Financial Accounting 11th edition Pratt Solutions Manual

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PRATT & PETERS, *FINANCIAL ACCOUNTING*, 11E

SOLUTIONS MANUAL CHAPTER 2: THE FINANCIAL STATEMENTS

BRIEF EXERCISES

BE2.1

2019 Beginning Retained Earnings	+	2019 Revenues	–	2019 Expenses	–	2019 Dividends	=	2019 Ending Retained Earnings
$59.9	+	$67.2	–	$59.9	–	X	=	$61.9
		X	=	$5.3				

2019 Dividends as a percentage of 2019 net income:

$$\frac{\text{2019 Dividends}}{\text{2019 Net income (\$67.2 – \$59.9)}} = \frac{\$5.3}{\$7.3} = 72.6\%$$

LO: 2 **BT:** AN; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

BE2.2

(1) Current Liabilities financed $27 billion of the assets.
Current Liabilities divided by Total assets = $27/$78 = 34.6%

(2) Long-term debt financed $36 billion of the assets.
Long-term debt divided by total assets = $36/$78 = 46.2 %

(3) Shareholders' equity financed $15 billion of the assets.
Shareholders' equity divided by total assets = $15/$78= 19.2%

LO: 1 **BT:** AP; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Measurement

BE2.3

(a) Working capital = current assets – current liabilities. Caterpillar's current assets total $39 billion, less $27 billion of current liabilities, gives the company about $12 billion of assets over liabilities. In addition, current assets divided by current liabilities or $39 billion divided by $27 billion = 1.44. Both measures indicate that Caterpillar appears to have reasonable ability to satisfy its current liabilities. Current assets are sufficient to cover current liabilities.

(b) No, Caterpillar has $26.2 billion of liquid current assets (cash, short term investments, and accounts receivable) but it has $27 billion of current liabilities.

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(c) No, Caterpillar would be less solvent if accounts receivable were $11.1 billion and inventory was $17.9 billion. Accounts receivable are closer to cash than inventory. When inventory is sold, it often becomes accounts receivable prior to being converted to cash. As a result, accounts receivable is one step closer to cash than inventory. Thus, if reversed, Caterpillar would be less likely to meet its current liabilities.

LO: 4 **BT:** AP; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Measurement

BE2.4

	2019	2018	2017
Net cash flow from operating activities.....	$ 48,668**	$ 43,602	$ 38,010
Net cash flow from investing activities	(16,690)	(63,145)	(18,943)
Net cash flow from financing activities	(25,083)	(25,989)*	25,930
Net change in cash.....	$ 6,895*	$(45,532)**	$ 44,997*
Cash at beginning of period	5,400	50,932***	5,935**
Cash at end of period	$ 12,295	$ 5,400	$ 50,932

2019
* $6,895 = $12,295 - $5,400
**x + ($16,690) + ($25,083) = $6,895; x = $48,668

2018
* $43,602 + ($63,145) + x = ($45,532); x = $(25,989)
**($45,532) = $5,400 - $50,932
***Cash at end of 2017 is same as cash at beginning of 2018.
*** ($45,532)) + $50,932 = x
X = $5,400

2017
* x = $38,010 + ($18,943) + $25,930; x = $44,997
** $5,935 = $50,932 - $44,997

AT&T's cash management activities over the three-year period of 2017-2019 appear to be extremely strong. The company is generating significant amounts of cash flow from operating activities, with all three years showing amounts greater than $38 billion. AT&T is then able to reinvest substantial amounts in its asset base. At the same time, AT&T is also able to fund its financing activities from its operating cash flow. The large amount of funds being used in investing activities indicates that AT&T is growing its capital-intensive business.

LO: 3 **BT:** AN; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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BE2.5

IFRS Format

Noncurrent assets	$301,712
Current assets	97,482
Total Assets	$399,194
Noncurrent liabilities	$118,847
Less: Current liabilities	77,813
Total Liabilities	196,660
Net Assets	$202,534
Equity	$202,534

GAAP Format

Current assets	$ 97,482
Noncurrent assets	301,712
Total	$399,194
Current liabilities	$ 77,813
Noncurrent liabilities	118,847
Shareholders' Equity	202,534
Total	$399,194

Note: Another format used for IFRS begins with non-current assets, add current assets, and then subtract current liabilities to reflect the resources available to generate revenues and profits. The IFRS balance sheet then lists non-current liabilities and shareholders' equity, which represent the financing sources of company resources; this amount is often labeled "capital employed."

GAAP balance sheets, on the other hand, list all assets owned (current and long-term) and then categorizes the financing sources (current and long-term liabilities, as well as shareholder equity) for those assets.

LO: 4 **BT:** AP; **Difficulty:** Easy; **Total Time:** 12 minutes; **AACSB:** Diversity; **AICPA:** Measurement

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EXERCISES

E2.1

	Operating, Investing, or Financing	Balance Sheet	Income Statement	Statement of Cash Flows	Statement of Shareholder's Equity
1	Financing	Yes	No	Yes	Yes
2	Operating	Yes	Yes	Cannot Tell	Yes
3	Operating	Yes	Cannot Tell*	Yes	Cannot Tell*
4	Investing	Yes	No	Yes	No
5	Financing	Yes	No	Yes	No
6	Financing	Yes	No	Yes	Yes
7	Investing	Yes	No	Yes	No
8	Operating	Yes	No	Yes	No

* It would impact these statements if the wages were paid in the same period as incurred.

