# CHAPTER 2

# Financial Statements and the Annual Report

### OVERVIEW OF EXERCISES, PROBLEMS, AND CASES

Estimated

Time in

Learning Outcomes Exercises Minutes Level

**1.** Describe the objectives of financial reporting.

**2.** Describe the qualitative characteristics of accounting information. 1 10 Easy

**3.** Explain the concept and purpose of a classified balance sheet 2 10 Mod

and prepare the statement. 3 10 Easy

5 10 Easy

12\* 10 Mod

**4.** Use a classified balance sheet to analyze a company’s 4 10 Easy

financial position.

**5.** Explain the difference between a single-step and a 6 10 Easy

multiple-step income statement and prepare each type 7 10 Mod

of income statement. 12\* 10 Mod

13\* 15 Mod

14\* 5 Easy

**6.** Use a multiple-step income statement to analyze a 8 10 Easy

company’s operations. 13\* 15 Mod

14\* 5 Easy

**7.** Identify the components of the statement of retained earnings 9 10 Mod

and prepare the statement. 12\* 10 Mod

**8.** Identify the components of the statement of cash flows and 10 10 Easy

prepare the statement.

**9.** Read and use the financial statements and other elements 11 20 Diff

in the annual report of a publicly held company.

\*Exercise, problem, or case covers two or more learning outcomes

Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

Problems Estimated

and Time in

Learning Outcomes Alternates Minutes Level

**1.** Describe the objectives of financial reporting. 12\* 45 Diff

**2.** Describe the qualitative characteristics of accounting information. 1 15 Diff

2 15 Mod

10\* 35 Mod

11\* 20 Mod

**3.** Explain the concept and purpose of a classified balance sheet 3 50 Mod

and prepare the statement.

**4.** Use a classified balance sheet to analyze a company’s 4 20 Easy

financial position. 5 15 Mod

10\* 35 Mod

12\* 45 Diff

**5.** Explain the difference between a single-step and a 6 30 Mod

multiple-step income statement and prepare each type 7 45 Mod

of income statement. 11\* 20 Mod

**6.** Use a multiple-step income statement to analyze a

company’s operations.

**7.** Identify the components of the statement of retained earnings

and prepare the statement.

**8.** Identify the components of the statement of cash flows and 8 30 Mod

prepare the statement. 12\* 45 Diff

**9.** Read and use the financial statements and other elements 9 30 Diff

in the annual report of a publicly held company.

\*Exercise, problem, or case covers two or more learning outcomes

Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

Estimated

Time in

Learning Outcomes Cases Minutes Level

**1.** Describe the objectives of financial reporting.

**2.** Describe the qualitative characteristics of accounting information. 5 30 Mod

**3.** Explain the concept and purpose of a classified balance sheet

and prepare the statement.

**4.** Use a classified balance sheet to analyze a company’s 1 30 Mod

financial position. 2 20 Mod

6\* 30 Mod

**5.** Explain the difference between a single-step and a

multiple-step income statement and prepare each type

of income statement.

**6.** Use a multiple-step income statement to analyze a 6\* 30 Mod

company’s operations.

**7.** Identify the components of the statement of retained earnings

and prepare the statement.

**8.** Identify the components of the statement of cash flows and 3 25 Mod

prepare the statement.

**9.** Read and use the financial statements and other elements 4 20 Mod

in the annual report of a publicly held company.

\*Exercise, problem, or case covers two or more learning outcomes

Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

questions

**1.** The primary concern to an investor is the future cash to be received from the investment. However, this does not mean that the cash flows of the company that has been invested in are not relevant. A relationship exists between the cash flows to the investor and those to the company. For example, a company that does not consistently generate sufficient cash flows from its operations will not be able to pay cash dividends to the investors over a sustained time.

**2.** The understandability characteristic does not imply that someone must have an extensive accounting background to be able to use financial statements. However, accounting information should be understandable to those who are willing to learn to use it properly. In other words, the information should make sense to someone who spends the time required to have a basic understanding of accounting.

**3.** Relevance is the capacity of accounting information to make a difference in a financial decision. For example, an income statement is relevant when the use of it has at least the potential to make a difference in an investment decision.

**4.** Comparability is the quality of accounting information that allows comparisons to be made between or among companies. Without it, financial statements would be very limited in their value. Financial decisions require choices to be made about the investment of limited resources. Investors need assurance that the financial statements of companies that they are considering as investments are comparable.

**5.** Comparability is the quality of information that allows for comparisons to be made between two or more companies, whereas consistency is the quality that allows for comparisons to be made within a single entity from one accounting period to the next.

**6.** The concept of materiality is closely related to the size of a company. For example, assume that a company must decide whether a $500 expenditure that will benefit future periods should be expensed immediately or capitalized (i.e., recorded as an asset). The decision cannot be made without considering the amount in relation to the size of the company. An amount that is immaterial for a large multinational corporation may be material for a smaller business.

**7.** The IASB recognizes the same qualitative characteristics for useful information as does the FASB. The two groups are working together on a joint conceptual framework project, of which the chapter on qualitative characteristics is completed.

**8.** A current asset is an asset that a company expects to realize in cash, sell, or consume during its normal operating cycle. Therefore, accounts receivable, inventory, and supplies all meet this definition and are classified as current assets. By their nature, the benefits from each of these assets will be realized during the normal operating cycle of the business.

**9.** The note payable will be classified on the balance sheet as long term until *one year* from its maturity date. At that time, it should be reclassified from long term to current because it will be paid within the next year. Any liability that will mature within one year of the date of the balance sheet should be classified as current, regardless of the original term of the loan (five years in this case).

**10.** Both capital stock and retained earnings represent claims of the stockholders on the assets of the business. They differ, however, in the source of those claims. Capital stock represents the claims of the stockholders that arise from their contributions of cash and other assets to the business. Retained earnings represent the accumulated earnings, or net income, of the business since its inception less all dividends declared during that time.

**11.** Working capital is an absolute measure of liquidity. That is, it is the total *dollar* amount of current assets minus current liabilities. One of the problems with working capital as a measure of liquidity is that it does not allow someone to compare the relative liquidity of two companies of different sizes. Even within a single company, it may be difficult to compare the relative liquidity of the company over time if the company has grown. The current ratio (current assets divided by current liabilities) overcomes these deficiencies by focusing attention on the relative size of the current   
assets and current liabilities.

**12.** Capital structure refers to the right side of a balance sheet. All items on the right side of the balance sheet represent claims against the assets of the business: liabilities are the claims of outsiders, and stockholders’ equity is the claim of the owners on the assets of the business. The capital structures of all companies differ in that some companies rely more on outsiders to provide assets, whereas others rely more on the owners to provide the necessary assets to run the business.

**13.** The single-step income statement shows a subtotal for all expenses and deducts this amount from total revenues. The weakness of the single-step form for the income statement is that relationships between key items on the statement are not highlighted. For example, the relationship between sales revenue and the cost of the products sold is very important for a product-oriented company. The difference between the two amounts is called gross profit and would appear on a multiple-step statement but not in the single-step form.

**14.** A statement of retained earnings links the income statement and the balance sheet in the following way. A statement of retained earnings shows the beginning balance in the account, the addition (deduction) to the account for the net income (loss) of the period, and any deduction from the account for dividends. The beginning balance in Retained Earnings is taken from the balance sheet at the end of the prior   
period. The income statement indicates the net income for the period. The ending balance in Retained Earnings appears on the balance sheet at the end of the period.

**15.** An audit of a set of financial statements does not ensure that the statements contain no errors. Because of the sheer number of transactions entered into during a period of time, it would be impossible for an auditor to check every single transaction to determine that it was correctly recorded. Instead, through various types of tests, the auditor renders an opinion as to whether the statements are free of material mis-statement.

**16.** The first note is the summary of significant accounting policies. As the name implies, the purpose of this note is to summarize all of the company’s important accounting policies, such as those relating to the method of depreciating assets and the method for valuing inventories.

