

# Chapter 3 The Balance Sheet and Financial Disclosures

---

## QUESTIONS FOR REVIEW OF KEY TOPICS

### Question 3-1

The purpose of the balance sheet, also known as the statement of financial position, is to present the financial position of the company on a particular date. Unlike the income statement, which is a change statement that reports events occurring during a period of time, the balance sheet is a statement that presents an organized array of assets, liabilities, and shareholders' equity at a point in time. It is a freeze frame or snapshot picture of financial position at the end of a particular day marking the end of an accounting period.

### Question 3-2

The balance sheet does not portray the market value of the entity for a number of reasons. Most assets are not reported at market value, but instead are measured according to historical cost. Also, there are certain resources, such as trained employees, an experienced management team, and a good reputation, that are not recorded as assets at all. Therefore, the assets of a company minus its liabilities, as shown in the balance sheet, will not be representative of the company's market value.

### Question 3-3

Current assets include cash and other assets that are reasonably expected to be converted to cash or consumed during one year, or within the normal operating cycle of the business if the operating cycle is longer than one year. The typical asset categories classified as current assets include:

- Cash and cash equivalents
- Short-term investments
- Accounts receivable
- Inventories
- Prepaid expenses

### Question 3-4

Current liabilities are those obligations that are expected to be satisfied through the use of current assets or the creation of other current liabilities. So, this classification will include all liabilities that are scheduled to be liquidated within one year or the operating cycle, whichever is longer, except those that management intends to refinance on a long-term basis. The typical liability categories classified as current liabilities include:

- Accounts payable
- Short-term notes payable
- Accrued liabilities
- Current maturities of long-term debt

## *Answers to Questions (continued)*

### **Question 3-5**

The operating cycle for a typical manufacturing company refers to the period of time required to convert cash to raw materials, raw materials to a finished product, finished product to receivables, and then finally receivables back to cash.

### **Question 3-6**

Investments in equity securities are classified as current if the company's management (1) intends to liquidate the investment in the next year or operating cycle, whichever is longer, and (2) has the ability to do so, i.e., the investment is marketable. If either of these criteria does not hold, the investment is classified as noncurrent.

### **Question 3-7**

The common characteristics that these assets have in common are that they are *tangible, long-lived assets used in the operations of the business*. They usually are the primary revenue-generating assets of the business. These assets include land, buildings, equipment, machinery, furniture and other assets *used* in the operations of the business, as well as natural resources, such as mineral mines, timber tracts and oil wells.

### **Question 3-8**

Property, plant, and equipment and intangible assets each represent assets that are long-lived and are used in the operations of the business. The difference is that property, plant, and equipment represent physical assets, while intangibles lack physical substance. Generally, intangibles represent the ownership of an exclusive right, such as a patent, copyright or franchise.

### **Question 3-9**

A note payable of \$100,000 due in five years would be classified as a long-term liability. A \$100,000 note due in five annual installments of \$20,000 each would be classified as a \$20,000 current liability — current maturities of long-term debt — and an \$80,000 long-term liability.

### **Question 3-10**

Paid-in-capital consists of amounts invested by shareholders in the corporation. Retained earnings equals net income less dividends paid to shareholders from the inception of the corporation.

### **Question 3-11**

Disclosure notes provide additional detail concerning specific financial statement items. Included are such data as the market values of financial instruments and off-balance-sheet risk associated with financial instruments and details of pension plans, leases, debt, and assets. Common to all companies' disclosures are certain specific notes such as a summary of significant accounting policies, descriptions of subsequent events, and related third-party transactions. However, many notes are designed to fit the disclosure needs of the particular reporting company. In fact, any explanation that helps investors and creditors make decisions should be included.

## Answers to Questions (continued)

### Question 3-12

The disclosure of the company's significant accounting policies is extremely important to external users in terms of their ability to *compare* financial information across companies. It is critical to a financial analyst involved in assessing future cash flows of two construction companies to know that one company uses the percentage-of-completion method in recognizing gross profit, while the other company uses the completed contract method.

### Question 3-13

A subsequent event is an event that occurs *after* the date of the financial statements but *prior* to the date on which the statements are actually issued. It may help to clarify a previously existing situation or it may represent a new event not directly affecting financial position at the end of the reporting period.

### Question 3-14

The discussion provides management's views on significant events, trends and uncertainties pertaining to the company's (a) operations, (b) liquidity, and (c) capital resources. Certainly the Management Discussion and Analysis section may be slanted to management's biased perspective and therefore can lack objectivity. However, management can offer an informed insight that might not be available elsewhere, so if the reader maintains awareness of the information's source, it can offer a unique view of the situation.

