Overview

This chapter covers the balance sheet in more detail than you likely encountered in your introductory accounting course. In addition, the topic of financial statement notes is included.

The balance sheet is the most important financial statement to many users. A wealth of information is contained on it. It reports the financial position of a company as of a particular date. Three kinds of accounts are included: assets, liabilities, and equity. Income statement accounts (revenues, gains, expenses, losses) are not included on a balance sheet. However, as discussed in Chapter 2, income statement accounts are closed out to equity. Classified balance sheets are the norm and refer to the segregation of assets and liabilities into current and noncurrent categories.

Financial statement notes can be very significant for a company. Large companies, or companies with complicated transactions, can produce notes to the financial statements that are several times lengthier than the financial statements themselves. Subsequent chapters will discuss required disclosures as they relate to specific kinds of transactions or activities. Some notes are required for nearly all companies. These include a summary of significant accounting policies, additional information to support summary totals, information about items not included in the financial statements, supplementary information, and subsequent events (if any).

Learning Objectives

Refer to the Review of Learning Objectives at the end of the chapter. It is crucial that this section of the chapter is second nature to you before you attempt the homework, a quiz, or exam. This important piece of the chapter serves as your CliffsNotes or “cheat sheet” to the basic concepts and principles that must be mastered.

If after reading this section of this chapter you still don’t feel comfortable with all of the Learning Objectives covered, you will need to spend additional time and effort reviewing those concepts you are struggling with.
The following “Tips, Hints, and Things to Remember” are organized according to the Learning Objectives (LOs) in the chapter and should be gone over after reading each of the LOs in the textbook.

**Tips, Hints, and Things to Remember**

Subsequent chapters (especially 5, 7, and 10–15) delve into even more particulars about the balance sheet and the accounts found thereon. Hence, it is of great importance that you master the material in this chapter before moving on. The content in Chapter 3 won’t “go away” if you don’t study it adequately in the hopes that its principles won’t appear in future chapters. It is a foundational chapter that is key to understanding later chapters.

**LO1 –** Describe the specific elements of the balance sheet (assets, liabilities, and owners’ equity), and prepare a balance sheet with assets and liabilities properly classified into current and noncurrent categories.

**How?** When referring to debt or stock, be careful to note whose instrument it is. (After Chapters 13–15 this should hopefully be clear, but you need to see the distinction now!) If the debt is something the company must repay (including interest), it will be a liability to the company. If the stock is the company’s own (for which cash came in when issued), it will be equity to the company. If, on the other hand, the debt or stock is issued by another company, then it is something the company owns (has purchased for future interest income, dividends, and/or appreciation possibilities) and it will, therefore, be an asset.

**Why?** Don’t confuse inventory with property, plant, and equipment. Inventory includes items held for sale in the ordinary course of business. Property, plant, and equipment, on the other hand, include items used in the business that are not generally held for sale. For a company like Wal-Mart, the merchandise on the shelves is inventory, but the shelves holding the merchandise would be classified as property, plant, and equipment.

**How?** The liability and equity side of the balance sheet deals with how a company finances itself. One cannot determine how a company is performing its financing, or leveraging itself, from the other financial statements. Likewise, liquidity can only be determined from a balance sheet.
Why? The balance sheet is the only financial statement that is as of a particular date. For instance, the cash on the balance sheet is the amount of cash on hand as of the date stated. It is not the amount of cash that came in during the period. All of the other financial statements are for a period of time (like a month, quarter, or year). A comparative balance sheet is not for a period of time either. It is for two or more points in time (i.e., How much cash did the company have at the beginning and at the end of the year?). The cash balance during the year may have fluctuated widely, but one cannot tell from a balance sheet—even if it is a comparative one.

How? Asset and liability accounts are normally listed in order of liquidity. As you work your way down the balance sheet and hit the “not liquid within 12 months” mark, your classification will change from current to noncurrent.


How? Help! My balance sheet doesn’t balance. Sometimes, when you are given a balance sheet creation problem, you end up with assets not equaling liabilities plus equity. Your assets, of course, must always equal liabilities plus equity. Hence, you know when they don’t equal that something has gone wrong.

- The most common error can be found in retained earnings. Make sure that the ending retained earnings balance equals the beginning retained earnings balance plus net income (or minus a net loss) minus any dividends.
- If that doesn’t bring your balance sheet into balance, your next step should be to re-foot (re-add) the amounts.
- The next item to check is the difference between the assets and the liabilities plus equity. If the difference between the two equals one of the items on your balance sheet or one of the items not on your balance sheet that was given, then you likely found your mistake.
- Divide the number you are off by in half. Then scan for that number. If you find it you probably included a debit as a credit or vice versa.
- If that doesn’t do the trick, check to see if the difference is a multiple of 9 (9, 18, 27, ..., 450, ..., 900, etc.). If it is a multiple of 9, you have probably transposed (reversed) a number somewhere (i.e., typed in 190 instead of 910 or 1,234,567 instead of 1,324,567).
- The above are the quick fixes. If none of them work, then you probably will need to start the problem from scratch (as there may be more than one error involved). Try the problem in a different order the second time. Maybe start with equity instead of assets and see if a new approach does the trick.

LO2 – Identify the different formats used to present balance sheet data.
LO3 – Analyze a company's performance and financial position through the computation of financial ratios.

How? The only differences between the current ratio and the quick ratio are inventory and prepaid expenses. The quick ratio includes neither. The current ratio includes both.