BRIEF exercises

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| LO 1 |  | **BRIEF EXERCISE 2-1 OBJECTIVES OF FINANCIAL REPORTING** |

The overriding objective of financial reporting is to provide financial information to permit users of the information to make informed decisions. Financial statements do not report the value of the reporting entity, but should provide useful information to allow users to make estimates of the value of the entity.

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| LO 2 |  | **BRIEF EXERCISE 2-2 QUALITATIVE CHARACTERISTICS OF ACCOUNTING  INFORMATION** |

The two fundamental qualities that make accounting information useful are relevance and faithful representation. Financial information is enhanced when it is understandable, comparable, and consistent.

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| LO 3 |  | **BRIEF EXERCISE 2-3 CLASSIFICATION OF ASSETS** |

Accounts receivable—CA Furniture and fixtures—NCA

Land—NCA Office supplies—CA

Inventories—CA Buildings—NCA

Cash—CA

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| LO 4 |  | **BRIEF EXERCISE 2-4 WORKING CAPITAL AND CURRENT RATIO** |

Working Capital = Current Assets – Current Liabilities

Working Capital: $80,000 – $60,000 = $20,000

Current Ratio = Current Assets/Current Liabilities

Current Ratio: $80,000/$60,000 = 1.33 to 1

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| LO 5 |  | **BRIEF EXERCISE 2-5 MULTIPLE- VERSUS SINGLE-STEP INCOME STATEMENT** |

Lines that will appear on a multiple-step income statement, but not on a single-step income statement, are Gross profit, Total operating expenses, Income from operations, Excess of other revenues over other expenses, and Income before income taxes.

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| LO 6 |  | **BRIEF EXERCISE 2-6 PROFIT MARGIN** |

Profit Margin = Net Income/Sales =

($100,000 – $60,000 – $15,000 – $10,000)/$100,000 = $15,000\*\*/$100,000\* = 15%

Sales $100,000\*

– Cost of goods sold 60,000

= Gross profit $ 40,000

– Total operating expenses 15,000

= Income before income taxes $ 25,000

– Income tax expense 10,000

= Net income $ 15,000\*\*

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| LO 7 |  | **BRIEF EXERCISE 2-7 RETAINED EARNINGS** |

Ending retained earnings = $200,000 + $80,000 – $50,000 = $230,000\*

Retained earnings, beginning balance $200,000

Add: Net income for the year 80,000

$280,000

Less: Dividends paid (50,000)

Retained earnings, ending balance $230,000\*

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| LO 8 |  | **BRIEF EXERCISE 2-8 INVESTING AND FINANCING ACTIVITIES** |

The amount borrowed from the bank, $100,000, would be reported on the statement of cash flows as an inflow from financing activities. The amount used to buy a new piece of equipment, $80,000, would be shown on the statement of cash flows as an outflow from investing activities.

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| LO 9 |  | **BRIEF EXERCISE 2-9 ELEMENTS OF AN ANNUAL REPORT** |

In addition to the financial statements, an annual report usually includes the following items: a letter to the stockholders from either the president or the chair of the board of directors, a section describing the company’s products/services and markets, the auditors’ report, management discussion and analysis, and notes to the financial statements.

exercises

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| LO 2 |  | **EXERCISE 2-1 CHARACTERISTICS OF USEFUL ACCOUNTING INFORMATION** |

**1.** materiality **4.** consistency

**2.** relevance **5.** understandability

**3.** faithful representation **6.** comparability

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| LO 3 |  | **EXERCISE 2-2 THE OPERATING CYCLE** |

**1.** For a company that sells a product, the operating cycle begins when the cash is invested in inventory and ends when cash is collected by the company from its customers. Two Wheeler’s operating cycle would be a minimum of 45 days (for cash sales) and a maximum of 75 days (for sales on credit: 45 days to sell the bike and 30 days to collect).

**2.** The operating cycle for Baxter, the manufacturer of the bikes, would normally be longer than Two Wheeler’s. This is because a manufacturer incurs various costs to produce the bikes before it sells them to retailers such as Two Wheeler and eventually collects cash from the sales. On the other hand, the retailer only buys a   
finished good from the manufacturer and then sells it to the customer.

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| LO 3 |  | **EXERCISE 2-3 CLASSIFICATION OF FINANCIAL STATEMENT ITEMS** |

**1.** CA **6.** CA

**2.** SE **7.** CL

**3.** CL **8.** NCA

**4.** CA **9.** SE

**5.** NCA **10.** LTL

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| LO 4 |  | **EXERCISE 2-4 CURRENT RATIO** |

**1.** Current Ratio = Current Assets/Current Liabilities

December 31, 2013:

Current Ratio = ($6,000 + $10,000 + $8,000)/($7,000 + $1,000 + $4,000)

= $24,000/$12,000

= 2.0 to 1

December 31, 2014:

Current Ratio = ($3,000 + $15,000 + $12,000)/($12,000 + $2,000 + $6,000)

= $30,000/$20,000

= 1.5 to 1

**EXERCISE 2-4 (Concluded)**

**2.** Baldwin’s current ratio decreased from 2.0 at the end of 2013 to 1.5 at the end of 2014. In general, the higher the current ratio, the more liquid the company.

**3.** Cash decreased by 50%, from $6,000 to $3,000, and accounts receivable increased by 50%, from $10,000 to $15,000. Inventory also increased by 50%, from $8,000 to $12,000. Not only did Baldwin’s current ratio decrease, but its current assets are also less liquid at the end of the year, with more invested in receivables and inventory and less in cash.

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| LO 3 |  | **EXERCISE 2-5 CLASSIFICATION OF ASSETS AND LIABILITIES** |

**1.** CA **4.** NCA **7.** CA

**2.** CL **5.** CL **8.** LTL

**3.** CA **6.** CL **9.** NCA

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| LO 5 |  | **EXERCISE 2-6 SELLING EXPENSES AND GENERAL AND ADMINISTRATIVE EXPENSES** |

**1.** Advertising expense—S

**2.** Depreciation expense—store furniture and fixtures—S

**3.** Office rent expense—G&A

**4.** Office salaries expense—G&A

**5.** Store rent expense—S

**6.** Store salaries expense—S

**7.** Insurance expense—G&A\*

**8.** Supplies expense—G&A\*

**9.** Utilities expense—G&A\*

\*Each of these could be classified as a selling expense if the cost is related in some way to the sales function; e.g., insurance on cars driven by salespeople could be   
classified as a selling expense.

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| LO 5 |  | **EXERCISE 2-7 MISSING INCOME STATEMENT AMOUNTS** |

**Sara’s Amy’s Jane’s**

**Coffee Shop Deli Bagels**

Net sales $35,000 **(3)** **$63,000** $78,000

Cost of goods sold **(1)** **28,000** 45,000 **(7)** **39,000**

Gross profit 7,000 18,000 **(6)** **39,000**

Selling expenses 3,000 **(4)** **6,000** 9,000

General and administrative expenses 1,500 2,800 **(5) 4,600**

Total operating expenses **(2)** **4,500** 8,800 13,600

Net income $ 2,500 $ 9,200 $25,400

Solved as follows (in the order listed):

**(1)** $35,000 – $7,000 = $28,000

**(2)** $3,000 + $1,500 = $4,500

**(3)** $45,000 + $18,000 = $63,000

**(4)** $8,800 – $2,800 = $6,000

**(5)** $13,600 – $9,000 = $4,600

**(6)** $25,400 + $13,600 = $39,000

**(7)** $78,000 – $39,000 = $39,000

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| LO 6 |  | **EXERCISE 2-8 INCOME STATEMENT RATIO** |

**Profit margin:**

Net Income/Revenues = $45,000\*/$134,800 = 33.4%

\*$134,800 – $38,310 – $36,990 – $580 – $13,920 = $45,000

A profit margin of 33% indicates that for every dollar of sales, Holly Enterprises has $0.33 in net income. It would be beneficial to compare the company’s profit margin with some of its competitors and with previous years.

