Financial Accounting 9th edition Libby Solutions Manual

SKU: 9781259222139-SOLUTIONS

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Chapter 2
Investing and Financing Decisions and the Accounting System

ANSWERS TO QUESTIONS

1. The primary objective of financial reporting for external users is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. These users are expected to have a reasonable understanding of accounting concepts and procedures. Usually, they are interested in information to assist them in projecting future cash inflows and outflows of a business.

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

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

   (c) A liability is a probable future sacrifice of economic benefits of the entity arising from preset obligations as a result of a past transaction.

   (d) A current liability is a liability that will be settled by providing cash, goods, or other services within the coming year.

   (e) Additional paid-in capital is the owner-provided financing to the business that represents the excess of the amount received when the common stock was issued over the par value of the common stock.

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

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

(b) The monetary unit assumption requires information to be reported in the national monetary unit without any adjustment for changes in purchasing power. That means that each business will account for and report its financial results primarily in terms of the national monetary unit, such as Yen in Japan and Australian dollars in Australia.

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

(d) Historical cost is a measurement model that requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all noncash considerations.

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

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

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

Assets = Liabilities + Stockholders' Equity

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

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

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

Assets = Liabilities + Stockholders' Equity

The two principles underlying the process are:

* every transaction affects at least two accounts.
* the accounting equation must remain in balance after each transaction.

The two steps in transaction analysis are:

(1) identify and classify accounts and the direction and amount of the effects.

(2) determine that the accounting equation (A = L + SE) remains in balance.

10. The equalities in accounting are:

(a) Assets = Liabilities + Stockholders' Equity

(b) Debits = Credits

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

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

13. The current ratio is computed as current assets divided by current liabilities. It measures the ability of the company to pay its short-term obligations with current assets. A ratio above 1.0 normally suggests good liquidity (that is, the company has sufficient current assets to settle short-term obligations). Sophisticated cash management systems allow many companies to minimize funds invested in current assets and have a current ratio below 1.0. However, a ratio that is too high in relation to other competitors in the industry may indicate inefficient use of resources.

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

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MULTIPLE CHOICE

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

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(Time in minutes)

Mini-exercises		*Exercises*		*Problems*		*Alternate Problems*		*Cases and Projects*	
No.	*Time*	*No.*	*Time*	*No.*	*Time*	*No.*	*Time*	*No.*	*Time*
1	3	1	8	1	20	1	20	1	15
2	3	2	15	2	25	2	25	2	15
3	4	3	8	3	40	3	40	3	15
4	4	4	10	4	15	4	15	4	20
5	5	5	10	5	40			5	15
6	3	6	10	6	20			6	20
7	3	7	10					7	30
8	6	8	15					8	20
9	6	9	20					9	*
10	6	10	20						
11	6	11	20						
12	4	12	20			*Continuing Problem*			
13	4	13	20						
		14	20						
		15	20			1	40		
		16	20						
		17	20						
		18	10						
		19	10						
		20	10						
		21	10						
		22	15						

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

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MINI-EXERCISES

M2–1.

F (1) Going concern assumption
H (2) Historical cost
G (3) Credits
A (4) Assets
I (5) Account

M2–2.

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

M2–3.

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

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M2–4.

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

M2–5.

	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Cash	+30,000		Notes payable	+30,000			
b.	Cash	–10,000						
	Notes receivable	+10,000						
c.	Cash	+500					Common stock	+10
							Additional paid-in capital	+490
d.	Cash	–5,000		Notes payable	+10,000			
	Equipment	+15,000						
e.	Cash	–2,000					Retained earnings	–2,000

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M2–6.

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

M2–7.

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

M2–8.

a.	Cash (+A)	30,000	
	Notes Payable (+L)		30,000
b.	Notes Receivable (+A)	10,000	
	Cash (–A)		10,000
c.	Cash (+A)	500	
	Common Stock (+SE)		10
	Additional Paid-in Capital (+SE)		490
d.	Equipment (+A)	15,000	
	Cash (–A)		5,000
	Notes Payable (+L)		10,000
e.	Retained Earnings (–SE)	2,000	
	Cash (–A)		2,000

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M2–9.

Cash			
Beg.	900		
(a)	30,000	10,000	(b)
(c)	500	5,000	(d)
		2,000	(e)
	14,400		

Notes Receivable			
Beg.	1,000		
(b)	10,000		
	11,000		

Equipment			
Beg.	15,100		
(d)	15,000		
	30,100		

Notes Payable			
		3,000	Beg.
		30,000	(a)
		10,000	(d)
		43,000	

Common Stock			
		1,000	Beg.
		10	(c)
		1,010	

Additional Paid-in Capital			
		3,000	Beg.
		490	(c)
		3,490	

Retained Earnings			
		10,000	Beg.
(e)	2,000		
		8,000	

M2-10.

Dennen, Inc. Trial Balance January 31		
	Debit	**Credit**
Cash	$14,400	
Notes receivable	11,000	
Equipment	30,100	
Notes payable		$43,000
Common stock		1,010
Additional paid-in capital		3,490
Retained earnings		8,000
Totals	$55,500	$55,500

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M2–11.

Dennen Inc.
Balance Sheet
At January 31

Assets		***Liabilities***	
Current assets:		*Current liabilities:*	
Cash	$ 14,400	Notes payable	$ 43,000
Notes receivable	11,000	Total current liabilities	43,000
Total current assets	25,400	***Stockholders' Equity***	
		Common stock	1,010
Equipment	30,100	Additional paid-in capital	3,490
		Retained earnings	8,000
		Total stockholders' equity	12,500
		Total Liabilities &	
Total Assets	$55,500	***Stockholders' Equity***	$55,500

M2–12.

Current Ratio =

	Current Assets	÷	Current Liabilities		
2013	280,000	÷	155,000	=	1.806
2014	270,000	÷	250,000	=	1.080

This ratio indicates that Sal's Taco Company has sufficient current assets to settle current liabilities, but that the ratio has also decreased between 2013 and 2014 by .726 (40%). Sal's Taco Company ratio is lower than Chipotle's 2014 ratio (of 3.576), indicating that Sal's Taco Company appears to have weaker liquidity than Chipotle; Sal's has less liquidity to withstand an economic downturn.

M2–13.

(a) F

(b) I

(c) F

(d) I

(e) F

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EXERCISES

E2–1.

E (1) Transaction
F (2) Going concern assumption
B (3) Balance sheet
P (4) Liabilities
K (5) Assets = Liabilities + Stockholders' Equity
M (6) Notes payable
L (7) Common stock
H (8) Historical cost
I (9) Account
Q (10) Dual effects
O (11) Retained earnings
A (12) Current assets
C (13) Separate entity assumption
X (14) Par value
D (15) Debits
J (16) Accounts receivable
N (17) Monetary unit assumption
W (18) Faithful representation
T (19) Relevance
R (20) Stockholders' Equity

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E2–2.

Req. 1

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

Req. 2

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

Req. 3

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

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E2–3.

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

E2–4.

Event	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Cash	+40,000					Common stock	+1,000
							Additional paid-in capital	+39,000
b.	Equipment	+15,000		Accounts payable	+12,000			
	Cash	–3,000						
c.	Cash	+10,000		Notes payable	+10,000			
d.	Note receivable	+800						
	Cash	–800						
e.	Land	+13,000		Mortgage notes payable	+9,000			
	Cash	–4,000						

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E2–5.

Req. 1

Event	Assets		=	Liabilities		+	Stockholders' Equity	
a.	Buildings	+172		Notes payable (long-term)	+10			
	Equipment	+270						
	Cash	– 432						
b.	Cash	+345					Common stock	
							Additional paid-in capital	+200
								+145
c.				Dividends payable	+145		Retained earnings	–145
d.	Short-term Investments	+7,616						
	Cash	-7,616						
e.	No effects							
f.	Cash	+4,313						
	Short-term Investments	–4,313						

Req. 2

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

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E2–6.

a.	Cash (+A)	40,000	
	Common stock (+SE)*		1,000
	Additional paid-in capital (+SE)		39,000
b.	Equipment (+A)	15,000	
	Cash (–A)		3,000
	Accounts payable (+L)		12,000
c.	Cash (+A)	10,000	
	Notes payable (+L)		10,000
d.	Notes receivable (+A)	800	
	Cash (–A)		800
e.	Land (+A)	13,000	
	Cash (–A)		4,000
	Mortgage notes payable (+L)		9,000

*Common stock at par value: 1,000 shares x $1 par value = $1,000
Additional paid-in capital is the excess over market: 1,000 shares x $39 excess = $39,000

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E2–7.

Req. 1

a.	Buildings (+A)	172	
	Equipment (+A)	270	
	Cash (–A)		432
	Notes payable (+L)		10
b.	Cash (+A)	345	
	Common stock (+SE)		200
	Additional paid-in capital (+SE)		145
c.	Retained earnings (–SE)	145	
	Dividends payable (+L)		145
d.	Short-term investments (+A)	7,616	
	Cash (–A)		7,616
e.	No journal entry required.		
f.	Cash (+A)	4,313	
	Short-term investments (–A)		4,313

Req. 2

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

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E2–8.

Req. 1

a.	Cash (+A)	30,000	
	Notes payable (+L)		30,000
b.	Cash (+A) *(500 shares x $30 market value per share)*	15,000	
	Common stock (+SE) *(500 shares x $0.10 par value)*		50
	Additional paid-in capital (+SE) *(difference)*		14,950
c.	Buildings (+A)	115,000	
	Cash (–A)		23,000
	Notes payable (+L)		92,000
d.	Equipment (+A)	20,000	
	Cash (–A)		4,000
	Accounts payable (+L)		16,000
e.	Notes receivable (+A)	1,000	
	Cash (–A)		1,000
f.	Accounts payable (–L)	2,000	
	Cash (–A)		2,000
g.	Short-term investments (+A)	10,000	
	Cash (–A)		10,000

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E2–9.

Req. 1

Cash		
Beg.	0	
(a)	70,000	4,500 (b)
(d)	3,000	2,500 (e)
	66,000	

Notes Receivable		
Beg.	0	
(e)	2,500	
	2,500	

Equipment		
Beg.	0	
(b)	18,000	
	18,000	

Land		
Beg.	0	
(d)	15,000	
	15,000	

Notes Payable		
		0 Beg.
		13,500 (b)
		13,500

Common Stock		
		0 Beg.
		5,040 (a)*
		100 (d)
		5,140

Additional Paid-in Capital	
	0 Beg.
	64,960 (a)
	17,900 (d)
	82,860

*6 investors x 8,400 shares each = 50,400 shares issued
50,400 shares issued x $0.10 par value per share = $5,040 for common stock

Req. 2

Assets $ 101,500 = Liabilities $ 13,500 + Stockholders' Equity $ 88,000

Req. 3

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

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E2–10.

Req. 1

Cash			Notes Receivable			Equipment		
Beg.	0		Beg.	0		Beg.	0	
(a)	60,000	9,000 (b)	(c)	2,500		(b)	36,000	
		2,500 (c)						
		12,000 (e)						
	36,500			2,500			36,000	

Land			Notes Payable			Common Stock		
Beg.	0				0 Beg.			0 Beg.
(a)	35,000		(e)	12,000	27,000 (b)			300 (a)*
	35,000				15,000			300

Additional Paid-in Capital		
		0 Beg.
		94,700 (a)*
		94,700

* Common Stock: 3 investors x 1,000 shares each = 3,000 shares issued
3,000 shares issued x $0.10 par value per share = $300 for common stock
Additional Paid-in Capital: $95,000 received - $300 par value = $94,700

Req. 2

Assets $ 110,000 = Liabilities $ 15,000 + Stockholders' Equity $ 95,000

Req. 3

Since transaction (d) is a personal purchase, not purchased by Precision Builders, there is no effect on the business due to the separate entity assumption.

Req. 4

Market value per share = total received ÷ number of shares issued
= $95,000 ÷ 3,000 shares issued
= $31.67 per share

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E2–11.

Req. 1

Transaction	*Brief Explanation*
1	Issued common stock to shareholders for $15,000 cash. (FastTrack Sports Inc. is a corporation because it issues stock. Par value of the stock was $0.10 per share because $1,500 common stock amount divided by 15,000 shares issued equals $0.10 per share).
2	Borrowed $75,000 cash and signed a short-term note for this amount.
3	Purchased land for $16,000; paid $5,000 cash and gave an $11,000 short-term note payable for the balance.
4	Loaned $4,000 cash; borrower signed a short-term note for this amount (Note Receivable).
5	Purchased store fixtures for $9,500 cash.
6	Purchased land for $4,000, paid for by signing a short-term note.

Req. 2

FastTrack Sports Inc.
Balance Sheet
At January 7

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$71,500	Note payable	$90,000
Note receivable	4,000	*Total Current Liabilities*	90,000
Total Current Assets	75,500		
		Stockholders' Equity	
Store fixtures	9,500	Common stock	1,500
Land	20,000	Additional paid-in capital	13,500
		Total Stockholders' Equity	15,000
		Total Liabilities &	
Total Assets	$105,000	***Stockholders' Equity***	$105,000

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E2–12.

Req. 1

Transaction	*Brief Explanation*
1	Issued common stock to shareholders for $45,000 cash. (Volz Cleaning is a corporation because it issues stock. Par value is $2.00 per share $6,000 common stock amount divided by 3,000 shares issued equals $2.00 per share).
2	Purchased a delivery truck for $35,000; paid $8,000 cash and gave a $27,000 long-term note payable for the balance.
3	Loaned $2,000 cash; borrower signed a short-term note for this amount.
4	Purchased short-term investments for $7,000 cash.
5	Sold short-term investments at cost for $3,000 cash.
6	Purchased computer equipment for $4,000 cash.

Req. 2

Volz Cleaning, Inc.
Balance Sheet
At March 31

Assets		***Liabilities***	
Current Assets		Notes payable	$27,000
Cash	$27,000	*Total Liabilities*	27,000
Investments	4,000		
Note receivable	2,000		
Total Current Assets	33,000	***Stockholders' Equity***	
		Common stock	6,000
Computer equipment	4,000	Additional paid-in capital	39,000
Delivery truck	35,000	*Total Stockholders' Equity*	45,000
		Total Liabilities &	
Total Assets	$72,000	***Stockholders' Equity***	$72,000

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E2–13.

a.	Cash (+A)	70,000	
	Common stock (+SE)		5,000
	Additional paid-in capital (+SE)		65,000
b.	No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.		
c.	Cash (+A)	18,000	
	Notes payable (long-term) (+L)		18,000
d.	Equipment (+A)	11,000	
	Cash (–A)		1,500
	Notes payable (short-term) (+L)		9,500
e.	Notes receivable (short-term) (+A)	2,000	
	Cash (–A)		2,000
f.	Store fixtures (+A)	15,000	
	Cash (–A)		15,000

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E2–14.

a.	Retained earnings (–SE)	1,508	
	Dividends payable (+L)		1,508

b. No transaction has occurred because there has been no exchange or receipt of cash, goods, or services.

c.	Dividends payable (–L)	852	
	Cash (–A)		852

d.	Cash (+A)	5,899	
	Notes payable (+L)		5,899

e.	Cash (+A)	53	
	Equipment (–A)		53

f.	Equipment (+A)	2,598	
	Cash (–A)		2,250
	Notes payable (+L)		348

g.	Investments (+A)	2,616	
	Cash (–A)		2,616

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E2–15.