How? You will likely be tested (if not in this class then on the CPA exam) on your knowledge of things like the current ratio, quick ratio, and debt ratio with a question like the following: “If IBM's current ratio is greater than 1 and they pay off some accounts payable, what will happen to their current ratio?” To solve this problem, always start with the numbers 3 and 2. (If you start with 2 and 1 or 1 and 0.5, you may get some strange answers.) The 3 (for current assets) goes to 2, and the 2 (for current liabilities) goes to 1. Since 3/2 is less than 2/1, your answer is that the current ratio increases. If IBM's current ratio was less than 1 to begin with, then your answer would be the opposite. Two (current assets) goes to 1, and 3 (current liabilities) goes to 2, so the ratio goes from 2/3 to 1/2 and decreases. Use real numbers (2 and 3) on these kinds of problems and don’t try to do them in your head. Write the numbers out.

How? Financial ratios are introduced in this chapter and additional ones will continue to be introduced in subsequent chapters. Some (like the current ratio) are so common and important that you simply need to memorize what they are and what they mean. Others aren’t necessarily as common, but there are tricks to learning what they are without resorting to always looking them up. Usually, the name of the ratio gives away what it is.

- Profitability, “return on,” ratios are going to have Net Income in the numerator and whatever word comes after “on” in the denominator.
- Activity, “turnover,” ratios are going to have whatever word comes before “turnover” in the denominator and usually Sales in the numerator (Cost of Goods Sold in the case of Inventory Turnover).
- “Margin” ratios are always going to have whatever word comes before “margin” in the numerator and Sales in the denominator.

LO4 – Recognize the importance of the notes to the financial statements, and outline the types of disclosures made in the notes.

Why? Notes to the financial statements never correct, or recognize, items that should otherwise be in the financial statements themselves. The notes disclose items required by GAAP. Disclosures should not duplicate details presented elsewhere in the financial statements.
**How?** Get a good feel for what is included in the summary of significant accounting policies as this note, in terms of format, is nearly the same for all companies. It’s also the note that is most frequently tested in this course and on the CPA exam. Usually included are a description of business, revenue recognition policies, definition of cash equivalents, depreciation methods, and inventory valuation methods. You can and should—to put some real-world examples behind your theoretical knowledge since this helps retain the concepts in your memory—access any publicly traded company’s financial statements and disclosure notes from the following Web site: http://www.sec.gov.

**Why?** Subsequent events include events that provide evidence about things that did not exist at the date of the balance sheet in addition to events that did exist at the balance sheet date that were clarified before the financial statements were issued. The former are disclosed but do not cause a change in the financial statements themselves.

*The following sections, featuring various multiple choice questions, matching exercises, and problems, along with solutions and approaches to arriving at the solutions, is intended to develop your problem-solving and critical-thinking abilities. While learning through trial and error can be effective for improving your quiz and exam scores, and it can be a more interesting way to study than merely re-reading a chapter, that is only a secondary objective in presenting this information in this format.*

*The main goal of the following sections is to get you thinking, “How can I best approach this problem to arrive at the correct solution—even if I don’t know enough at this point to easily arrive at the proper results?” There is not one simple approach that can be applied to all questions to arrive at the right answer. Think of the following approaches as possibilities, as tools that you can place in your problem-solving toolkit—a toolkit that should be consistently added to. Some of the tools have yet to even be created or thought of. Through practice, creative thinking, and an ever-expanding knowledge base, you will be the creator of the additional tools.*

**Multiple Choice**

**MC3-1 (LO1)** Which of the following would NOT be classified as a current asset on a classified balance sheet?

- a. trading securities
- b. inventory
- c. property, plant, and equipment
- d. prepaid advertising
MC3-2 (LO1) The accounts and balances shown below were gathered from Pudge Corporation’s trial balance on December 31, 2011. All adjusting entries have been made.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages Payable</td>
<td>$25,600</td>
</tr>
<tr>
<td>Cash</td>
<td>17,700</td>
</tr>
<tr>
<td>Mortgage Payable ($1,000 monthly over the next 10 years)</td>
<td>120,000</td>
</tr>
<tr>
<td>Prepaid Rent</td>
<td>13,600</td>
</tr>
<tr>
<td>Inventory</td>
<td>81,800</td>
</tr>
<tr>
<td>Short-Term Investments</td>
<td>15,200</td>
</tr>
<tr>
<td>Taxes Payable</td>
<td>22,800</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>24,800</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>36,600</td>
</tr>
</tbody>
</table>

Pudge Corporation's working capital is
a. $79,700.
b. $(28,300).
c. $56,100.
d. $(51,900).

MC3-3 (LO1) The following changes in Greylan Corporation’s account balances occurred during 2011:

<table>
<thead>
<tr>
<th>Account</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$250,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>50,000</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>210,000</td>
</tr>
</tbody>
</table>

Greylan paid dividends of $19,000 during the year. There were no changes in Retained Earnings for 2011 except dividends and net income. What was Greylan’s net income for 2011?
a. $19,000
b. $9,000
c. $231,000
d. $10,000

MC3-4 (LO1) The December 31, 2010, balance sheet of Carrie, Inc., reported total assets of $1,150,000 and total liabilities of $750,000. The following information relates to the year 2011:
- Carrie, Inc., issued an additional 10,000 shares of common stock at $20 per share on July 1, 2011.
- Carrie, Inc., paid dividends totaling $90,000.
- Net income for 2011 was $105,000.
- No other changes occurred in stockholders’ equity during 2011.
The stockholders’ equity section of the December 31, 2011, balance sheet would report a balance of
a. $400,000.
b. $600,000.
c. $215,000.
d. $615,000.