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| LO 7 |  | **EXERCISE 2-9 STATEMENT OF RETAINED EARNINGS** |

LANDON CORPORATION

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDED DECEMBER 31, 2014

Retained earnings, January 1, 2014 $130,520\*

Add: Net income for 2014 145,480

Less: Dividends declared and paid (40,000)

Retained earnings, December 31, 2014 $236,000

\*Retained earnings, January 2, 2012 $ 0

Add: Net income:

2012 $ 85,200

2013 125,320 210,520

Deduct: Dividends:

2012 $ 40,000

2013 40,000 80,000

Retained earnings, December 31, 2013 $130,520

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| LO 8 |  | **EXERCISE 2-10 COMPONENTS OF THE STATEMENT OF CASH FLOWS** |

**1.** Paid for supplies—O

**2.** Collected cash from customers—O

**3.** Purchased land (held for resale)—O

**4.** Purchased land (for construction of new building)—I

**5.** Paid dividend—F

**6.** Issued stock—F

**7.** Purchased computers (for use in the business)—I

**8.** Sold old equipment—I

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| LO 9 |  | **EXERCISE 2-11 BASIC ELEMENTS OF FINANCIAL REPORTS** |

**1.** **Management discussion and analysis—**The information in this section of the annual report is prepared by management and is management’s opportunity to explain various items that appear in the financial statements. Increases and decreases in various items are highlighted and reasons for these changes are given. The information in this section is not subject to any outside review or support. Users must rely on the integrity of management that the information contained in the report is reliable.

**2.** **Product/markets of company—**Management provides information in the annual report about the company’s products and markets. The detail provided by management differs widely among companies, but most companies describe their various products and often show pictures of them. The distribution system for the products, i.e., whom the company sells to, is also described. Because the company’s products and markets are a matter of public knowledge, they are subject to verification.

**3.** **Financial statements—**These are the responsibility of management and are normally prepared by the controller. They include the income statement, balance sheet, statement of changes in stockholders’ equity, and statement of cash flows. The information provided in the financial statements is subject to verification as part of the external audit.

**4.** **Notes to financial statements—**These are also the responsibility of management, and they include detailed explanations about the various items appearing in the   
financial statements. The first note in most annual reports is a summary of the significant accounting policies, such as the company’s inventory valuation methods and depreciation methods. The information included in the notes is subject to review by the independent auditors and is therefore highly verifiable.

**5.** **Independent accountants’ report—**As the name implies, this report is prepared by the independent auditors. It includes information about the scope of the audit (the statements included in the audit), the auditing standards followed in conducting the audit, and an opinion as to the fairness of presentation of the financial statements. Because the public relies on the auditors to render an impartial opinion, the auditing profession is subject to a set of high ethical standards in performing audits.

MULTI-CONCEPT EXERCISES

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| LO 3,5,7 |  | **EXERCISE 2-12 FINANCIAL STATEMENT CLASSIFICATION** |

BS = Balance sheet; IS = Income statement; RE = Retained earnings statement

**1.** Accounts payable—BS **11.** Land held for future expansion—BS

**2.** Accounts receivable—BS **12.** Loan payable—BS

**3.** Advertising expense—IS **13.** Office supplies—BS

**4.** Bad debt expense—IS **14.** Patent—BS

**5.** Bonds payable—BS **15.** Patent amortization expense—IS

**6.** Buildings—BS **16.** Prepaid insurance—BS

**7.** Cash—BS **17.** Retained earnings—BS and RE

**8.** Common stock—BS **18.** Sales—IS

**9.** Depreciation expense—IS **19.** Utilities expense—IS

**10.** Dividends—RE **20.** Wages payable—BS

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| LO 5,6 |  | **EXERCISE 2-13 SINGLE- AND MULTIPLE-STEP INCOME STATEMENT** |

**1.** Sales—B **7.** Net income—B

**2.** Cost of goods sold—B **8.** Supplies on hand—N

**3.** Selling expenses—M\* **9.** Accumulated depreciation—N

**4.** Total revenues—S **10.** Income before income taxes—M

**5.** Utilities expense—B **11.** Gross profit—M

**6.** Administrative expense—M\*

\*This assumes that selling and administrative expenses are each headings for a group of expenses. If this is the case, they would appear only on a multiple-step income statement.

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| LO 5,6 |  | **EXERCISE 2-14 MULTIPLE-STEP INCOME STATEMENT** |

**Profit margin:**

Net Income/Sales = $614,200\*/$1,200,000 = 51.2%

\*$1,200,000 – $450,000 – $60,800 – $75,000 = $614,200\*

Sales $1,200,000

– Cost of sales 450,000

= Gross profit $ 750,000

– Total operating expenses 135,800\*\*

= Net income $ 614,200\*

\*\*Total Operating Expenses = Selling Expenses ($60,800) + General and Administrative Expenses ($75,000) = $135,800

Gaynor Corporation has been very profitable on the basis of its very high profit margin of 51.2%. Before making an investment, however, you would want to consider how this ratio compares with that of prior years and with that of other companies in the same line of business.

PROBLEMS

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| LO 2 |  | **PROBLEM 2-1 MATERIALITY** |

**1.** Among the questions that might be answered by the analysis that was performed are these: Is the usage of any of the items cyclical? Is there a relationship between the usage of any two or more of the items? Is the amount being spent on these items material? Would it be feasible to set up an account at an office supply store for some of these items if they are used in large quantities? From this analysis, the company might decide to change the timing of its ordering to correspond to its need.

**2.** This question deals with the concept of materiality. It is likely this information would be more relevant for a real estate company than for a hardware store. Normally, a realtor would use more office supplies, relative to its use of other types of supplies, and thus the amount spent on office supplies would be more material to it than to a hardware store.

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| LO 2 |  | **PROBLEM 2-2 COSTS AND EXPENSES** |

**1.** **Display fixtures in a retail store—**Only a portion of the cost would appear in the period of acquisition; the fixtures should be depreciated over their useful lives.

**2.** **Advertising—**All.

**3.** **Merchandise for sale—**Only the cost of the merchandise sold during the current period would appear on the income statement; the remainder would appear as an asset on the balance sheet.

**4.** **Incorporation**—Because of the difficulty in determining the period over which benefits will be received from the costs necessary to incorporate, accounting standards require that these costs be expensed as incurred.

**5.** **Cost of a franchise—**This is a cost that should benefit several future periods, and only a portion should be expensed in the current period; the cost of the franchise should be treated as an intangible asset and amortized over the periods during which benefits are expected.

**6.** **Office supplies—**The portion of the supplies used should be recognized as an   
expense in the current period; the unused portion should be reported as a current asset.

**7.** **Wages and salaries—**All.

**8.** **Computer software**—Assuming that the software was purchased, an intangible asset should be recognized and a portion of the cost recognized as expense in each of the periods benefited.

**9.** **Computer hardware**—Only the portion of the cost associated with the benefits provided during the current period would be recognized as depreciation expense; the cost should be written off over the useful life of the hardware.

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| LO 3 |  | **PROBLEM 2-3 CLASSIFIED BALANCE SHEET** |

**1.** Classified balance sheet:

RUTH CORPORATION

BALANCE SHEET

DECEMBER 31, 2014

**Assets**

Current assets:

Cash $ 13,230

Accounts receivable 23,450

Inventory 45,730

Prepaid rent 1,500

Office supplies 2,340

Total current assets $ 86,250

Long-term investments 85,000

Property, plant, and equipment:

Land $250,000

Automobiles $112,500

Less: Accumulated depreciation 22,500 90,000

Buildings $200,000

Less: Accumulated depreciation 40,000 160,000

Total property, plant, and equipment 500,000

Intangible assets:

Patents 40,000

Total assets $711,250

**Liabilities**

Current liabilities:

Accounts payable $ 18,255

Income taxes payable 6,200

Interest payable 1,500

Notes payable, due June 30, 2015 10,000

Salaries and wages payable 4,200

Total current liabilities $ 40,155

Long-term debt:

Bonds payable, due December 31, 2018 160,000

Total liabilities $200,155

**PROBLEM 2-3 (Concluded)**

**Stockholders’ Equity**

Contributed capital:

Capital stock, $10 par value,

15,000 shares issued and outstanding $150,000

Paid-in capital in excess of par value 50,000

Total contributed capital $200,000

Retained earnings 311,095

Total stockholders’ equity 511,095

Total liabilities and stockholders’ equity $711,250

**2.** Current Ratio = Current Assets/Current Liabilities

$86,250/$40,155 = 2.15 to 1

**3.** From the current ratio alone, Ruth appears to be relatively liquid. To fully assess its liquidity, however, it would be useful to look more specifically at the composition of the current assets and liabilities. How long does it take to sell inventory? How long does it take to collect an account receivable? Also, you would want to compare Ruth’s current ratio at the end of this period with those of prior periods and with the current ratio for companies in the same industry.

