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.

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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 financial leverage ratio is computed as average total assets divided by average stockholders' equity (where "average" is the average of the beginning and ending balances for the year). It measures the relation between total assets and the stockholders' capital that finances them. The higher the ratio, the more debt has been assumed by the company to finance its assets.

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. a
3. d	8. d
4. a	9. b
5. d	10. a

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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	20
6	3	6	10	6	20			6	15
7	3	7	10					7	20
8	6	8	15					8	25
9	6	9	20					9	30
10	6	10	20					10	20
11	4	11	15					11	*
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) N
(6) Y

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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)	Note 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.

Bandera Inc.
Balance Sheet
At January 31, 2011

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.

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$240{,}000+\$280{,}000)\ /\ 2}{(\$140{,}000+\$160{,}000)\ /\ 2} = \frac{\$260{,}000}{\$150{,}000} = 1.73$$

This ratio indicates that, for every $1 of equity investment, Sal's Pizza maintains $1.73 of assets. Sal's Pizza's ratio is lower than Papa John's 2006 ratio (of 2.37), indicating that Sal's Pizza maintains a lower debt level and follows a less risky financing strategy than does Papa John's.

M2–12. (a) F

(b) I

(c) F

(d) I

(e) F

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EXERCISES

E2–1.

E	(1)	Transaction
F	(2)	Continuity assumption
B	(3)	Balance sheet
P	(4)	Liabilities
K	(5)	Assets = Liabilities + Stockholders' Equity
H	(6)	Historical cost principle
M	(7)	Note payable
O	(8)	Dual effects
N	(9)	Retained earnings
D	(10)	Debits
C	(11)	Separate-entity assumption
A	(12)	Current assets
J	(13)	Accounts receivable
Q	(14)	Unit-of-measure assumption
I	(15)	Account

E2–2.

Req. 1

	Received	**Given**
(a)	Equipment (A) *[or Computer equipment]*	Note payable (L)
(b)	Equipment (A) *[or Delivery truck]*	Cash (A)
(c)	*No exchange transaction*	—
(d)	Cash (A)	Contributed capital (SE)
(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)	Investments (A)	Cash (A)
(i)	Land (A)	Cash (A)
(j)	Intangibles (A) *[or Patents]*	Cash (A) and Note payable (L)
(k)	*No exchange transaction*	—
(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 $21,000. The land in (i) would be recorded as an asset of $50,000. These are applications of the 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 (k) 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)	Land	NCA	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)	Machinery and Equipment	NCA	Debit
(8)	Accounts Payable	CL	Credit
(9)	Short-term Investments	CA	Debit
(10)	Notes Payable (due in 3 yrs)	NCL	Credit

E2–4.

Event	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Cash	+24,000					Contributed capital	+24,000
b.	Equipment	+8,000		Notes payable	+7,000			
	Cash	–1,000						
c.	Note receivable	+500						
	Cash	–500						
d.	Cash	+7,000		Notes payable	+7,000			
e.	Land	+15,000		Mortgage note payable	+11,000			
	Cash	–4,000						

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E2–5.

Req. 1

Event	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Buildings	+182.0		Notes payable (long-term)	+155.8			
	Equipment	+21.9						
	Cash	– 48.1						
b.	Cash	+253.6					Contributed capital	+253.6
c.				Dividends payable	+179.2		Retained earnings	–179.2
d.	Investments (short-term)	+400.8						
	Cash	– 400.8						
e.	No effects							
f.	Cash	+1.4						
	Short-term Investments	–1.4						

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)	24,000	
	Contributed capital (+SE)		24,000
b.	Equipment (+A)	8,000	
	Cash (–A)		1,000
	Notes payable (+L)		7,000
c.	Notes receivable (+A)	500	
	Cash (–A)		500
d.	Cash (+A)	7,000	
	Notes payable (+L)		7,000
e.	Land (+A)	15,000	
	Cash (–A)		4,000
	Mortgage notes payable (+L)		11,000

E2–7.