Req. 1

Assets $ 10,500 = Liabilities $ 3,000 + Stockholders' Equity $ 7,500

Req. 2

Cash			Short-Term Investments			Property & Equipment		
Beg.	5,000		Beg.	2,500		Beg.	3,000	
(a)	4,000				1,500 (b)			1,500 (c)
(b)	1,500							
(c)	1,500	800 (d)						
End.	11,200		End.	1,000		End.	1,500	

Short-Term Notes Payable		Long-Term Notes Payable	
	2,200 Beg.		800 Beg.
			4,000 (a)
	2,200 End.		4,800 End.

Common Stock		Additional Paid-in Capital		Retained Earnings			
	500 Beg.		4,000 Beg.				3,000 Beg.
				(d)	800		
	500		4,000				2,200

Req. 3

Assets $ 13,700 = Liabilities $ 7,000 + Stockholders' Equity $ 6,700

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$11,200+\$1,000}{\$2,200} = \frac{\$12,200}{\$2,200} = 5.55$$

This ratio indicates that, for every $1 of current liabilities, Higgins maintains $5.55 of current assets. Higgins' ratio is higher than the industry average of 1.50, indicating that Higgins maintains a lower level of short-term debt and has higher liquidity. However, maintaining such a high current ratio also suggests that the company may not be using its resources efficiently. Increasing short-term obligations would lower Higgins' current ratio, but this strategy alone would not help its efficiency. Higgins should consider investing more of its cash in order to generate future returns.

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E2–16.

Higgins Company
Balance Sheet
At December 31

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$ 11,200	Short-term notes payable	$ 2,200
Short-term investments	1,000	*Total Current Liabilities*	2,200
Total Current Assets	12,200	Long-term notes payable	4,800
		Total Liabilities	7,000
		Stockholders' Equity	
		Common stock	500
		Additional paid-in capital	4,000
Property and equipment	1,500	Retained earnings	2,200
		Total Stockholders' Equity	6,700
		Total Liabilities &	
Total Assets	$13,700	***Stockholders' Equity***	$13,700

E2–17.

Req. 1

Cash

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

Short-Term Notes Receivable

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

Land

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

Equipment

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

Short-Term Notes Payable

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

Long-Term Notes Payable

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

Common Stock

		0	Beg.
		10,000	(a)
		10,000	

Additional Paid-in Capital

		0	Beg.
		30,000	(a)
		30,000	

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E2–17. (continued)

Req. 2

Strauderman Delivery Company, Inc. Trial Balance December 31, 2016		
	Debit	**Credit**
Cash	$35,000	
Short-term notes receivable	4,000	
Land	12,000	
Equipment	21,000	
Short-term notes payable		$16,000
Long-term notes payable		16,000
Common stock		10,000
Additional paid-in capital		30,000
Totals	$72,000	$72,000

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E2–17. (continued)

Req. 3

Strauderman Delivery Company, Inc.
Balance Sheet
At December 31, 2016

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$35,000	Short-term notes payable	$16,000
Short-term note receivable	4,000	*Total Current Liabilities*	16,000
Total Current Assets	39,000	Long-term notes payable	16,000
		Total Liabilities	32,000
Land	12,000		
Equipment	21,000	***Stockholders' Equity***	
		Common stock	10,000
		Additional paid-in capital	30,000
		Total Stockholders' Equity	40,000
		Total Liabilities &	
Total Assets	$72,000	***Stockholders' Equity***	$72,000

Req. 4

	Current Assets	÷	Current Liabilities	=	Current Ratio
2016	$39,000	÷	$16,000	=	2.44
2017	52,000	÷	23,000	=	2.26
2018	47,000	÷	40,000	=	1.18

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

Req. 5

The management of Strauderman Delivery Company has already been financing the company's development through additional short-term debt, from $16,000 in 2016 to $40,000 in 2018. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. Based solely on the current ratio, the bank's vice president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

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E2–18.

Transaction	*Brief Explanation*
(a)	Issued 100,000 shares of common stock (par value $0.02 per share) to shareholders in exchange for $20,000 cash and $5,000 tools and equipment.
(b)	Loaned $1,800 cash; borrower signed a note receivable for this amount.
(c)	Purchased a building for $40,000; paid $10,000 cash and signed a $30,000 note payable for the balance.
(d)	Sold tools and equipment for $900 cash (their original cost).

E2–19.

Req. 1

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

Req. 2

Equipment			**Notes Receivable**			**Notes Payable**		
1/1	500		1/1	150			100	1/1
	250	650		245	225	110	170	
12/31	100		12/31	170			160	12/31

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

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E2–20.

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

E2–21.

Activity	Type of Activity	Effect on Cash
(a) Additional borrowing from banks	F	+
(b) Purchase of investments	I	–
(c) Sale of assets and investments (assume sold at cost)	I	+
(d) Issuance of stock	F	+
(e) Purchases of property, plant, and equipment	I	–
(f) Payment of debt principal	F	–
(g) Dividends paid	F	–
(h) Receipt of principal payment on a note receivable	I	+

E2–22.

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

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PROBLEMS

P2–1.

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

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P2–2.

Req. 1

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

Req. 2 (On next page)

Req. 3

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

Req. 4

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

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

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

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

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

Req. 5

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

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

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P2–2. (continued)

Req. 2

	Assets						=	Liabilities		+	Stockholders' Equity		
	Cash	Short-Term Investments	Notes Receivable	Land	Buildings	Equipment		ST Notes Payable	LT Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
Beg.	50,000			500,000	100,000	50,000	=	100,000	100,000		20,000	80,000	400,000
(a)	+90,000						=				+9,000	+81,000	
(b)	–9,000			+14,000	+60,000	+15,000	=		+80,000				
(c)	+3,500			–3,500			=						
(d)	–18,000	+18,000					=						
(e)	No effect												
(f)	–5,000		+5,000				=						
	+111,500	+18,000	+5,000	+510,500	+160,000	+65,000	=	+100,000	+180,000		+29,000	+161,000	+400,000
				$870,000				$280,000			$590,000		

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P2–3.

Req. 1 and 2

Cash		
Beg.	22,000	
(e)	11,000	10,000 (a)
(f)	9,000	5,000 (b)
(i)	1,000	5,000 (c)
		3,000 (g)
		8,000 (h)
	12,000	

Investments (short-term)		
Beg.	3,000	
(a)	10,000	
	13,000	

Accounts Receivable		
Beg.	3,000	
	3,000	

Inventory		
Beg.	20,000	
	20,000	

Notes Receivable (long-term)		
Beg.	1,000	
(b)	5,000	
	6,000	

Equipment		
Beg.	50,000	
(c)	18,000	1,000 (i)
End.	67,000	

Factory Building		
Beg.	90,000	
(h)	24,000	
End.	114,000	

Intangibles		
Beg.	5,000	
(g)	3,000	
End.	8,000	

Accounts Payable		
		15,000 Beg.
		15,000

Accrued Liabilities Payable		
		4,000 Beg.
		4,000

Notes Payable (short-term)		
		7,000 Beg.
		13,000 (c)
		9,000 (f)
		29,000

Long-Term Notes Payable		
		47,000 Beg.
		16,000 (h)
		63,000

Common Stock		
		10,000 Beg.
		1,000 (e)
		11,000

Additional Paid-in Capital		
		80,000 Beg.
		10,000 (e)
		90,000

Retained Earnings		
		31,000 Beg.
		31,000

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P2–3. (continued)

Req. 3

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

Req. 4

Cougar Plastics Company
Trial Balance
At December 31

	Debit	Credit
Cash	$ 12,000	
Investments (short-term)	13,000	
Accounts receivable	3,000	
Inventory	20,000	
Notes receivable (long-term)	6,000	
Equipment	67,000	
Factory building	114,000	
Intangibles	8,000	
Accounts payable		$ 15,000
Accrued liabilities payable		4,000
Notes payable (short-term)		29,000
Notes payable (long-term)		63,000
Common stock		11,000
Additional paid-in capital		90,000
Retained earnings		31,000
Totals	$243,000	$243,000

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P2–3. (continued)

Req. 5

Cougar Plastics Company
Balance Sheet
At December 31

Assets		***Liabilities***	
Current Assets		*Current Liabilities*	
Cash	$ 12,000	Accounts payable	$ 15,000
Investments	13,000	Accrued liabilities payable	4,000
Accounts receivable	3,000	Notes payable	29,000
Inventory	20,000	*Total Current Liabilities*	48,000
Total Current Assets	48,000	Long-term notes payable	63,000
		Total Liabilities	111,000
Notes receivable	6,000		
Equipment	67,000	***Stockholders' Equity***	
Factory building	114,000	Common stock	11,000
Intangibles	8,000	Additional paid-in capital	90,000
		Retained earnings	31,000
		Total Stockholders' Equity	132,000
		Total Liabilities &	
Total Assets	$243,000	***Stockholders' Equity***	$243,000

Req. 6

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

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

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P2–4.

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

P2–5.

Req. 1

a.	Cash (+A)	18,266	
	Long-term debt (+L)		18,266
b.	Long-term investments (+A)	4,200	
	Short-term investments (+A)	16,800	
	Cash (–A)		21,000
c.	Property, plant, and equipment (+A)	10,981	
	Cash (–A)		9,571
	Short-term notes payable (+L)		1,410
d.	Cash (+A)	1,469	
	Common stock (+SE)		1
	Additional paid-in capital (+SE)		1,468
e.	Cash (+A)	18,810	
	Short-term investments (–A)		18,810
f.	Retained earnings (–SE)	11,126	
	Dividends payable (+L)		11,126

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P2–5. (continued)

Req. 2

Cash		
Beg.	13,844	
(a)	18,266	21,000 (b)
(d)	1,469	9,571 (c)
(e)	18,810	
	21,818	

Short-Term Investments		
Beg.	11,233	
(b)	16,800	18,810 (e)
	9,223	

Accounts Receivable		
Beg.	17,460	
	17,460	

Inventories		
Beg.	2,111	
	2,111	

Other Current Assets		
Beg.	23,883	
	23,883	

Long-Term Investments		
Beg.	130,162	
(b)	4,200	
	134,362	

Property, Plant, and Equipment		
Beg.	20,624	
(c)	10,981	
	31,605	

Other Noncurrent Assets		
Beg.	12,522	
	12,522	

Accounts Payable	
	30,196 Beg.
	30,196

Accrued Expenses	
	18,453 Beg.
	18,453

Unearned Revenue	
	8,491 Beg.
	8,491

Short-term Notes Payable	
	6,308
	1,410 (c)
	7,718

Dividends Payable	
	0 Beg.
	11,126 (f)
	11,126

Long-term Debt	
	28,987 Beg.
	18,266 (a)
	47,253

Other Noncurrent Liabilities	
	27,857 Beg.
	27,857

Common Stock	
	1 Beg
	1 (d)
	2

Additional Paid-in Capital	
	23,312 Beg.
	1,468 (d)
	24,780

Retained Earnings		
		88,234 Beg.
(f)	11,126	
		77,108

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P2–5. (continued)

Req. 3

Apple, Inc.
Balance Sheet
At September 26, 2015
(in millions)

ASSETS	
Current Assets:	
Cash	$ 21,818
Short-term investments	9,223
Accounts receivable	17,460
Inventories	2,111
Other current assets	23,883
Total current assets	**74,495**
Long-term investments	134,362
Property, plant and equipment	31,605
Other noncurrent assets	12,522
Total assets	**$252,984**
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities:	
Accounts payable	$30,196
Accrued expenses	18,453
Unearned revenue	8,491
Dividends payable	11,126
Short-term notes payable	7,718
Total current liabilities	**75,984**
Long-term debt	47,253
Other noncurrent liabilities	27,857
Total liabilities	151,094
Stockholders' Equity:	
Common stock	2
Additional paid-in capital	24,780
Retained earnings	77,108
Total stockholders' equity	101,890
Total liabilities and stockholders' equity	**$252,984**

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P2–5. (continued)

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$74,495}{\$75,984} = 0.980$$

For every $1 of short-term liabilities, Apple Inc. has $0.98 of current assets. This suggests that Apple almost has sufficient current resources to pay current liabilities. This may appear to suggest a liquidity problem. What is more likely, however, is that Apple has a very efficient cash management system and keeps its current resources at lower levels to maximize investment opportunities.

P2–6.

Activity	Type of Activity	Effect on Cash
(a) Borrowed from banks	F	+ 18,266
(b) Purchased investments	I	– 21,000
(c) Purchased property, plant, and equipment	I	– 9,571
(d) Issued additional stock	F	+ 1,469
(e) Sold short-term investments	I	+ 18,810
(f) Declared dividends (does not affect cash flows)	NE	NE

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ALTERNATE PROBLEMS

AP2–1.

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

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AP2–2.

Req. 1

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

Req. 2 (On next page)

Req. 3

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

Req. 4

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

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

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

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

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

Req. 5

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

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

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AP2–2. (continued)

Req. 2

	Assets					=	Liabilities		+	Stockholders' Equity		
	Cash	Notes Receivable	Long-Term Investments	Equipment	Building		Short-Term Notes Payable	Long-Term Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
Beg.	120,000			70,000	310,000	=	140,000	60,000		20,000	200,000	80,000
(a)	+110,000					=		+110,000				
(b)	–3,000			+30,000		=	+27,000					
(c)	+100,000					=				+10,000	+90,000	
(d)	–5,000			+10,000		=	+5,000					
(e)	–2,000	+2,000				=						
(f)	–200,000				+200,000	=						
(g)	–85,000		+85,000			=						
(h)				–3,000		=	–3,000					
(i)	No effect					=						
	+35,000	+2,000	+85,000	+107,000	+510,000	=	+169,000	+170,000		+30,000	+290,000	+80,000
				$739,000				$339,000			$400,000	

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AP2–3.

Req. 1 and 2

Cash and Cash Equivalents		
Beg.	78,519	
(a)	1,020	3,400 (b)
(d)	4,020	2,980 (e)
(g)	310	1,830 (f)
	75,659	

Short-Term Investments		
Beg.	12,909	
(e)	2,980	
	15,889	

Accounts Receivable		
Beg.	15,036	
	15,036	

Inventories		
Beg.	141,692	
	141,692	

Prepaid Expenses and Other Current Assets		
Beg.	20,372	
	20,372	

Property, Plant, and Equipment		
Beg.	294,853	
(f)	11,230	4,020 (d)
	302,063	

Intangibles		
Beg.	45,128	
(b)	3,400	
	48,528	

Other Assets		
Beg.	19,816	
		310 (g)
	19,506	

Accounts Payable		
		26,958 Beg.
		26,958

Accrued Expenses Payable		
		127,639 Beg.
		127,639

Dividends Payable		
.		0 Beg
		300 (h)
		300

Long-Term Debt*		
		165,032 Beg.
		9,400 (f)
		174,432

Other Long-Term Liabilities		
		27,009 Beg.
		27,009

Common Stock		
		484 Beg.
		16 (a)
		500

Additional Paid-in Capital		
		359,728 Beg.
		1,004 (a)
		360,732

Retained Earnings		
		501,908 Beg.
(h)	300	
		501,608

Other Stockholders' Equity Items		
Beg.	580,433	
	580,433	

* Current portion is $19.