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| LO 4 |  | **PROBLEM 2-4 FINANCIAL STATEMENT RATIOS** |

**1. a.** Working capital at 12/31/14:

Current assets: $27,830 + $20,200 + $450 + $24,600 + $6,250 + $3,600 = $82,930

Current liabilities: $8,400 + $1,450 + $1,200 = $11,050

Working capital: $82,930 – $11,050 = $71,880

Working capital at 12/31/13:

Current assets: $35,770 + $19,450 + $700 + $26,200 + $5,020 + $4,800 = $91,940

Current liabilities: $5,200 + $1,200 + $12,000 + $1,230 + $1,600 = $21,230

Working capital: $91,940 – $21,230 = $70,710

**b.** Current ratio at 12/31/14:

$82,930/$11,050 = 7.50 to 1

Current ratio at 12/31/13:

$91,940/$21,230 = 4.33 to 1

**PROBLEM 2-4 (Concluded)**

**2.** Both the absolute liquidity position of the company and the relative liquidity position of the company have improved during 2014. First, the absolute position, as indicated by the amount of working capital, has improved from $70,710 to $71,880. The   
liquidity of the company has also improved on a relative basis, as indicated by the increase in the current ratio from 4.33 to 7.50. The primary reason for the improvement in the company’s liquidity is the repayment during the year of the $12,000 note payable, along with the $1,200 of interest payable on the note. This is counter-  
balanced somewhat, though, by the decrease in accounts receivable from $35,770 to $27,830.

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| LO 4 |  | **PROBLEM 2-5 WORKING CAPITAL AND CURRENT RATIO** |

**1.** Current Ratio = Current Assets/Current Liabilities

= ($23,000 + $13,000 + $45,000 + $800)/($54,900 + $1,200)

= $81,800/$56,100 = 1.46 to 1

Working Capital = Current Assets – Current Liabilities

= $81,800 – $56,100 = $25,700

**2.** One concern is the relatively large percentage of the current assets tied up in inventory. This asset accounts for $45,000/$81,800, or 55% of the total current assets. What is the normal period of time it takes to sell inventory? Is any part of the inventory slow moving or obsolete?

**3.** On the basis of the current ratio alone, Stevenson appears to be relatively liquid, although it would be important to compare the ratio with those of prior years and with those of other companies in the same industry.

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| LO 5 |  | **PROBLEM 2-6 SINGLE-STEP INCOME STATEMENT** |

**1.** Single-step income statement:

SHAW CORPORATION

INCOME STATEMENT

FOR THE CURRENT YEAR

Revenues:

Sales $48,300

Interest 1,340

Rent 6,700

Total revenues $56,340

Expenses:

Advertising $ 1,500

Commissions 2,415

Cost of goods sold 29,200

Depreciation—office building 2,900

Income tax 1,540

Insurance—salesperson’s auto 2,250

Interest 1,400

Salaries and wages—office 12,560

Supplies—office 890

Total expenses 54,655

Net income $ 1,685

**2.** A single-step income statement does not lend itself as readily to analysis as does a multiple-step statement. The lack of any grouping of the various expenses makes any type of analysis more difficult.

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| LO 5 |  | **PROBLEM 2-7 MULTIPLE-STEP INCOME STATEMENT AND PROFIT MARGIN** |

**1.** Multiple-step income statement:

SHAW CORPORATION

INCOME STATEMENT

FOR THE CURRENT YEAR

Sales $48,300

Cost of goods sold 29,200

Gross profit $ 19,100

Operating expenses:

Selling expenses:

Advertising $ 1,500

Commissions 2,415

Insurance—salesperson’s auto 2,250

Total selling expenses $ 6,165

General and administrative expenses:

Depreciation—office building $ 2,900

Salaries and wages—office 12,560

Supplies—office 890

Total general and administrative expenses 16,350

Total operating expenses 22,515

Loss from operations $ (3,415)

Other revenues and expenses:

Interest expense $ 1,400

Interest revenue 1,340

Rent revenue 6,700

Excess of other revenues over other expenses 6,640

Income before taxes $ 3,225

Income tax expense 1,540

Net income $ 1,685

**2.** The main advantages of the multiple-step income statement are the groupings of various items and the provision of important subtotals such as income from operations.

**3.** Profit Margin = Net Income/Sales

= $1,685/$48,300 = 3.5%

**4.** A profit margin of 3.5% means that for every dollar of sales the company has net income of $0.035. This would appear to be a reasonable profit margin, but it would be important to compare the profit margin with prior years and with other companies in the same industry.

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| LO 8 |  | **PROBLEM 2-8 STATEMENT OF CASH FLOWS** |

1. COLORADO CORPORATION

STATEMENT OF CASH FLOWS

FOR THE FIRST YEAR

Cash flows from operating activities:

Cash collected from customers $ 93,970

Cash paid for inventory (65,600)

Cash paid in salaries and wages (20,400)

Cash paid in taxes (3,100)

Net cash provided by operating activities $ 4,870

Cash flows from investing activities:

Payment on office building (210,000)

Cash flows from financing activities:

Proceeds from issuance of stock $250,000

Proceeds from long-term note 60,000

Dividends declared and paid (5,600)

Net cash provided by financing activities 304,400

Net increase in cash $ 99,270

Cash at beginning of year 0

Cash at end of year $ 99,270

*Note:* Colorado should report one significant noncash activity as supplementary information to its statement of cash flows: the three-year, $90,000 note signed to finance the purchase of the office building.

**2.** First, the statement of cash flows reports on operations on a cash basis, as opposed to the income statement which is prepared on an accrual basis. Second, investing and financing activities are also reported on a statement of cash flows. For example, information about dividends paid during the year is shown on a statement of cash flows but not on an income statement. It is interesting to note that Colorado paid more in dividends, $5,600, than the amount of cash it generated from operations, $4,870.

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| LO 9 |  | **PROBLEM 2-9 BASIC ELEMENTS OF FINANCIAL REPORTS** |

Letter from the President to Stockholders of Grammar Inc.:

On the surface, 2014 does not appear to have been a successful year for Grammar Inc. One specific event, however, caused the net loss we experienced for the year. Operating income was $380,000 in 2014; however, the sale of a subsidiary at a loss of $400,000 resulted in a net loss for the year of $20,000. The sale of this unprofitable unit of the business should allow us to concentrate our attention in the future on our successful businesses and clear the way for a return to overall profitability in 2015.

I should point out to you that aside from the loss experienced on the sale of the subsidiary, 2014 was a very good year. We were able to control our operating expenses, as operating income as a percentage of sales increased from 20% to 38%. These are clear signals that Grammar is moving in the right direction and should have a solid year of operations in 2015.

MULTI-CONCEPT PROBLEMS

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| LO 2,4 |  | **PROBLEM 2-10 MAKING BUSINESS DECISIONS: LOANING MONEY TO The  COCA-COLA company** |

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**Part A. Ratio Decision Model**

1. Formulate the Question:

Is The Coca-Cola Company liquid enough to pay its obligations as they come due?