MC3-5 (LO3) Huggins Company has total debt of $200,000 and stockholders’ equity of $400,000. Huggins is seeking capital to fund an expansion. Huggins is planning to issue an additional $150,000 in common stock, and is negotiating with a bank to borrow additional funds. The bank’s loan covenant includes a maximum debt ratio of 0.8. What is the maximum additional amount Huggins will be able to borrow after the common stock is issued?
a. $2,400,000
b. $4,200,000
c. $2,000,000
d. $600,000

MC3-6 (LO3) Ferris Company’s current ratio is greater than 1. Which of the following transactions would normally increase Ferris’s current ratio?
a. purchasing inventory on account
b. paying off an account with cash
c. collecting an account receivable
d. purchasing land for cash

MC3-7 (LO3) Information from Seehee Company’s balance sheet is as follows:

<table>
<thead>
<tr>
<th>Current Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Investment securities</td>
<td>3,750,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>28,800,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>31,580,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>600,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$65,730,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes payable</td>
<td>$780,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>9,750,000</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>6,250,000</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>250,000</td>
</tr>
<tr>
<td>Payments due within one year on long-term debt</td>
<td>1,750,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$18,780,000</td>
</tr>
</tbody>
</table>
What is Seehee’s quick (acid-test) ratio?

a. 1.59 to 1
b. 1.79 to 1
c. 3.47 to 1
d. 3.50 to 1

**MC3-8 (LO4)** Which of the following are you NOT likely to find in a company’s summary of significant accounting policies?

a. definition of what the company considers a cash equivalent
b. how the company recognizes revenue
c. subsequent events
d. depreciation methods
Matching 3-1 (LO1) Listed below are the terms and associated definitions from the chapter for LO1. Match the correct definition letter with each term number.

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. balance sheet</td>
<td>current assets minus current liabilities</td>
</tr>
<tr>
<td>2. asset</td>
<td>a business entity owned by two or more people</td>
</tr>
<tr>
<td>3. liability</td>
<td>a definite obligation with only the amount of the obligation in question including pensions, warranties, and deferred taxes</td>
</tr>
<tr>
<td>4. equity</td>
<td>a resource of an entity</td>
</tr>
<tr>
<td>5. working capital</td>
<td>the portion of the amount invested by stockholders that is designated as par or stated value</td>
</tr>
<tr>
<td>6. current assets/liabilities</td>
<td>debt and equity instruments that are purchased mainly with the intent of reselling in the short term</td>
</tr>
<tr>
<td>7. trading securities</td>
<td>real owners of the corporation hold this stock which has voting rights and legal ownership of the corporate assets after the claims of all others have been satisfied</td>
</tr>
<tr>
<td>8. contingent liabilities</td>
<td>expected to be used, paid, or satisfied within a year or less</td>
</tr>
<tr>
<td>9. estimated liability</td>
<td>an obligation to transfer assets or provide a good or service in the future arising from a past transaction or event</td>
</tr>
<tr>
<td>10. proprietorship</td>
<td>the difference between assets and liabilities</td>
</tr>
<tr>
<td>11. partnership</td>
<td>possible claims due to past activities or circumstances although obligations do not exist on the date of the balance sheet</td>
</tr>
<tr>
<td>12. corporation</td>
<td>equity not originating from owner investments or undistributed profits</td>
</tr>
<tr>
<td>13. retained earnings</td>
<td>holders usually receive a fixed annual cash dividend and have a higher likelihood of recovering their investment if the company goes bankrupt</td>
</tr>
<tr>
<td>14. capital stock</td>
<td>changes in owners' equity exclusive of contributions by and distributions to owners</td>
</tr>
<tr>
<td>15. additional paid-in capital</td>
<td>long-term rights and privileges acquired for use in business operations including goodwill, patents, trademarks, franchises, and copyrights</td>
</tr>
<tr>
<td>16. preferred stock</td>
<td>a business entity owned by one person</td>
</tr>
<tr>
<td>17. common stock</td>
<td></td>
</tr>
<tr>
<td>18. treasury stock</td>
<td></td>
</tr>
<tr>
<td>19. comprehensive income</td>
<td></td>
</tr>
<tr>
<td>20. intangible assets</td>
<td></td>
</tr>
</tbody>
</table>
### Matching 3-2 (LO3, LO4, LO5)

Listed below are the terms and associated definitions from the chapter for LO3 through LO5. Match the correct definition letter with each term number.

<table>
<thead>
<tr>
<th></th>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>liquidity</td>
<td>a. total current assets divided by total current liabilities</td>
</tr>
<tr>
<td>2</td>
<td>current ratio</td>
<td>b. only the most liquid current assets divided by total current liabilities</td>
</tr>
<tr>
<td>3</td>
<td>loan covenant</td>
<td>c. the overall measure of company efficiency</td>
</tr>
<tr>
<td>4</td>
<td>quick (or acid-test) ratio</td>
<td>d. the degree to which a company uses borrowed funds instead of invested funds</td>
</tr>
<tr>
<td>5</td>
<td>leverage</td>
<td>e. profitability relative to what the company owns</td>
</tr>
<tr>
<td>6</td>
<td>debt ratio</td>
<td>f. the ability of a company to pay its short-term obligations</td>
</tr>
<tr>
<td>7</td>
<td>asset turnover</td>
<td>g. the difference between the balance sheet amounts and the currently traded value of a company</td>
</tr>
<tr>
<td>8</td>
<td>return on assets</td>
<td>h. profits relative to owner investments and retained earnings</td>
</tr>
<tr>
<td>9</td>
<td>return on equity</td>
<td>i. occurrences or happenings after the balance sheet date before the financial statements are issued</td>
</tr>
<tr>
<td>10</td>
<td>subsequent events</td>
<td>j. liabilities divided by assets</td>
</tr>
<tr>
<td>11</td>
<td>book-to-market ratio</td>
<td>k. restrictions included in credit terms which may require companies to maintain certain ratios</td>
</tr>
</tbody>
</table>
Problem 3-1 (LO1) The following is an adjusted, pre-closing trial balance in alphabetical order for Jackson’s Bikes, Inc., at December 31, 2011. No dividends were paid during the year. Prepare a classified balance sheet as of that date with correct header.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>11,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td>Cash</td>
<td>14,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>36,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Interest revenue</td>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>119,000</td>
<td></td>
</tr>
<tr>
<td>Note payable (due in three months)</td>
<td></td>
<td>2,500</td>
</tr>
<tr>
<td>Note payable (due in three years)</td>
<td></td>
<td>21,000</td>
</tr>
<tr>
<td>Prepaid rent</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Rent expense</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td>64,500</td>
</tr>
<tr>
<td>Salaries expense</td>
<td>28,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>210,000</td>
</tr>
<tr>
<td>Totals</td>
<td>372,500</td>
<td>372,500</td>
</tr>
</tbody>
</table>