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AP2–3. (continued)

Req. 3

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

Req. 4

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

	Debit	Credit
Cash and cash equivalents	$ 75,659	
Short-term investments	15,889	
Accounts receivable	15,036	
Inventories	141,692	
Prepaid expenses and other current assets	20,372	
Property, plant, and equipment	302,063	
Intangibles	48,528	
Other assets	19,506	
Accounts payable		$ 26,958
Accrued expenses payable		127,639
Dividends payable		300
Long-term debt (current portion, $19)		174,432
Other long-term liabilities		27,009
Common stock		500
Additional paid-in capital		360,732
Retained earnings		501,608
Other stockholders' equity items	580,433	
Totals	$1,219,178	$1,219,178

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AP2–3. (continued)

Req. 5

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

Assets	
Current assets	
Cash and cash equivalents	$ 75,659
Short-term investments	15,889
Accounts receivable	15,036
Inventories	141,692
Prepaid expenses and other current assets	20,372
Total current assets	268,648
Property, plant, and equipment	302,063
Intangibles	48,528
Other assets	19,506
Total Assets	$638,745
Liabilities	
Current liabilities	
Accounts payable	$ 26,958
Accrued expenses payable	127,639
Dividends payable	300
Current portion of long-term debt	19
Total current liabilities	154,916
Long-term debt	174,413
Other long-term liabilities	27,009
Total Liabilities	356,338
Stockholders' Equity	
Common stock ($0.01 par value)	500
Additional paid-in capital	360,732
Retained earnings	501,608
Other stockholders' equity items	(580,433)
Total Stockholders' Equity	282,407
Total Liabilities and Stockholders' Equity	$638,745

Req. 6

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}} = \frac{\$268,648}{\$154,916} = 1.73$$

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

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AP2–4.

Transaction	Type of Activity	Effect on Cash
(a)	F	+1,020
(b)	I	–3,400
(c)	NE	NE
(d)	I	+4,020
(e)	I	–2,980
(f)	I	–1,830
(g)	I	+310
(h)	NE	NE

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CONTINUING PROBLEM

CON2–1.

Req. 1

		Debit	Credit
a.	Cash (+A)	25,000	
	Equipment (+A)	36,000	
	Common stock (+SE)		200
	Additional paid-in capital (+SE)		60,800
b.	Land (+A)	18,000	
	Building (+A)	72,000	
	Cash (–A)		10,000
	Mortgage notes payable (+L)		80,000
c.	Equipment (+A)	6,500	
	Cash (–A)		2,500
	Short-term notes payable (+L)		4,000
d.	No transaction		
e.	Mortgage notes payable (–L)	1,000	
	Cash (–A)		1,000
f.	Short-term investments (+A)	5,000	
	Cash (–A)		5,000
g.	No transaction		

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CON2–1. (continued)

Req. 2

Cash			
Beg.	0		
(a)	25,000	10,000	(b)
		2,500	(c)
		1,000	(e)
		5,000	(f)
	6,500		

Short-term Investments			
Beg.	0		
(f)	5,000		
	5,000		

Equipment			
Beg.	0		
(a)	36,000		
(c)	6,500		
	42,500		

Land			
Beg.	0		
(b)	18,000		
	18,000		

Buildings			
Beg.	0		
(b)	72,000		
	72,000		

Short-term Notes Payable			
		0	Beg.
		4,000	(c)
		4,000	

Mortgage Notes Payable			
		0	Beg.
(e)	1,000	80,000	(b)
	1,000	79,000	

Common Stock			
		0	Beg.
		200	(a)
		200	

Additional Paid-in Capital			
		0	Beg.
		60,800	(a)
		60,800	

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CON2–1. (continued)

Req. 3

Penny's Pool Service and Supply, Inc. Trial Balance March 31		
	Debit	**Credit**
Cash	$ 6,500	
Short-term investments	5,000	
Equipment	42,500	
Land	18,000	
Buildings	72,000	
Short-term notes payable		$ 4,000
Mortgage notes payable		79,000
Common stock		200
Additional paid-in capital		60,800
Totals	$144,000	$144,000

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CON2–1. (continued)

Req. 4

Penny's Pool Service and Supply, Inc.
Balance Sheet
On March 31

Assets	
Current Assets:	
Cash	$ 6,500
Short-term investments	5,000
Total current assets	11,500
Equipment	42,500
Land	18,000
Buildings	72,000
Total assets	$144,000
Liabilities and Stockholder's Equity	
Current Liabilities:	
Short-term notes payable	$4,000
Total current liabilities	4,000
Mortgage notes payable	79,000
Total liabilities	83,000
Stockholder's Equity:	
Common stock ($0.05 par value)	200
Additional paid-in capital	60,800
Total stockholder's equity	61,000
Total liabilities and stockholder's equity	$144,000

Req. 5

	Type of Activity (I, F, or NE)	Effect on Cash Flows (+ or - and amount)
(a)	F	+ 25,000
(b)	I	- 10,000
(c)	I	- 2,500
(d)	NE	NE
(e)	F	- 1,000
(f)	I	- 5,000
(g)	NE	NE

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CON2–1. (continued)

Req. 6

	Current Assets	÷	Current Liabilities	=	Current Ratio
On March 31	$11,500	÷	$4,000	=	2.875

With a current ratio of 2.875, PPSS has liquidity with sufficient current assets to settle short-term obligations. However, this may change as the inventory is received in April and operations begin requiring paying cash for inventory purchases from suppliers, advertising, utilities, employee salary, and other operating needs, and paying notes payable when due. One of the most significant problems for new small businesses is generating sufficient cash from operations to pay obligations and maintain liquidity.

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CASES AND PROJECTS

ANNUAL REPORT CASES

CP2–1.

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

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

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

4 Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{\$890{,}513}{\$459{,}093} = 1.94$

The current ratio measures the ability of the company to settle short-term obligations with current assets. American Eagle Outfitters' current ratio of 1.94 suggests strong liquidity with $1.94 in current assets for every $1 in current liabilities. In the most recent year presented, the company had a significant amount of cash, partly from selling short-term investments.

5. The company spent $245,002,000 on purchasing property and equipment in the year ended 1/31/15; $278,499,000 in the year ended 2/1/14; and $93,939,000 in the year ended 2/2/13. This information is listed as Capital Expenditures on the Statement of Cash Flows in the investing activities section.

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CP2–2.

1.

Assets	=	Liabilities	+	Shareholders' Equity
$1,888,741,000	=	$560,772,000	+	$1,327,969,000

2. No – shareholders' equity is a residual balance, meaning that the shareholders will receive what remains in cash and assets after the creditors have been satisfied. It is likely that shareholders would receive less than $1,327,969,000. In addition, nearly all assets on the balance sheet are stated at historical cost, not at market value (the amount that could be received if the assets are sold at the end of the year).

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

4. Current Ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$809,117,000}{\$353,740,000} = 2.29$

5. The company had a net cash inflow from investing activities of $194,834,000, primarily because the company sold investments (sold marketable securities for $830,297,000). The company also purchased property and equipment for $229,804,000 and additional marketable securities for $405,659,000.

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CP2–3.

1.	Industry Average	American Eagle Outfitters	Urban Outfitters
Current Ratio =	2.03	1.94	2.29

American Eagle Outfitters' current ratio of 1.94 is lower than the industry average, but Urban Outfitters' current ratio of 2.29 is higher the industry average of 2.03. For the year ended January 31, 2015, Urban Outfitters is more able and American Eagle is less able to meet current obligations compared to the industry average.

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

2. As indicated in the financing activities section of each company's statement of cash flows, during the most recent year, American Eagle Outfitters spent $7,464,000 repurchasing common stock from employees and did not repurchase any common stock from investors. Urban Outfitters spent $611,475,000 repurchasing shares.

3. As indicated in the statement of cash flows, American Eagle Outfitters paid $97,224,000 in dividends. Urban Outfitters did not pay any dividends during the year. Refer to the financing activities section of the statement of cash flows.

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

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FINANCIAL REPORTING AND ANALYSIS CASES

CP2–4.

Dollars are in thousands:

1. (a) Chipotle's total assets reported for the quarter ended September 30, 2014 are $2,437,053.

   (b) Current liabilities increased over nine months from $199,228 at December 31, 2013, to $264,986 on June 30, 2014.

   (c) Current Ratio at 9/30/14 $= \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$873,870}{\$264,986} = 3.298$

   Chipotle's current ratio increased from the level of 3.298 at the end of September 2014 up to 3.576 on December 31, 2014 (as discussed in the chapter). This indicates that, between September 30, 2014, and December 31, 2014, Chipotle increased its liquidity. Current assets increased by approximately $4 million while current liabilities decreased by about $19 million.

2. (a) For the three months ended September 30, 2014, Chipotle spent $160,400 on the purchase of leasehold improvements, property, and equipment.

   (b) The total cash flows used in financing activities was $50,503, mostly from the acquisition of the company's stock from investors ($60,405) called "treasury stock."

CP2–5.

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

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

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

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CP2–6.

Dollars are in thousands:

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

2.

Assets	=	Liabilities	+	Stockholders' Equity
$5,583,082	=	$1,956,679	+	$3,626,403

3.

	Current Assets	÷	Current Liabilities	=	Current Ratio
2014	$4,255,853		$393,794		10.81
2013	2,574,679		225,430		11.42

In 2014, for every $1 of current liabilities, Twitter maintains $10.81 of current assets, suggesting that Twitter is highly liquid and has the ability to pay its short-term obligations with current assets in the upcoming year. Since 2013, the current ratio has dropped slightly from 11.42. The interpretation of this ratio would be more useful given information on the company's current ratio compared to the current ratio for the industry and/or competitors and additional years of data to observe trends.

4.

Accounts Payable (–L)	53,241	
Cash (–A)		53,241

5. Over its years in business, it appears that Twitter has been unprofitable, based on a negative amount in Accumulated Deficit of $1,582,470. The Accumulated Deficit account represents the cumulative losses of the firm since the business began.

   In addition, Twitter appears unprofitable in the most recent year because Accumulated Deficit increased (due to larger losses). It is possible to determine the amount of net loss by using the following equation, assuming no dividends were declared:

(in thousands)

Beginning Accum.. Deficit	+	For the Year: Net Income(Loss)	–	For the Year: Dividends declared	=	Ending Accum. Deficit
$(994,949)	+	?	–	$ 0	=	$(1,582,470)

Thus, net loss for the most recent year was $(587,521).

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CRITICAL THINKING CASES

CP2–7.

Req. 1

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

Assets	
Current Assets:	
Cash	$ 1,000
Accounts receivable	8,000
Inventory	8,000
Total current assets	17,000
Furniture and fixtures	52,000
Delivery truck (net)	12,000
Buildings (net)	60,000
Total assets	$141,000
Liabilities	
Current Liabilities:	
Accounts payable	$ 16,000
Payroll taxes payable	13,000
Total current liabilities	29,000
Notes payable (due in three years)	15,000
Mortgage payable	50,000
Total liabilities	94,000
Stockholders' Equity	
Common stock	4,000
Additional paid-in capital	76,000
Accumulated deficit	(33,000)
Total stockholders' equity	47,000
Total liabilities and stockholders' equity	$141,000

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CP2–7. (continued)

Req. 2

Dear _____,

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

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

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CP2–8.

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

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

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

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

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

CP2–9.

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

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CHAPTER 2
INVESTING AND FINANCING DECISIONS AND THE ACCOUNTING SYSTEM

Learning Objectives and Related Assignment Materials

Learning Objectives	*Mini-Exercises*	*Exercises*	*Problems*	*Alternate Problems*	*Cases and Projects*	*Continuing Case*
2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.	1, 2	1	1	1	1, 2, 5, 7	
2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.	2, 3, 4	1, 2, 3,, 22	1, 2, 3, 5	1, 2, 3	1, 2, 3, 4, 6, 9	
2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.	2, 5	1, 4, 5	2	2		
2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.	1, 2, 6, 7, 8, 9	1, 3, 6, 7, 8, 9, 10, 11, 12, 13, 14 15, 17, 18, 19	1, 3, 5	1, 3	6	1
2-5 Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio.	10, 11, 12	9, 10, 11, 12, 15, 16, 17, 20, 22	2, 3, 5	2, 3	1, 2, 3, 4, 5, 6, 7, 9	1
2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.	13	20, 21, 22	4, 6	4	1, 2, 3, 4, 9	1

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Synopsis of Chapter Revisions

Focus Company: Chipotle Mexican Grill

- Chapter 2 introduces the accounting cycle for Chipotle Mexican Grill, a trendy, yet relatively simple company. The chapter integrates financial information for investing and financing activities for the first quarter of 2015, resulting in the company's actual quarterly balance sheet (with a few simplifications). This fast-casual restaurant does not utilize franchising, thus reducing the complexities found with most other competitors and allowing focused emphasis on transaction analysis, journal entries, T-accounts, and the structure of the balance sheet.
- Focus and contrast company data updated.
- Update of the conceptual framework to reflect the new definitions from the FASB.
- Simplified account titles that relate more closely to end-of-chapter material.
- T-accounts now follow each transaction to illustrate posting the effects, while marginal notes have been deleted for a cleaner visual approach.
- *New* additional GUIDED HELP feature provides free access to step-by-step video instruction applying transaction analysis to identify accounts and effects on the accounting equation. This is in addition to the existing Guided Help for recording, posting, and classifying accounts for financing and investing activities.
- *New* CONTINUING PROBLEM added to the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, Pool Corporation. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 2, students prepare journal entries, post to T-accounts, prepare a trial balance and classified balance sheet, identify investing and financing activities affecting cash flows, and compute and interpret the current ratio based on the balance sheet for Penny's Pool Service & Supply.
- *New and updated real companies,* as well as additional exercises on key concepts, in end-of-chapter exercises, problems, and cases.
- *New* Annual Report Case that can be graded through Connect®.

PowerPoint Slides

Learning Objectives	***PowerPoint® Slides***
2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.	2-3 through 2-5
2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.	2-6 through 2-11
2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.	2-12 through 2-19
2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.	2-20 through 2-29
2-5 Prepare a trial balance and simple classified balance sheet and analyze the company using the current ratio.	2-30 through 2-35
2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.	2-36

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Chapter Take-Aways

2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.

Objective:

- The primary objective of financial reporting to external users is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

Qualitative characteristics of useful financial information:

- Relevance (including materiality) allows users to assess past activities and/or predict future activities.
- Faithful representation requires information to be complete, neutral, and free from error.
    - To enhance its qualitative characteristics, information should also be comparable (to other companies and over time), verifiable, timely, and understandable.

Key recognition, measurement, and disclosure concepts:

Assumptions—

- Separate entity assumption—Transactions of the business are accounted for separately from transactions of the owner.
- Going concern assumption—A business is expected to continue to operate into the foreseeable future.
- Monetary unit assumption—Financial information is reported in the national monetary unit without adjustment for changes in purchasing power.

Principles—

- Mixed-attribute measurement model—Most balance sheet elements are recorded following the historical cost (or cost) principle—financial statement elements should be recorded at the cash equivalent cost on the date of the transaction; however, these values may be adjusted to other amounts, such as market value, depending on certain conditions.

Elements of the balance sheet:

- Assets—Probable future economic benefits owned or controlled by the entity as a result of past transactions.
- Liabilities—Probable future sacrifices of economic benefits arising from present obligations of a business as a result of past transactions.
- Stockholders' equity—Residual interest of owners in the assets of the entity after settling liabilities; the financing provided by the owners (contributed capital) and by business operations (earned capital).

2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.

- An exchange of cash, goods, or services for cash, goods, services, or promises between a business and one or more external parties to a business (not the exchange of a promise for a promise), or
- A measurable internal event, such as adjustments for the use of assets in operations.

An account is a standardized format that organizations use to accumulate the dollar effects of transactions related to each financial statement item. Typical balance sheet account titles include the following:

- *Assets*: Cash, Accounts Receivable, Inventory, Prepaid Expenses, Investments, Property (buildings and land) and Equipment, and Intangible (rights without physical substance).
- *Liabilities*: Accounts Payable, Notes Payable, Accrued Expenses Payable, Unearned Revenues, and Taxes Payable.
- *Stockholders' Equity*: Common Stock, Additional Paid-in Capital, and Retained Earnings.