1. Gather the Information from the Financial Statements:

Current assets: From the balance sheet

Current liabilities: From the balance sheet

1. Calculate the Ratio:

Current Ratio =\_\_Current Assets\_

Current Liabilities

The Coca-Cola Company (in millions of dollars at December 31, 2011):

Current Assets: $12,803 + $1,088 + $144 + $4,920 + $3,092 + $3,450 = $25,497

Current Liabilities: $9,009 + $12,871 + $2,041 + $362 = $24,283

Current Ratio = $25,497 = 1.05 to 1

$24,283

**PROBLEM 2-10 (Continued)**

1. Compare the Ratio with Other Ratios:

**Current Ratio**

**The Coca-Cola Company PepsiCo**

**December 31, 2011 December 31, 2010 December 31, 2011 December 25, 2010**

1.05 to 1 1.17 to 1 0.96 to 1 1.11 to 1

**Calculations:**

The Coca-Cola Company at December 31, 2010:

($8,517 + $2,682 + $138 + $4,430 + $2,650 + $3,162)/ ($8,859 + $8,100 +

$1,276 + $273) = $21,579/$18,508 = 1.17 to 1

PepsiCo at December 31, 2011:

($4,067 + $358 + $6,912 + $3,827 + $2,277)/($6,205 + $11,757 + $192)

= $17,441/$18,154 = 0.96 to 1

PepsiCo at December 25, 2010:

($5,943 + $426 + $6,323 + $3,372 + $1,505)/($4,898 + $10,923 + $71) = $17,569/$15,892 = 1.11 to 1

1. Interpret the Ratios:

The Coca-Cola Company’s current ratio is slightly lower at the end of 2011 compared to the end of 2010, 1.05 compared to 1.17. Similarly, PepsiCo’s current ratio decreased slightly from one year to the next, 0.96 compared to 1.11.

The composition of a company’s current assets adds another level to the analysis of liquidity. The Coca-Cola Company’s cash and cash equivalents, the most liquid of assets, make up one half of its current assets at the end of 2011. PepsiCo’s cash and cash equivalents comprise less than one-fourth of its current assets. On the other hand, PepsiCo’s accounts and notes receivable, also highly liquid, are 40% of current assets, contrasting with The Coca-Cola Company’s trade accounts receivable of 19%. Although receivables are considered very liquid, questions may arise about collectibility.

**PROBLEM 2-10 (Continued)**

**Part B. Business Decision Model**

1. Formulate the Question:

After considering all relevant information, should I loan money to The Coca-Cola Company?

1. Gather Information from the Financial Statements and Other Sources:

The information will come from a variety of sources, not limited to but including:

1. The balance sheet provides information about liquidity.
2. The income statement provides information about profitability.
3. The statement of cash flows reports on the company’s cash inflows and outflows.
4. The outlook for the beverage industry, including consumer trends, foreign markets, labor issues, and other factors.
5. The outlook for the economy during the time the loan would be outstanding.
6. Projections for interest rates for similar loans during the term of the loan.
7. Alternative uses for the bank’s money.
8. Analyze the Information Gathered:

The information gathered in (2) above must be analyzed. Among the relevant questions that must be answered are the following:

* 1. Refer to part (5) of the Ratio Decision Model for a comparison of the current ratios for The Coca-Cola Company and its competitor, PepsiCo, over the last two years. The analysis also needs to consider the composition of the current assets. For example, cash and receivables are more liquid than inventories and prepaid expenses. The company’s existing long-term liabilities must also be taken into account.
  2. What has been the trend in profits over recent years? Has the company been able to increase revenues and at the same time control its costs?
  3. How much cash has the company spent in recent years to retire existing debt? What other significant cash outflows have been made?
  4. What is the company’s share of the growing market for sports drinks? How significant are revenues from Asian markets?
  5. Is inflation projected to increase during this time? Are labor costs likely to increase?
  6. Are interest rates projected to increase or decrease during the term of the loan?
  7. If a loan is not made to The Coca-Cola Company, what other uses does the bank have for the money?

1. Make the Decision:

Taking into account all of the various sources of information, decide either to loan money to The Coca-Cola Company or find an alternative use for the money.

**PROBLEM 2-10 (Concluded)**

1. Monitor Your Decision:

If you decide to make the loan, you will need to monitor it periodically. During the time the loan is outstanding, you will want to assess the company’s continuing liquidity as well as other factors you considered before making the loan.

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| LO 2,5 |  | **PROBLEM 2-11 COMPARABILITY AND CONSISTENCY IN INCOME STATEMENTS** |

**1.** The income statement for 2013 is in single-step format, and the 2014 statement uses the multiple-step format.

2. GLEESON COMPANY

INCOME STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2013

Sales $1,500,000

Less: Cost of sales 450,000

Gross profit $1,050,000

Selling expenses $ 593,000\*

Administrative expenses 94,000\*\*

Total selling and administrative expenses $ 687,000

Net income $ 363,000

\*$398,000 + $175,000 + $20,000

\*\*$54,000 + $40,000

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| LO 1,4,8 |  | **PROBLEM 2-12 CASH FLOW** |

Cash available to pay a dividend on December 31, 2015:

Cash balance, September 30, 2015 $ 5,000

+ Accounts receivable collections 39,406\*

+ Note receivable due on November 1 10,000

+ Interest due on November 1: $10,000 × 5% 500

– Cash paid for purchases (15,762)\*\*

– Mortgage note payments: 3 months × $1,200 (3,600)

– Operating expenses: 3 months × $3,000 (9,000)

Cash balance, December 31, 2015 $ 26,544

\*September sales collected in October $ 12,500

October sales collected in November:

$12,500 × 1.05 13,125

November sales collected in December:

$13,125 × 1.05 13,781

Total accounts receivable collections $ 39,406

\*\*September purchases paid for in October $ 5,000

October purchases paid for in November:

$13,125 × 40% 5,250

November purchases paid for in December:

$13,781 × 40% 5,512

Total payments on account $ 15,762

*Note:* Because inventory levels are maintained at $75,000, purchases are equal to 40% of sales each month.

*Conclusion:* 50,000 shares of common stock × $0.50 per share will require cash of $25,000 to pay the quarterly dividend. With $26,544 of cash available, Franklin will barely be able to meet the dividend payment. Unless one or more of the following actions are successful in increasing the cash balance, management should not recommend the normal quarterly dividend of $0.50 per share:

Reduce inventory levels.

Speed up the collection of receivables.

Lengthen the average amount of time taken to pay for purchases of inventory.

Reduce operating expenses.

alternate problems

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| LO 2 |  | **PROBLEM 2-1A MATERIALITY** |

**1.** The pattern of long-distance calls might point to alternative long-distance plans with one of the many carriers now in this business. For example, some companies might give a discount for calls made in off-peak hours. The analysis might point to misuse by certain employees (overuse, personal use, etc.), a situation that could be corrected by talking to the employees who are misusing the long-distance service.

**2.** This question deals with the concept of materiality. It would be difficult to decide which of the two types of companies, a realtor or a hardware store, would make more long-distance calls. A realtor might make a large number of long-distance calls if it deals with out-of-state clients. The hardware store might regularly order inventory from vendors outside of its area code.

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| LO 2 |  | **PROBLEM 2-2A COSTS AND EXPENSES** |

**1.** **Point-of-sale systems in a retail store**—The cost associated with these systems is a tangible asset that should be reported in the Long-Term Assets section of the balance sheet and depreciated over the life of the systems; only a portion would be recognized as expense during the current period.

**2.** **An ad in the yellow pages**—All of the cost for the ad would normally be expensed in the period the cost is incurred unless there was evidence that the ad would provide benefits for a number of future periods.

**3.** **An inventory-control computer software system**—Assuming that the software was purchased, an intangible asset should be recognized and a portion of the cost recognized as expense in each of the periods benefited.

**4.** **Shipping merchandise for resale to chain outlets**—All of the costs associated with shipping merchandise for resale would normally be recognized as expense when the costs are incurred. Even though one could argue that under the matching principle these costs should be recognized as expense only when the inventory is sold, the practical difficulty in associating shipping costs with specific items sold results in most companies expensing these costs as incurred.