LO: 3,4; **BT:** C; **Difficulty:** Moderate; **Total Time:** 12 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.2

	Operating, Investing, or Financing	Balance Sheet	Income Statement	Statement of Cash Flows	*Statement of Shareholder's Equity*
1	Financing	Yes	No	Yes	*No*
2	Operating	Yes	No	No	*No*
3	Operating	Yes	Yes	Yes	*Yes*
4	Operating	Yes	Yes	No	*Yes*
5	Investing	Yes	No	Yes	*No*
6	Investing	Yes	Cannot tell	Yes	*Cannot tell*
7	Financing	Yes	No	Yes	*No*
8	*Operating*	*Yes*	*No*	*Yes*	*No*

LO: 3,4; **BT:** C; **Difficulty:** Moderate; **Total Time:** 12 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.3

a.	Balance sheet	g.	Balance sheet	m.	Balance sheet
b.	Income statement	h.	Balance sheet	n.	Balance sheet
c.	Balance sheet	i.	Balance sheet	o.	Balance sheet
d.	Income statement	j.	Balance sheet	p.	Income statement
e.	Balance sheet	k.	Income statement	q.	Balance sheet
f.	Income statement	l.	Income statement	r.	Balance sheet

LO: 4; **BT:** C; **Difficulty:** Easy; **Total Time:** 8 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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E2.4

1. Statement of Shareholders' Equity, Statement of Cash Flows, Income Statement
2. Income Statement
3. Balance Sheet
4. Statement of Cash Flows, Balance Sheet
5. Statement of Shareholders' Equity; Statement of Cash Flows
6. Income Statement, Balance Sheet
7. Income Statement
8. Balance Sheet, Statement of Cash Flows, Income Statement (Days Payable Outstanding)

LO: 4; **BT:** C; **Difficulty:** Easy; **Total Time:** 10 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.5

2017

2017 Beginning Retained Earnings		2017 Revenues		2017 Expenses		2017 Dividends		2017 Ending Retained Earnings
$2.4	+	$23.6	–	$20.5	–	X	=	$3.0
	+	X	=	$2.5				

2018*

2018 Beginning Retained Earnings		2018 Revenues		2018 Expenses		2018 Dividends		2018 Ending Retained Earnings
$3.0	+	$24.5	–	X	–	$2.6	=	$3.1
	+	X	=	$21.8				

2019

2019 Beginning Retained Earnings		2019 Revenues		2019 Expenses		2019 Dividends		2019 Ending Retained Earnings
X	+	$25.1	–	21.4	–	$2.7	=	$4.1
	+	X	=	$3.1				

*The 2019 equation must be calculated before the 2018 equation.

	2019	**2018**	**2017**
Sales growth ($)	$0.6	$0.9	N/A
Sales growth (%)	2.45%**	3.81%*	N/A
Profits ($)	$3.7***	$2.7***	$3.1***
Profits / Sales	14.7%	11.0%	13.1%
Dividends / Net income	87.1%%	96.3%	80.6%

* 3.8% = ($24.5 - $23.6)/$23.6
** 2.45% = ($25.1 - $24.5)/$24.5
*** 2017: $3.1 = $23.6 R - $20.5 E; 2018: $2.7 = $24.5 - $21.8; 2019: $3.7 = $25.1 - $21.4

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The company had modest sales growth even though profits had more variability; however, very strong overall. Dividends are consistently very high as a percentage of profits, which is common in the utility industry.

LO: 5; **BT:** AN; **Difficulty:** Medium; **Total Time:** 25 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.6

2018

Beginning Retained Earnings		2018 Revenues		2018 Expenses		2018 Dividends		Ending Retained Earnings
($499)	+	$1,383	–	X	–	0	=	($523)
X	=	$1,407						

Expenses for 2018 are $1,407.

2019

Beginning Retained Earnings		2019 Revenues		2019 Expenses		2019 Dividends		Ending Retained Earnings
($523)	+	$1,522	–	$1,608	–	X	=	($758)
X	=	$149						

Dividends declared for 2019 are $149.

2020

Beginning Retained Earnings		2020 Revenues		2020 Expenses		2020 Dividends		Ending Retained Earnings
($758)	+	X	–	$1,550	–	$5	=	($596)
X	=	$1,717						

Revenue for 2020 is $1,717.

	2020	2019	2018
Sales growth (%)	12.8%**	10.1%*	N/A
Profits (Revenues – Expenses)	$167	($86)	$ (24)
Profits / Sales	9.7%	(5.7%)	(1.7%)
Dividends	$ 5	$ 149	$ 0
Dividends / Profits	3.0%	N/A	N/A

* 10.1% = ($1,522 - $1,383)/$1,383
** 12.8% = ($1,717 - $1,522)/$1,522

The advertising agency had strong sales growth from 2018 to 2020. From 2019 to 2020, the company was able to go from losses to a profit. Even though the company had a loss in 2019 the company paid a healthy dividend. Then in 2020, when the company showed a profit, it virtually eliminated the dividend. There is reason to be optimistic going forward. In 2020 the company was able to show a nice growth in its sales while at the same time showing a reduction in its expenses.

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LO: 5; **BT:** AN; **Difficulty:** Medium; **Total Time:** 25 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.7

Solvency primarily indicates a company's ability to meet its debt payments as they come due. Current liabilities are obligations that will be settled within one year or the company's operating cycle, whichever is longer; these obligations will be settled via current assets or the creation of new current liabilities. Current assets are those assets that will be consumed or converted to cash within one year or the company's operating cycle, whichever is longer. Consequently, comparing current assets to current liabilities provides an indication of a company's ability to meet its short-term debts. In this case, current assets were 2.26 ($541/$239) and 2.86 ($518/$181) times greater than current liabilities as of December 31, 2019 and December 31, 2018, respectively.