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Chapter Take-Aways, continued

2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.

To determine the economic effect of a transaction on an entity in terms of the accounting equation, each transaction must be analyzed to determine the accounts (at least two) that are affected. In an exchange, the company receives something and gives up something. If the accounts, direction of the effects, and amounts are correctly analyzed, the accounting equation will stay in balance. The transaction analysis model is:

ASSETS (many accounts)		=	**LIABILITIES** (many accounts)		+	**STOCKHOLDERS' EQUITY**	
						Contributed Capital (2 accounts)	**Earned Capital** (1 account)
+ debit	– credit		– debit	+ credit		**Common Stock and Additional Paid-in Capital**	**Retained Earnings**
						– debit	+ credit Investments by owners
							– debit Dividends declared
							+ credit Net income (expanded in Ch. 3)

Systematic transaction analysis includes (1) determining the accounts that were received and were given in the exchange, including the type of each account (A, L, or SE), the amounts, and the direction of the effects, and (2) determining that the accounting equation remains in balance.

2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.

- Journal entries express the effects of a transaction on accounts in a debits-equal-credits format. The accounts and amounts to be debited are listed first. Then the accounts and amounts to be credited are listed below the debits and indented, resulting in debit amounts on the left and credit amounts on the right. Each entry needs a reference (date, number, or letter).

		Debit	Credit
(a)	Cash (+A)	62,300	
	Common Stock (+SE)		100
	Additional Paid-in Capital (+SE)		62,200

- T-accounts summarize the transaction effects for each account. These tools can be used to determine balances and draw inferences about a company's activities.

+ (dr) **Assets** (cr) –	
Beginning balance Increases	Decreases
Ending balance	

– (dr) **Liabilities and Stockholders' Equity** (cr) +	
	Beginning balance Increases
Decreases	
	Ending balance

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Chapter Take-Aways, continued

2-5 Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio.

A trial balance lists all accounts and their balances, with debit balances in left column and credit balances in the right column. The two columns are added to determine if debits equal credits.

Classified balance sheets are structured as follows:

- Assets are categorized as current assets (those to be used or turned into cash within the year, with inventory always considered a current asset) and noncurrent assets, such as long-term investments, property and equipment, and intangible assets.
- Liabilities are categorized as current liabilities (those that will be paid with current assets) and long-term liabilities.
- Stockholders' equity accounts are listed as Common Stock (number of shares X par value per share) and Additional Paid-in Capital (number of shares X excess of market value over par value per share) first, followed by Retained Earnings (earnings reinvested in the business).

The current ratio (Current Assets ÷ Current Liabilities) measures a company's liquidity, that is, the ability of the company to pay its short-term obligations with current assets.

2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.

A statement of cash flows reports the sources and uses of cash for the period by the type of activity that generated the cash flow: operating, investing, and financing. Investing activities include purchasing and selling long-term assets and making loans and receiving principal repayments from others. Financing activities include borrowing from and repaying to banks the principal on loans, issuing and repurchasing stock, and paying dividends.

Key Ratio

Current ratio measures the ability of the company to pay its short-term obligations with current assets. Although a ratio above 1.0 indicates sufficient current assets to meet obligations when they come due, many companies with sophisticated cash management systems have ratios below 1.0. (see the "Key Ratio Analysis" box in the How is the Balance Sheet Prepared and Analyzed? Section):

Current Ratio = Current Assets ÷ Current Liabilities

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Finding Financial Information

BALANCE SHEET	
Current Assets	***Current Liabilities***
Cash	Accounts payable
Short-term investments	Accrued expenses payable
Accounts receivable	Short-term notes payable
Notes receivable	Unearned revenue
Inventory	***Noncurrent Liabilities***
Prepaid expenses	Long-term debt (notes payable)
Noncurrent Assets	***Stockholders' Equity***
Long-term investments	Common Stock
Property and equipment	Additional paid-in capital
Intangibles	Retained earnings

INCOME STATEMENT
To be presented in Chapter 3

STATEMENT OF CASH FLOWS
Operating Activities
To be presented in Chapter 3
Investing Activities
+ Sales of noncurrent assets and investments for cash
– Purchases of noncurrent assets and investments for cash
– Loans to others
+ Receipt of loan principal payments from others
Financing Activities
+ Borrowing from banks
– Repayment of loan principal to banks
+ Issuance of stock
– Repurchasing stock
– Dividends paid

NOTES
To be discussed in future chapters

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Chapter Outline	Teaching Notes
LO 2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.	
I. Overview of Accounting Concepts—Concepts Emphasized in Chapter 2	*Conceptual Framework summarized in Exhibit 2.1*
A. Objective of Financial Reporting	
1. Primary objective of external financial reporting is to provide useful economic information about a business to help external parties make sound financial decisions	
2. Decision makers—users of accounting information; include existing and potential investors, lenders, and other creditors.	
3. Most are interested in information needed to assess amount, timing, and uncertainty of business's future cash inflows and outflows.	
B. Qualitative Characteristics of Financial Information	
1. Relevant information—can influence a decision; it is timely and has predictive and/or feedback value	
2. Faithful representation—requires information to be complete, neutral, and free from error	
3. Qualitative aspects that enhance the usefulness of information that is relevant and faithfully representative include: comparability, verifiability, timeliness, and understandability	
C. Recognition and Measurement Concepts	
1. Separate-entity assumption—business transactions are accounted for separately from the transactions of owners	
2. Going concern assumption (also called continuity assumption)—unless there is evidence to the contrary, business is expected to continue operating into the foreseeable future	
3. Monetary unit assumption—each business entity accounts for and reports its financial results primarily in terms of the national monetary unit without any adjustments for changes in purchasing power	
4. Mixed-attribute measurement model:	
a. Applied to measuring different assets and liabilities	
b. Most balance sheet elements are recorded at their cost (historical cost), which is the cash-equivalent value on the date of the transaction	
D. Elements of the Balance Sheet	*Chipotle's Balance Sheet illustrated in Exhibit 2.2*
1. Assets—probable future economic benefits owned or controlled by an entity as a result of past transactions or events	

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2. Assets are listed in order of liquidity—how soon an asset is expected by management to be turned into cash or used
   i. Current assets –will be used or turned into cash within one year
   ii. All other assets are considered long term (or noncurrent); that is, they are to be used or turned into cash after the coming year.
3. Liabilities—probable future sacrifices of economic benefits arising from present obligations of a business to transfer cash or other assets or to provide services as a result of past transactions or events
   a. Creditors—entities that a company owes money
   b. Liabilities are usually listed on the balance sheet in order of maturity (how soon an obligation is to be paid)
      i. Current liabilities—obligations that will be settled by providing cash, goods, other current assets, or services within the coming year
      ii. All other liabilities are considered long term (or noncurrent)
4. Stockholders' equity (also called shareholders' equity or owners' equity)—the residual interest in the assets of the entity after subtracting liabilities
   a. Financing provided by owners—referred to as contributed capital
   b. Financing provided by operations—referred to as earned capital or retained earnings
      i. When companies earn profits, they can be distributed to owners as dividends or reinvested in the business; the portion of profits reinvested in the business is called retained earnings
      ii. Companies with a growth strategy often pay little or no dividends to retain funds for expansion

See Financial Analysis feature "Unrecorded But Valuable Assets and Liabilities"

Refer students to Pause for Feedback – Self-Study Quiz

LO 2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.

II. What Business Activities Cause Changes in Financial Statement Amounts?

A. Nature of Business Transactions

1. A transaction is:
   a. An exchange of assets or services for assets, services, or promises to pay between a business and one or more external parties to a business or
   b. A measurable internal event such as the use of assets in operations
2. Only economic resources and debts resulting from past transactions are recorded on the balance sheet

External events—exchanges of assets, goods, or services by one party for assets, services, or promises to pay (liabilities) by one or more other parties

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b. Internal events—include certain events that are not exchanges between the business and other parties but nevertheless have a direct and measurable effect on the entity
c. Some important events have a future economic impact on a company, but are not reflected in the financial statements (e.g., an exchange of promises)

B. Accounts
1. Account—a standardized format that organizations use to accumulate the dollar effect of transactions on each financial statement item — *Illustrated in Exhibit 2.3*
2. Chart of accounts—a list of all account titles and their unique numbers; are usually organized by financial statement element (asset, liability, stockholders' equity, revenue, and expense accounts in that order)
3. Every company creates its own chart of accounts to fit the nature of its business activities
4. The accounts in the financial statements of large companies are actually summations of a number of specific accounts in their recordkeeping system

LO 2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.

III. How Do Transactions Affect Accounts?

A. Principles of Transaction Analysis
1. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation
2. Two principles underlying the transaction analysis:
a. Every transaction affects at least two accounts; correctly identifying those accounts and the direction of the effect (increase or decrease) is critical — *Stress the importance of a clear understanding of these principles*
b. The accounting equation must remain in balance after each transaction
3. Dual effects concept—every transaction has at least two effects on the basic accounting equation
4. Most transactions with external parties involve an exchange by which the business entity both receives something and gives up something in return
a. If Chipotle purchases tomatoes for cash, it receives food supplies (an increase in an asset) and gives up cash (a decrease in an asset)
b. If Chipotle purchases tomatoes on credit (that is, money is owed to suppliers) for cash, it would engage in two separate transactions at different points in time
i. It receives food supplies (an increase in an asset) and gives a promise to pay later (an increase in a liability)
ii. Later, It pays cash (a decrease in an asset) and eliminates the promise (a decrease in a liability)

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c. Not all important business activities result in a transaction that affects the financial statements
   i. Most importantly, signing a contract involving the exchange of two promises to perform does not result in an accounting transaction that is recorded
   ii. For example, if Chipotle sent an order for tomatoes to its food supplier and the supplier accepted the order but did not fill it immediately, no transaction took place

5. Balancing the Accounting Equation
   a. Step 1: Ask—What was received and what was given?
      i. Identify the account affected by title, making sure that at least two accounts change
      ii. Classify them by type of account—Asset (A), a liability (L), or a stockholders' equity (SE) account?
      iii. Determine the direction of the effect—Did the account increase (+) or decrease (−)?
   b. Step 2: Verify—Is the accounting equation in balance? (A = L + SE)

B. Analyzing Chipotle's Transactions

Use Supplemental Enrichment Activity #1

Use Supplemental Enrichment Activity#2

1. Transaction (a) Chipotle issued (sold) 10,000 additional shares of common stock with a par value of $.01 per share and at a market value of $0.37 per share, receiving $3,700 in cash from investors
   a. Related terminology
      i. Par value—a legal amount per share established by the board of directors; it represents the minimum amount a stockholder must contribute and has no relationship to the market price of the stock
      ii. Common stock—the account that is equal to the number of shares issued by a corporation times the par value per share
      iii. Additional paid-in capital (or Paid-in Capital or Contributed Capital in Excess of Par)—the amount of capital contributed by the shareholders less the par value of the stock
   a. Step 1: What was received and what was given?
      Received: Cash (+A) $3,700
      Given: Additional stock shares, Common Stock (+SE) $100 (10,000 shares x $0.01) and Additional Paid-in Capital $3,600 ($3,700 – $100)
   b. Step 2: Is the accounting equation in balance?
      Yes. The left side increased by $3,700 and the right side increased by $3,700
      Assets = Liabilities + Stockholders' Equity
      Cash (A) + 3,700= Common Stock (SE) + 100 + Additional Paid-in Capital (SE) + 3,600

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2. Transaction (b) Chipotle borrowed $2,000 from its local bank, signing a note to be paid in three years
   a. Step 1: What was received and what was given?
      Received: Cash (+A) $2,000
      Given: Written promise to the bank, Long-Term Notes Payable (+L) $2,000
   b. Step 2: Is the accounting equation in balance?
      Yes. The left side increased by $2,000 and the right side increased by $2,000
      Assets = Liabilities + Stockholders' Equity
      Cash (A) + 2,000 = Long-Term Notes Payable (L) + 2,000
3. Transaction (c) Chipotle purchased $10,000 in additional land, $8,200 in new buildings, $33,800 in new equipment, and $3,700 in additional intangible assets; paid $53,400 in cash and signing a short-term note payable for the remainder owed ($2,300)
   a. Step 1: What was received and what was given?
      Received: Property and Equipment (+A) $52,000 and Intangible Assets (+A) $3,700
      Given: (1) Cash (−A) $53,400 (2) Short-Term Notes Payable (+L) $2,300
   b. Step 2: Is the accounting equation in balance?
      Yes. The left side increased by $2,300 and the right side increased by $2,300
      Assets = Liabilities + Stockholders' Equity
      Cash (A) − 53,400 + Property and Equipment (A) + 52,000 + Intangible Assets (A) +3,700 = Short-Term Notes Payable (L) + 2,300
4. Transaction (d) Chipotle paid $2,300 on the short-term note payable in (c) and $2,300 on other noncurrent liabilities (b) (ignore interest)
   a. Step 1: What was received and what was given?
      Received: Reduction in amount due: Short-Term Notes Payable (−L) $2,300 and Other Liabilities (−L) $2,300
      Given: Cash (−A) $4,600
   b. Step 2: Is the accounting equation in balance?
      Yes. The equation stays in balance because assets increase and decrease by the same amount, $4,600
      Assets = Liabilities + Stockholders' Equity
      Cash (A) – 4,600 = Short-Term Notes Payable (L) − 2,300 + Other Liabilities (L) − 2,300

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5. Transaction (e) Chipotle purchased the stock of other companies as investments, paying $44,000 in cash; of this $9,000 was in short-term investments and $35,000 was in long-term investments
   a. Step 1: What was received and what was given?
      Received: Short-Term Investments (+A) $9,000 and Long-Term Investments (+A) $35,000
      Given: Cash (−A) $44,000
   b. Step 2: Is the accounting equation in balance?
      Yes. The equation stays in balance because assets increase and decrease by the same amount, $44,000
      Assets = Liabilities + Stockholders' Equity
      Cash (A) – 44,000 + Short-Term Investments (A) + 9,000 + Long-Term Investments (A) + 35,000 = No change

Refer students to Pause for Feedback – Self-Study Quiz

6. Transaction (f) Chipotle's board of directors declared that the Company will pay $3,000 in cash dividends to shareholders next quarter
   a. Step 1: What was received and what was given?
      Received: Lower claim from stockholders, Retained Earnings (−SE) $3,000
      Given: Dividends Payable (+L) $3,000
   b. Step 2: Is the accounting equation in balance?
      Yes. The equation stays in balance because liabilities increase and stockholders' equity decreases by the same amount, $3,000
      Assets = Liabilities + Stockholders' Equity
      No change = Dividends Payable (L) + $3,000 + Retained Earnings (SE) − $3,000

Note that Chipotle does actually not pay dividends; it reinvests profits

Refer students to Pause for Feedback – Self-Study Quiz

LO2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.