Req. 1

a.	Buildings (+A)	182.0	
	Equipment (+A)	21.9	
	Cash (–A)		48.1
	Note payable (+L)		155.8
b.	Cash (+A)	253.6	
	Contributed capital (+SE)		253.6
c.	Retained earnings (–SE)	179.2	
	Dividends payable (+L)		179.2
d.	Investments (+A)	400.8	
	Cash (–A)		400.8
e.	No journal entry required.		
f.	Cash (+A)	1.4	
	Investments (–A)		1.4

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	4,000 (d)
(c)	4,000	2,200 (e)
	60,800	

Note Receivable

	Debit	Credit
Beg.	0	
(e)	2,200	
	2,200	

Equipment

	Debit	Credit
Beg.	0	
(d)	16,000	
	16,000	

Land

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

Note Payable

Debit	Credit
	0 Beg.
	12,000 (d)
	12,000

Contributed Capital

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

Req. 2

Assets $ 92,000 = Liabilities $ 12,000 + Stockholders' Equity $ 80,000

Req. 3

The agreement in (b) 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.

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E2–9.

Req. 1

Transaction	***Brief Explanation***
1	Issued capital stock to shareholders for $16,000 cash. (Cirba Sports Inc. is a corporation.)
2	Borrowed $70,000 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 $9,000 cash.
6	Purchased land for $4,000, paid for by signing a short-term note.

Req. 2

Cirba Sports Inc.
Balance Sheet
At January 7, 2011

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$68,000	Note payable	$85,000
Note receivable	4,000	*Total Current Liabilities*	85,000
Total Current Assets	72,000		
Store fixtures	9,000	***Stockholders' Equity***	
Land	20,000	Contributed capital	16,000
		Total Stockholders' Equity	16,000
Total Assets	$101,000	***Total Liabilities & Stockholders' Equity***	$101,000

E2–10.

Req. 1

Transaction	***Brief Explanation***
1	Issued capital stock to shareholders for $60,000 cash.
2	Purchased a delivery truck for $30,000; paid $4,000 cash and gave a $26,000 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

Clifford's Cleaning, Inc.
Balance Sheet
At March 31, 2010

Assets		***Liabilities***	
Current Assets		Notes payable	$26,000
Cash	$47,000	*Total Liabilities*	26,000
Investments	5,000		
Notes receivable	4,000		
Total Current Assets	56,000		
		Stockholders' Equity	
Computer equipment	4,000	Contributed capital	64,000
Delivery truck	30,000	*Total Stockholders' Equity*	64,000
Total Assets	$90,000	***Total Liabilities & Stockholders' Equity***	$90,000

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E2–11.

a.	Cash (+A)	60,000	
	Contributed capital (+SE)		60,000
b.	Cash (+A)	10,000	
	Notes payable (long-term) (+L)		10,000
c.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
d.	Equipment (+A)	12,000	
	Cash (–A)		1,500
	Notes payable (short-term) (+L)		10,500
e.	Store fixtures (+A)	20,000	
	Cash (–A)		20,000
f.	Notes receivable (short-term) (+A)	1,000	
	Cash (–A)		1,000

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E2–12.

a.	Retained earnings (–SE)	532	
	Dividends payable (+L)		532
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Dividends payable (–L)	419	
	Cash (–A)		419
d.	Cash (+A)	3,956	
	Notes payable (+L)		3,956
e.	Cash (+A)	2,677	
	Equipment (–A)		2,677
f.	Equipment (+A)	12,890	
	Cash (–A)		9,870
	Notes payable (+L)		3,020
g.	Investments (+A)	2,654	
	Cash (–A)		2,654

E2–13.

Req. 1
Assets $ 7,500 = Liabilities $ 500 + Stockholders' Equity $ 7,000

Req. 2

Cash

Beg.	3,000		
(a)	2,000		
(b)	1,000		
(c)	1,250	300	(d)
End.	6,950		

Short-Term Investments

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

Property & Equipment

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

Short-Term Notes Payable

		200	Beg.
		200	End.

Long-Term Notes Payable

		300	Beg.
		2,000	(a)
		2,300	End.

Contributed Capital

		5,000	Beg.
		5,000	End.