Although comparing current assets to current liabilities provides a measure of a company's solvency, this measure is not perfect. A true test of a company's short-term solvency would be to compare the cash value of its current assets to the cash value of its current liabilities. For current liabilities, the book value is usually a good approximation of the cash value, since a company cannot, from a legal viewpoint, unilaterally change its debts. However, the situation is different for current assets. The book value may or may not accurately represent the cash value. Consequently, comparing the book value of current assets to current liabilities may not give an accurate measure of a company's solvency.

LO: 5; **BT:** AN; **Difficulty:** Easy; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.8

	Method 1	Method 2
Working capital as of 12/31/2019	$ 302*	$ 302*
Impact of method on current assets	0	0
Impact of method on current liabilities	300	0
New working capital as of January 2020	$ 2	$ 302

* $302 = $541 current assets - $239 current liabilities

It seems that only the second method would be acceptable to the company in terms of maintaining compliance with the minimum working capital covenant. Therefore, the Company would need to borrow money with a long-term note payable to meet the debt covenant.

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E2.9

	2019	2018	2017
Beginning cash balance	$ 8,993	$ Y*	$ 7,739
Net cash flow from operating activities	15,831	X	13,876
Net cash flow from investing activities	(14,837)	(15,318)	X
Net cash flow from financing activities	X	(31,764)	(3,806)
Ending cash balance	$ 11,722	$ Z**	$ 11,773
X equals	$ 1,735	$ 44,302	$(6,036)

*Beginning cash balance for 2018 = Ending cash balance for 2017; Thus Y = $11,773
** Ending cash balance for 2018 = Beginning cash balance for 2019; Thus Z = $8,993

Cisco Systems' cash management activities over the three-year period of 2017, 2018, and 2019 appears to be strong. The company is generating a significant amount of net cash flow from operations each year and then is investing in its business. Financing activities (including dividends and/or share repurchases) reduced cash in all three years.

LO: 3,4; **BT:** AN; **Difficulty:** Easy; **Total Time:** 12 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.10

	2019	2018	2017
Beginning cash balance	$ Z**	$ 1,495	$ X
Net cash flow from operating activities	3,987	4,893	3,929
Net cash flow from investing activities	X	(2,038)	(2,408)
Net cash flow from financing activities	(2,990)	X	(1,706)
Ending cash balance	$ 2,458	$ 1,854	$ Y*
X equals	$ (393)	$ (2,496)	$ 1,680

*2018 Beginning balance = 2017 Ending balance; thus Y = $1,495
**2019 Beginning balance = 2018 Ending balance; thus Z = 1,854

Southwest Airlines' cash management activities appear to be strong for 2017, 2018, and 2019. The company generated a net cash inflow from its operating activities for the years shown. A look at its investing activities reveals that the company is expanding its asset base, as necessary in such a capital-intensive industry. During each year, the company increased its cash outflows due to financing activities. Overall, Southwest Airlines is a strong company that has done very well in this economy.

LO: 3,4; **BT:** AN; **Difficulty:** Easy; **Total Time:** 12 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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E2.11

Lana & Sons
Statement of Cash Flows
For the Year Ended

Cash flows from operating activities:		
Cash collection from services provided	$4,000	
Cash payment for expenses	(3,000)	
Net cash increase (decrease) from operating activities		$1,000
Cash flows from investing activities:		
Purchase of property, plant, and equipment	$(3,000)	
Net cash increase (decrease) from investing activities		(3,000)
Cash flows from financing activities:		
Proceeds from shareholders' contributions	$7,000	
Payment of dividends	(1,500)	
Net cash increase (decrease) from financing activities		5,500
Increase (decrease) in cash balance		$ 3,500
Beginning cash balance		13,000
Ending cash balance		$ 16,500

Based on just one year's statement of cash flows it is difficult to comment adequately on Lana & Son's cash management activities. However, one can observe that most of the cash during the year was generated by issuing equity. The company seems to be investing in its asset base. That will certainly help it grow in the future. Cash flows from operations is positive, which certainly is a good sign.

LO: 3,4; **BT:** AP; **Difficulty:** Medium; **Total Time:** 18 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.12

Emory Inc.
Statement of Cash Flows
For the Year Ended

Cash flows from operating activities:		
Cash collection from services provided	$40,000	
Cash payment for expenses	(23,000)	
Net cash increase (decrease) from operating activities		$17,000
Cash flows from investing activities:		
Purchase of equipment	$(23,000)	
Net cash increase (decrease) from investing activities		(23,000)
Cash flows from financing activities:		
Proceeds from the bank loan	$30,000	
Payment of dividends	(24,000)*	
Net cash increase (decrease) from financing activities		6,000
Increase (decrease) in cash balance		$ 0
Beginning cash balance		25,000
Ending cash balance		$ 25,000

Based on just one year's statement of cash flows, it is difficult to comment adequately on Emory's cash management activities. However, it seems that the company is generating a substantial portion of its

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cash flows from operating activities. The company is taking some loans to finance its asset base, which would be helpful in the future. Return on total assets and return on equity would probably increase.