Chapter 3
Problem 3-2 (LO1) Pratt Company is trying to determine whether the following items should be classified as current or long term. For each item, determine how much should be classified as current and how much is noncurrent. If the item is an asset, under which section of the asset portion of the balance sheet should it be listed?

a. The amount of $80,000 in cash has been set aside in a savings account to pay for bonds that mature in five years.
b. Property (land) was acquired this past year for $100,000; the company plans to sell it in the next few months because the value has increased, and they no longer will use it as originally planned for expansion.
c. Pratt has a note payable of $150,000 with equal, annual payments scheduled each year for ten years.
d. Related to the ten-year notes is interest payable of $8,000, which will be paid with the next payment.
e. Investments in securities of other companies total $120,000. Pratt intends to sell half of them in ten months.

Problem 3-3 (LO4) For each of the following items, identify whether or not the item is an example of a subsequent event. If it is a subsequent event, note whether it should be included in the financial statements for the period already ended, disclosed in the notes to the financial statements, or completely omitted. If it is not a subsequent event, note what the proper treatment of the event should be. Assume that the financial statements were issued on February 15 of the current year for the prior year ended December 31.

a. A count of the inventory in January of the current year determined that the inventories were overstated in the accounting records as of year end.
b. The company was named as a defendant in a lawsuit in October of the prior year. The company's counsel is of the opinion that they have a good defense and does not anticipate any impairment of assets or that any significant liability will be incurred. However, counsel admits in a letter dated January 23 of the current year that loss of the suit is "possible."
c. Late in January of the current year, the company was notified that one of its largest customers had filed for bankruptcy as the result of a flood that destroyed a substantial portion of its assets on January 11. The customer's accounts receivable balance at December 31 of the prior year was substantial.
d. Five-year notes payable will mature in six months. Management is seriously considering refinancing the notes when they become due.
e. In March of the current year, the company acquires a large subsidiary, which will more than double their revenue and assets.
Solutions, Approaches, and Explanations

MC3-1
Answer: c
Approach and explanation: Remember from the first LO1 How? on page 3-3 that asset and liability accounts are normally listed in order of liquidity before ever looking at the choices. Also remember that current assets are expected to be used up or turned into cash within the next year. Take the four items listed and order them according to liquidity. You should order them as follows:
Trading securities
Inventory
Prepaid advertising
Property, plant, and equipment

The last item is the least liquid and is also the one that isn’t a current asset because it isn’t likely going to turn into cash in the next year or be used up (like the prepaid advertising for instance).

MC3-2
Answer: a
Approach and explanation: First, you must know that working capital is the difference between current assets and current liabilities. Go down the list and note which items are current assets and which are current liabilities. The most difficult one is the mortgage payable. The next year’s worth of payments ($1,000 × 12) is the only piece that is current. Do the computation before looking at the choices.

If your answer doesn’t match any of the choices, do not pick the one closest to your answer. That would be a last resort to be used only if you are out of time. Instead, redo your calculation in a different order, being extra careful to add correctly and to not transpose any numbers. Also make sure that you don’t accidentally get any accounts misclassified.

The solution is $17,700 + $13,600 + $81,800 + $15,200 + $36,600 – $25,600 – $12,000 – $22,800 – $24,800 = $79,700 (choice a).

MC3-3
Answer: b
Approach and explanation: This question requires you to use two equations of accounting:
1. The standard accounting equation: Assets = Liabilities + Equity
2. The method/equation used to calculate retained earnings: Beginning retained earnings + Net income – Dividends = Ending retained earnings
It may prove helpful to sketch out a simple “change” balance sheet as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>+250,000</td>
<td>+50,000</td>
<td>+210,000</td>
<td>?</td>
</tr>
</tbody>
</table>

= 

Since both sides of our balance sheet must equal, retained earnings must have decreased by $10,000. Then using our formula in 2. above, we can substitute the $19,000 of dividends and figure that if retained earnings decreased by a total of $10,000, then net income must have been $9,000 \([($0 + $9,000) – $19,000 = $(10,000)]\).

**MC3-4**

Answer: d

Approach and explanation: With accounting problems, one of the most important items to be very concerned about are the dates. A fast glance at the problem may lead you to a quick answer that is incorrect. Many students will think Assets – Liabilities = Equity, so the answer must be $400,000 ($1,150,000 – $750,000). But the problem is asking for the end of 2011 balance, and $400,000 was the end of 2010 balance. So we’ve got a start, but we must now add in the 2011 changes. Equity is made up of both contributed capital and retained earnings, so we need to compute the 2011 changes for each.

