

**CHAPTER 3**  
*Lecture Guide Examples*

**Example 1 – Asset Classification**

Indicate how land should be classified assuming it is:

- a. Used as a factory site.
- b. Owned by a realty company and held for resale.
- c. Held for speculation.
- d. Contains idle facilities.

**SOLUTION**

- a. PP&E.
- b. Current asset.
- c. LT investment.
- d. Other assets.

**Example 2 – Subsequent Events**

State the proper accounting treatment for the following subsequent events that occurred after the end of the report date but prior to issuing financial statements for the report date:

- a. Employees at a plant site went on strike, causing a shut-down of the plant, which is anticipated to cost the company lost revenue during the period of nonoperation.
- b. Issued additional shares of common stock.
- c. Settled a lawsuit against the company for damages of \$2.5 million. In anticipation of a probable loss of this suit, the company had already recorded an estimated loss and contingent liability for \$3 million.
- d. Settled a lawsuit against the company for damages of \$2.5 million. The lawsuit was in existence prior to the report date, but a contingent liability for the suit had not been recorded because the company had estimated a low probability of losing the suit.

**SOLUTION**

- a. Need not be disclosed.
- b. Must be disclosed, but statements do not need adjustment.
- c. Correct for the overstated loss and add back \$.5 million to income.
- d. The \$2.5 million loss must be recorded in the financial statements.

**Example 3 – Liquidity Measures (do in advance)**

For 2002 and 2001, calculate the working capital, current ratio, and quick ratio for Procter & Gamble. Interpret the results. [Note: industry (and S&P 500) averages for the current and quick ratios are: 1.26 (1.81) and .72 (1.29).]

**SOLUTION**

**2002:**

Working capital	=	current assets- current liabilities	=	12,166 – 12,704	=	\$(538)
Current ratio	=	$\frac{\text{current assets}}{\text{current liabilities}}$	=	$\frac{12,166}{12,704}$	=	.96
Quick ratio	=	$\frac{\text{quick assets}}{\text{current liabilities}}$	=	$\frac{3,427 + 196 + 3,090}{= 6,713}$	=	.53

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**2001:**

$$\text{Working capital} = \frac{\text{current assets} - \text{current liabilities}}{\text{current liabilities}} = \frac{10,889 - 9,846}{9,846} = \$1,043$$

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}} = \frac{10,889}{9,846} = 1.11$$

$$\text{Quick ratio} = \frac{\text{quick assets}}{\text{current liabilities}} = \frac{2,306 + 212 + 2,931}{9,846} = \frac{5,449}{9,846} = .55$$

*Interpret:* To interpret these measures, we might (1) understand what they measure, (2) compare to last year, (3) compare to other companies in the same industry, and/or (4) compare to rules of thumb.

- (1) In 2002, P&G has \$538 more in current liabilities than it has in current assets. For every \$1 of current liabilities, it has \$.96 in current assets and \$.53 in quick assets.
- (2) Last year's numbers are shown above. Amounts from 2000 were: working capital = \$5; current ratio = 1.00; quick ratio = .44. All measures improved from 2000 to 2001, but worsened again in 2002.
- (3) P&G is lower than their industry overall, and significantly lower than the companies in the S&P 500 (a broad measure of the market) for both the current ratio and the quick ratio.
- (4) Rules of thumb: working capital = none; current ratio = 2.00; quick ratio = 1.00. P&G is significantly below these levels.

**Example 4 – Solvency (Financing) Ratios (do in advance)**

For 2002 and 2001, calculate the debt ratio, the debt to equity ratio, and the times interest earned ratio for Procter & Gamble. How can we interpret these calculations? [Note: industry (and S&P 500) averages for the debt to equity and times interest earned ratios are: 1.45 (1.00) and 16.93 (12.28).]

**SOLUTION**

**2002:**

$$\text{Debt ratio} = \frac{\text{total debt (liab.)}}{\text{total assets}} = \frac{27,070}{40,776} = 66.4\%$$

$$\text{Debt to equity ratio} = \frac{\text{total debt}}{\text{stockholder's equity}} = \frac{27,070}{13,706} = 1.98$$

$$\text{Times interest earned} = \frac{\text{income b/4 int. \& taxes}}{\text{interest expense}} = \frac{6383+603=6986}{6603} = 11.6 \text{ times}$$

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**2001:**

$$\text{Debt ratio} = \frac{\text{total debt (liab.)}}{\text{total assets}} = \frac{22,377}{34,387} = 65.1\%$$

$$\text{Debt to equity ratio} = \frac{\text{total debt}}{\text{stockholder's equity}} = \frac{22,377}{12,010} = 1.86$$

$$\text{Times interest earned} = \frac{\text{income b/4 int. \& taxes}}{\text{interest expense}} = \frac{4640+794 = 5410}{794} = 6.8 \text{ times}$$

*Interpret:* To interpret these measures, we might (1) understand what they measure, (2) compare to last year, (3) compare to other companies in the same industry, and/or (4) compare to rules of thumb.

- (1) Debt to total assets: for every \$1 invested in assets, \$.66 has been provided by creditors. Debt to equity: P&G has almost twice (1.98 times) as much debt as it has equity. Times interest earned: P&G's interest earnings before interest and taxes are almost 12 times as much as its interest expense.
- (2) Last year's numbers are shown above. Numbers for 2000 were: debt to total assets = 64.2%; debt to equity = 1.80; times interest earned = 8.7. The debt measures have worsened a bit, but the times interest earned ratio has improved over the previous two years.
- (3) P&G has a higher (worse) debt to equity ratio than both its industry and the companies in the S&P 500 (a broad measure of the market). Its times-interest-earned ratio is not as good as the industry, but is about the same as for the S&P overall.
- (4) Rules of thumb: debt to total assets = 60%; debt to equity = 1.5; times-interest-earned = 4. P&G is more highly leveraged (it has relatively more debt) than is suggested by the rules of thumb. However, compared to the rule of thumb, it has plenty of income to cover its interest payments.