### Question 3-15

Depending on the circumstances, the auditor will issue a (an):

1. **Unqualified opinion** – The auditors are satisfied that the financial statements “present fairly” the financial position, results of operations, and cash flows and are “prepared in accordance with generally accepted accounting principles.”
2. **Qualified opinion** – This contains an exception to the standard unqualified opinion, but not of sufficient seriousness to invalidate the financial statements as a whole. Examples of exceptions are (a) unconformity with generally accepted accounting principles, (b) inadequate disclosures, and (c) a limitation or restriction of the scope of the examination.
3. **Adverse opinion** – This is necessary when the exceptions are so serious that a qualified opinion is not justified. Adverse opinions are rare because auditors usually are able to persuade management to rectify problems to avoid this undesirable report.
4. **Disclaimer** – An auditor will disclaim an opinion if insufficient information has been gathered to express an opinion.

### Question 3-16

A proxy statement must be sent each year to all shareholders. It usually is in the same mailing with the annual report. The statement invites shareholders to the shareholders' meeting to elect board members and to vote on issues before the shareholders. It also permits shareholders to vote using an enclosed proxy card. Beginning with 1992 financial statements, the proxy statement also provides for more disclosures on compensation to directors and executives, and in particular, stock options granted to executives.

## Answers to Questions (concluded)

### Question 3-17

Working capital is the difference between current assets and current liabilities. The current ratio is computed by dividing current assets by current liabilities. The acid-test ratio (or quick ratio) is computed by dividing quick assets (cash and cash equivalents, marketable securities, and accounts receivable) by current liabilities.

### Question 3-18

Debt to equity ratio	=	$\frac{\text{Total liabilities}}{\text{Shareholders' equity}}$
Times interest earned ratio	=	$\frac{\text{Net income} + \text{interest} + \text{taxes}}{\text{Interest}}$

### Question 3-19

An **operating segment** is a component of an enterprise:

1. That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise).
2. Whose operating results are regularly reviewed by the enterprise's chief operating decision-maker to make decisions about resources to be allocated to the segment, and to assess its performance.
3. For which discrete financial information is available.

### Question 3-20

For areas determined to be reportable operating segments, the following disclosures are required:

1. General information about the operating segment,
2. Information about reported segment profit or loss, including certain revenues and expenses included in reported segment profit or loss, segments assets, and the basis of measurement.
3. Reconciliations of the totals of segment revenues, reported profit or loss, assets, and other significant items to corresponding enterprise amounts.
4. Interim period information.

# EXERCISES

## Exercise 3-2

- |              |                                      |              |                     |
|--------------|--------------------------------------|--------------|---------------------|
| 1. <u>c</u>  | Equipment                            | 10. <u>a</u> | Inventories         |
| 2. <u>f</u>  | Accounts payable                     | 11. <u>d</u> | Patent              |
| 3. <u>-a</u> | Allowance for uncollectible accounts | 12. <u>c</u> | Land, in use        |
| 4. <u>b</u>  | Land, held for investment            | 13. <u>f</u> | Accrued liabilities |
| 5. <u>g</u>  | Note payable, due in 5 years         | 14. <u>a</u> | Prepaid rent        |
| 6. <u>f</u>  | Unearned rent revenue                | 15. <u>h</u> | Common stock        |
| 7. <u>f</u>  | Note payable, due in 6 months        | 16. <u>c</u> | Building, in use    |
| 8. <u>i</u>  | Income less dividends, accumulated   | 17. <u>a</u> | Cash                |
| 9. <u>b</u>  | Investment in XYZ Corp., long-term   | 18. <u>f</u> | Taxes payable       |

## Exercise 3-3

- |              |   |              |                            |
|--------------|---|--------------|----------------------------|
| 1. <u>f</u>  | Accrued interest payable                                    | 10. <u>a</u> | Supplies                   |
| 2. <u>d</u>  | Franchise   | 11. <u>c</u> | Machinery                  |
| 3. <u>-c</u> | Accumulated depreciation                                    | 12. <u>c</u> | Land, in use               |
| 4. <u>e</u>  | Prepaid insurance, for 2005                                 | 13. <u>f</u> | Unearned revenue           |
| 5. <u>g</u>  | Bonds payable, due in 10 years                              | 14. <u>d</u> | Copyrights                 |
| 6. <u>f</u>  | Current maturities of long-term debt                        | 15. <u>h</u> | Preferred stock            |
| 7. <u>f</u>  | Note payable, due in 3 months                               | 16. <u>b</u> | Land, held for speculation |
| 8. <u>b</u>  | Long-term receivables                                       | 17. <u>a</u> | Cash equivalents           |
| 9. <u>b</u>  | Bond sinking fund, will be used to retire bonds in 10 years | 18. <u>f</u> | Wages payable              |