Retained Earnings

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

Req. 3
Assets $ 9,200 = Liabilities $ 2,500 + Stockholders' Equity $ 6,700

Req. 4

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$7{,}500+\$9{,}200)\ /\ 2}{(\$7{,}000+\$6{,}700)\ /\ 2} = \frac{\$8{,}350}{\$6{,}850} = 1.22$$

This ratio indicates that, for every $1 of equity investment, Massimo maintains $1.22 of assets. Massimo's ratio is lower than the industry average of 2.00, indicating that Massimo maintains a lower debt level and follows a less risky financing strategy than does the average firm in the industry. As such, Massimo can finance expansion by borrowing without taking on excessive debt compared to the industry average.

E2–14.

Massimo Company
Balance Sheet
At December 31, 2011

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$ 6,950	Short-term notes payable	$ 200
Short-term investments	1,000	*Total Current Liabilities*	200
Total Current Assets	7,950	Long-term notes payable	2,300
		Total Liabilities	2,500
		Stockholders' Equity	
		Contributed capital	5,000
Property and equipment	1,250	Retained earnings	1,700
		Total Stockholders' Equity	6,700
		Total Liabilities &	
Total Assets	$9,200	***Stockholders' Equity***	$9,200

E2–15.

Req. 1

Cash

	Debit	Credit
Beg.	0	
(a)	40,000	4,000 (c)
		1,000 (e)
	35,000	

Short-Term Note Receivable

	Debit	Credit
Beg.	0	
(d)	3,000	
	3,000	

Land

	Debit	Credit
Beg.	0	
(b)	12,000	3,000 (d)
	9,000	

Equipment

	Debit	Credit
Beg.	0	
(c)	20,000	
(e)	1,000	
	21,000	

Short-Term Notes Payable

Debit	Credit
	0 Beg.
	12,000 (b)
	12,000

Long-Term Notes Payable

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

Contributed Capital

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

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E2–15. (continued)

Req. 2

Chu Delivery Company, Inc.
Balance Sheet
At December 31, 2010

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$35,000	Short-term notes payable	$12,000
Short-term note receivable	3,000	*Total Current Liabilities*	12,000
Total Current Assets	38,000	Long-term notes payable	16,000
		Total Liabilities	28,000
Land	9,000		
Equipment	21,000	***Stockholders' Equity***	
		Contributed capital	40,000
		Total Stockholders' Equity	40,000
Total Assets	$68,000	***Total Liabilities & Stockholders' Equity***	$68,000

Req. 3

2011:

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$68{,}000+\$90{,}000)\ /\ 2}{(\$40{,}000+\$50{,}000)\ /\ 2} = \frac{\$79{,}000}{\$45{,}000} = 1.76$$

2012:

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$90{,}000+\$120{,}000)\ /\ 2}{(\$50{,}000+\$60{,}000)\ /\ 2} = \frac{\$105{,}000}{\$55{,}000} = 1.91$$

The financial leverage ratio has increased over the years. This suggests that the company has been taking on additional risk through debt financing.

Req. 4

The management of Chu Delivery Services has already been financing the company's development through debt (as evidenced by the increasing leverage ratio). This suggests the company is taking on increasing risk. Based solely on the financial leverage 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 for $17,000 cash and $3,000 tools and equipment.
(b)	Purchased a building for $50,000; paid $10,000 cash and gave a $40,000 note payable for the balance.
(c)	Loaned $1,500 cash; borrower signed a note receivable for this amount.
(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

1/1	500	
	250	$\boxed{700}$
12/31	50	

Notes Receivable

1/1	150	
	$\boxed{225}$	225
12/31	150	

Notes Payable

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

	Beginning balance	+	"+"	–	"–"	=	Ending balance
Equipment	$500	+	250	–	?	=	$50
					?	=	700
Notes receivable	150	+	?	–	225	=	150
					?	=	225
Notes payable	100	+	170	–	?	=	160
					?	=	110

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E2–18.