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| LO 3 |  | **PROBLEM 2-3A CLASSIFIED BALANCE SHEET** |

**1.** Classified balance sheet:

SINGER COMPANY

BALANCE SHEET

DECEMBER 31, 2014

**Assets**

Current assets:

Cash $ 60,790

Marketable securities 15,000

Accounts receivable 26,700

Merchandise inventory 112,900

Prepaid rent 3,600

Office supplies 400

Total current assets $219,390

Property, plant, and equipment:

Land $250,000

Buildings $150,000

Less: Accumulated depreciation 40,000 110,000

Equipment $ 84,500

Less: Accumulated depreciation 12,500 72,000

Total property, plant, and equipment 432,000

Intangible assets:

Patents 45,000

Total assets $696,390

**Liabilities**

Current liabilities:

Accounts payable $ 34,280

Income taxes payable 7,500

Interest payable 2,200

Notes payable, due April 15, 2015 6,500

Salaries payable 7,400

Total current liabilities $ 57,880

Long-term debt:

Bonds payable, due December 31, 2020 250,000

Total liabilities $307,880

**PROBLEM 2-3A (Concluded)**

**Stockholders’ Equity**

Contributed capital:

Capital stock, $1 par value, 200,000

shares issued and outstanding $200,000

Paid-in capital in excess of par value 75,000

Total contributed capital $275,000

Retained earnings 113,510

Total stockholders’ equity 388,510

Total liabilities and stockholders’ equity $696,390

**2.** Current Ratio = Current Assets/Current Liabilities

$219,390/$57,880 = 3.79 to 1

**3.** From the current ratio alone, Singer appears to be relatively liquid. In fact, Singer may be too liquid, in that its cash balance is greater than its total current liabilities. Singer may be missing significant investment opportunities by maintaining such a large cash balance. To fully assess its liquidity, it would be useful to look more specifically at the activity in accounts receivable and merchandise inventory. How long does it take to collect an account receivable? How long does it take to sell inventory? Also, you would want to compare Singer’s current ratio at the end of this period with prior periods and with the current ratio for companies in the same industry.

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| LO 4 |  | **PROBLEM 2-4A FINANCIAL STATEMENT RATIOS** |

**1. a.** Working capital at 12/31/14:

Current assets: $16,500 + $12,750 + $200 + $900 + $400 = $30,750

Current liabilities: $10,500 + $1,800 + $10,000 = $22,300

Working capital: $30,750 – $22,300 = $8,450

Working capital at 12/31/13:

Current assets: $26,000 + $11,800 + $1,100 + $250 = $39,150

Current liabilities: $6,500 + $800 + $5,800 = $13,100

Working capital: $39,150 – $13,100 = $26,050

**b.** Current ratio at 12/31/14:

$30,750/$22,300 = 1.38 to 1

Current ratio at 12/31/13:

$39,150/$13,100 = 2.99 to 1

**PROBLEM 2-4A (Concluded)**

**2.** Both the absolute liquidity position of the company and the relative liquidity position of the company have declined during 2014. First, the absolute position, as indicated by the amount of working capital, has decreased from $26,050 to $8,450. The liquidity of the company has also decreased on a relative basis, as indicated by the decrease in the current ratio from 2.99 to 1.38. The primary reasons for the decline in the company’s liquidity are the significant increases in accounts payable and taxes payable and the decrease in accounts receivable.

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| LO 4 |  | **PROBLEM 2-5A WORKING CAPITAL AND CURRENT RATIO** |

**1.** Current Ratio = Current Assets/Current Liabilities

= ($23,000 + $43,000 + $75,000 + $2,800)/($84,900 + $3,200)

= $143,800/$88,100 = 1.63 to 1

Working Capital = Current Assets – Current Liabilities

= $143,800 – $88,100 = $55,700

**2.** Even though Kapinski has a current ratio that is over 1 to 1, it may experience trouble paying its bills, specifically its accounts payable. This depends on two factors: (1) how long it normally takes to collect accounts receivable and (2) the normal length of time to sell inventory. In addition, the company must be concerned about whether any portion of the accounts receivable may prove to be uncollectible and whether any portion of the inventory is not saleable.

**3.** Three things Kapinski might be able to do to help it pay its bills on time:

**a.** Decrease the average collection period for accounts receivable.

**b.** Negotiate with suppliers to increase the time Kapinski is given to pay for its

accounts payable.

**c.** Reduce its inventory levels.

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| LO 5 |  | **PROBLEM 2-6A SINGLE-STEP INCOME STATEMENT** |

**1.** Single-step income statement:

CORBIN ENTERPRISES

INCOME STATEMENT

FOR THE CURRENT YEAR

Revenues:

Sales $350,000

Dividend 2,700

Total revenues $352,700

Expenses:

Cost of goods sold $150,000

Wages—office 45,600

Income tax 30,700

Rent—office 26,400

Rent—salesperson’s car 18,000

Advertising 9,000

Utilities 6,750

Depreciation—computer 4,500

Interest 1,900

Supplies—office 1,300

Total expenses 294,150

Net income $ 58,550

**2.** A single-step income statement does not lend itself as readily to analysis as does a multiple-step statement. The lack of any type of grouping of the various expenses makes any type of analysis more difficult.

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| LO 5 |  | **PROBLEM 2-7A MULTIPLE-STEP INCOME STATEMENT AND PROFIT MARGIN** |

**1.** Multiple-step income statement:

CORBIN ENTERPRISES

INCOME STATEMENT

FOR THE CURRENT YEAR

Sales $350,000

Cost of goods sold 150,000

Gross profit $200,000

Operating expenses:

Selling expenses:

Advertising $ 9,000

Rent—salesperson’s car 18,000

Total selling expenses $ 27,000

General and administrative expenses:

Depreciation—computer $ 4,500

Rent—office 26,400

Supplies—office 1,300

Wages—office 45,600

Utilities 6,750

Total general and administrative expenses 84,550

Total operating expenses 111,550

Income from operations $ 88,450

Other revenues and expenses:

Interest expense $ 1,900

Dividend revenue 2,700

Excess of other revenues over other expenses 800

Income before taxes $ 89,250

Income tax expense 30,700

Net income $ 58,550

**2.** The main advantages of the multiple-step income statement are the groupings of various items and the provision of important subtotals such as income from operations.

**3.** Profit Margin = Net Income/Sales

= $58,550/$350,000 = 16.7%

**4.** A profit margin of 16.7% means that for every dollar of sales the company has net income of $0.167. This would appear to be a good profit margin, but it would be important to compare the profit margin with prior years and with other companies in the same industry.

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| LO 8 |  | **PROBLEM 2-8A STATEMENT OF CASH FLOWS** |

1. WISCONSIN CORPORATION

STATEMENT OF CASH FLOWS

FOR THE FIRST YEAR

Cash flows from operating activities:

Cash collected from customers $ 310,000

Cash paid for inventory (185,000)

Cash paid in salaries and wages (30,100)

Cash paid in taxes (40,000)

Net cash provided by operating activities $ 54,900

Cash flows from investing activities:

Purchase of manufacturing facility (150,000)

Cash flows from financing activities:

Proceeds from issuance of stock $ 400,000

Proceeds from long-term note 50,000

Dividends declared and paid (4,000)

Net cash provided by financing activities 446,000

Net increase in cash $ 350,900

Cash at beginning of year 0

Cash at end of year $ 350,900

*Note:* Wisconsin should report one significant noncash activity as supplementary information to its statement of cash flows: the five-year, $150,000 note signed to finance the purchase of the manufacturing facility.

**2.** First, the statement of cash flows reports on operations on a cash basis, as opposed to the income statement which is prepared on an accrual basis. Second, investing and financing activities are also reported on a statement of cash flows. For example, information about dividends paid during the year are shown on a statement of cash flows but not on an income statement.

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| LO 9 |  | **PROBLEM 2-9A BASIC ELEMENTS OF FINANCIAL REPORTS** |

**Letter from the President to Stockholders of Thesaurus Inc.:**

Thesaurus Inc. has just completed another very successful year. The decrease in net income from 2013 to 2014 was due to a single, nonrecurring gain in 2013, a $400,000 gain on the sale of a subsidiary in that year. A comparison of the operating income of the two years shows a distinct improvement, from $100,000 in 2013 to $380,000 in 2014.