<table>
<thead>
<tr>
<th>Beginning balance</th>
<th>$400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ New contributed capital</td>
<td>200,000*</td>
</tr>
<tr>
<td>+ Increase in retained earnings due to net income</td>
<td>105,000</td>
</tr>
<tr>
<td>– Decrease in retained earnings due to dividends</td>
<td>(90,000)</td>
</tr>
<tr>
<td>= Ending balance</td>
<td>$615,000</td>
</tr>
</tbody>
</table>

**MC3-5**

Answer: c

Approach and explanation: This problem requires the use of some algebra (in addition to an understanding of the debt ratio). The debt ratio is Debt/Assets. So working backwards from the end of the question, we know we need to max out this number at 0.8. First, fill in what we know:

\[
\frac{\text{Debt}}{\text{Assets}} = 0.8
\]

\[
\frac{\text{Debt}}{\text{Liabilities} + \text{Equity}} = 0.8
\]

Then, begin to add variables for what we can derive from the given information in the problem and for what we are solving for:

\[
\frac{$200,000 + x}{$400,000 + $150,000 + $200,000 + x} = 0.8
\]
$200,000 + x = 0.8
$750,000 + x

Multiply both sides of the equation by ($750,000 + x) to yield:

$600,000 + 0.8x = $200,000 + x

Subtract the smaller variables to yield:

$400,000 = 0.2x

Finally, multiply each side by 5:

$2,000,000 = x

It's a good idea to check your answer by putting it back in to see if it does in fact result in a debt ratio of 0.8. ($2,000,000 + $200)/($2,000,000 + $200,000 + $400,000 + $150,000) = 0.8, so now you have more confidence in your answer.

Yikes! That looks like more algebra than I've had in a long time. Is there any other way I can solve this problem based solely on my knowledge of the debt ratio?

Yes, if the question is multiple choice and not open ended. You merely take each of the choices and plug them into the debt ratio to see which one yields 0.8. So, for example, choice a results in ($2,400,000 + $200,000)/($2,400,000 + $200,000 + $400,000 + $150,000) = 0.825, so you know that not only is choice a incorrect but so is choice b since that will result in an even higher debt ratio. Move on to choice c and you'll obtain the correct answer.

MC3-6
Answer: b

Approach and explanation: Before looking at the choices, make an assumption about what the current ratio is using real numbers. (See the first How? under LO3 on page 3-4.) If the number starts off at 3:2, there are several possibilities of movement: 3:3, 4:2, 4:3, 2:2, 2:1, 2:3, 4:1, 3:1. Which are greater than 3:2? Only four: 4:2, 4:1, 2:1, 3:1. Note that 4:3 is a decrease in the ratio (1.3 < 1.5). Therefore, a transaction that will increase current assets and current liabilities will not be correct if the current ratio starts out greater than one.

With that in mind, you should now go through each transaction and look for one that results in one of the four scenarios. Here are the results:
Purchasing inventory on account: 3:2 => 4:3 (decrease)
Paying off an account with cash: 3:2 => 2:1 (increase—correct)
Collecting an account receivable: 3:2 => 3:2 (no change)
Purchasing land for cash: 3:2 => 2:2 (decrease)
MC3-7
Answer: b
Approach and explanation: Do your calculation before looking at the choices. Don't pick the closest answer if you don't come up with any of them after rounding to the nearest hundredths. Instead, retry your calculation in a different order to make sure you didn't make any input errors. If you still have an incorrect answer, it probably means that you are including, or not including, something that you should be.

Remember that the quick assets include only those that will likely turn into cash in the very near future. Therefore, prepaids are always excluded. In addition, inventory usually takes more than a month to turn into cash (since inventory usually has to first turn into accounts receivable) and is, therefore, not counted as a quick asset.

One other reasonableness check that you can do on a quick ratio computation is to compute your current ratio and make sure to exclude any choices that are higher than the current ratio. The quick ratio will never be higher than the current ratio and will usually be lower. It will always be lower for a company that has prepaid assets or inventory (and, hence, choice d can be eliminated from consideration).

MC3-8
Answer: c
Approach and explanation: As you are reading through a multiple choice question, underline, highlight, or emphasize (circle, cross out, etc.) key words. Key words include what the problem is ultimately asking for, dates, parties to the transaction, and the word “not.” With all the pressure that comes with taking a test, sometimes these key words don’t enter the mind and anything you can do to make sure they do will benefit you. A common student excuse after missing a problem is that they didn't see the word “not” or they thought the question was asking something else. Avoid having to make such excuses by catching all the “nots” and actual questions, rather than the ones your mind was coming up with.

So for a question like this one, underline “not” even if it has already been underlined, italicized, boldfaced, or capitalized for you. Then you won’t make the mistake of seeing choice a and marking it as correct since it shows up in the summary of significant accounting policies.

Cover the choices and think about, or better yet write out, what appears in a summary of significant accounting policies. Then look for three matches to your list. The one not on your list should be correct.
What if only two of the choices appeared on your list? Let's say you knew that depreciation methods and cash equivalents are on a summary of significant accounting policies, but you are unsure of the other two. At that point try to determine which of the remaining choices is a better fit. Which one seems more like a policy? Subsequent events aren't really a policy that differ by entity. They are occurrences for which standard-setting bodies have dictated treatment. Revenue recognition, on the other hand, (and you'll learn more about this in Chapter 8) can vary widely by company. A company can elect different methods for the same kind of transactions (percentage of completion or completed contract for instance), so these kinds of revenue recognition policies need to be disclosed in the summary of significant accounting policies.