Activity	Type of Activity	Effect on Cash
(a) Reduction of long-term debt	F	–
(b) Sale of land	I	+
(c) Issuance of common stock	F	+
(d) Capital expenditures	I	–
(e) Issuance of short-term debt	F	+

E2–19.

Hilton Hotels Corporation
Partial Statement of Cash Flows
For the year ended December 31, 2011

Investing Activities	
Purchase of investments	$(139)
Purchase and renovation of properties	(370)
Sale of property	230
Receipt of payment from note receivable	125
Cash flow from investing activities	(154)
Financing Activities	
Additional borrowing from banks	992
Payment of debt	(24)
Issuance of stock	6
Cash flow from financing activities	974

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

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P2–2.

Req. 1

Cornell 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 Cornell did in transaction (a).

Req. 2 (On next page)

Req. 3

The transaction between the two stockholders (Event *d*) was not included in the tabulation. Since the transaction in *(d)* 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 = \$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 – \$18,000 – \$5,000 + \$3,500
= \$111,500

(e) Total current assets = \$111,500 + \$18,000 + \$5,000 = \$134,500

Req. 5

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$700{,}000+\$870{,}000)\ /\ 2}{(\$500{,}000+\$590{,}000)\ /\ 2} = \frac{\$785{,}000}{\$545{,}000} = 1.44$$

This suggests that Cornell uses significantly more equity than debt to finance the company's assets.

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P2–2. (continued)

Req. 2

	Assets						=	Liabilities	+	Stockholders' Equity	
	Cash	Short-term Investments	Notes Receivable	Land	Building	Equipment		Notes Payable		Contributed Capital	Retained Earnings
Beg.	50,000			500,000	100,000	50,000	=	200,000		100,000	400,000
(a)	+90,000						=			+90,000	
(b)	–9,000			+14,000	+60,000	+15,000	=	+80,000			
(c)	–18,000	+18,000					=				
(d)	No effect										
(e)	–5,000		+5,000				=				
(f)	+3,500			–3,500			=				
	+111,500	+18,000	+5,000	+510,500	+160,000	+65,000	=	+280,000		+190,000	+400,000

$\underbrace{\text{Assets}}_{\$870{,}000}$ $\quad$ $\underbrace{\text{Notes Payable}}_{\$280{,}000}$ $\quad$ $\underbrace{\text{Contributed Capital + Retained Earnings}}_{\$590{,}000}$

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P2–3.

Req. 1 and 2

Cash

Beg.	21,000		
(c)	12,000	7,000	(a)
(d)	12,000	6,000	(b)
(h)	1,000	9,000	(e)
		3,000	(g)
		9,000	(i)
End.	12,000		

Investments (short-term)

Beg.	2,000		
(e)	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		
(a)	7,000		
End.	8,000		

Equipment

Beg.	48,000		
(b)	18,000	1,000	(h)
End.	65,000		

Factory Building

Beg.	90,000		
(i)	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	(b)
		12,000	(d)
		31,000	End.

Long-Term Notes Payable

		48,000	Beg.
		16,000	(i)
		64,000	End.

Contributed Capital

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

Retained Earnings

		30,000	Beg.
		30,000	End.

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P2–3. (continued)

Req. 3

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

Req. 4

Injection Plastics Company
Balance Sheet
At December 31, 2011

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$ 12,000	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	50,000	Long-term notes payable	64,000
		Total Liabilities	112,000
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	$244,000	***Total Liabilities & Stockholders' Equity***	$244,000

Req. 5

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$192{,}000+\$244{,}000) / 2}{(\$120{,}000+\$132{,}000) / 2} = \frac{\$218{,}000}{\$126{,}000} = 1.73$$

This ratio indicates that, for every $1 of equity investment, Injection Plastics maintains $1.73 of assets, with the additional $0.73 of assets financed by debt. The company utilizes more equity than debt to finance assets.

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P2–4.

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

P2–5.