* $17,000 (CFOA) - $23,000 (CFIA) + $30,000 (Bank Loan Proceeds) - X = $0 (Change in Cash Balance)
X = Dividends Paid = $24,000

LO: 3,4; **BT:** AP; **Difficulty:** Hard; **Total Time:** 18 minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.13

George's Business
Income Statement
For the Year Ended

Rent revenue	$3,000
Operating Expenses	2,500
Net income	$ 500

George's Business
Statement of Shareholders' Equity
For the Year Ended

	Common Stock	Retained Earnings
Beginning Balance	$ 0	$ 0
Stock Issue	6,000	
Net Income		500
Cash Dividends		(800)
Ending Balance	$6,000	$ (300)

George's Business
Balance Sheet
As of_____

Assets	
Cash	$ 2,700*
Land	8,000
Total assets	$ 10,700
Liabilities & Shareholders' Equity	
Note payable	$ 5,000
Common Stock	6,000
Retained earnings	(300)
Total liabilities & shareholders' equity	$ 10,700

* $2,700 = $6,000 Equity + $5,000 Loan - $8,000 Land purchase + $3,000 rent - $2,500 expenses - $800 dividends

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George's Business
Statement of Cash Flows
For the Year Ended

Cash flows from operating activities:		
Cash collections from customers	$ 3,000	
Cash payments for expenses	(2,500)	
Net cash flow from operating activities		$ 500
Cash flows from investing activities:		
Purchase of land	$ (8,000)	
Net cash flow from investing activities		(8,000)
Cash flows from financing activities:		
Proceeds from equity investor	$ 6,000	
Proceeds from borrowing	5,000	
Cash payments for dividends	(800)	
Net cash flow from financing activities		10,200
Increase in cash		$ 2,700
Beginning cash balance		0
Ending cash balance		$ 2,700

Upon examining George's financial statements, the bank would certainly be concerned because George paid out more in dividends than the net income he realized during the year. George's statement of retained earnings shows a negative balance, which means that the payment to equity investors, which was disguised as return *on* capital was in fact a return *of* capital. Generally, dividend payments cannot exceed the Retained Earnings balance.

LO: 3,4; 5 **BT:** C, AP; **Difficulty:** Hard; **Total Time:** 35minutes; **AACSB:** Analytic; **AICPA:** Measurement

E2.14

Mary's Business
Income Statement
For the Year Ended__

Rent revenue	$ 12,000
Operating Expenses	14,000
Net loss	$ (2,000)

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Mary's Business
Statement of Shareholders' Equity
For the Year Ended__

	Common Stock	Retained Earnings
Beginning Balance	$ 0	$ 0
Stock Issue	30,000	
Net Income (Loss)		(2,000)
Cash Dividends		(1,000)
Ending Balance	$30,000	$ (3,000)

Mary's Business
Balance Sheet
As of____

Assets	
Cash	$ 2,000*
Land	40,000
Total assets	$ 42,000
Liabilities & Shareholders' Equity	
Note payable	$ 15,000
Common Stock	30,000
Retained earnings	(3,000)
Total liabilities & shareholders' equity	$ 42,000

* $2,000 = $30,000 equity + $15,000 loan - $40,000 land purchase + $12,000 rent - $14,000 expenses - $1,000 dividend.

Mary's Business
Statement of Cash Flows
For the Year Ended

Cash flows from operating activities:		
Cash collections from customers	$ 12,000	
Cash payments for expenses	(14,000)	
Net cash flow from operating activities		$(2,000)
Cash flows from investing activities:		
Purchase of land	$ (40,000)	
Net cash flow from investing activities		(40,000)
Cash flows from financing activities:		
Proceeds from equity investor	$ 30,000	
Proceeds from borrowing	15,000	
Cash payments for dividends	(1,000)	
Net cash flow from financing activities		44,000
Increase in cash		$ 2,000
Beginning cash balance		0
Ending cash balance		$ 2,000

Mary should not have paid a cash dividend of $1,000 because of her dwindling cash position and negative earnings during the year. The dividend was a return *of* capital rather than a return *on* capital.

LO: 3,4,5; **BT:** C, AP; **Difficulty:** Hard; **Total Time:** 35minutes; **AACSB:** Analytic; **AICPA:** Measurement

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PROBLEMS

P2.1

1.	e	9.	a	17.	d
2.	e	10.	a	18.	a
3.	a	11.	c	19.	h
4.	a	12.	d	20.	e
5.	g	13.	c	21.	e
6.	c	14.	b	22.	e
7.	f	15.	e		
8.	c	16.	a		

X Company
Balance Sheet
(Date)

Assets			
Current assets:			
Cash		$XX	
Short-term investments		XX	
Accounts receivable	$XX		
Less: Allowance for uncollectible accounts	XX	XX	
Inventory		XX	
Prepaid rent		XX	
Total current assets			$XX
Long-term investments:			
Long-term investments		XX	
Total long-term investments			XX
Property, plant, & equipment			
Land		XX	
Buildings		XX	
Machine		XX	
Less: Accumulated depreciation		XX	
Net Property, plant, & equipment			XX
Intangible assets:			
Patents		$XX	
Less: Accumulated amortization		XX	
Total intangible assets			XX
Total assets			$XX
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable		$XX	
Payroll payable		XX	
Dividends payable		XX	
Short-term notes payable		XX	
Current maturities of long-term debt		XX	
Unearned Revenue		XX	
Total current liabilities			$XX

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Long-term liabilities:		
Bonds payable	$XX	
Total long-term liabilities		XX
Shareholders' equity:		
Contributed Capital:		
Common stock	$XX	
Retained earnings	XX	
Total shareholders' equity		XX
Total liabilities and shareholders' equity		$XX

LO: 4; **BT:** C; **Difficulty:** Easy; **Total Time: 15**minutes; **AACSB:** Analytic; **AICPA:** Measurement

P2.2

1.	e	6.	e	11.	c
2.	b	7.	e	12.	f
3.	e	8.	f	13.	d
4.	a	9.	c	14.	c
5.	e	10.	e		

X Company
Income Statement
For the Period Ended _____

Revenues:		
Sales	$XX	
Service revenue	XX	
Total revenues		XX
Expenses:		
Cost of goods sold		XX
Operating expenses:		
Payroll expense	$XX	
Selling and administrative expenses	XX	
Insurance expense	XX	
Depreciation expense	XX	
Supplies expense	XX	
Advertising expense	XX	
Total operating expenses		XX
Other income/expenses:		
Interest revenue	XX	
Dividend revenue	XX	
Gain on sale of investments	XX	
Interest expense	XX	
Gain on disposal of plan assets	XX	
Loss on disposal of plant assets	XX	
Total other income/expenses		XX
Net income		$XX