## Exercise 3-4

<b>JACKSON CORPORATION</b>	
Balance Sheet	
At December 31, 2003	
<b>Assets</b>	
<i>Current assets:</i>	
Cash .....	\$ 30,000
Marketable securities .....	10,000
Accounts receivable .....	34,000
Inventories .....	75,000
Prepaid rent .....	<u>6,000</u>
Total current assets .....	155,000
<i>Property, plant, and equipment:</i>	
Machinery .....	\$145,000
Less: Accumulated depreciation .....	<u>(11,000)</u>
Net property, plant, and equipment .....	134,000
<i>Intangibles:</i>	
Patent .....	<u>83,000</u>
Total assets .....	<u>\$372,000</u>
<b>Liabilities and Shareholders' Equity</b>	
<i>Current liabilities:</i>	
Accounts payable .....	\$ 8,000
Wages payable .....	4,000
Taxes payable .....	<u>32,000</u>
Total current liabilities .....	44,000
<i>Long-term liabilities:</i>	
Bonds payable .....	200,000
<i>Shareholders' equity:</i>	
Common stock .....	\$100,000
Retained earnings .....	<u>28,000</u>
Total shareholders' equity .....	<u>128,000</u>
Total liabilities and shareholders' equity .....	<u>\$372,000</u>

### Exercise 3-8

- |  |          |
|--|----------|
| 1. Inventory costing method                            | <u>A</u> |
| 2. Information on related party transactions           | <u>B</u> |
| 3. Composition of property, plant, and equipment       | <u>B</u> |
| 4. Depreciation method                                 | <u>A</u> |
| 5. Subsequent event information                        | <u>B</u> |
| 6. Basis of revenue recognition on long-term contracts | <u>A</u> |
| 7. Important merger occurring after year-end           | <u>B</u> |
| 8. Composition of receivables                          | <u>B</u> |

### Exercise 3-9

1. When related-party transactions occur, companies must disclose the nature of the relationship, provide a description of the transaction, and report the dollar amounts of the transactions and any amounts due from or to related parties.
2. When an event that has a material effect on the company's financial position occurs after the fiscal year-end, but before the financial statements actually are issued, the event is disclosed in a *subsequent event* disclosure note.
3. The choice of the straight-line method to determine depreciation typically is disclosed in the company's summary of significant accounting policies disclosure note.
4. This information would be included in a disclosure note describing the company's debt.
5. The choice of the FIFO method to determine value inventory typically is disclosed in the company's summary of significant accounting policies disclosure note.

## Exercise 3-11

### List A

- d 1. Balance sheet
- h 2. Liquidity
- b 3. Current assets
- j 4. Operating cycle
- a 5. Current liabilities
- k 6. Cash equivalent
- m 7. Intangible asset
- l 8. Working capital
- g 9. Accrued liabilities
- e 10. Summary of significant accounting policies
- i 11. Subsequent events
- c 12. Unqualified opinion
- f 13. Qualified opinion

### List B

- a. Will be satisfied through the use of current assets.
- b. Items expected to be converted to cash or consumed within one year or the operating cycle.
- c. The statements are presented fairly in conformity with GAAP.
- d. An organized array of assets, liabilities and equity.
- e. Important to a user in comparing financial information across companies.
- f. Scope limitation or a departure from GAAP.
- g. Recorded when an expense is incurred but not yet paid.
- h. Relates to the amount of time before an asset is converted to cash or a liability is paid.
- i. Occurs after the fiscal year-end but before the statements are issued.
- j. Cash to cash.
- k. One-month U.S. treasury bill.
- l. Current assets minus current liabilities.
- m. Lacks physical existence.

## Exercise 3-12

- 1. Current ratio  $[\$100 + 150 + 200 + 400] \div \$400 = 2.125$
- 2. Acid-test ratio  $[\$100 + 150 + 200] \div \$400 = 1.125$
- 3. Debt to equity ratio  $[\$400 + 350] \div [\$700 + 400] = .68$
- 4. Times interest earned ratio  $[\$160 + 20 + 100] \div \$20 = 14 \text{ times}$

## Exercise 3-14

Action	Current Ratio	Acid-test Ratio	Debt to Equity Ratio
1. Issuance of long-term bonds	<u>I</u>	<u>I</u>	<u>I</u>
2. Issuance of short-term notes	<u>I</u>	<u>I</u>	<u>I</u>
3. Payment of accounts payable	<u>D</u>	<u>D</u>	<u>D</u>
4. Purchase of inventory on account	<u>I</u>	<u>D</u>	<u>I</u>
5. Purchase of inventory for cash	<u>N</u>	<u>D</u>	<u>N</u>
6. Purchase of equipment with a 4-year note	<u>N</u>	<u>N</u>	<u>I</u>
7. Retirement of bonds	<u>D</u>	<u>D</u>	<u>D</u>
8. Sale of common stock	<u>I</u>	<u>I</u>	<u>D</u>
9. Write-off of obsolete inventory	<u>D</u>	<u>N</u>	<u>I</u>
10. Purchase of short-term investment for cash	<u>N</u>	<u>N</u>	<u>N</u>
11. Decision to refinance on a long-term basis some currently maturing debt	<u>I</u>	<u>I</u>	<u>N</u>