As mentioned in the How? under LO4 on page 3-5, you'll gain a better understanding and retain your memory longer of what is in a summary of significant accounting policies if you look at some actual company summaries. They can even be somewhat interesting (imagine that!) if they are for a company that you have an interest in (maybe because you worked for the company before or you'd like to work for the company someday or because they sell something that you like to buy).
Matching 3-1
1. g
2. e
3. m
4. n
5. a
6. l
7. h
8. o
9. c
10. t
11. b
12. f
13. p
14. d
15. j
16. q
17. i
18. k
19. r
20. s

Remember that accounting is the "language of business." Terminology can account for anywhere from 10 to 40 percent of many quizzes and exams. Sometimes answering problems, that aren’t directly testing terminology knowledge, correctly can also be dependent on an accurate understanding of the terms used in the problem. New vocabulary is essential to master when first encountered since the same words will appear (without definitions provided again) in subsequent chapters. A few of the terms raised in the chapter, that are covered in more depth in a later chapter, have been omitted from this exercise but will be included when discussed later.
Matching 3-2

1. f
2. a
3. k
4. b
5. d
6. j
7. c
8. e
9. h
10. i
11. g

Approaching matching problems is intuitive, and you probably have already figured it out. However, here are some steps to go through, especially if you get stuck.

Step 1: Start with the terms that you are sure of. Cross them (and the match) out as you fill in the matching definitions to reduce the number of choices you will have for the ones that are more difficult.

Step 2: Look for solutions that are a better fit. For instance, “the degree to which a company uses borrowed funds instead of invested funds” sounds like a possible fit for “debt ratio,” but a better fit for “debt ratio” is “liabilities divided by assets.” That reduces your choices for “the degree to which a company uses borrowed funds instead of invested funds” and should help steer your match of it to “leverage.”

Step 3: Synonyms can be a give away, so scan the remaining list for them. Examples in this exercise include “occurrences or happenings,” which mean basically the same thing as “events,” and “currently traded value,” which means the same as “market.”
Problem 3-1
In practice, trial balances are not in alphabetical order. They are ordered according to the chart of accounts with assets first, then liabilities, etc. When solving such a problem, you should take the following steps:

Step 1: Create the header (company name, name of the statement, date). Remember that a balance sheet is as of a point in time. Your date should be December 31, 2011, or “As of December 31, 2011.” It should not say 2011 or “For the period (or month or quarter or year) ending December 31, 2011.”

Step 2: Go down the list of account names and write next to each account what it is (CA for current asset, CL for current liability, etc.)

Step 3: Scan your current assets and begin to list them in the order of liquidity beginning with Cash. Put a check mark next to each account on the trial balance when you list it on your balance sheet so that you don’t skip any or accidentally include one twice.

Step 4: Continue through the process for all of the various classifications. Include headers for each classification. Include subtotals for total current assets, total property, plant, and equipment, etc.

Step 5: Include totals of assets, liabilities, equity, and liabilities plus equity, making sure that your assets equal your liabilities plus equity.

Step 6: Troubleshoot your balance sheet if it is out of balance using the steps outlined under the last How? tip for LO1 on page 3-3.
## Jackson’s Bikes, Inc.

**Balance Sheet**  
**December 31, 2011**

### Current Assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$14,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$10,500*</td>
</tr>
<tr>
<td>Inventory</td>
<td>$18,000</td>
</tr>
<tr>
<td>Prepaid rent</td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td><strong>$48,500</strong></td>
</tr>
</tbody>
</table>

### Property, Plant, and Equipment

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$119,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$36,000</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>(12,000)</td>
</tr>
<tr>
<td><strong>Total property, plant, and equipment</strong></td>
<td><strong>$143,000</strong></td>
</tr>
</tbody>
</table>

### Total assets  
**$191,500**

### Current Liabilities

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$10,000</td>
</tr>
<tr>
<td>Note payable (due in three months)</td>
<td>$2,500</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td><strong>$12,500</strong></td>
</tr>
</tbody>
</table>

### Long-Term Liabilities

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable (due in three years)</td>
<td>$21,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td><strong>$12,500</strong></td>
</tr>
</tbody>
</table>

### Equity

<table>
<thead>
<tr>
<th>Equity</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$50,000</td>
</tr>
<tr>
<td>Retained earnings*</td>
<td>$108,000</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td><strong>$158,000</strong></td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>$191,500</strong></td>
</tr>
</tbody>
</table>

*Accounts receivable ($11,000) – Allowance for doubtful accounts ($500)

***(Beginning retained earnings + Revenue + Gains – Expenses – Losses – Dividends)
Problem 3-2
There are two items that must be known to solve this problem correctly:
1. The current/noncurrent threshold of one year.
2. How sinking funds are classified (see the “Current Liabilities” section of LO1 in the textbook).

With the above two items in mind, classifications are fairly simple as follows:

a. Since the bonds aren’t current (> 1 year), the sinking fund isn’t either. The entire sinking fund of $80,000 should be classified under “Investments (noncurrent)” or “Other noncurrent assets.”
b. The land is a short-term investment at this point so even if it was originally classified under “Property, plant, and equipment” when purchased, it should be reclassified as a current asset for the full amount of $100,000 now.
c. $150,000/10, or $15,000, should be classified as a current liability. The remaining $135,000 should be listed under long-term liabilities.
d. The entire $8,000 will be paid in the next year, so it should all be included in current liabilities along with the $15,000 from part c.
e. Half of the securities ($60,000) are trading securities and should be listed as such under current assets. The other $60,000 should be listed under “Investments (noncurrent)” along with the sinking fund.