LO: 4; **BT:** C; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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P2.3

Nimmo Brothers Corporation

Statement of Cash Flows	
for the year ending 12/31/2020	
Cash-Operating	275
Cash-Investing	(200)
Cash-Financing	330
Δ in Cash	405
Cash-12/31/19	420
Cash-12/31/20	825

Balance Sheet		
as of 12/31/2020		
Cash	825	
Other Current Assets	1,550	
Long-term Assets	1,600	
Total Assets		3,975
Current Liabilities	995	
Long-term Liabilities	1,200	
Common Stock	1,200	
Retained Earnings	580	
Total		3,975

Income Statement	
for the year ending 12/31/2020	
Revenue	4,200
Expenses	4,050
Net Income	150

Statement of Shareholders' Equity	Common Stock	Retained Earnings
for the year ending 12/31/2020		
12/31/19	1,000	500
Net Income		150
Dividends		(70)
Stock Issuance	200	
12/31/20	1,200	580

LO: 4; **BT:** AN; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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P2.4

Johnson Company
Balance Sheet
December 31, 2020

Assets			
Current assets:			
Cash		$ 8,000	
Short-term investments		40,000	
Accounts receivable	$125,000		
Less: Allowance for doubtful accounts	2,400		
Net accounts receivable		122,600	
Inventory		161,000[a]	
Total current assets			$331,600
Property, plant, & equipment:			
Buildings		$ 35,000	
Less: Accumulated depreciation		8,000	
Total property, plant, & equipment			27,000
Total assets			$358,600
Liabilities & Shareholders' Equity			
Current liabilities:			
Accounts payable		$110,000	
Income Taxes payable		29,400	
Total current liabilities			$139,400
Notes payable			79,100
Shareholders' equity:			
Common Stock		$100,000[b]	
Retained earnings		40,100[c]	
Total shareholders' equity			140,100
Total liabilities & shareholders' equity			$358,600

---

a Inventory is reported at the lower of its cost or its market value.

b $100,000 = $12,500 shares × $8 per share.

c $40,100 = $65,000 cumulative earnings – $24,900 cumulative declared dividends.

Based on only one year's balance sheet it is a very difficult question to answer. This fact proves the point that (1) all the financial statements must be interpreted as a whole, and (2) that the information should be analyzed over several years to draw any meaningful conclusions.

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P2.5

2017

Common Stock:

Total assets	=	Total liabilities + Total shareholders' equity
($300 + $200 + $500 + $800)	=	($200 + $500) + (Common Stock + $400)
Common Stock	=	$700

Net Income:

Net income	=	Sales – Operating Expenses
	=	$1,000 – $400
	=	$600

Dividends:

Ending retained earnings	=	Beginning retained earnings + Net income – Dividends
$400	=	$0 + $600 – Dividends
Dividends	=	$200

2018

Inventory:

Total assets	=	Total liabilities + Total shareholders' equity
($300 + $300 + Inventory + $800)	=	($300 + $600) + ($400 + $800)
Inventory	=	$700

Expenses:

Net income	=	Sales – Operating Expenses
$400	=	$1,100 – Operating Expenses
Expenses	=	$700

Dividends:

Ending retained earnings	=	Beginning retained earnings + Net income – Dividends
$800	=	$400 + $400 – Dividends
Dividends	=	$0

2019

Accounts Receivable:

Total assets	=	Total liabilities + Total shareholders' equity
($200 + Accts. rec. + $400 + $1,100)	=	($500 + $800) + ($600 + $300)
Accounts receivable	=	$500

Expenses:

Net income	=	Sales – Operating Expenses
($100)	=	$700 – Operating Expenses
Expenses	=	$800

Dividends:

Ending retained earnings	=	Beginning retained earnings + Net income – Dividends
$300	=	$800 + ($100) – Dividends
Dividends	=	$400

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2020

Accounts Payable:

Total assets	=	Total liabilities + Total shareholders' equity
($500 + $700 + $400 + $1,200)	=	(Accts. pay. + $700) + ($600 + $600)
Accounts payable	=	$900

Net income:

Ending retained earnings	=	Beginning retained earnings + Net income – Dividends
$600	=	$300 + Net income – $200
Net income	=	$500

Sales:

Net income	=	Sales – Operating Expenses
$500	=	Sales – $600
Sales	=	$1,100

LO: 4,5, **BT:** AN; **Difficulty:** Medium; **Total Time:** 25 minutes; **AACSB:** Analytic; **AICPA:** Measurement

P2.6

Kroger
Balance Sheet
December 31, 2019, 2018

	2019	2018
Assets		
Cash	$ 1,610	$ 1,508
Accounts receivable	1,589	1,637
Inventory	6,846	6,533
Total Current Assets	10,045	9,678
Property, plant, and equipment (net)	21,635	21,071
Other assets	6,438	6,448
Total assets	$ 38,118	$ 37,197
Liabilities and Shareholders' Equity		
Accounts payable	$ 6,059	$ 5,858
Other short-term debts	8,215	8,339
Total Current Liabilities	14,274	14,197
Long term debt	16,009	16,095
Shareholders' Equity	7,835	6,905
Total liabilities and shareholders' equity	$ 38,118	$ 37,197

