	+2,000				=					
(f)	–200,000				+200,000	=					
(g)	–85,000		+85,000			=					
(h)				–3,000		=	–3,000				
(i)	No effect					=					
	+35,000	+2,000	+85,000	+107,000	+510,000	=	+169,000	+170,000		+320,000	+80,000
	$739,000						$339,000			$400,000	

AP2–3.

Req. 1 and 2

Cash and Cash Equivalents

	Debit	Credit	
Beg.	74,376		
(a)	1,020	3,400	(b)
(d)	4,020	2,980	(e)
(g)	310	1,830	(f)
		300	(h)
	71,216		

Short-Term Investments

	Debit	Credit	
Beg.	0		
(e)	2,980		
	2,980		

Accounts Receivable

	Debit	Credit	
Beg.	12,672		
	12,672		

Inventories

	Debit	Credit	
Beg.	186,265		
	186,265		

Prepaid Expenses and Other Current Assets

	Debit	Credit	
Beg.	36,865		
	36,865		

Property, Plant, and Equipment

	Debit	Credit	
Beg.	350,432		
(f)	11,230	4,020	(d)
	357,642		

Intangibles

	Debit	Credit	
Beg.	96,823		
(b)	3,400		
	100,223		

Other Assets

	Debit	Credit	
Beg.	4,540		
		310	(g)
	4,230		

Accounts Payable

	Debit	Credit	
		26,444	Beg.
		26,444	

Accrued Expenses Payable

	Debit	Credit	
		109,017	Beg.
		109,017	

Long-Term Debt*

	Debit	Credit	
		203,029	Beg.
		9,400	(f)
		212,429	

Other Long-Term Liabilities

	Debit	Credit	
		47,710	Beg.
		47,710	

Contributed Capital

	Debit	Credit	
		21,048	Beg.
		1,020	(a)
		22,068	

* Current portion is $41.

Retained Earnings

	Debit	Credit	
		354,725	Beg.
(h)	300		
		354,425	

Req. 3

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

AP2–3. (continued)

Req. 4

Ethan Allen Interiors, Inc.
Balance Sheet
At September 30, 2008
(in thousands of dollars)

Assets	
Current assets	
Cash and cash equivalents	$ 71,216
Short-term investments	2,980
Accounts receivable	12,672
Inventories	186,265
Prepaid expenses and other current assets	36,865
Total current assets	309,998
Property, plant, and equipment	357,642
Intangibles	100,223
Other assets	4,230
Total Assets	$772,093
Liabilities	
Current liabilities	
Accounts payable	$ 26,444
Accrued expenses payable	109,017
Current portion of long-term debt	41
Total current liabilities	135,502
Long-term debt	212,388
Other long-term liabilities	47,710
Total Liabilities	395,600
Stockholders' Equity	
Contributed capital	22,068
Retained earnings	354,425
Total Stockholders' Equity	376,493
Total Liabilities and Stockholders' Equity	$772,093

Req. 5

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}} = \frac{\$309,998}{\$135,502} = 2.29$$

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

AP2–4.

Transaction	Type of Activity	Effect on Cash
(a)	F	+
(b)	I	–
(c)	NE	NE
(d)	I	+
(e)	I	–
(f)	I	–
(g)	I	+
(h)	F	–

CASES AND PROJECTS

ANNUAL REPORT CASES

CP2–1.

1. The company is a corporation since it maintains share capital and its owners are referred to as "shareholders." (Refer to the stockholders' equity section of the balance sheet).

2. The amount listed on the balance sheet for inventories does not represent the expected selling price. It represents the historical cost of acquiring the inventory, as required by the cost principle.

3. The company's current obligations include: accounts payable, notes payable, accrued compensation and payroll taxes, accrued rent, accrued income and other taxes, unredeemed stored value cards and gift certificates, current portion of deferred lease credits, and other liabilities and accrued expenses.

4 Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{\$925{,}359}{\$401{,}763} = 2.30$

The current ratio measures the ability of the company to settle short-term obligations with current assets. American Eagle Outfitters' current ratio of 2.30 suggests strong liquidity with \$2.30 in current assets for every \$1 in current liabilities. In the most recent year presented, the company had a significant amount of cash primarily from selling short-term investments. Given the poor economic environment beginning in 2008 with a downturn in the financial markets, maintaining a cash position may be an investing strategy.

5. The company spent \$265,335,000 on purchasing property and equipment in the year ended 1/31/09; \$250,407,000 in the year ended 2/2/08; and \$225,939,000 in the year ended 2/3/07. This information is listed as Capital Expenditures on the Statement of Cash Flows in the investing activities section.

CP2–2.

1.

Assets	=	Liabilities	+	Shareholders' Equity
$1,329,009,000	=	$275,234,000	+	$1,053,775,000

2. No – shareholders' equity is a residual balance, meaning that the shareholders will receive what remains in cash and assets after the creditors have been satisfied. It is likely that shareholders would receive less than $1,053,775,000. In addition, nearly all assets on the balance sheet are not stated at market value, only historical cost.

3. The company's only noncurrent liability is Deferred Rent and Other Liabilities.

4. $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$624,402,000}{\$141,150,000} = 4.42$$

5. The company had a net cash outflow from investing activities of $56,907,000, primarily because of capital expenditures (the purchase of property and equipment for $112,553,000). The company also purchased marketable securities (investments) for $809,039,000, nearly equivalent to the amount of marketable securities that were sold or matured during the year ($864,685,000).