## PROBLEMS

### Problem 3-2

#### Requirement 1

##### Inventories:

Current assets - Cash and cash equivalents - Short-term investments -  
Accounts receivable - Prepaid expenses = Inventories  
\$1,594,927 - 239,186 - 353,700 - 504,944 - 83,259 = **\$413,838**

##### Total assets:

Total liabilities + Shareholders' equity = Total assets  
\$956,140 + 1,370,627 = **\$2,326,767**

##### Property and equipment (net):

Total assets - Current assets - Long-term receivables = Property and equipment  
\$2,326,767 - 1,594,927 - 110,800 = **\$621,040**

##### Accounts payable:

Total current liabilities - Notes payable and short-term debt - Accrued liabilities - Other current liabilities = Accounts payable  
\$693,564 - 31,116 - 421,772 - 181,604 = **\$59,072**

##### Long-term debt and deferred taxes:

Total liabilities - Current liabilities = Long-term debt and deferred taxes  
\$956,140 - 693,564 = **\$262,576**

## Requirement 2

<b>AMDAHL CORPORATION</b>	
Balance Sheet	
<b>Assets</b>	
(\$ in thousands)	
<i>Current assets:</i>	
Cash and cash equivalents .....	\$ 239,186
Short-term investments .....	353,700
Accounts receivable, net of allowance for uncollectible accounts .....	504,944
Inventories .....	413,838
Prepaid expenses .....	<u>83,259</u>
Total current assets .....	1,594,927
<i>Investments:</i>	
Long-term receivables .....	110,800
<i>Property and equipment (net) .....</i>	<u>621,040</u>
Total assets .....	<u><u>\$2,326,767</u></u>
<b>Liabilities and Shareholders' Equity</b>	
<i>Current liabilities:</i>	
Notes payable and short-term debt .....	\$ 31,116
Accounts payable .....	59,072
Accrued liabilities .....	421,772
Other current liabilities .....	<u>181,604</u>
Total current liabilities .....	693,564
<i>Long-term debt and deferred taxes .....</i>	262,576
<i>Shareholders' equity .....</i>	<u>1,370,627</u>
Total liabilities and shareholders' equity .....	<u><u>\$2,326,767</u></u>

## CASES

### Judgment Case 3-5

Accounts receivable, net - disclosure on the face of the statement of the allowance for uncollectible accounts, if material.

Inventories - disclosure in Accounting Policies note of the cost method used. Also, for a manufacturer, note disclosure of the breakout of inventory into raw materials, work in process and finished goods.

Property, plant and equipment - original cost by major category should be disclosed along with the accumulated depreciation either on the face of the statement or in a note. Also, the method used to compute depreciation should be disclosed in the Accounting Policies disclosure note.

Long-term liabilities - disclosure in a note of the various debt instruments comprising long-term liabilities to include information such as payment terms, interest rates, and collateral pledged as security for the debt.

Common stock - disclosure on the face of the statement of par value, if any, and the number of shares authorized, issued and outstanding.

### Judgment Case 3-7

1. This is a significant event occurring after the end of the fiscal year but prior to the issuance of the financial statements. Details of the merger should be disclosed in a note to the financial statements.
2. This is a significant event occurring after the end of the fiscal year but prior to the issuance of the financial statements. Details of the issuance of the new debt should be described in a note to the financial statements.
3. This is a significant event occurring after the end of the fiscal year but prior to the issuance of the financial statements. The event should be described in a note to the financial statements along with the amount of uninsured damage.

### Analysis Case 3-15

#### Requirement 1

The balance sheet includes three asset classifications: Current assets, Property and equipment, and Other assets; and four liability classifications: Current liabilities, Long-term debt, Deferred income taxes, and Other liabilities.

## **Requirement 2**

These assets are shown as current because the company intends to use them in the next year or operating cycle.

## **Requirement 3**

Current portion of long-term debt represents the principal amounts due in the next year on long-term debt.

## **Requirement 4**

Disclosure notes explain or elaborate upon the data presented in the financial statements themselves. They must include certain specific notes such as a summary of significant accounting policies, descriptions of subsequent events, and related third-party transactions, but many notes are company specific. Actually, any explanation that contributes to investors' and creditors' understanding of the results of operations, financial position, or cash flows of the company should be included.

## **Requirement 5**

Straight-line.

## **Requirement 6**

No.