Req. 1

a.	Cash (+A)	200	
	Contributed capital (+SE)		200
b.	Cash (+A)	30	
	Long-term liabilities (+L)		30
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.	Receivables and other assets (+A)	250	
	Cash (–A)		250
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

	Debit	Credit	
Beg.	7,042		
(a)	200		
(b)	30	13,000	(c)
(f)	10,000	875	(d)
		250	(e)
		52	(g)
	3,095		

Short-term Investments

	Debit	Credit	
Beg.	2,016		
(c)	10,400	10,000	(f)
	2,416		

Receivables and Other Assets

	Debit	Credit
Beg.	5,452	
(e)	250	
	5,702	

Inventories

	Debit	Credit
Beg.	576	
	576	

Other Current Assets

	Debit	Credit
Beg.	2,620	
	2,620	

Property, Plant and Equipment

	Debit	Credit
Beg.	2,005	
(d)	2,285	
	4,290	

Long-term Investments

	Debit	Credit
Beg.	2,691	
(c)	2,600	
	5,291	

Other Noncurrent Assets

	Debit	Credit
Beg.	707	
	707	

Accounts Payable

Debit	Credit	
	9,840	Beg.
	9,840	

Other Short-term Obligations

Debit	Credit	
	6,087	Beg.
	6,087	

Long-term Liabilities

Debit	Credit	
	3,053	Beg.
	30	(b)
	1,410	(d)
	4,493	

Contributed Capital

Debit	Credit	
	284	Beg.
	200	(a)
	484	

Retained Earnings

	Debit	Credit	
		3,845	Beg.
(g)	52		
		3,793	

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P2–5. (continued)

Req. 3

Dell, Inc.
Balance Sheet
At January 28, 2007
(in millions)

ASSETS	
Current Assets	
Cash	$ 3,095
Short-term investments	2,416
Receivables and other assets	5,702
Inventories	576
Other current assets	2,620
	14,409
Noncurrent Assets	
Property, plant and equipment	4,290
Long-term investments	5,291
Other noncurrent assets	707
Total assets	**$24,697**
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 9,840
Other short-term obligations	6,087
	15,927
Long-term Liabilities	**4,493**
Stockholders' Equity	
Contributed capital	484
Retained earnings	3,793
Total liabilities and stockholders' equity	**$24,697**

Req. 4

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$23{,}109+\$24{,}697)\ /\ 2}{(\$4{,}129+\$4{,}277)\ /\ 2} = \frac{\$23{,}903}{\$4{,}203} = 5.69$$

For every $1 of equity investment, Dell utilizes $4.69 of debt to finance its assets. Dell uses more than four times as much debt as equity financing.

P2–6.

Dell, Inc.
Partial Statement of Cash Flows
For the year ended January 28, 2007
(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	7,042
Cash balance on January 28, 2007	**$ 3,095**

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ALTERNATE PROBLEMS

AP2–1.

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

AP2–2.

Req. 1

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

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 = $45,000 + $2,000 + $85,000 + $107,000 + $510,000 = $749,000

(b) Total liabilities = $169,000 + $180,000 = $349,000

(c) Total stockholders' equity = Total assets – Total liabilities
= $749,000 – $349,000 = $400,000

(d) Cash balance = $120,000 – $3,000 + $100,000 + $120,000 – $5,000 – $200,000 – $85,000– $2,000 = $45,000

(e) Total current assets = $45,000 + $2,000 = $47,000

Req. 5

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$500{,}000+\$749{,}000) / 2}{(\$300{,}000+\$400{,}000) / 2} = \frac{\$624{,}500}{\$350{,}000} = 1.78$$

This suggests that Kalman uses slightly less debt than equity to finance the company's assets. For every $1 of equity, there is $.78 of debt utilized in financing.

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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)	–3,000			+30,000		=	+27,000				
(b)	+100,000					=				+100,000	
(c)	+120,000					=		+120,000			
(d)	–5,000			+10,000		=	+5,000				
(e)	–200,000				+200,000	=					
(f)	–85,000		+85,000			=					
(g)				–3,000		=	–3,000				
(h)	–2,000	+2,000				=					
(i)	No effect					=					
	+45,000	+2,000	+85,000	+107,000	+510,000	=	+169,000	+180,000		+320,000	+80,000

$$\underbrace{\text{Assets}}_{\$749,000} = \underbrace{\text{Liabilities}}_{\$349,000} + \underbrace{\text{Stockholders' Equity}}_{\$400,000}$$

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AP2–3.