If you were asked to create a balance sheet to show the effect of these items, you should follow the steps outlined in the solution to Problem 3-1. Current assets would be shown before the noncurrent investments on the asset side. Current liabilities would be shown on top of the long-term liabilities.

Problem 3-3
Step 1: Identify whether each transaction is a subsequent event or not. Subsequent events are only those events discovered between the end of the period and the issuance of the financial statements. Hence, any events for which the information was already in hand at the prior year end, or that was discovered after the financial statements were issued, are not going to fall under the category of subsequent event.

Step 2: Determine the correct treatment of each item, whether or not it was a subsequent event or something else. Problems frequently ask multiple questions. Students, in their haste to finish an exam or to get to the next problem, sometimes answer only a portion of the problem. Make sure to answer all of the portions of the question or questions.
a. Since the count took place after December 31 but before February 15, this is a subsequent event. The inventory balance should be adjusted now, retroactively to December 31 to correct the balance. This is a type 1 subsequent event (those that require retroactive recognition and thus affect the amounts to be reported in the financial statements for the preceding accounting period).

b. This is also a subsequent event even though the company was initially informed in October. The reason is that the letter from counsel was dated in January. Because the potential liability is only possible and not probable, an entry need not be booked in the prior year financial statements. However, a disclosure note should be made since a loss is possible and not remote. This is a type 2 subsequent event (those that do not require recognition but should be disclosed in the notes to the financial statements).

c. This is another subsequent event since the event didn’t happen until after December 31. Since the casualty happened after the year end, it is a type 2 event and should be disclosed but not booked for the prior year.

d. This is not a subsequent event. Nor should anything be done to change the current liability for the notes. See the “Short-Term Obligations to Be Refinanced” section under LO1 for more details on why this is so in this case.

e. Although this is a very significant event, and it is subsequent to the balance sheet date, it does not fall under the category of a subsequent event for type 1 and type 2 purposes. The event happens after the issuance of the financial statements, and hence, nothing is done to the prior year financial statements or disclosure notes. This event will show up in the current year financial statements. Financial statements are not reissued or restated for new events in any situation. (However, they are sometimes restated when large errors or fraud took place.) Had this acquisition event taken place in January, instead of March, a disclosure note (type 2) would have been necessary for the prior year financial statements.

Glossary

Note that Appendix C in the rear portion of the textbook contains a comprehensive Glossary for all of the terms used in the textbook. That is the place to turn to if you need to look up a word but don’t know which chapter(s) it appeared in. The glossary below is identical with one major exception: It contains only those terms used in Chapter 3. This abbreviated Glossary can prove quite useful when reviewing a chapter, when studying for a quiz for a particular chapter, or when studying for an exam which covers only a few chapters including this one. Use it in those instances instead of wading through the 19 pages of comprehensive glossary in the textbook trying to pick out just those words that were used in this chapter.

**accounts payable** Amounts due for the purchase of materials by a manufacturing company or merchandise by a wholesaler or retailer.
accounts receivable  Trade receivables that are not evidenced by a formal agreement or “note”; accounts receivables are usually unsecured “open accounts” and represent an extension of short-term credit to customers.

acid-test ratio  A financial ratio used as a measure of short-term liquidity; also called quick ratio.

additional paid-in capital  The investment by stockholders in excess of the amounts assignable to capital stock as par or stated value, as well as invested capital from other sources, such as sale of treasury stock.

asset  A resource of an entity.

asset turnover  Financial ratio measuring how efficiently a company uses its assets to generate sales. The ratio formula is total sales divided by total assets.

available-for-sale securities  Investment securities not intended for immediate trading but, in the case of debt securities, not intended to be held until maturity.

balance sheet  A statement that reports, as of a given point in time, the assets, liabilities, and owners’ equity of a business.

bond discount  The difference between the face value and the sales price when bonds are sold below their face value.

bond premium  The difference between the face value and the sales price when bonds are sold above their face value.


callable obligation  A debt instrument that is (1) payable on demand or (2) has a specified due date but is payable on demand if the debtor defaults on the provisions of the loan agreement.

capital lease  A lease that is economically equivalent to the purchase of the leased asset.

capital stock  The portion of the amount invested by stockholders that is designated as par or stated value.

cash  Coin, currency, and other items that are acceptable for deposit at face value; serves as a medium of exchange and provides a basis of measurement for accounting.

cash equivalents  Short-term, highly liquid investments that can be converted easily to cash. Generally, only investments that on the day of acquisition have less than three months remaining to maturity qualify as cash equivalents.

common stock  The class of stock issued by corporations that represents the basic ownership of the company; allows shareholders the right to vote and to receive dividends if declared, although the right to dividends is generally secondary to that of preferred stockholders.
comprehensive income  A concept of income measurement and reporting that includes all changes in owners’ equity except investments by and distributions to owners.

contingent liability  A potential obligation whose existence is uncertain because it depends on the outcome of a future event, such as a pending lawsuit. The amount of the potential obligation may or may not be determinable.

contributed capital  The portion of corporate capital that represents investments by the stockholders. Also referred to as paid-in capital.

corporation  A business entity that is a separate legal entity owned by its shareholders.

current asset  Cash or assets that are reasonably expected to be converted into cash during the normal operating cycle of a business or within one year, whichever period is longer.

current liability  Obligations that are reasonably expected to be paid within one year.

current ratio  Current assets divided by current liabilities.

debt ratio  A financial ratio used to measure the degree of leverage of a company. The debt ratio formula is total liabilities divided by total assets.

deferred income tax asset  Expected future benefits from tax deductions that have been recognized as expenses in the income statement but not yet deducted for income tax purposes.