IV. How Do Companies Keep Track of Account Balances?

A. The accounting cycle—the process followed by entities to analyze and record transactions, adjust the records at the end of the period, prepare financial statements, and prepare the records for the next cycle; during the accounting cycle:
   1. Transactions are analyzed and recorded in the general journal in chronological order
   2. The related accounts are updated in the general ledger

Accounting cycle illustrated in Exhibit 2.4

B. The Direction of Transaction Effects
   1. Each account is set up as a "T" with the following structure:
      a. Increases in asset accounts are on the left because assets are on the left side of the accounting equation
      b. Increases in liability and stockholders' equity accounts are on the right because liability and stockholders' equity are on the right side of the accounting equation

Illustrated in Exhibit 2.5

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2. Names for each side of an account:
   a. Debit (dr) is on the left side of the T
   b. Credit (cr) is on the right side of the T
3. Rules for increases and decreases:
   a. Asset accounts increase on the left (debit) side and they normally have debit balances
   b. Liability and stockholders' equity accounts increase on the right (credit) side and they normally have credit balances
4. Summary:

Assets	=	Liabilities	+	Stockholders' Equity
Increase with debits		Increase with credits		Increase with credits
Accounts have debit balances		Accounts have credit balances		Accounts have credit balances

5. If the correct accounts and effects are identified, the accounting equation will remain in balance because the total debits will equal the total credits in a transaction

Refer students to Pause for Feedback – Self-Study Quiz

C. Analytical Tools:
1. Transactions are recorded in chronological order in a general journal (or simply, journal)
2. Journal entry—an accounting method for expressing the effects of a transaction on accounts in a debits-equal-credits format
   a. It is useful to include a date or some form of reference for each transaction
   b. The debited accounts are written first (on top) with the amounts recorded in the left column
   c. The credited accounts are written below the debits and are usually indented with the credited amounts written in the right column
   d. Compound entry—a journal entry that affects more than two accounts
3. T-account—A tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities
   a. By themselves, journal entries do not provide the balances in accounts
   b. After journal entries are recorded, the dollar amounts are posted (transferred) to each account affected by the transaction to determine the new account balances
   c. As a group, the accounts are called a general ledger

Posting transaction effects illustrated in Exhibit 2.6

See Financial Analysis feature "Inferring Business Activities from T-Accounts"

T-accounts illustrated in Exhibit 2.7

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D. Transaction Analysis Illustrated

1. Transaction (a) Chipotle issued (sold) 10,000 additional shares of common stock with a par value of $.01 per share and at a market value of $0.37 per share, receiving $3,700 in cash from investors

dr Cash (+A)	3,700	
cr Common Stock (+SE)		100
cr Additional Paid-in Capital (SE)		3,600

Assets = Liabilities + Stockholders' Equity
Cash (A) + 3,700 = Common Stock (SE) + 100 + Additional Paid-in Capital + 3,600 (SE)

2. Transaction (b) Chipotle borrowed $2,000 from its local bank, signing a note to be paid in three years

dr Cash (+A)	2,000	
cr Long-Term Notes Payable (+L)		2,000

Assets = Liabilities + Stockholders' Equity
Cash (A) + 2,000 = Long-Term Notes Payable (L) + 2,000

3. Transaction (c) Chipotle purchased $10,000 in additional land, $8,200 in new buildings, $33,800 in new equipment, and $3,700 in additional intangible assets; paid $53,400 in cash and signing a short-term note payable for the remainder owed ($2,300)

dr Land (+A)	10,000	
dr Buildings (+A)	8,200	
dr Equipment (+A)	33,800	
dr Intangible Assets (+A)	3,700	
cr Cash (–A)		53,400
cr Short-Term Notes Payable (+L)		2,300

Assets = Liabilities + Stockholders' Equity
Cash (A) – 53,400 + Land (A) + 10,000 + Buildings (A) + 8,200 + Equipment (A) + 33,800 + Intangible Assets (A) + 3,700 = Short-Term Notes Payable (L) + 2,300

4. Transaction (d) Chipotle paid $2,300 on the short-term note payable in (c) and $2,300 on other noncurrent liabilities (b) (ignore interest)

dr Short-Term Notes Payable (–L)	2,300	
dr Other Liabilities (–L)	2,300	
cr Cash (–A)		4,600

Assets = Liabilities + Stockholders' Equity
Cash (A) − $4,600 = Short -Term Notes Payable (L) − $2,300 + Other Liabilities (L) – 2,300

Use Supplemental Enrichment Activity #3

Use Supplemental Enrichment Activity#4

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5. Transaction (e) Chipotle purchased the stock of other companies as investments, paying $44,000 in cash; of this $9,000 was in short-term investments and $35,000 was in long-term investments

dr Short-Term Investments (+A)	35,000	
dr Long-Term Investments (+A)	9,000	
cr Cash (–A)		44,000

Assets = Liabilities + Stockholders' Equity
Cash (A) – 44,000 + Short-Term Investments (A) + 35,000 + Long-Term Investments (A) + 9,000 = No change

6. Transaction (a) Chipotle's board of directors declared that the Company will pay $3,000 in cash dividends to shareholders next quarter

dr Retained Earnings (–SE)	3,000	
cr Dividends Payable (+L)		3,000

Assets = Liabilities + Stockholders' Equity
No change = Dividends Payable (L) + $3,000 + Retained Earnings (SE) − $3,000

Refer students to Pause for Feedback – Self-Study Quiz

7. Posting of these transactions to the T-accounts is illustrated in the text after the analysis of transaction (f)

Use Supplemental Enrichment Activity #5

LO 2-5 Prepare a trial balance and simple classified balance sheet and analyze the company using the current ratio.

V. How Is the Balance Sheet Prepared and Analyzed?

A. Trial Balance

1. Trial balance—list of all accounts with their balances to provide a check on the equality of the debits and credits
2. A trial balance spreadsheet is created first for internal purposes before preparing statements for external users
3. A trial balance lists the names of the T-accounts in one column in financial statement order (assets, liabilities, stockholders' equity, revenues, and expenses), with their ending debit or credit balances in the next two columns
4. Debit balances are indicated in the left column and credit balances are indicated in the right column
5. Then the two columns are totaled to provide a check on the equality of the debits and credits
6. Errors in a computer-generated trial balance may exist if wrong accounts and/or amounts are used in the journal entries

Use Supplemental Enrichment Activity #7

B. Classified Balance Sheet

1. Prepared from the trial balance
2. The assets and liabilities are classified into two categories: current and noncurrent
3. Dollar signs are indicated at the top and bottom of the asset section and top and bottom of the liabilities and shareholders' equity section

Chipotle's Balance Sheet illustrated in Exhibit 2.8
Use Supplemental Enrichment Activity #7

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4. Includes comparative data; when multiple periods are presented, the most recent balance sheet amounts are usually listed on the left	*See Financial Analysis feature "Understanding Foreign Financial Statements"*
C. Ratio Analysis in Decision Making	
1. Users of financial information compute a number of ratios in analyzing a company's past performance and financial condition as input in predicting its future potential	
2. How ratios change over time and how they compare to the ratios of the company's competitors or industry averages provide valuable information about a company's strategies for its operating, investing, and financing activities..	
D. Key Ratio Analysis: Current Ratio	
1. Current Ratio = Current Assets – Current Liabilities	
2. Creditors and security analysts use the current ratio to measure the ability of the company to pay its short-term obligations with short-term assets	*Use Supplemental Enrichment Activity #8*
3. Generally, the higher the ratio, the more cushion a company has to pay its current obligations if future economic conditions take a downturn	
4. While a high ratio normally suggests good liquidity, too high of a ratio suggests inefficient use of resources	
5. An old rule of thumb was that companies should have a current ratio between 1.0 and 2.0; today, many strong companies have current ratios below 1.0	*Refer students to Pause for Feedback – Self-Study Quiz*
LO 2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.	
VI. Focus on Cash Flows - Investing and Financing Activities	
A. The statement of cash flows divides all transactions that affect cash into three categories:	
1. Operating activities (covered in Chapter 3)	
2. Investing activities include buying and selling noncurrent assets and investments	
3. Financing activities include borrowing and repaying debt, including short-term bank loans, issuing and repurchasing stock, and paying dividends	

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4. Effects of transactions in this chapter on the statement of cash flows:

Refer students to Pause for Feedback – Self-Study Quiz

Operating Activities	
(None of the transactions impact operating activities)	
Investing Activities	
Purchasing long-term assets and investments for cash	–
Selling long-term assets and investments for cash	+
Lending cash to others	–
Receiving principal payments on loans made to others	+
Financing Activities	
Borrowing cash from banks	+
Repaying the principal on borrowings from banks	–
Issuing stock for cash	+
Repurchasing stock with cash	–
Paying cash dividends	–

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Supplemental Enrichment Activities

Note: These activities would be suitable for individual or group activities.

1. Handout 2-1

   Use this handout for an in-class activity designed to review the analysis of various investing and financing transactions. The solution follows the handout master.

2. Handout 2-2

   This activity is a continuation of Activity #1. Use this handout for an in-class activity designed to continue the review of the analysis of various investing and financing transactions. The solution follows the handout master.

3. Handout 2-3

   Use Handout 2-3 for an in-class activity designed to review the debit/credit framework. Note that these transactions are the same as those analyzed on Handout 2-1. However, it can be assigned even if Activity #1 was not assigned. The solution follows the handout master.

4. Handout 2-4

   This activity is a continuation of Activity #3. Use this handout for an in-class activity designed to review the debit/credit framework. Note that these transactions are the same as those analyzed on Handout 2-2. However, it can be assigned even if Activity #2 was not assigned. The solution follows the handout master.

5. Handout 2-5

   Use this handout for an in-class activity designed to review the posting of various investing and financing transactions to T-accounts. This activity is a continuation of Activity #3 and Activity #4; it should be assigned only if both of those activities were assigned. The solution follows the handout master.

6. Handout 2-6

   Use this handout for an in-class activity designed to review the preparation of a trial balance. This activity is a continuation of Activity #5; it should be assigned only if that activity was assigned. The solution follows the handout master.

7. Handout 2-7

   Use this handout for an in-class activity designed to review the preparation of a classified balance sheet. This activity is a continuation of Activity #6; it should be assigned only if that activity was assigned. The solution follows the handout master.

8. Use Handout 2-8

   Use this handout for an in-class activity designed to review the calculation and interpretation of the current ratio. This activity is a continuation of Activity #7; it should be assigned only if that activity was assigned. The solution follows the handout master.

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HANDOUT 2 – 1

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

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HANDOUT 2 – 1, continued

(d) Purchase $300 worth of supplies from a vendor on credit. ("On credit," or "on account," means that the company received the supplies now and will pay for them later.)

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(e) Sign contract for first website design for $10,000.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities				Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)						=					
(b)						=					
(c)						=					
(d)						=					
Total						=					
						=					
						=					

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HANDOUT 2 – 1 SOLUTION, continued

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

1.	Decide if a transaction took place.	Yes – received cash and gave stock.
2.	Identify the accounts affected.	Cash and Common Stock
3.	Classify each account affected.	Cash is an Asset (A) and Common Stock is Stockholders' Equity (SE)
4.	Identify direction and amount.	Cash (A) + $10,000 = Common Stock (SE) + $10,000.
5.	Ensure the accounting equation is in balance.	Yes – see below.

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

1.	Decide if a transaction took place.	Yes – received cash and gave a short-term note payable.
2.	Identify the accounts affected.	Cash and Short-Term Notes Payable
3.	Classify each account affected.	Cash is an Asset (A) and Short-Term Notes Payable is a Liability (L)
4.	Identify direction and amount.	Cash (A) + $15,000 = Short-Term Notes Payable + $15,000.
5.	Ensure the accounting equation is in balance.	Yes – see below.

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

1.	Decide if a transaction took place.	Yes – paid cash and received truck and equipment.
2.	Identify the accounts affected.	Cash and Equipment
3.	Classify each account affected.	Cash is an Asset (A) and Equipment is an Asset (A)
4.	Identify direction and amount.	Cash (A) - $20,000 and Equipment (A) + $20,000
5.	Ensure the accounting equation is in balance.	Yes – see below.

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HANDOUT 2 – 1 SOLUTION, continued

(d) Purchase $300 worth of supplies from a vendor on credit. ("On credit," or "on account," means that the company received the supplies now and will pay for them later.)

1.	Decide if a transaction took place.	Yes – received supplies and obligated to pay for them.
2.	Identify the accounts affected.	Supplies and Accounts Payable
3.	Classify each account affected.	Supplies is an Asset (A) and Accounts Payable is a Liability (L)
4.	Identify direction and amount.	Supplies (A) + $300 and Accounts Payable (L) + $300.
5.	Ensure the accounting equation is in balance.	Yes – see below.

(e) Sign contract for first website design for $10,000.

1.	Decide if a transaction took place.	No – no exchange took place.
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities				+ Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)	+10,000					=					+10,000
(b)	+15,000					=			+15,000		
(c)	–20,000				+20,000	=					
(d)			+300			=	+300				
Total	5,000		300		20,000		300		15,000		10,000
	Assets $25,300					=	Liabilities $15,300 + Stockholders' Equity $10,000				
	$25,300					=	$25,300				

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HANDOUT 2 – 2

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(f) Company pays $300 on accounts payable to the vendor in (d).

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(g) Company pays for and receives $600 worth of supplies.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

(h) Company acquires and receives $1,000 worth of equipment.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

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HANDOUT 2 – 2, continued

(i) Order a $900 lawn mower, to be delivered next month.

1.	Decide if a transaction took place.	
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities			+	Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)	+10,000					=					+10,000
(b)	+15,000					=			+15,000		
(c)	–20,000				+20,000	=					
(d)			+300			=	+300				
(f)						=					
(g)						=					
(h)						=					
(i)						=					
Total						=					
						=					
						=					

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HANDOUT 2 – 2 SOLUTION

ANALYZING TRANSACTIONS

Analyze each of the following transactions of World Wide Webster by performing each of the following steps. Then, use the chart on the following page to (1) keep track of the amount in each account and (2) ensure the accounting equation is in balance.

(f) Company pays $300 on accounts payable to the vendor in (d).

1.	Decide if a transaction took place.	Yes – paid cash to reduce accounts payable.
2.	Identify the accounts affected.	Cash and Accounts Payable
3.	Classify each account affected.	Cash is an Asset (A) and Accounts Payable is a Liability (L)
4.	Identify direction and amount.	Cash (A) – $300 = Liabilities (L) – $300
5.	Ensure the accounting equation is in balance.	Yes – see below.

(g) Company pays for and receives $600 worth of supplies.

1.	Decide if a transaction took place.	Yes – paid cash to purchase supplies.
2.	Identify the accounts affected.	Cash and Supplies
3.	Classify each account affected.	Cash is an Asset (A) and Supplies is an Asset
4.	Identify direction and amount.	Cash (A) – $600 and Supplies (A) + $600.
5.	Ensure the accounting equation is in balance.	Yes - see below.

(h) Company acquires and receives $1,000 worth of equipment.

1.	Decide if a transaction took place.	Yes – paid cash to purchase equipment
2.	Identify the accounts affected.	Cash and Equipment
3.	Classify each account affected.	Cash is an Asset (A) and Equipment is an Asset (A)
4.	Identify direction and amount.	Cash (A) – $1,000 and Equipment (A) + $1,000
5.	Ensure the accounting equation is in balance.	Yes - see below.

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HANDOUT 2 – 2 SOLUTION, continued

(i) Order a $900 computer, to be delivered next month.

1.	Decide if a transaction took place.	No exchange took place.
2.	Identify the accounts affected.	
3.	Classify each account affected.	
4.	Identify direction and amount.	
5.	Ensure the accounting equation is in balance.	

Chart

	Assets					=	Liabilities			+	Stockholders' Equity
Ref.	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Short-Term Notes Payable	+	Common Stock
(a)	+10,000					=					+10,000
(b)	+15,000					=			+15,000		
(c)	–20,000				+20,000	=					
(d)			+300			=	+300				
(f)	–300						–300				
(g)	–600		+600								
(h)	–1,000				+1,000						
(i)											
Total	3,100		900		21,000		0		15,000		10,000
	Assets $25,000					=	Liabilities $15,000 + Stockholders' Equity $10,000				
	$25,000					=	$25,000				

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HANDOUT 2 – 3

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

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HANDOUT 2 – 3, continued

(d) Purchase $300 worth of supplies from a vendor on credit. ("On credit," or "on account," means that the company received the supplies now and will pay for them later.)