Req. 1 and 2

Cash and Cash Equivalents

	Debit	Credit	
Beg.	147,879		
(a)	1,020	3,400	(b)
(c)	4,020	1,830	(e)
(f)	310	2,980	(g)
		300	(h)
	144,719		

Short-Term Investments

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

Accounts Receivable

	Debit	Credit
Beg.	14,602	
	14,602	

Inventories

	Debit	Credit
Beg.	181,884	
	181,884	

Prepaid Expenses and Other Current Assets

	Debit	Credit
Beg.	38,064	
	38,064	

Property, Plant and Equipment

	Debit	Credit	
Beg.	322,185		
(e)	11,230	4,020	(c)
	329,395		

Intangibles

	Debit	Credit
Beg.	92,500	
(b)	3,400	
	95,900	

Other Assets

	Debit	Credit	
Beg.	5,484		
		310	(f)
	5,174		

Accounts Payable

Debit	Credit	
	78,722	Beg.
	78,722	

Accrued Expenses Payable

Debit	Credit	
	68,677	Beg.
	68,677	

Long-Term Debt*

Debit	Credit	
	202,908	Beg.
	9,400	(e)
	212,308	

Other Long-Term Liabilities

Debit	Credit	
	42,649	Beg.
	42,649	

Contributed Capital

Debit	Credit	
	79,374	Beg.
	1,020	(a)
	80,394	

* Current portion is $40.

Retained Earnings

	Debit	Credit	
		330,268	Beg.
(h)	300		
		329,968	

Req. 3

No effect was recorded for *(d)*. 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, 2007
(in thousands of dollars)

Assets	
Current assets	
Cash and cash equivalents	$ 144,719
Short-term investments	2,980
Accounts receivable	14,602
Inventories	181,884
Prepaid expenses and other current assets	38,064
Total current assets	382,249
Property, plant and equipment	329,395
Intangibles	95,900
Other assets	5,174
Total Assets	$812,718
Liabilities	
Current liabilities	
Accounts payable	$ 78,722
Accrued expenses payable	68,677
Current portion of long-term debt	40
Total current liabilities	147,439
Long-term debt	212,268
Other long-term liabilities	42,649
Total Liabilities	402,356
Stockholders' Equity	
Contributed capital	80,394
Retained earnings	329,968
Total Stockholders' Equity	410,362
Total Liabilities and Stockholders' Equity	$812,718

Req. 5

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$802{,}598+\$812{,}718)\ /\ 2}{(\$409{,}642+\$410{,}362)\ /\ 2} = \frac{\$807{,}658}{\$410{,}002} = 1.97$$

This ratio indicates that, for every $1 of equity investment, Ethan Allen maintains $1.97 of assets, with the additional $0.97 of assets financed by debt. This suggests that Ethan Allen relies fairly equally on debt and equity financing.

AP2–4.

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

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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, 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 $$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$1{,}605{,}649+\$1{,}987{,}484)\ /\ 2}{(\$1{,}155{,}552+\$1{,}417{,}312)\ /\ 2} = \frac{\$1{,}796{,}566.5}{\$1{,}286{,}432} = 1.40$$

   Thus, for every $1 of equity investment, American Eagle Outfitters maintains $1.40 of assets, with the additional $0.40 financed by debt. This ratio indicates that American Eagle Outfitters does not rely heavily on debt financing.

5. The company spent $225,939,000 on purchasing property and equipment in the year ended 2/3/07; $81,545,000 in the year ended 1/28/06; and $97,288,000 in the year ended 1/29/05. This information is listed on the Statement of Cash Flows in the investing activities section.

CP2–2.

1.

Assets	=	Liabilities	+	Shareholders' Equity
$899,251,000	=	$223,968,000*	+	$675,283,000

* Liabilities are determined by either adding current ($135,318,000) and non-current liabilities ($88,650,000) or by solving the accounting equation: Assets ($899,251,000) = Liabilities + Shareholders' Equity ($675,283,000)

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 $675,283,000. In addition, assets on the balance sheet are not stated at market value, only historical cost.