All signs point to a successful year just completed. We were able to control our operating expenses: operating income as a percentage of operating revenues increased from 50% to 76%. These are clear signals that Thesaurus is moving in the right direction and should have a solid year of operations in 2015.

alternate MULTI-CONCEPT problems

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| LO 2,4 |  | **PROBLEM 2-10A making business decisions: Loaning Money to STARWOOD HOTELS & RESORTS Worldwide, Inc.** |

**Part A. Ratio Decision Model**

1. Formulate the Question:

Is Starwood Hotels & Resorts Worldwide, Inc., liquid enough to pay its obligations as they come due?

1. Gather the Information from the Financial Statements:

Current assets: From the balance sheet

Current liabilities: From the balance sheet

1. Calculate the Ratio:

Current Ratio = \_Current Assets\_

Current Liabilities

Starwood Hotels & Resorts Worldwide, Inc. (in millions of dollars at December 31, 2011):

Current Assets: $569 + $454 + $125 + $232 + $64 + $278 + $812 = $2,534

Current Liabilities: $144 + $1,177 + $375 + $163 + $130 + $3 = $1,992

Current Ratio = $2,534 = 1.27 to 1

$1,992

1. Compare the Ratio with Other Ratios:

**Current Ratio**

**Starwood Hotels & Resorts Worldwide, Inc. Hyatt Hotels Corporation and Subsidiaries**

**December 31, 2011 December 31, 2010 December 31, 2011 December 31, 2010**

1.27 to 1 1.21 to 1 2.80 to 1 3.63 to 1

**Calculations:**

Starwood Hotels & Resorts Worldwide, Inc. at December 31, 2010:

($513 + $753 + $126 + $53 + $59 + $315 + $802)/($138 + $1,104 +

$410 + $377 + $127 + $9) = $2,621/$2,165 = 1.21 to 1

Hyatt Hotels Corporation and Subsidiaries at December 31, 2011:

($534 + $23 + $87 + $78 + $29 + $225 + $27 + $588)/($144 + $114 + $306 + $4)

= $1,591/$568 = 2.80 to 1

Hyatt Hotels Corporation and Subsidiaries at December 31, 2010:

($18 + $1,110 + $29 + $100 + $73 + $6 + $199 + $106 + $524)/($145 + $108 + $286 + $57) = $2,165/$596 = 3.63 to 1

**PROBLEM 2-10A (Continued)**

1. Interpret the Ratios:

Starwood Hotels & Resorts Worldwide’s current ratio is slightly higher at the end of 2011 compared to the end of 2010, 1.27 compared to 1.21. Hyatt Hotel’s current   
ratio decreased from one year to the next, 2.80 compared to 3.63.

The composition of a company’s current assets adds another level to the analysis of liquidity. Starwood Hotels & Resorts Worldwide’s cash and cash equivalents, the most liquid of assets, make up only 18% of its current assets at the end of 2011. Hyatt Hotel’s cash and cash equivalents comprise one-third of its current assets.

**Part B. Business Decision Model**

1. Formulate the Question:

After considering all relevant information, should I loan money to Starwood Hotels & Resorts Worldwide?

1. Gather Information from the Financial Statements and Other Sources:

The information will come from a variety of sources, not limited to but including:

* 1. The balance sheet provides information about liquidity.
  2. The income statement provides information about profitability.
  3. The statement of cash flows reports on the company’s cash inflows and outflows.
  4. The outlook for the hospitality industry, including consumer trends, foreign competition for travel dollars, labor issues, and other factors.
  5. The outlook for the economy during the time the loan would be outstanding.
  6. Projections for interest rates for similar loans during the term of the loan.
  7. Alternative uses for the bank’s money.

1. Analyze the Information Gathered:

The information gathered in 2. above must be analyzed. Among the relevant questions that must be answered are the following:

1. Refer to part (5) of the Ratio Decision Model for a comparison of the current   
   ratios for Starwood Hotels & Resorts Worldwide and its competitor, Hyatt Hotels, over the last two years. The analysis also needs to consider the composition of the current assets. For example, cash and receivables are more liquid than inventories and prepaid expenses. The company’s existing long-term liabilities must also be taken into account.
2. What has been the trend in profits over recent years? Has the company been able to increase revenues and at the same time control its costs?
3. How much cash has the company spent in recent years to retire existing debt? What other significant cash outflows have been made?
4. What is the company’s share of the hospitality industry’s market? How significant are revenues from foreign locations?
5. Is inflation projected to increase during this time? Are labor costs likely to increase?
6. Are interest rates projected to increase or decrease during the term of the loan?
7. If a loan is not made to Starwood Hotels & Resorts Worldwide, what other uses does the bank have for the money?

**PROBLEM 2-10A (Concluded)**

1. Make the Decision:

Taking into account all of the various sources of information, decide either to loan money to Starwood Hotels & Resorts Worldwide or find an alternative use for the money.

1. Monitor Your Decision:

If you decide to make the loan, you will need to monitor it periodically. During the time the loan is outstanding, you will want to assess the company’s continuing liquidity as well as other factors you considered before making the loan.

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| LO 2,5 |  | **PROBLEM 2-11A COMPARABILITY AND CONSISTENCY IN INCOME STATEMENTS** |

**1.** The income statements for both years are in single-step form.

**2.** Income statement items as a percentage of sales:

**2014 2013**

Sales 100.0% 100.0%

Cost of sales 36.0 30.0

Sales salaries 25.1 26.5

Delivery expense 10.6 11.7

Office supplies 3.2 3.6

Depreciation—truck 2.4 2.7

Computer line expense 1.4 1.3

Total expenses 78.7% 75.8%

Net income 21.3% 24.2%

Restating each item on the income statement as a percentage of sales allows the reader to better understand how successful a business was in controlling costs. For example, Chisholm Company increased its sales by $200,000 for the year, but this did not translate to an increase in the bottom line, i.e., net income. The restatement of each of the expenses as a percentage of sales reveals why net income did not increase. Total expenses, as a percentage of sales, increased from 75.8% to 78.7%. Aside from a slight increase in one of the minor expenses, computer lines, only one other expense increased as a percentage of sales. The primary reason for the   
increase in expenses as a percentage of sales was the increase in the cost of   
Chisholm’s products from 30% to 36% of sales.

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| LO 1,4,8 |  | **PROBLEM 2-12A CASH FLOW** |

**Cash available to pay a dividend on December 31, 2015:**

Cash balance, December 1, 2015 $ 15,000

+ Cash collections from November 2015 sales 40,000\*

– Operating expenses (10,000)

– Payroll: 2 × $4,500 (9,000)

Cash balance, December 31, 2015 $ 36,000

\*Accounts receivable balance on December 1.

*Conclusion:* Roosevelt has $50,000 par value of stock, with the par value of each share set at $2. Thus, there are 25,000 shares of stock outstanding. At $1 per share in dividends, $25,000 in cash will be needed to meet the annual dividend payment. On the surface, it appears that Roosevelt should have no trouble in paying its annual   
dividend—the above analysis indicates a December 31, 2015, cash balance of $36,000. However, the $30,000 note payable, along with six months’ interest of $450 ($30,000 × 3% × 6/12), will be due two weeks into the new year (January 15, 2016). If we assume that accounts receivable are collected relatively evenly over the month, the balance available to repay the $30,000 note and interest on January 15, 2016, would be only $29,000:

December sales $40,000 × 95% $ 38,000

– Unearned revenue already collected (2,000)

December sales collected in January $ 36,000

Divided by 2 (assuming receivables are collected

ratably over the month) ÷ 2

Cash available on January 15 from December sales $ 18,000

+ Cash available, December 31, 2015 36,000

– Dividend payment (25,000)

Cash available to repay note and interest $ 29,000

*Conclusion:* Roosevelt should not declare its normal annual dividend of $1 per share.

decision CASES

**READING AND INTERPRETING FINANCIAL STATEMENTS**

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| LO 4 |  | **DECISION CASE 2-1 COMPARING TWO COMPANIES IN THE SAME INDUSTRY: COLUMBIA SPORTSWEAR AND UNDER ARMOUR** |

(Amounts in thousands of dollars)