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(e) Sign contract for first website design for $10,000.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

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HANDOUT 2 – 3 SOLUTION

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(a) Stockholder invests $10,000 into the business in exchange for 10,000 shares of $1 par value common stock.

Debit and credit the accounts affected

(a)	Cash (+A)	10,000	
	Common Stock (+SE)		10,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+10,000				Common Stock	+10,000

(b) Borrow $15,000 signing a note payable to the bank that is due in three months.

Debit and credit the accounts affected

(b)	Cash (+A)	15,000	
	Short-Term Notes Payable (+L)		15,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	+15,000		Short-Term Notes Payable	+15,000			

(c) Acquire a $15,000 truck and $5,000 worth of equipment.

Debit and credit the accounts affected

(c)	Equipment (+A)	20,000	
	Cash (–A)		20,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	–20,000						
Equipment	+20,000						

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HANDOUT 2 – 3 SOLUTION, continued

(d) Purchase $300 worth of supplies from a vendor on credit. ("On credit," or "on account," means that the company received the supplies now and will pay for them later.)

Debit and credit the accounts affected

(d)	Supplies (+A)	300	
	Accounts Payable (+A)		300

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Supplies	+300		Accounts Payable	+300			

(e) Sign contract for first website design for $10,000.

No entry – this is not a transaction

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HANDOUT 2 – 4

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(f) Company pays $300 on accounts payable to the vendor in (d).

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	

(g) Company pays for and receives $600 worth of supplies.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

(h) Company acquires and receives $1,000 worth of equipment.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

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HANDOUT 2 – 4, continued

(i) Order a $900 computer, to be delivered in 90 days.

Debit and credit the accounts affected

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	

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HANDOUT 2 – 4 SOLUTION

THE DEBIT/CREDIT FRAMEWORK

Analyze each of the following transactions of World Wide Webster and prepare the journal entry required to record the related transaction.

(f) Company pays $300 on accounts payable to the vendor in (d).

Debit and credit the accounts affected

(f)	Accounts Payable (–L)	300	
	Cash (–A)		300

Ensure the equation still balances and debits = credits

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	–300		Acct. Pay.	–300			

(g) Company pays for and receives $600 worth of supplies.

Debit and credit the accounts affected

(g)	Supplies (+A)	600	
	Cash (–A)		600

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	
Supplies	+600					
Cash	–600					

(h) Company acquires and receives $1,000 worth of equipment.

Debit and credit the accounts affected

(h)	Equipment (+A)	1,000	
	Cash (–A)		1,000

Ensure the equation still balances and debits = credits

Assets		=	Liabilities	+	Stockholders' Equity	
Equipment	+1,000					
Cash	–1,000					

(i) Order a $900 computer, to be delivered in 90 days.

No entry – this is not a transaction.

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HANDOUT 2 – 5

POSTING TO T-ACCOUNTS

Post the transactions from handouts 2-3 and 2-4 and determine the ending balances of each of the following T-accounts.

Assets	Liabilities	Stockholders' Equity
+ Cash –	- Accounts Payable +	- Common Stock +
+ Supplies –	- Short-Term Notes Payable +	- Retained Earnings +
+ Equipment –		

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HANDOUT 2 – 5 SOLUTION

POSTING TO T-ACCOUNTS

Post the transactions from handouts 2-3 and 2-4 and determine the ending balances of each of the following T-accounts.

Assets				Liabilities				Stockholders' Equity			
+ Cash –				- Accounts Payable +				- Common Stock +			
BegBal	0					0	BegBal			0	BegBal
(a)	10,000			(f)	300	300	(d)			10,000	(a)
(b)	15,000	20,000	(c)			0	EndBal				
		300	(f)							10,000	EndBal
		600	(g)								
		1,000	(h)								
EndBal	3,100										
+ Supplies –				- Short-Term Notes Payable +				- Retained Earnings +			
BegBal	0					0	BegBal			0	BegBal
(d)	300					15,000	(b)			0	EndBal
(g)	600					15,000	EndBal				
EndBal	900										
+ Equipment –											
BegBal	0										
(c)	20,000										
(h)	1,000										
EndBal	21,000										

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HANDOUT 2 – 6

PREPARING A TRIAL BALANCE

Use the ending balances from the T-accounts on Handout 2-5 to prepare a trial balance for World Wide Webster as of December 31 of the current year.

World Wide Webster
Trial Balance
At December 31, Current Year

	Debit	Credit

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HANDOUT 2 – 6

PREPARING A TRIAL BALANCE

Use the ending balances from the T-accounts on Handout 2-5 to prepare a trial balance for World Wide Webster as of December 31 of the current year.

World Wide Webster
Trial Balance
At December 31, Current Year

	Debit	Credit
Cash	$ 3,100	
Supplies	900	
Equipment	21,000	
Short-Term Notes Payable		$15,000
Common Stock		10,000
Totals	$25,000	$25,000

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HANDOUT 2 – 7 SOLUTION

PREPARING A BALANCE SHEET

Use the balances from the trial balance on Handout 2-6 to prepare a classified balance sheet for World Wide Webster as of December 31 of the current year.

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HANDOUT 2 – 7 SOLUTION

PREPARING A BALANCE SHEET

Use the balances from the trial balance on Handout 2-6 to prepare a classified balance sheet for World Wide Webster as of December 31 of the current year.

World Wide Webster
Balance Sheet
At December 31, Current Year

Assets

Current Assets:	
Cash	$ 3,100
Supplies	900
Total Current Assets	4,000
Equipment	21,000
Total Assets	$25,000

Liabilities

Current Liabilities:	
Short-Term Notes Payable	$15,000
Total Current Liabilities	15,000

Stockholders' Equity

Common Stock	10,000
Retained Earnings	0
Total Stockholders' Equity	10,000
Total Liabilities and Stockholders' Equity	$25,000

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HANDOUT 2 – 8

CURRENT RATIO

Refer to the classified balance sheet from Handout 2-7 and calculate the current ratio of World Wide Webster as of December 31 of the current year. Then, interpret the current ratio.

Calculation:

Interpretation:

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HANDOUT 2 – 8 SOLUTION

CURRENT RATIO

Refer to the classified balance sheet from Handout 2-7 and calculate the current ratio of World Wide Webster as of December 31 of the current year. Then, interpret the current ratio.

Calculation:

Current Ratio = Current Assets ÷ Current Liabilities

Current ratio = $4,000 ÷ $15,000 = 0.27

Interpretation:

A current ratio of 0.27 indicates that the company has $0.27 of current assets for $1.00 of current liabilities. It does not appear that the company's current assets are sufficient to pay its current liabilities.

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chapter 2

Investing and Financing Decisions and the Accounting System

Financial Accounting

9e

Libby • Libby • Hodge

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Learning Objectives

After studying this chapter, you should be able to:

2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.

2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.

2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.

2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.

2-5 Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio.

2-6 Identify investing and financing transactions and demonstrate how they impact cash flows.

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Understanding the Business

To understand amounts appearing on a company's balance sheet:

What business activities cause changes in the balance sheet?

How do specific activities affect each balance?

How do companies keep track of balance sheet amounts?

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Exhibit 2.1

Financial Accounting and Reporting Conceptual Framework

Objective of Financial Reporting to External Users: (Ch. 2)

To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity

- **Pervasive Cost-Benefit Constraint:** Benefits of providing information should outweigh its costs

Fundamental Qualitative Characteristics of Useful Information: (Ch. 2)

Relevance (including materiality) and Faithful Representation

Attributes That Enhance Qualitative Characteristics:

Comparability (including consistency), Verifiability, Timeliness, and Understandability

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Exhibit 2.1
Financial Accounting and Reporting Conceptual Framework

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Relevance (including materiality) and Faithful Representation

Attributes That Enhance Qualitative Characteristics:

Comparability (including consistency), Verifiability, Timeliness, and Understandability

Elements to Be Measured and Reported:

Assets, Liabilities, Stockholders' Equity, Investments by Owners, and Distributions to Owners (Ch. 2)
Revenues, Expenses, Gains, and Losses (Ch. 3)
Comprehensive Income (Ch. 5)

Recognition, Measurement, and Disclosure Concepts:

Assumptions: Separate Entity, Going Concern, and Monetary Unit (Ch. 2)
Time Period (Ch. 3)

Principles: Mixed-Attribute Measurement (Ch. 2)
Revenue Recognition and Expense Recognition (Ch. 3)
Full Disclosure (Ch. 5)

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Elements of the Balance Sheet

A = L + SE

Assets	Liabilities	Stockholders' Equity
Economic resources with probable future benefits owned or controlled by the entity.	Debts or obligations (claims to a company's resources) that result from a company's past transactions and will be paid with assets or services. Entities that a company owes money to are called creditors.	The financing provided by the owners and business operations.

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Exhibit 2.2

Chipotle Mexican Grill, Inc., Balance Sheet

**The information has been adapted from actual statements and simplified for this chapter.*

CHIPOTLE MEXICAN GRILL, INC.
Consolidated Balance Sheet*
December 31, 2014
(in thousands of dollars, except per share data)

ASSETS		
Current Assets:		
Cash	$ 419,500	
Short-term investments	338,600	*Ownership of other companies' stocks and bonds*
Accounts receivable	34,800	*Amounts due from customers and others*
Supplies	15,300	*Food, beverage, and packaging supplies on hand*
Prepaid expenses	70,300	*Rent, advertising, and insurance paid in advance*
Total current assets	878,500	
Property and equipment:		
Land	11,100	
Buildings	1,267,100	
Equipment	442,500	*Includes furniture and fixtures*
Total cost	1,720,700	*Cost of property and equipment at date of acquisition*
Accumulated depreciation	(613,700)	*Amount of cost used in past operations*
Net property and equipment	1,107,000	
Long-term investments	496,100	*Ownership of other companies' stocks and bonds*
Intangible assets	64,700	*Rights, such as patents, trademarks, and licenses*
Total assets	$2,546,300	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 69,600	*Amount due to suppliers*
Unearned revenue	16,800	*Unredeemed gift cards*
Accrued expenses payable:		
Wages payable	73,900	*Amount due to employees*
Utilities payable	85,400	*Amount due for electric, gas, and telephone usage*
Total current liabilities	245,700	
Other liabilities	288,200	*Summary of liabilities due beyond one year*
Total liabilities	533,900	
Stockholders' Equity:		
Common stock ($0.01 par value)	400	*Total par value of stock issued by company to investors*
Additional paid-in capital	290,200	*Excess of amount received from investors over par*
Retained earnings	1,721,800	*Undistributed earnings reinvested in the company*
Total stockholders' equity	2,012,400	
Total liabilities and stockholders' equity	$2,546,300	

Current assets — *Noncurrent assets* — *Current liabilities* — *Noncurrent liabilities* — *Stockholders' equity*

EXPLANATIONS

"Consolidated" means all subsidiaries are combined
Point in time for which the balance sheet was prepared

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Unrecorded but Valuable Assets and Liabilities

FINANCIAL ANALYSIS



Some assets and liabilities may not be reported on the balance sheet.

Some intangible assets:

✓Internally developed over time

✓Not purchased

Off-balance-sheet financing:

✓Rental obligations

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What Business Activities Cause Changes in the Financial Statement Amounts?

Nature of Business Transactions

External Events: Exchanges between the entity and one or more parties.

Ex: Purchase of a machine from a supplier.

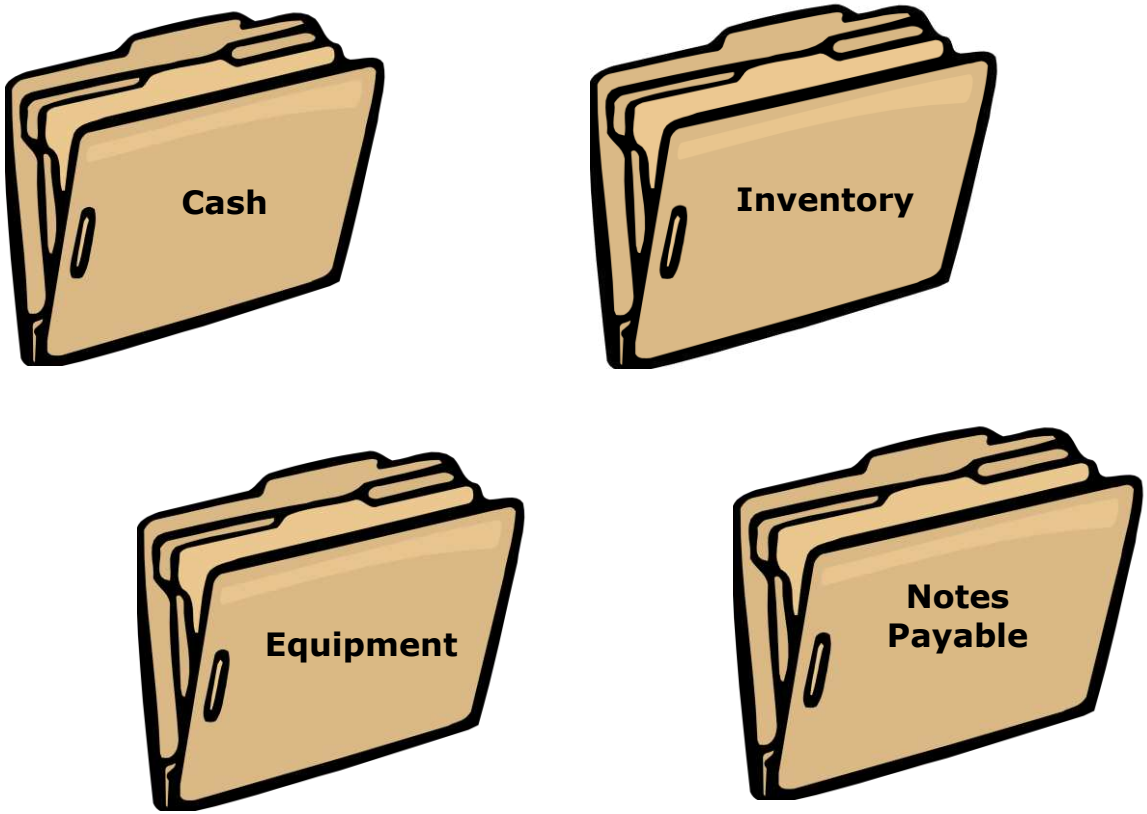
Internal Events: Events that are not exchanges between parties but that have a direct and measurable effect on the entity.

Ex: Using up insurance paid in advance.

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Accounts

A standardized format used by companies to accumulate the dollar effect of transactions.



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Exhibit 2.3

Typical Account Titles

Accounts with "payable" in the title are always liabilities and represent amounts owed by the company to be paid to others in the future.

Title expense accounts by what was incurred or used followed by the word "expense," except for inventory sold, which is titled Cost of Goods Sold.

Accounts with "receivable" in the title are always assets; they represent amounts owed by (receivable from) customers and others to the business.