Kroger
Income Statement
For the Years Ended December 31, 2019, 2018

	2019	2018
Sales	$121,162	$122,662
Expenses	118,052	120,755
Net income	$ 3,110	$ 1,907

LO: 4,5, **BT:** C, AN; **Difficulty:** Medium; **Total Time:** 20 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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P2.7

a. Assets are, for the most part, recorded at original cost. Over time, the value of an item will change. For instance, the value of Eat and Run's property, plant, and equipment will most likely change as the items become older. Consequently, over time the cost of an item may have no relation to the item's market value. Since the cash received from selling an asset is based on the asset's market value, the asset's book value is not an accurate indicator of a company's value.

b. The value of the firm would equal the sum of the fair market value of the assets less the sum of liabilities. The value of Eat and Run would, therefore, be as follows:

	Market Value	
Cash	$ 25,000	
Short-term investments	19,000	
Accounts receivable	25,000	
Inventory	33,000	($30,000 + $3,000)
Prepaid insurance	0	
Property, plant, & equipment	100,000	
Patents	0	
Total market value of assets	$ 202,000	
Less: Total liabilities	196,000*	
Value of Eat and Run	$ 6,000	

* $196,000 = $42,000 A/P + $20,000 SWP + $34,000 Accrued P + $75,000 N/P + $25,000 M/P

c. If Eat and Run were to go bankrupt, the shareholders would receive anything left after all the assets were sold and the creditors were paid. In this case the fair market value of the assets exceeds the total liabilities, so the shareholders would receive the residual, which would be $6,000. As a practical matter, Eat and Run might have to hire lawyers and accountants for the bankruptcy proceedings. If this were the case, the lawyers and accountants would have to be paid before the shareholders received anything. In this case, there may be nothing left for the shareholders once the creditors, lawyers, and accountants are paid.

LO: 1, **BT:** AN; **Difficulty:** Medium; **Total Time:** 20 minutes; **AACSB:** Analytic; **AICPA:** Measurement

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P2.8

There are several positive signs that increase the likelihood of granting the loan. First, net income has grown from 2019 to 2020. Second, the dollar amount of assets financed by liabilities appears lower than the amount financed by equity. That is a good sign as it means fewer future cash flows will be required to pay other creditors. Third, the company appears to be generating a good amount of cash from its operating activities, meaning it is doing a good job of converting its profit to cash. In addition, when looking at the investing activity section of the statement of cash flows, the company appears to be investing in its asset base.

LO: 5, **BT:** AN; **Difficulty:** Medium; **Total Time:** 12 minutes; **AACSB:** Analytic; **AICPA:** Measurement

P2.9

There appears to be more negative than positive signals, decreasing the likelihood of investing in this company. First, the trend of net income is down. Second, the company appears to have a large amount of liabilities relative to its overall equity base. That means, a significant portion of its cash flow will be used to make the required payments for these liabilities, leaving less cash to pay dividends to shareholders. Third, while the liquid assets have experienced a slight increase, it is less than the increase in its current liabilities. Finally, while the company is generating cash from operating activities, it has decreased from 2019-2020.

LO: 5, **BT:** AN; **Difficulty:** Medium; **Total Time:** 12 minutes; **AACSB:** Analytic; **AICPA:** Measurement

P2.10

a. As of 12/31/20 the current asset balance of Ellington Industries is 1.33 times the current liability balance (1.33 = $12,000 current asset / $9,000 current liability)

   Since the debt covenant requires this balance to be 2 times the current liability balance, Ellington Industries must have current assets of at least $18,000. It already has $12,000 invested in current assets, it will need to invest an additional $6,000 out of the long-term borrowing of $40,000 to comply with the debt covenant. That would leave $34,000 ($40,000 – $6,000) for additional investment in the land. The land investment will then become $89,000 ($55,000 + $34,000)

b.

Ellington Industries
Balance Sheet
January 1, 2021

Assets	
Current assets	$ 18,000
Land	89,000
Total assets	$ 107,000
Liabilities & Shareholders' Equity	
Accounts payable	$ 9,000
Long-term liabilities	70,000
Shareholders' equity	28,000
Total liabilities and shareholders' equity	$ 107,000

Ratios
Current assets/Current liabilities = $18,000/$9,000 = 2
Total liabilities/Total assets = $79,000*/$107,000 = 0.74

* $79,000 = $9,000 + $70,000

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c.

Ellington Industries
Balance Sheet
December 31, 2021

Assets	
Current assets	$ 36,000
Land	89,000
Total assets	$ 125,000
Liabilities & Shareholders' Equity	
Accounts payable	$ 7,000
Long-term liabilities	70,000
Shareholders' equity	48,000
Total liabilities and shareholders' equity	$ 125,000

Since the dividend will be paid in cash, it will come out of the current assets. According to the restrictions imposed by the debt covenant, the current assets must be twice the current liabilities, i.e., at least $14,000. This would result in an excess of $22,000 ($36,000 – $14,000) in the current assets. Therefore, the company can pay a maximum of $22,000 in dividends without violating the debt covenant.

If the company declares and pays $22,000 in dividends, then total liabilities/total assets would be equal to .75 ($77,000/$103,000*).

* $103,000 = $125,000 Total Assets - $22,000 cash paid dividends

LO: 5, **BT:** AN; **Difficulty:** Hard; **Total Time:** 30minutes; **AACSB:** Analytic; **AICPA:** Measurement

ISSUES FOR DISCUSSION

ID2.1

a. Net income represents the change in net assets (i.e., assets less liabilities) generated during the year from operating activities. Alternatively, cash flows from operating activities are the amount of cash the company generated during the year from operating activities. Since cash is simply one of many assets a company has, it is obvious that net income and cash flows from operating activities are not the same. Thus, it is quite possible for a company to have an increase in net assets from operating activities (i.e., net income) and at the same time, have negative cash flows from operating activities.