3. The company's only noncurrent liability is deferred rent.

4. $$\text{Financial Leverage} = \frac{\text{Avg. Total Assets}}{\text{Avg. Stockholders' Equity}} = \frac{(\$769{,}205+\$899{,}251)\ /\ 2}{(\$560{,}880 + \$675{,}283)\ /\ 2} = \frac{\$834{,}228}{\$618{,}081.5} = 1.35$$

5. The company had a net cash outflow from investing activities of $201,408,000, primarily because of the purchase of investments and capital expenditures.

CP2–3.

1.	Industry Average	American Eagle Outfitters	Urban Outfitters
Financial leverage =	1.77	1.40	1.35

Both American Eagle Outfitters' and Urban Outfitters' financial leverage ratios are lower than the industry average of 1.77. Therefore they finance their assets with less debt than the average company in their industry.

Renting store space instead of buying store space will cause American Eagle Outfitters' and Urban Outfitters' financial leverage ratios to be lower. Renting is a form of financing that does not show up in the liabilities section of the balance sheet. If they purchased store space by borrowing (instead of selling additional stock), the numerator (Average Total Assets) would increase, but the denominator (Average Stockholders' Equity) would stay the same.

2. During the most recent year, American Eagle Outfitters spent $154,120,000 repurchasing common stock from investors and employees. Urban Outfitters spent $20,801,000 purchasing shares of its own common stock.

3. American Eagle Outfitters paid $61,521,000 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. Both American Eagle and Urban Outfitters report property and equipment combined as "Property and equipment, net." 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."

CP2–4.

1. (a) Papa John's total assets reported at July 1, 2007 are $402,582,000.

   (b) Long-term debt including the current portion due increased over six months from $97,036,000 at December 31, 2006, to $126,784,000 on July 1, 2007.

   (c) $$\text{Financial Leverage} = \frac{\text{Avg Total Assets}}{\text{Avg Stockholders' Equity}} = \frac{(\$379{,}639+\$402{,}582)\ /\ 2}{(\$146{,}168+\$147{,}005)\ /\ 2} = \frac{\$391{,}110.5}{\$146{,}586.5} = 2.67$$

   Papa John's financial leverage has increased from the level of 2.37 as discussed in the chapter. This indicates that, between December 31, 2006, and July 1, 2007, Papa John's financed its assets with slightly more debt than previously. As discussed in the text, Papa John's uses more debt than equity to finance its assets.

2. (a) For the six months ended July 1, 2007, Papa John's spent $16,433,000 on the purchase of property and equipment.

   (b) The total cash flows provided by financing activities was $6,596,000.

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CP2–5.

1. Distressed investing occurs when an individual or organization purchases debt instruments or assets of companies facing financial trouble or bankruptcy, often during the “bust “ period following a boom in the financial markets. Often, the investor is looking for a relatively quick turnaround, betting that a new management, new strategy, or cheaper costs can lead to improved returns, and then is hoping to sell to a healthier rival to make a profit.
2. Investing in stocks is riskier than investing in bonds because debt holders have preference over stockholders upon liquidation of assets. However, those interested in distressed investing often take on more risk. The potential for greater returns if the company can be turned around is attractive to these investors and could yield a higher return than the interest on debt.
3. Mr. Ross studies companies extensively, primarily in industries with bleak outlooks, such as steel and textiles. He then “sells the stock short” (bets that the stock price will drop), then makes quick decisions to purchase at least one-third of the debt of these companies to ensure “he has the clout to protect his interests.” His attitude is strictly rational and he avoids situations that involve fraud or litigation. He also has limitless energy.

CP2–6.

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 stockholders’ equity should be only $5,000, rather than $305,000. Thus, the correct financial leverage ratio (based on the year-end balance sheet) is very high: 21.0 ($105,000 ÷ $5,000) versus 1.33 ($405,000 ÷ $305,000). Frances Sabatier’s business is far riskier than suggested by this balance sheet.

CP2–7.