deferred income tax liability  Expected future income taxes to be paid on income that has been recognized in the income statement but not yet taxed. Deferred income tax liabilities often arise from the temporary tax shielding provided by accelerated depreciation.

deficit  A negative retained earnings balance caused by an excess of dividend payments and losses over net income.

disclosure  Reporting the details of a transaction in the notes to the financial statements. Disclosure is sometimes used in place of recognition; that is, instead of including the results of a transaction in the financial statements themselves, it is disclosed in the notes.

equity  The residual interest in the assets of an entity that remains after deducting its liabilities; sometimes referred to as net assets.

equity method  The method of accounting for long-term investments in the stock of another company where significant influence exists (generally, 20 to 50 percent ownership); the initial investment is recorded at cost but is increased by a proportionate share of investor’s income and decreased by dividends and a proportionate share of losses to reflect the underlying claim by the investor on the net assets of the investee company.

equity method securities  Equity securities purchased with the intent of being able to control or significantly influence the operations of the investee.
**equity securities**  Securities that represent ownership in a company. These shares of stock typically carry with them the right to collect dividends and to vote on corporate matters.

**estimated liability**  A liability for an indefinite amount that must be estimated.

**financial ratios**  Mathematical relationships between financial statement amounts, used to quantify various characteristics of a company’s performance such as efficiency and profitability.

**full disclosure principle**  A basic accounting concept that requires that all relevant information be presented in an unbiased, understandable, and timely manner.

**goodwill**  A residual number, the value of all of the synergies of a functioning business that cannot be specifically identified with any other intangible factor, that is recognized only when it is purchased as part of the acquisition of another company.

**historical cost**  The cash equivalent price of goods or services at the date of acquisition.

**impairment**  Reduction in the expected cash flow to be generated by a long-term asset sufficient to warrant reducing the recorded value of the asset.

**intangible assets**  Legal or economic rights controlled by a company that are expected to generate future economic benefits.

**inventory**  Assets held for sale in the normal course of business; also, assets held to be used as materials in a production process.

**investors**  Owners and potential owners of a company.

**leverage**  The degree to which a company uses borrowed funds instead of invested funds. By adding borrowed funds to their own capital, owners are said to “leverage” their investment.

**liabilities**  The claims of creditors against an entity’s resources; technically defined by the FASB as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

**liquidity**  The ability of a company to pay its short-term obligations.

**loan covenant**  Provision of a loan contract restricting the actions of the borrower or allowing for some monitoring of the borrower’s actions.

**long-term debt**  Obligations that are not expected to be paid in cash or other current assets within one year or the normal operating cycle.

**lower of cost or market (LCM)**  Generally accepted method for valuation of inventories in which assets are recorded at the lower of their cost or market value; this method can be applied to inventories on an aggregate or individual item basis.

**mortgage**  A loan backed by an asset with the asset title pledged to the lender.
noncurrent operating assets  Assets used in the normal course of business that are expected to have a useful life exceeding one year, or one operating cycle, whichever is longer.

notes payable  Formal written promises to pay a sum of money in the future. Notes payable are generally evidenced by a promissory note.

notes receivable  Receivables that are evidenced by a formal written promise to receive a certain sum of money at a specified date.

notes to the financial statements  Supplemental information that outlines the accounting assumptions and estimates.

objective acceleration clause  A clause in a debt agreement that identifies specific conditions that will cause the debt to be callable immediately.

off-balance-sheet financing  Procedures used by companies to avoid disclosing all of their debt on the balance sheet to make their financial position look stronger.

other comprehensive income  The summary typically provided by companies as part of their statement of stockholders' equity showing changes in owners’ equity exclusive of net income and contributions by and distributions to owners; required by the FASB beginning in 1998.

paid-in capital  The portion of corporate capital that represents investments by the stockholders. Also referred to as contributed capital.

partnership  A business entity owned by two or more people.

par value  A nominal value that is assigned to stock by the terms of a corporation’s charter.

post-balance sheet event  Event occurring between the balance sheet date and the date financial statements are issued and made available to external users. Also called a subsequent event.

preferred stock  A class of stock that usually confers dividend and liquidation rights that take precedence over those of common stock; preferred stockholders usually aren’t allowed to vote in the selection of the board of directors.

proprietorship  A business entity owned by one person.

quick ratio  A financial ratio used as a measure of short-term liquidity. Also called acid-test ratio.

retained earnings  The portion of owners’ equity that represents the net accumulated earnings of a corporation.

return on assets  A financial ratio used to measure the degree to which assets have been used to generate profits. The return on assets formula is net income divided by total assets.

return on equity  A financial ratio used to measure the degree to which funds invested by owners have been used to generate profits. The return on equity formula is net income divided by total equity.
sinking fund  Assets that have been accumulated in order to repay a loan.

stockholders’ (shareholders’) equity  Total owners’ equity of a corporation.

subjective acceleration clause  A clause in a debt agreement that identifies general conditions that can cause the debt to be callable immediately, but violation of the conditions cannot be determined objectively.

subsequent event  Event occurring between the balance sheet date and the date financial statements are issued and made available to external users. Also called a post-balance sheet event.

trading securities  Debt and equity securities that are purchased with the intent of selling them in the near future to generate profits from short-term changes in market prices.

treasury stock  Stock issued but subsequently bought back by the same company and held for possible future reissuance or retirement.

turnover  Degree to which assets are used to generate sales.

unrealized holding gains and losses  Increases or decreases in the current values of assets held during a period but not sold or used.

working capital  Current assets less current liabilities; a measure of liquidity.