The ability of a company to pay dividends is a function of how much cash the company has available. A company could generate negative cash flows from operating activities but have large cash reserves from generating cash from operating activities in prior years. Alternatively, a company may have obtained enough cash to pay a dividend by borrowing the money or by selling assets. Remember, companies can generate cash from investing activities and financing activities in addition to cash from operating activities.

b. A company could not continue generating negative cash flows from operating activities and expect to continue in business. A company cannot borrow money or issue stock indefinitely. At some point, the creditors will demand to be repaid and the owners will demand some return on their investment. Sooner or later the company will have to generate cash from its operations to repay the creditors. Paying out

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dividends while generating negative cash flows from operating activities will only increase the company's cash problems.

LO: 2, **BT:** C, AP; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.2

Analysts and investors following Netflix would react positively to the number of subscribers in general, especially if this number is growing. A critically acclaimed show, similarly, would have a positive effect on interested subscribers and would therefore be welcome news to investors. Subscribers, of course, are the source of cash flow for the company, so additional subscribers will mean additional cash flow for the company. Now whether that incoming cash results in profitable operations depends on the associated expenses of gaining and serving those subscribers. But, as shown on the quarterly financial statements, for the first quarter, at least, the growth of subscribers resulted in revenues exceeding expenses (and well ahead of the previous year's performance). Analysts and investors would look to the income statement and the statement of cash flows for the resulting effects of the subscriber growth.

LO: 2,3, **BT:** AN; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.3

a. The excerpt indicates that the Cummins Engine Company's creditors have imposed restrictions on Cummins as part of the borrowing agreement. The covenants restrict Cummins' abilities to pay dividends and borrow money and the relative amount of its current assets and current liabilities. If Cummins fails to comply with the covenants, its creditors could require Cummins to repay the loans immediately.

b. A bank or other creditor would impose such restrictions to protect itself from a loan default. That is, creditors impose restrictions on borrowers, such as the amount of cash that can be paid out for dividends, which increases the probability that the borrower will have sufficient resources to be able to make the interest and principal payments required under the borrowing agreement.

c. Debt covenants are often explicitly based on financial accounting numbers; for example, the fact that current assets must be greater (1.25 in this example) than current liabilities. For example, the measure is based on the amount of current assets and current liabilities reported on Cummins' balance sheet. Similarly, compliance with the dividend restriction can be assessed by examining the dollar amount of dividends declared and paid as reported in the statement of retained earnings and statement of cash flows.

LO: 1, **BT:** AN; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.4

TJ Maxx: TJ Maxx is generating significant cash from its operating activities and using this cash to invest into its assets and return cash to either the creditors and/or owners.

Pier One: Pier One is struggling from a cash perspective. It has negative cash from its operating activities and did invest monies into assets. Financing activities are positive so they either borrowed more money or sold stock.

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Pepsico: Pepsico is generating strong cash from its operating activities as well as its investing activities. The cash it received from selling assets must have been greater than the cash paid for investing in assets. The cash generated from operating and investing activities was returned to either the creditors and/or owners, which is evidenced by the negative cash flow from financing activities.

LO: 3, **BT:** C; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.5

From the data given about the United Technologies Corporation, United Technologies appears to have done a good job of generating cash from its operating activities as this amount grew each year from 2017-2019. In all three years, it invested in its assets with a significant amount occurring in 2018. It is likely that the company made one or more significant purchases of other companies during this year. During 2017 and 2019, the company returned cash to its creditors and/or owners as evidenced by the negative financing activity cash flows. However, during 2018, United raised a significant amount of cash via its financing activities, which likely helped finance the significant investing it made during 2018.

LO: 3, **BT:** C; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.6

Earnings according to GAAP are accrual numbers, meaning that they don't represent cash. For some income statement numbers, there is a timing difference between the accrual and cash effect. For example, net income represents revenues minus expenses, but revenue can be recognized even if the company has yet to receive the cash (e.g., a company will record account receivables with the expectation that cash will be received at a later date). However, if the accounts receivable, which represents a promise from a customer to pay cash, never converts into cash, the accrual net income figure is an overstatement of the company's earnings power. Investors, therefore, look at net income in conjunction with operating cash flow to determine if the various components of accrual net income are supported by cash flows.

LO: 5; **BT:** AP; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.7

Both General Electric (GE) and Comcast are interested in focusing efforts on core business activities: for GE, running a television network did not fit in with its manufacturing and financial businesses, while Comcast saw a television network as a logical vertical extension of its core business of providing cable television services to consumers.

The NBC transaction was completed simultaneously, with NBC's ownership switching from GE/Vivendi to Comcast/GE. From GE's perspective, it saw a net cash inflow (cash from investing activities decreased to purchase Vivendi's 20% share and then increased when the 51% stake was sold to Comcast), while its balance sheet ultimately showed a decrease in NBC-related assets (from a consolidation of all NBC assets to a line item investment in NBC).

LO: 4; **BT:** AP; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Analytic; **AICPA:** Measurement

ID2.8

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An analyst following both Nike (GAAP) and Adidas (IFRS) would not be pleased with the SEC decision. An analyst would like to review the financial results of the companies in a side-by-side, "apples-to-apples" comparison. With the previous requirement, the analyst could take the reconciliation prepared by Adidas and compare its net income and shareholders' equity to those of Nike. Once the requirement was dropped, the analyst (with the same need for industry peer comparison) would effectively have to do the reconciliation by him/herself. The analyst would therefore need to be an expert in both GAAP and IFRS to compare the results of the two footwear and athletic apparel firms.