**1.** Columbia Sportswear:

12/31/11 Working capital: $1,049,526 – $267,002 = $782,524

12/31/10 Working capital: $990,880 – $251,626 = $739,254

Change in working capital: $782,524 – $739,254 = $43,270

Under Armour:

12/31/11 Working capital: $689,663 – $183,607 = $506,056

12/31/10 Working capital: $555,850 – $149,147 = $406,703

Change in working capital: $506,056 – $406,703 = $99,353

**2.** Columbia Sportswear:

12/31/11 Current ratio: $1,049,526/$267,002 = 3.93:1

12/31/10 Current ratio: $990,880/$251,626 = 3.94:1

Percentage change in ratio: (3.93 – 3.94)/3.94 = 0.3% decrease

Under Armour:

12/31/11 Current ratio: $689,663/$183,607 = 3.76:1

12/31/10 Current ratio: $555,850/$149,147 = 3.73:1

Percentage change in ratio: (3.76 – 3.73)/3.73 = 0.8% increase

**3.** The composition of current assets is similar for the two companies. Inventories is the largest current asset for both companies. The next largest current assets for Columbia Sportswear are accounts receivable and cash and cash equivalents, in that order. This is reversed for Under Armour, with cash and cash equivalents and then accounts receivable as its next largest current assets.

**4.** The current ratios for both companies were virtually unchanged from the end of 2010 to the end of 2011. Also, the ratios were very similar for both companies, at nearly 4.0 to 1, indicating a high degree of liquidity.

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| LO 4 |  | **Decision Case 2-2 Reading Columbia Sportswear’s Balance Sheet** |

**1.** Inventories is the largest of Columbia Sportswear’s current assets on December 31, 2011. It represents $365,199 thousand/$1,049,526 thousand, or 34.8% of the total current assets. Inventories consists of raw materials, work-in-process, and finished goods and is the lifeblood of a product company.

**2.** The second largest of Columbia Sportswear’s current assets is accounts receivable. This asset represents $351,538 thousand/$1,049,526 thousand, or 33.5% of total current assets on December 31, 2011. A large receivables balance is an indication that the company has been successful in selling its products; however, it also means that the company has to be diligent in collecting the amounts due from customers.

**3.** Inventories increases as the various products are purchased from distributors, and the account decreases when the products are sold to customers. Receivables increases when Columbia Sportswear sells its products to its customers and decreases when cash is collected from them.

**MAKING FINANCIAL DECISIONS**

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| LO 8 |  | **DECISION CASE 2-3 ANALYSIS OF CASH FLOW FOR A SMALL BUSINESS** |

All financial decisions involve a trade-off between risk and return. The offer to work for an investment firm for $40,000 per year may be much less risky than running one’s own business. Charles needs to consider, however, how likely it is that the employment with the investment firm will continue indefinitely. For example, could a downswing in the economy cause the firm to cut Charles’s position?

Charles has experienced for himself the risks and rewards of running a business. To date, the business has not produced significant profits: only $11,500 over a two-year period. However, the significant increase in commissions revenue from one year to   
the next is very encouraging. This is an example of the potential rewards of running a business.

This case also illustrates the difference between income and cash flow. Because depreciation is not a cash flow, there is a significant difference between the cash flow for each of the two years and net income. Assuming that the revenues and all of the expenses other than depreciation result in cash flows of the business, the cash inflow for the first year is ($11,000) + $15,000 (add-back of depreciation), or $4,000. The cash inflow for the second year is even better, after adjusting for depreciation: $22,500 + $15,000, or $37,500.

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| LO 9 |  | **DECISION CASE 2-4 FACTORS INVOLVED IN AN INVESTMENT DECISION** |

Sections of the annual report that should be read in comparing investment alternatives:

**1.** **Financial statements, including income statement, balance sheet, statement of stockholders’ equity, and statement of cash flows**—The statements give an overall picture of the financial position and results of operations of the companies.

**2.** **Notes to the financial statements**—The notes are an integral part of the financial statements. They give the reader an indication of the accounting policies used; the various legal obligations, such as those for leases and pension plans; the composition of the long-term assets; and many other details.

**3.** **Management’s discussion and analysis**—This report by management will reveal how management views the year just completed in comparison to prior years and how it feels about the company’s prospects in the future.

**4.** **Other information contained in the annual report**—This might include descriptions of the company’s services as well as plans for expansion and other nonfinancial information. The investor may also want to consult various trade publications for insights into the industry.

**ETHICAL DECISION MAKING**

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| LO 2 |  | **DECISION CASE 2-5 THE EXPENDITURE APPROVAL PROCESS** |

The sales rep should be skeptical about Roberto’s request for two separate bills for $900 each. If the rep is aware that the request was made to circumvent a corporate policy, it would be unethical of the rep to comply with the request. This certainly puts the rep in a predicament: should he or she risk losing the sale by refusing to write up two separate bills?

Roberto is not acting in an ethical manner by requesting two bills, given that it is a deliberate attempt on his part to circumvent corporate policy. He may not agree with the policy, but it is not ethical to devise a scheme to work around the policy. Instead, he should write a memo to the corporate chief financial officer to explain his dissatisfaction with the policy and why it is not appropriate in this particular situation.

Whether or not the corporate policy is appropriate is difficult to answer without additional information. At the very least, it seems unreasonable that it should take three weeks for the approval process.

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| LO 4,6 |  | **DECISION CASE 2-6 SUSAN APPLIES FOR A LOAN** |

1. **Recognize an ethical dilemma:**

The ethical dilemma for you is whether you should present financial statements to the banker that are incomplete (that make Susan’s financial position appear to be better than it actually is).

1. **Analyze the key elements in the situation:**
2. Your decision affects not only Susan but also the banker. Susan could benefit if a balance sheet is not provided and the bank could be harmed.
3. Susan would benefit by getting a loan based on incomplete information and the bank would be at risk by not having all the information it needs to make a decision.
4. The bank has the right to all the relevant information it needs to make a loan decision.
5. The interests of Susan, the owner of the business, and those of the bank are in conflict in this situation.
6. Your responsibility is to present a balance sheet that accurately reflects all of Susan’s debts.

3**.** **List alternatives and evaluate the impact of each on those affected:**

The alternatives are to follow Susan’s instructions and not provide a balance sheet or discuss with her your concerns. If the balance sheet is not provided, the banker will not have all the relevant information useful to the decision process. Without the balance sheet, the banker will not be able to predict future cash outflows related to the company’s debt. Also, the information is not neutral because it is presented to show the company’s financial health as better than it is.

4**.** **Select the best alternative:**

You should provide the balance sheet to the bank. If the banker does not receive the balance sheet and makes a decision only based on the income statement, this user of the information will not evaluate the risk of the company correctly. It is unlikely that the banker would consider making the loan on the basis of the quarterly income statements alone. The most recent balance sheet tells the banker about the overall financial strength of the company, and it is an integral part of any loan analysis. As the chief financial officer for the organization, you have a responsibility to provide the banker with the necessary information needed to make an informed decision on the loan. Susan would rather not show the banker the balance sheet because it would reveal the substantial loan already on the books. You are obligated, however, to provide the balance sheet to the bank if it would be relevant to the bank’s decision. Without it, it is unlikely the bank will make the loan.

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| REAL WORLD PRACTICE 2.1 |

The amount of working capital at December 31, 2011, was $1,049,526 thousand – $267,002 thousand = $782,524 thousand. On December 31, 2010,, the working capital amounted to $990,880 thousand – $251,626 thousand = $739,254 thousand. Total assets increased during the year.

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| REAL WORLD PRACTICE 2.2 |

Net income increased over the three years from $67,021 thousand in 2009 to $103,479 thousand in 2011, an increase of $36,458 thousand. This represents a percentage increase of $36,458/$67,021, or 54.4%. During this same time period, net sales increased from $1,244,023 thousand to $1,693,985 thousand, an increase of $449,962 thousand. This represents a percentage increase of $449,962/$1,244,023, or 36.2%. Thus, net income increased at a higher percentage than did net sales; this is an indication that the company is successfully controlling its costs.