Assets	Liabilities	Stockholder's Equity	Revenues	Expenses
Cash	Accounts Payable	Common Stock	Sales Revenue	Cost of Goods Sold
Short-Term Investments	Accrued Expenses Payable	Additional Paid-in Capital	Fee Revenue	Wages Expense
Accounts Receivable	Notes Payable	Retained Earnings	Interest Revenue	Rent Expense
Notes Receivable	Taxes Payable		Rent Revenue	Interest Expense
Inventory (to be sold)	Unearned Revenue		Service Revenue	Depreciation Expense
Supplies	Bonds Payable			Advertising Expense
Prepaid Expenses				Insurance Expense
Long-Term Investments				Repair Expense
Equipment				Income Tax Expense
Buildings				
Land				
Intangibles				

Prepaid Expenses is always an asset; it represents amounts paid in advance by the company to others for future benefits, such as future insurance coverage, rental of property, or advertising.

Accounts with "unearned" in the title are always liabilities representing amounts paid in the past to the company by others who expect future goods or services from the company.

Title revenue accounts by their source followed by the word "revenue."

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Principles of Transaction Analysis

- Every transaction affects at least two accounts (duality of effects).
- The accounting equation must remain in balance after each transaction.

A = L + SE

Assets | Liabilities | Stockholders' Equity

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Balancing the Accounting Equation

Step 1: Ask—What was received and what was given?

- Identify the accounts (by title) affected and make sure at least two accounts change.
- Classify them by type of account. Was the account an asset (A), a liability (L), or a stockholders' equity (SE) account?
- Determine the direction of the effect. Did the account increase [+] or decrease [−]?

Step 2: Verify—Is the accounting equation in balance?

- Verify the equality of the accounting equation (A = L + SE)

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Analyzing Chipotle's Transactions

***(a)* Chipotle issued 10,000 additional shares of common stock with a par value of $0.01 per share at a market value of $0.37 per share, receiving $3,700 in cash from investors.**

Step 1: What was received and what was given?
(account name, type of account, amount, and direction of effect)

Received: Cash (+A) $3,700

Given: Additional stock shares:
Common Stock (+SE) $100 *(10,000 shares × $0.01 per share)*
Additional Paid-in Capital (+SE) $3,600 *(10,000 shares × $0.36 per share)*

	Assets				=	Liabilities			+	Stockholders' Equity		
	Cash	Investments	Property and Equipment	Intangible Assets		Notes Payable	Dividends Payable	Other Liabilities		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+3,700				=					+100	+3,600	

Step 2: Is the accounting equation in balance?

Assets $3,700 = Liabilities $0 + Stockholders' Equity $3,700

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Analyzing Chipotle's Transactions

***(b)* Chipotle borrowed $2,000 from its local bank, signing a note to be paid in three years.**

Step 1: What was received and what was given?
(account name, type of account, amount, and direction of effect)

Received: Cash (+A) $2,000

Given: Long-Term Notes Payable (+L) $2,000

	Assets				=	Liabilities			+	Stockholders' Equity		
	Cash	Investments	Property and Equipment	Intangible Assets		Notes Payable	Dividends Payable	Other Liabilities		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+3,700				=					+100	+3,600	
(b)	**+2,000**				=	**+2,000**						

Step 2: Is the accounting equation in balance?

Assets $2,000 = Liabilities $2,000 + Stockholders' Equity $0

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Analyzing Chipotle's Transactions

***(c)* Chipotle purchased $10,000 in additional land, $8,200 in new buildings, $33,800 in new equipment, and $3,700 in additional intangible assets; paid $53,400 in cash and signed a short-term note payable for the remainder owed ($2,300).**

Step 1: What was received and what was given?

(account name, type of account, amount, and direction of effect)

Received:	Land (+A)	$10,000	**Given:**	Cash (−A) $53,400
	Buildings (+A)	8,200		Short-Term Notes Payable (+L) 2,300
	Equipment (+A)	33,800		
	Intangible Assets (+A)	3,700		

	Assets				=	Liabilities			+	Stockholders' Equity		
	Cash	Investments	Property and Equipment	Intangible Assets		Notes Payable	Dividends Payable	Other Liabilities		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+3,700				=					+100	+3,600	
(b)	+2,000				=	+2,000						
(c)	**–53,400**		**+52,000**	**+3,700**	=	**+2,300**						

Step 2: Is the accounting equation in balance?

Assets $2,300 = Liabilities $2,300 + Stockholders' Equity $0

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Analyzing Chipotle's Transactions

***(d)* Chipotle paid $2,300 on the short-term note payable in (*c*) above and $2,300 on other noncurrent liabilities (ignore interest).**

Step 1: What was received and what was given?
(account name, type of account, amount, and direction of effect)

Received: Reduction in amount due:
Short-Term Notes Payable (−L) $2,300
Other Liabilities (−L) 2,300

Given: Cash (−A) $4,600

	Assets				=	Liabilities			+	Stockholders' Equity		
	Cash	Investments	Property and Equipment	Intangible Assets		Notes Payable	Dividends Payable	Other Liabilities		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+3,700				=					+100	+3,600	
(b)	+2,000				=	+2,000						
(c)	−53,400		+52,000	+3,700	=	+2,300						
(d)	**−4,600**				=	**−2,300**		**−2,300**				

Step 2: Is the accounting equation in balance?

Assets −$4,600 = Liabilities −$4,600 + Stockholders' Equity $0

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Analyzing Chipotle's Transactions

***(e)* Chipotle purchased the stock of other companies as investments, paying $44,000 cash; of this, $9,000 was in short-term investments and $35,000 was in long-term investments.**

Step 1: What was received and what was given?
(account name, type of account, amount, and direction of effect)

Received: Short-Term Investments (+A) $9,000
Long-Term Investments (+A) 35,000

Given: Cash (−A) $44,000

	Assets				=	Liabilities			+	Stockholders' Equity		
	Cash	Investments	Property and Equipment	Intangible Assets		Notes Payable	Dividends Payable	Other Liabilities		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+3,700				=					+100	+3,600	
(b)	+2,000				=	+2,000						
(c)	–53,400		+52,000	+3,700	=	+2,300						
(d)	–4,600				=	–2,300		–2,300				
(e)	**–44,000**	**+44,000**			=							

Step 2: Is the accounting equation in balance?

Assets $0 = Liabilities $0 + Stockholders' Equity $0

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Analyzing Chipotle's Transactions

(f) Chipotle does not pay dividends but instead reinvests profits into growing the business. However, for illustration purposes, **assume Chipotle's board of directors declared that the Company will pay $3,000 in cash as dividends to shareholders next quarter.**

Step 1: What was received and what was given?
(account name, type of account, amount, and direction of effect)

Received: Lower undistributed earnings
Retained Earnings (−SE) $3,000

Given: Dividends Payable (+L) $3,000

	Assets				=	Liabilities			+	Stockholders' Equity		
	Cash	Investments	Property and Equipment	Intangible Assets		Notes Payable	Dividends Payable	Other Liabilities		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+3,700				=					+100	+3,600	
(b)	+2,000				=	+2,000						
(c)	−53,400		+52,000	+3,700	=	+2,300						
(d)	−4,600				=	−2,300		−2,300				
(e)	−44,000	+44,000			=							
(f)							**+3,000**					**−3,000**
	−96,300	**+44,000**	**+52,000**	**+3,700**	=	**+2,000**	**+3,000**	**−2,300**		**+100**	**+3,600**	**−3,000**

Step 2: Is the accounting equation in balance?

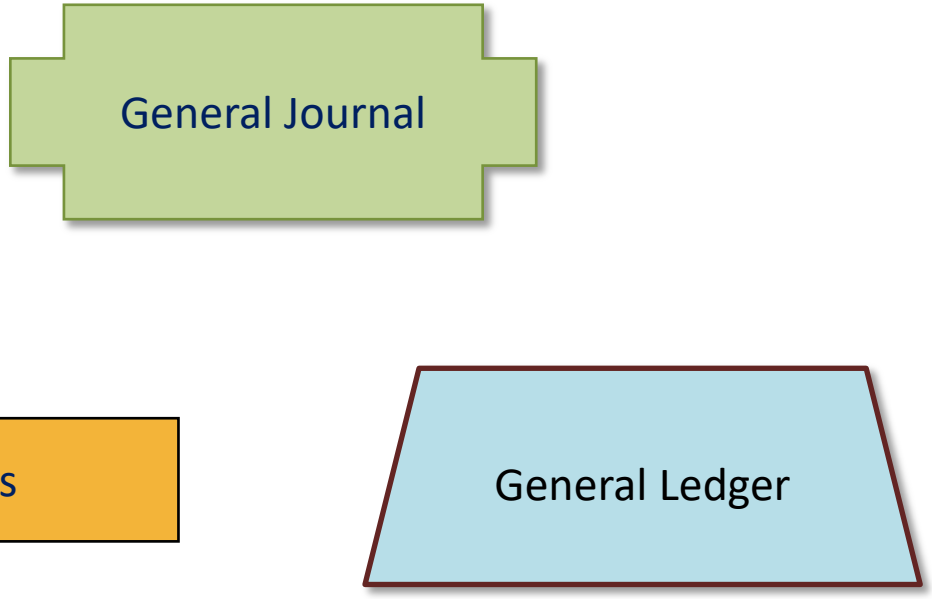
Assets $0 = Liabilities $3,000 + Stockholders' Equity −$3,000

Overall effects of *(a)–(f)*: Assets $3,400 = Liabilities $2,700 + Stockholders' Equity $700

$ 3,400 = $3,400

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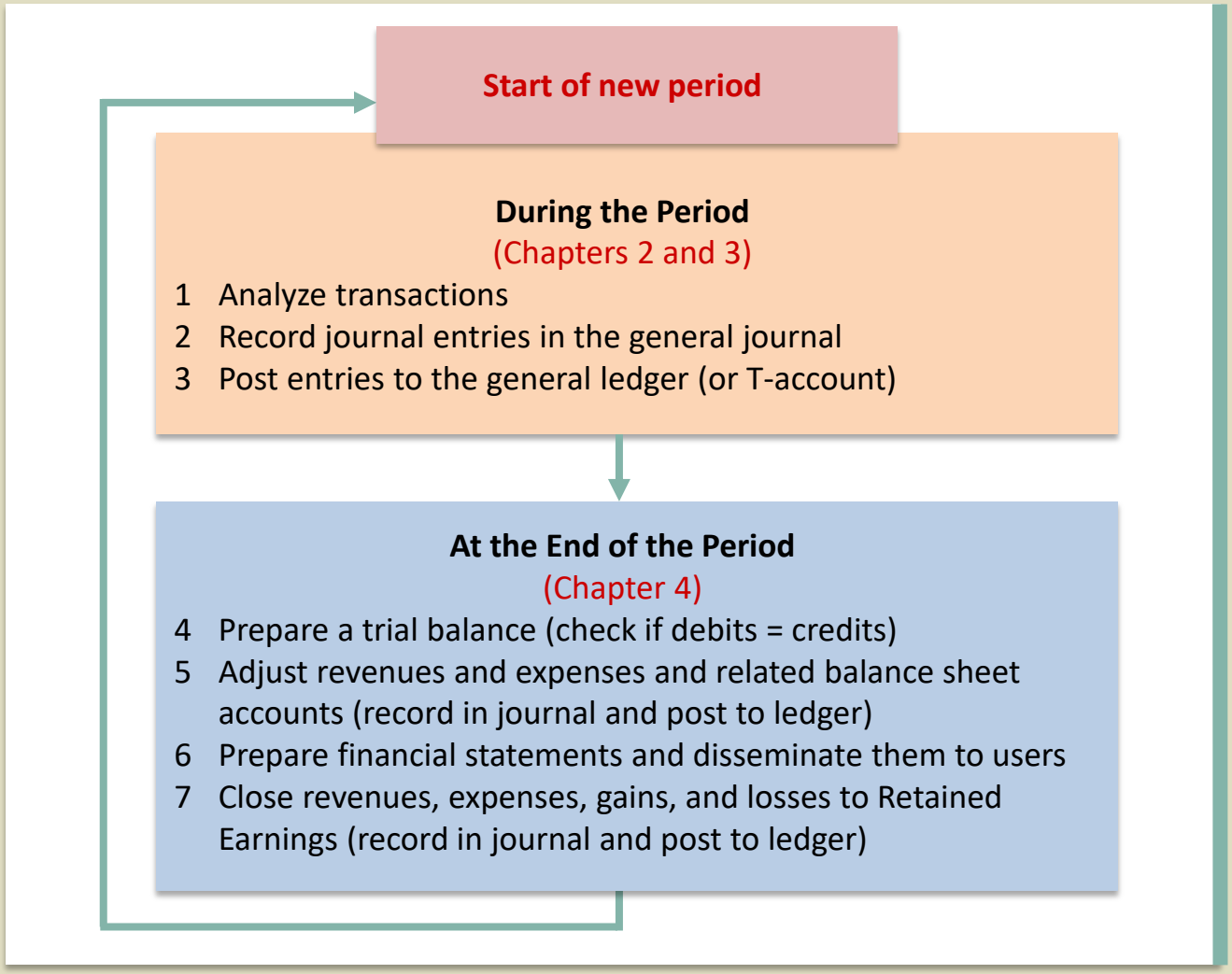
How Do Companies Keep Track of Account Balances?



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Exhibit 2.4

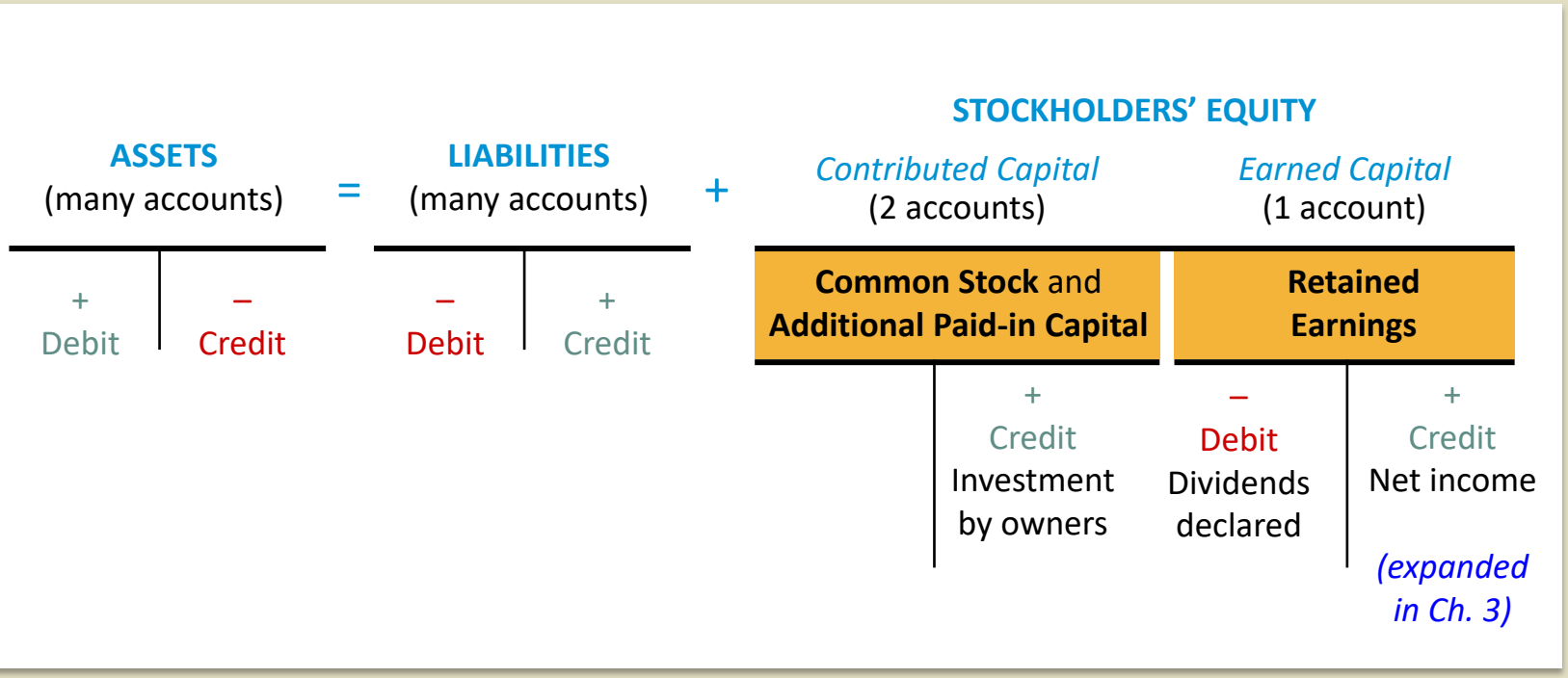
The Accounting Cycle



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Exhibit 2.5

Basic Transaction Analysis Model



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The Journal Entry

Amounts:
Debited amounts on left.
Credited amounts on right.