LO: 2,4, **BT:** AP; **Difficulty:** Medium; **Total Time:** 15 minutes; **AACSB:** Diversity; **AICPA:** Measurement

ID2.9

a.

	2019	2018	2017
Net Income (A)	$11,584	$13,066	$ 9,366
Sales (B)	$69,570	$59,434	$55,137
Net Income / Sales (A) / (B)	0.167	0.220	0.170

b.

	2019	2018
Current assets (CA)	$ 28,124	$ 16,825
Current liabilities (CL)	31,341	17,860
CA - CL	(3,217)	(1,035)

c.

	2019	2018
Total liabilities	$100,095	$45,766
Total assets	$193,984	$98,598
Total L / Total A	0.52	0.46

d. In each of the three years (2017, 2018, and 2019), Disney is generating strong cash flows from its operating activities. Disney uses this cash to invest in assets (as evidenced by the negative cash flow from investing activities) and returns some to creditors and/or owners.

e. Yes, Disney does pay dividends to its shareholders. The dividend amount is on the statement of shareholders' equity and in the financing activity section of the statement of cash flows.

LO: 5, **BT:** AN; **Difficulty:** Hard; **Total Time:** 30 minutes; **AACSB:** Analytic; **AICPA:** Research

DA2.1
Data and Analytics

Analysis table resulting from data extraction

	Nordstrom 2019	Nordstrom 2018	Macys 2019	Macys 2018
Net income	564	437	1,108	1,566
Total assets	7,886	8,115	19,194	19,583
Total liabilities	7,013	7,138	12,758	13,850
Total shareholders' equity	873	977	6,436	5,733

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	Nordstrom 2019	Nordstrom 2018	Macys 2019	Macys 2018
Cash flow from operating activities	1,296	1,400	1,735	1,976
Cash flow from investing activities	(653)	(684)	(456)	(351)
Cash flow from financing activities	(867)	(542)	(1,544)	(1,446)

Comparing the financial performance of Nordstrom and Macys

Net Income:

Macys reports higher net income than Nordstrom for both years. Nordstrom's net income increased from 2018 to 2019 while Macys' decreased.

Total Assets, Liabilities, and Shareholders' Equity:

Macys, a much larger company, reports total assets more than two times that of Nordstrom, which relies more heavily on liabilities as a source of financing its assets. Nordstrom's liabilities to total asset ratio (Total Liabilities / Total Assets) is about 88% – 89% for both years ($7,138 / $8,115 = 88% for 2018; $7,013 / $7,886 = 89% for 2019), while Macys' ranges between 66% and 69%. ($13,580 / $19,583 = 69% for 2018; $12,758 / $19,194 = 66% for 2019). Shareholders' equity dipped for Nordstrom most likely because the cash it returned to shareholders (i.e., dividends/repurchase stock) was greater than its net income; conversely, the shareholders' equity for Macys increased likely because its net income exceeded the cash it returned to shareholders.

Cash from Operating, Investing, and Financing Activities:

While Macys' cash flows tend to be larger than Nordstrom, both generate more than enough cash from operating activities to cover their investing activities. Also, the negative numbers in the cash flows from financing activities indicate that both companies pay more cash to their capital providers (shareholders and lenders) than they collect from them, which is expected for mature profitable companies.

LO: 6; **BT:** AN; **Difficulty:** Moderate; **Total Time:** 20 minutes; **AACSB:** Technology;
AICPA: Leverage Technology

LO: 6; **BT:** AN; **Difficulty:** Moderate; **Total Time:** 20 minutes; **AACSB:** Technology;
AICPA: Leverage Technology

DA2.2
Data and Analytics
Analysis table resulting from data extraction

	Pfizer 2019	Pfizer 2018	Merck 2019	Merck 2018
Net income	16,273	11,153	9,843	6,220
Total assets	167,489	159,422	84,397	82,637
Total liabilities	104,042	95,664	58,396	55,755
Total shareholders' equity	63,447	63,758	26,001	26,882
Cash flow from operating activities	12,588	15,827	13,440	10,922

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	Pfizer 2019	Pfizer 2018	Merck 2019	Merck 2018
Cash flow from investing activities	(3,945)	4,525	(2,629)	4,314
Cash flow from financing activities	(8,550)	(20,441)	(8,827)	(13,570)

Comparing the financial performance of Pfizer and Merck

Net Income:

Pfizer reports considerably higher net income than Merck for 2018

Total Assets, Liabilities, and Shareholders' Equity:

Pfizer, a much larger company, reports total assets around two times that of Merck. Both rely heavily on liabilities as a source of financing their assets. Pfizer's liabilities to total asset ratio (Total Liabilities / Total Assets) ranged from 60% to 62% ($95,664 / $159,422 = 60% for 2018 and $104,042 / $167,489 = 62% for 2019), while Merck's ranged from 67% to 69% ($55,755 / $82,637 = 67% for 2018 and $58,396 / $84,397 = 69%). Shareholders' equity decreased across both firms.

Cash from Operating, Investing, and Financing Activities:

Pfizer's cash flows are larger than Merck's, especially from its operating activities. Neither company seems to be investing heavily in its business or in other businesses. However, both companies either paid off significant debt or returned cash to shareholders that was greater than net income, as evidenced by the negative cash flow from financial activities. In other words, the negative numbers in the cash flows from financing activities indicate that both companies pay more cash to their capital providers (shareholders and lenders) than they collect from them.

LO: 6; **BT:** AN; **Difficulty:** Moderate; **Total Time:** 20 minutes; **AACSB:** Technology;
AICPA: Leverage Technology

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