CP2–3.

1.	Industry Average	American Eagle Outfitters	Urban Outfitters
Current Ratio =	2.55	2.30	4.42

American Eagle Outfitters' current ratio of 2.30 is slightly lower than the industry average, but Urban Outfitters' current ratio of 4.42 is significantly higher than the industry average of 2.55. For the year ended January 31, 2009, Urban Outfitters tripled its amount of cash from the prior year while maintaining similar balances in the remaining current assets. This suggests that Urban Outfitters chose to respond to the poor economic environment beginning in 2008 by maintaining a strong cash position.

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

2. As indicated in the financing activities section of each company's statement of cash flows, during the most recent year, American Eagle Outfitters spent $3,432,000 repurchasing common stock from employees with no repurchases from investors. This was a dramatic shift from prior years. Urban Outfitters did not repurchase shares of common stock in the current or prior years.

3. As indicated the statement of cash flows, American Eagle Outfitters paid $82,394,000 in dividends. Urban Outfitters did not pay any dividends during the year. Refer to the financing activities section of the statement of cash flows.

4. American Eagle reports "Property and equipment, at cost, net of accumulated depreciation and amortization" and Urban Outfitters reports "Property and equipment, net." Details of the amount of land, building, and equipment are reported by each in the notes to the financial statements. Other companies sometimes choose to report these assets separately on the balance sheet, for example in accounts such as: "Land," "Buildings and building improvements," Furniture, fixtures and equipment," and "Rental property and equipment."

FINANCIAL REPORTING AND ANALYSIS CASES

CP2–4.

1. (a) Papa John's total assets reported at March 29, 2009 are $387,861,000.

   (b) Long-term debt including the current portion due decreased over three months from $130,654,000 ($123,579,000 long-term + $7,075,000 current portion) at December 28, 2008, to $111,525,000 ($103,075,000 long-term + $8,450,000 current portion) on March 29, 2009.

   (c) $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$80,351,000}{\$102,065,000} = .79$$

   Papa John's current ratio increased from the level of .75 as discussed in the chapter. This indicates that, between December 28, 2008, and March 29, 2009, Papa John's increased its liquidity slightly. Current assets increased by approximately $5 million while current liabilities increased by only $2 million. Cash and cash equivalents increased the most (over $7 million). Given the difficult economic environment that continued through 2009, Papa John's appeared to increase its cash balance as an added cushion.

2. (a) For the three months ended March 29, 2009, Papa John's spent $5,064,000 on the purchase of property and equipment, its largest use of cash for investing activities.

   (b) The total cash flows used in financing activities was $17,447,000, mostly from the repayment of debt and the repurchase of its common stock.

CP2–5.

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

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

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

CP2–6.

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

2.

Assets	=	Liabilities	+	Stockholders’ Equity	(in millions)
$26,500	=	$22,229	+	$4,271	

3. Current Ratio = $\dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{\$20,151}{\$14,859} = 1.36$ (dollars in millions)

   For every $1 of current liabilities, Dell maintains $1.36 of current assets, suggesting that Dell has the ability to pay its short-term obligations with current assets in the upcoming year. The interpretation of this ratio would be more useful given information on the company’s current ratio over time and on the typical current ratio for the computer industry.

4.

Accounts Payable (–L)	8,309 million	
Cash (–A)		8,309 million

5. Over its years in business, it appears that Dell has been profitable, based on a positive amount in Retained Earnings of $20,677,000,000. The Retained Earnings account represents the cumulative earnings of the firm less any dividends paid to the shareholders since the business began.

   In addition, Dell appears profitable in the most recent year because Retained Earnings increased. It is possible to determine the amount of net income by using the following equation, assuming no dividends were declared:
   (in millions)

Beg.		For the Year				End.
Retained Earnings	+	Net Income	–	Dividends declared	=	Retained Earnings
$18,199	+	?	–	$ 0	=	$20,677

   Thus, net income for the most recent year was $2,478,000,000.

CRITICAL THINKING CASES

CP2–7.

Req. 1

Dewey, Cheetum, and Howe, Inc.
Balance Sheet
December 31, 2012

Assets	
Current Assets:	
Cash	$ 1,000
Accounts receivable	8,000
Inventory	8,000
Total current assets	17,000
Furniture and fixtures	52,000
Delivery truck (net)	12,000
Buildings (net)	60,000
Total assets	$141,000
Liabilities	
Current Liabilities:	
Accounts payable	$ 16,000
Payroll taxes payable	13,000
Total current liabilities	29,000
Notes payable (due in three years)	15,000
Mortgage payable	50,000
Total liabilities	94,000
Stockholders' Equity	
Contributed capital	80,000
Accumulated deficit	(33,000)
Total stockholders' equity	47,000
Total liabilities and stockholders' equity	$141,000

CP2–7. (continued)

Req. 2

Dear ___________,

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

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

CP2–8.

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

   Those who were helped by the fraud included the former executives who were able to receive substantial bonuses based on the inflated results of operations. The SEC also charged two individuals with insider trading for trading on a tip illegally.

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

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

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

CP2–9.

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