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

2.

Assets	=	Liabilities	+	Stockholders' Equity	(in millions)
$1,656	=	$1,385	+	$271	

3. $$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$1{,}921+\$1{,}656)/2}{(\$255+\$271)/2} = \frac{\$1{,}788.5}{\$263.0} = 6.80$$

   For every $1 of equity investment, Gateway maintains $6.80 of assets, with the additional $5.80 financed by debt. This ratio indicates that Gateway relies more heavily on riskier debt financing than on equity financing. The interpretation of this ratio would be more useful given information on the company's financial leverage over time and on the typical financial leverage ratio for the computer industry.

4.

Accrued liabilities (–L)	159	
Cash (–A)		159

5. Over its years in business, it appears that Gateway has not been profitable. Gateway appears to have been profitable in its business during 2006. This is based on the 2005 balance in the accumulated deficit (negative retained earnings) account, which represents the cumulative deficit in earnings of the firm since the business began (including any dividends paid to the shareholders). Gateway reported an accumulated deficit for 2006, but the balance was less negative than in 2005, suggesting a gain for the year. Assuming no dividends were paid during the year, net profit in 2006 was $14 calculated as follows:

Accumulated Deficit

	Debit	Credit	
Beginning balance	717		
Dividends	0		
		$\boxed{14}$	**Net income**
	703		Ending balance (deficit)

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CP2–8.

Req. 1

McDonald's Corporation
Balance Sheets
At December 31, 2001 and December 31, 2010
(in millions of dollars)

	2011	2010
Assets		
Current Assets:		
Cash and equivalents	$ 299.2	$ 341.4
Accounts and notes receivable	609.4	483.5
Inventories	77.3	70.5
Prepaid expenses and other current assets	323.5	246.9
Total current assets	**1,309.4**	**1,142.3**
Property and equipment, net	16,041.6	14,961.4
Intangible assets	973.1	827.5
Investments in and advances to affiliates	854.1	634.8
Notes receivable due after one year	67.9	67.0
Other noncurrent assets	538.3	608.5
Total Assets	**$19,784.4**	**$18,241.5**
Liabilities		
Current Liabilities:		
Accounts payable	$ 621.3	$ 650.6
Accrued liabilities	783.3	503.5
Taxes payable	237.7	201.0
Notes payable	686.8	1,293.8
Current maturities of long-term debt	168.0	335.6
Total current liabilities	**2,497.1**	**2,984.5**
Long-term debt	6,188.6	4,834.1
Other long-term liabilities	1,574.5	1,491.0
Total Liabilities	**10,260.2**	**9,309.6**
Stockholders' Equity		
Contributed capital	1,065.3	787.8
Retained earnings	8,458.9	8,144.1
Total Stockholders' Equity	**9,524.2**	**8,931.9**
Total Liabilities and Stockholders' Equity	**$19,784.4**	**$18,241.5**

CP2–8. (continued)

Req. 2

$$\text{Financial Leverage} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}} = \frac{(\$18{,}241.5+\$19{,}784.4)\ /\ 2}{(\$8{,}931.9+\$9{,}524.2)\ /\ 2} = \frac{\$19{,}012.95}{\$9{,}228.05} = 2.06$$

Req. 3

For every $1 of equity investment, McDonald's maintains $2.06 of assets, with the additional $1.06 financed by debt. This ratio indicates that McDonald's utilizes debt financing slightly more than equity financing, and that McDonald's utilizes debt financing more than the average company in the restaurant industry (with a ratio of 1.72 as indicated in the chapter).

CRITICAL THINKING CASES

CP2–9.

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

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CP2–9. (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.

The effect of the corrections also changes the financial leverage ratio (based on the year-end figures provided):

Prior to the correction ($179,000 ÷ $85,000)	2.11
After the corrections ($141,000 ÷ $47,000)	3.00

This suggests that the company has assumed a proportionately larger debt burden than indicated on the original balance sheet.

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 financial leverage ratio to that of the industry. 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.

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CP2–10.

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 its audit, not knowing it to be tainted or fraudulent.

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

CP2–11.

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

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