Account Titles:
Debited accounts on top.
Credited accounts on bottom, usually indented.

		Debit	Credit
(a)	Cash (+A)	3,700	
	Common Stock (+SE)		100
	Additional Paid-in Capital (+SE)		3,600

Reference:
Letter, number, or date.

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Exhibit 2.6

Posting Transaction Effects from the Journal to the Ledger

General Journal Page G1

Date	Account Titles and Explanation	Ref.	Debit	Credit
	(in thousands)			
1-2-15	Cash	101	3,700	
	Common Stock	301		100
	Additional Paid-in Capital	302		3,600
	(Investment by stockholders.)			

General Ledger **CASH** 101

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				419,500
1-2-15		G1	3,700		423,200

General Ledger **COMMON STOCK** 301

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				400
1-2-15		G1		100	500

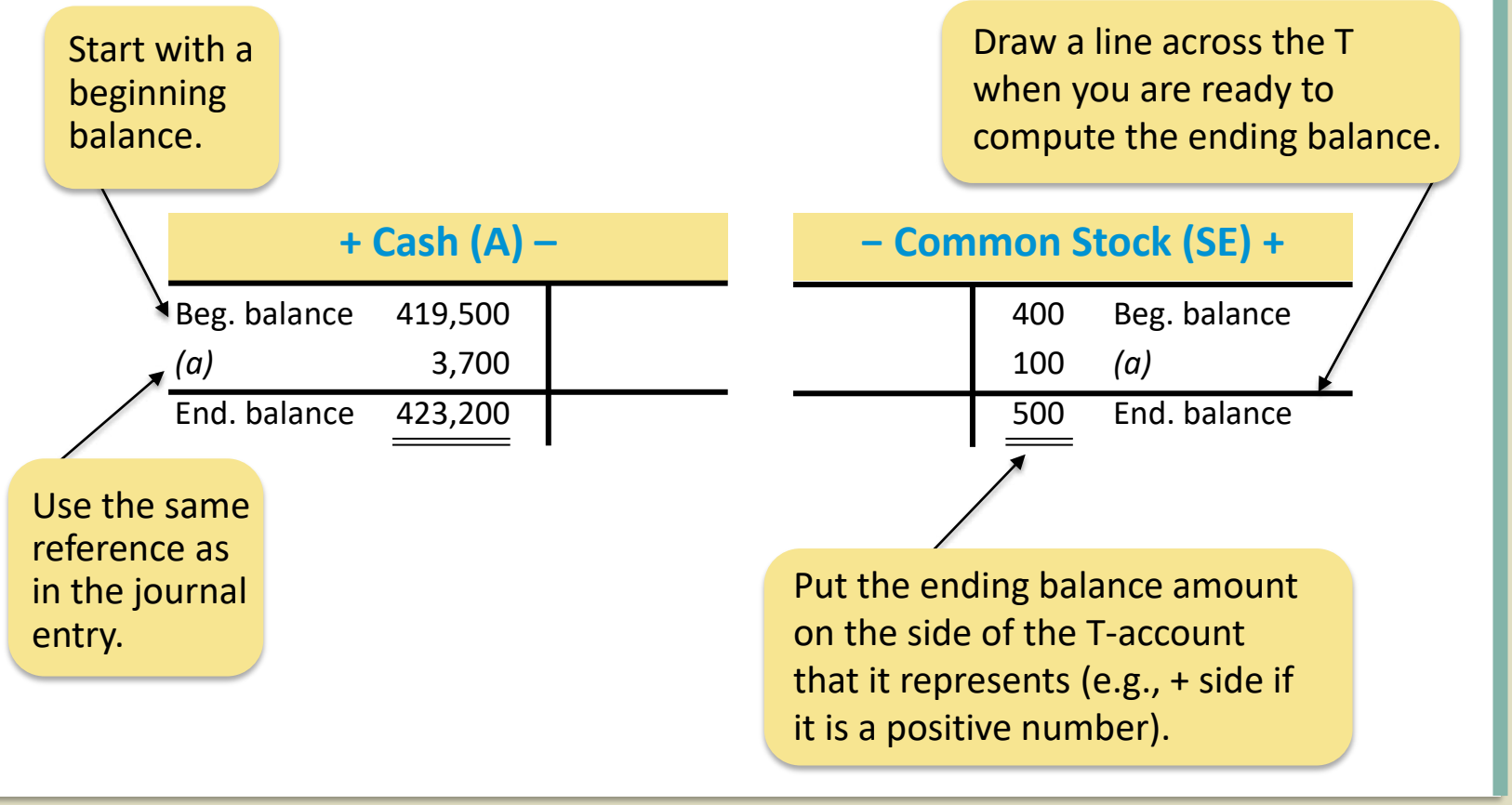
General Ledger **ADDITIONAL PAID-IN CAPITAL** 302

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				290,200
1-2-15		G1		3,600	293,800

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Exhibit 2.7

T-Accounts Illustrated



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Inferring Business Activities from T-Accounts

FINANCIAL ANALYSIS



− Accounts Payable (L) +	
	600 Beg. bal.
Cash payments to suppliers?	1,500 Purchases on account
	300 End bal.

Solution:

Beginning Balance	+	Purchases on Account	-	Cash Payments to Suppliers	=	Ending Balance
$600	+	$1,500	-	?	=	$ 300
		$2,100	-	?	=	$ 300
					=	$1,800

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Transaction Analysis Illustrated

***(a)* Chipotle issued (sold) 10,000 additional shares of common stock with a par value of $0.01 per share at a market value of $0.37 per share, receiving $3,700 in cash from investors. Common Stock is recorded at par (10,000 shares × $0.01 par value per share), and Additional Paid-in Capital is recorded for the excess over par value (10,000 shares × $0.36 per share).**

		Debit	Credit
(a)	Cash (+A)	3,700	
	Common Stock (+SE)		100
	Additional Paid-in Capital (+SE)		3,600

Assets		= Liabilities	+ Stockholders' Equity	
Cash	+3,700		Common Stock	+100
			Additional Paid-in Capital	+3,600

+ Cash (A) –			– Common Stock (SE) +			Additional Paid-in – Capital (SE) +		
1/1/15	419,500			400	1/1/15		290,200	1/1/15
(a)	**3,700**			**100**	***(a)***		**3,600**	***(a)***

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Transaction Analysis Illustrated

(b) **Chipotle borrowed $2,000 from its local bank, signing a note to be paid in three years.** Since Notes Payable is a new account not listed on the December 31, 2014, balance sheet in Exhibit 2.2, its beginning balance is $0.

		Debit	Credit
(b)	Cash (+A)	2,000	
	Long-Term Notes Payable (+L)		2,000

Assets		=	Liabilities		+	Stockholders' Equity
Cash	+2,000		Long-Term Notes Payable	+2,000		

+ Cash (A) –			– Long-Term Notes Payable (L) +		
1/1/15	419,500			0	1/1/15
(a)	3,700			**2,000**	***(b)***
(b)	**2,000**				

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Transaction Analysis Illustrated

After analyzing all transactions from (*a*)–(*f*), the balance in our T-accounts will appear as follows:

+ Cash (A) –			
1/1/15	419,500		
(a)	3,700	53,400	(c)
(b)	2,000	4,600	(d)
		44,000	(e)
	323,200		

+ Short-Term Investments (A) –			
1/1/15	338,600		
(e)	9,000		
	347,600		

+ Land (A) –			
1/1/15	11,100		
(c)	10,000		
	21,100		

+ Buildings (A) –			
1/1/15	1,267,100		
(c)	8,200		
	1,275,300		

+ Equipment (A) –			
1/1/15	442,500		
(c)	33,800		
	476,300		

+ Intangible Assets (A) –			
1/1/15	64,700		
(c)	3,700		
	68,400		

+ Long-Term Investments (A) –			
1/1/15	496,100		
(e)	35,000		
	531,100		

Short-Term – Notes Payable (L) +			
		0	1/1/15
(d)	2,300	2,300	(c)
		0	

Long-Term – Notes Payable (L) +			
		0	1/1/15
		2,000	(b)
		2,000	

Dividends – Payable (L) +			
		0	1/1/15
		3,000	(f)
		3,000	

– Other Liabilities (L) +			
		288,200	1/1/15
(d)	2,300		
		285,900	

– Common Stock (SE) +			
		400	1/1/15
		100	(a)
		500	

– Additional Paid-in Capital (SE) +			
		290,200	1/1/15
		3,600	(a)
		293,800	

– Retained Earnings (SE) +			
		1,721,800	1/1/15
(f)	3,000		
		1,718,800	

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Trial Balance

- The trial balance is a listing of the ending balances in each account in the general ledger.
- The purpose of the trial balance is to make sure the debits and credits are equal before we prepare the balance sheet.

CHIPOTLE MEXICAN GRILL–TRIAL BALANCE

(based on investing and financing transactions only during the first quarter ended March 31, 2015)

(in thousands)	Debit	Credit
Cash	323,200	
Short-term investments	347,600	
Accounts receivable	34,800	
Supplies	15,300	
Prepaid expenses	70,300	
Land	21,100	
Buildings	1,275,300	
Equipment	476,300	
Accumulated depreciation		613,700
Long-term investments	531,100	
Intangible assets	68,400	
Accounts payable		69,600
Unearned revenue		16,800
Dividends payable		3,000
Wages payable		73,900
Utilities payable		85,400
Short-term notes payable		0
Long-term notes payable		2,000
Other liabilities		285,900
Common stock		500
Additional paid-in capital		293,800
Retained earnings		1,718,800
Total	**3,163,400**	**3,163,400**

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Classified Balance Sheet

Assets and liabilities are classified into two categories: current and noncurrent.

Current assets are those to be used or turned into cash within the upcoming year, whereas noncurrent assets are those that will last longer than one year.

Current liabilities are those obligations to be paid or settled within the next 12 months with current assets.

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Exhibit 2.8

Chipotle Mexican Grill's First Quarter 2015 Balance Sheet

(based on investing and financing activities only)

CHIPOTLE MEXICAN GRILL, INC.

Consolidated Balance Sheets
(in thousands of dollars, except per share data)

	March 31, 2015	December 31 2014
ASSETS		
Current Assets:		
Cash	$ 323,200	$ 419,500
Short-term investments	347,600	338,600
Accounts receivable	34,800	34,800
Supplies	15,300	15,300
Prepaid expenses	70,300	70,300
Total current assets	791,200	878,500
Property and equipment:		
Land	21,100	11,100
Buildings	1,275,300	1,267,100
Equipment	476,300	442,500
Total cost	1,772,700	1,720,700
Accumulated depreciation	(613,700)	(613,700)
Net property and equipment	1,159,000	1,107,000
Long-term investments	531,100	496,100
Intangible assets	68,400	64,700
Total assets	**$2,549,700**	**$2,546,300**

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Exhibit 2.8

Chipotle Mexican Grill's First Quarter 2015 Balance Sheet

(based on investing and financing activities only)

CHIPOTLE MEXICAN GRILL, INC.

Consolidated Balance Sheets
(in thousands of dollars, except per share data)

	March 31, 2015	December 31 2014
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 69,600	$ 69,600
Unearned revenue	16,800	16,800
Dividends payable	3,000	—
Accrued expenses payable:		
Wages payable	73,900	73,900
Taxes payable	85,400	85,400
Total current liabilities	248,700	245,700
Notes payable	2,000	—
Other liabilities	285,900	288,200
Total liabilities	536,600	533,900
Stockholders' Equity:		
Common stock ($0.01 par value per share)	500	400
Additional paid-in capital	293,800	290,200
Retained earnings	1,718,800	1,721,800
Total stockholders' equity	2,013,100	2,012,400
Total liabilities and stockholders' equity	**$2,549,700**	**$2,546,300**

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International Perspective

INTERNATIONAL PERSPECTIVE



Understanding Foreign Financial Statements



Although IFRS differ from GAAP, they use the same system of analyzing, recording, and summarizing the results of business activities that you have learned in this chapter. One place where IFRS differ from GAAP is in the formatting of financial statements.

Financial statements prepared using GAAP and IFRS include the same elements (assets, liabilities, revenues, expenses, etc.). However, a single, consistent format has not been mandated. Consequently, various formats have evolved over time, with those in the U.S. differing from those typically used internationally. The formatting differences include:

	GAAP	IFRS
Balance Sheet Order	**Assets:**	**Assets:**
	Current	Noncurrent
Similar accounts are shown,	Noncurrent	Current
but the order of liquidity	**Liabilities:**	**Stockholders' Equity**
(for assets) and the order of	Current	**Liabilities:**
maturity (for liabilities) differ	Noncurrent	Noncurrent
	Stockholders' Equity	Current

On the balance sheet, GAAP begins with current items whereas IFRS begins with noncurrent items. Consistent with this, **assets are listed in decreasing order of liquidity under GAAP, but internationally are usually listed in increasing order of liquidity.** IFRS similarly emphasize longer-term financing sources by listing equity before liabilities and, within liabilities, by listing noncurrent liabilities before current liabilities (**decreasing time to maturity**). The key to avoiding confusion is to be sure to **pay attention to the subheadings** in the statement. Any account under the heading "liabilities" must be a liability.

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Current Ratio

KEY RATIO ANALYSIS



$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

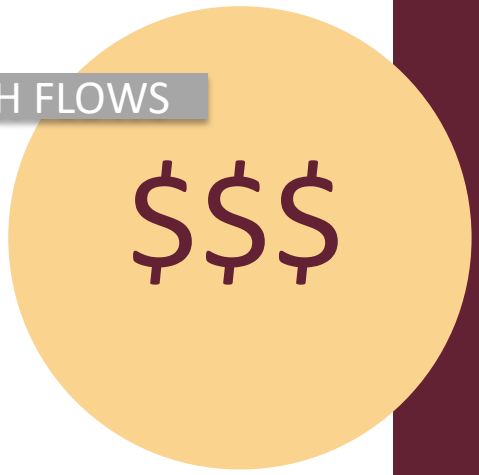
Does a company have the short-term resources to pay its short-term debt?

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Investing and Financing Activities

FOCUS ON CASH FLOWS



Companies report cash inflows (+) and outflows (−) over a period in their statement of cash flows.

Operating Activities	
(Covered in the next chapter)	
Investing Activities	
Purchasing long-term assets and investments for cash	−
Selling long-term assets and investments for cash	+
Lending cash to others	−
Receiving principal payments on loans made to others	+
Financing Activities	
Borrowing cash from banks	+
Repaying the principal on borrowings from banks	−
Issuing stock for cash	+
Repurchasing stock with cash	−
Paying cash dividends	−

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