CHAPTER

4

The Balance Sheet and the Statement of Changes in Stockholders' Equity

OBJECTIVES

After reading this chapter, you will be able to:

1 Understand the purposes of the balance sheet.

2 Define the elements of a balance sheet.

3 Explain how to measure the elements of a balance sheet.

4 Classify the assets of a balance sheet.

5 Classify the liabilities of a balance sheet.

6 Report the stockholders' equity of a balance sheet.

7 Prepare a statement of changes in stockholders' equity.

8 Understand the other disclosure issues for a balance sheet.

9 Describe the SEC integrated disclosures.

10 Explain the reporting techniques used in an annual report.

Do You Believe in Magic?

Walt Disney Company is well known for the magic that its "imagineers" have created in movie theaters and theme parks across the globe. To those not well versed in accounting, it appears that financial analysts may possess similar mystical qualities as they value a company's securities. Using several key financial variables (fundamentals) as their crystal ball, financial analysts will often make predictions of a company's future performance. For example, accounts receivable or inventory increases that are disproportionate to sales increases are often perceived as signals that a company is having trouble generating sales and that near-term economic prospects may be gloomy.

However, before you begin analyzing balance sheet information, you should be aware that the balance sheet has some significant limitations, or you could get the mistaken impression that a company's accountants possess as much financial magic as Disney's imagineers. For example, at the end of Disney's 2004 fiscal year, its market value of stockholders' equity (number of shares outstanding multiplied by stock price) was approximately $44 billion while the book value (reported amount) of this equity on its balance sheet was approximately $26 billion. What causes these differences between the market value of a company's stockholders' equity and its book value? Is it financial magic? Is it due to the mispricing in the stock market or in the way that accountants calculate book values? The explanations are varied and include the use of historical costs for valuing assets and liabilities, the use of estimates, and the existence of "off-balance sheet" assets and liabilities.

Credit: KIN CHEUNG/Reuters/Landov

Let's examine the sources of these differences in a little more detail. Disney's book value is based on past transactions measured at historical costs, yet its market value is based on market estimates of Disney's future prospects. For example, in the 1960s, Walt Disney was able to acquire about 43 acres (about twice the size of Manhattan Island) for a little over $5 million to build the Disney World Resort area. The market value of that land is certainly much more than that today, yet the increased value does not appear on Disney's balance sheet. Second, Disney makes many estimates of balance sheet items including accounts receivable, property, plant, and equipment, and contingent liabilities. These estimates are disclosed in the notes to the financial statements and should be considered in any financial analysis. Finally, many assets and liabilities are not recorded at all. The intellectual capital of Disney's imagineers is not shown as an asset on the balance sheet. Additionally, Disney reported contractual obligations of over $34 billion; however $20 billion of these obligations do not appear on the balance sheet.

With a clear understanding of the balance sheet and its limitations, we can see that the balance sheet isn't the result of magic but simply the result of current accounting rules and practices.

For Further Investigation

For an article discussing a current balance sheet limitation of interest to accounting professionals (off-balance sheet structures), consult the Business & Company Resource Center (BCRC):

- All in the family: FIN 46 made companies admit paternity of special purpose entities. But it also resulted in some surprise adoptions. Tim Reason, *CFO, The Magazine for Senior Financial Executives*, 8756-7113, September 2004, v20, i11, p99(2).

FASB Statement of Concepts No. 5 recommends that a full set of financial statements for an accounting period should show a company's

- financial position at the end of the period,
- net income for the period,
- comprehensive income for the period,
- cash flows for the period, and
- investments by and distributions to owners for the period.[1]

Currently, companies include at least three major financial statements and several supporting schedules as the "full set" of financial statements in their **annual reports**. The three major financial statements are

1. the **balance sheet** or statement of financial position, which shows the company's financial position at the end of the accounting period,
2. the **income statement**, which shows the results of the company's income-producing activities for the accounting period, and
3. the **statement of cash flows**, which shows the cash inflows and cash outflows of the company for the accounting period.

Many companies include a statement of changes in stockholders' equity, which shows the changes in each item of stockholders' equity for the accounting period, as a fourth major financial statement.[2] A company also includes explanatory notes in its annual report to supplement these financial statements.

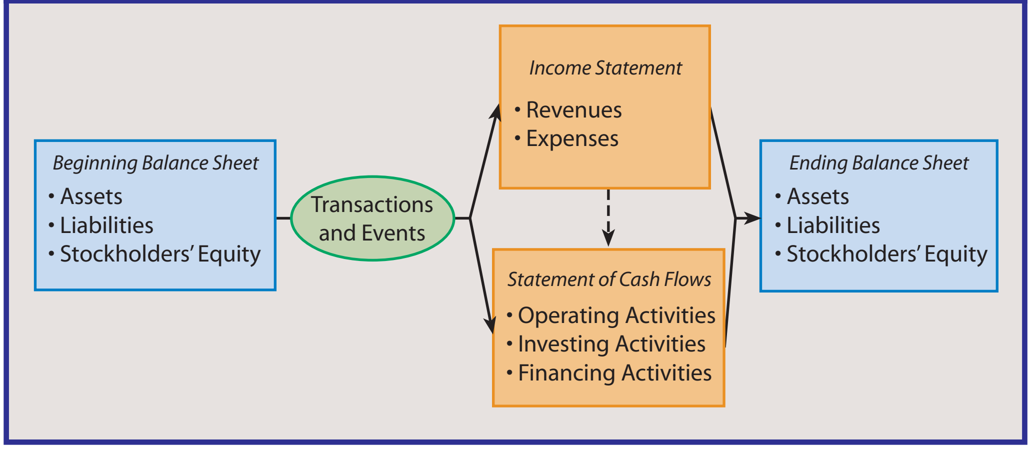
In this chapter, we focus primarily on the balance sheet, the statement of changes in stockholders' equity, and the accompanying notes. We discuss the balance sheet first because the FASB defines revenues and expenses in terms of changes in assets and liabilities. Thus, you need a clear understanding of the nature and measurement of assets and liabilities to understand net income and its components. Furthermore, the chapters of this book in general follow a balance sheet framework. Consequently, you need to know its purpose, content, format, and preparation to understand the more complex issues we discuss later. The statement of changes in stockholders' equity helps to explain the changes that occurred in each stockholders' equity item on a company's balance sheet from the beginning to the end of the accounting period. We also discuss this statement in this chapter as it relates to the balance sheet. The discussion focuses on the corporation, the major business entity in the United States. We discuss the income statement and statement of cash flows in Chapter 5.

Interrelationship of Financial Statements

Exhibit 4-1 shows the interrelationship of the information in a company's major financial statements. The solid lines indicate the major flows of interrelated financial accounting information among the financial statements because of transactions and events during the period. For instance, the company may use assets from the beginning balance sheet (i.e., the ending balance sheet from the previous period) in an income-producing activity or it may sell them as a source of cash. The related financial accounting information will affect the company's income statement and statement of cash flows, respectively. Both the information about the income-producing activities reported in the income statement and the

1. "Recognition and Measurement in Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 5* (Stamford, Conn.: FASB, 1984), par. 13.
2. Some companies include a statement of comprehensive income as another major financial statement. We discuss this statement in Chapter 5.

EXHIBIT 4-1 Interrelationship of Financial Statements



information about the cash inflows and cash outflows shown in the statement of cash flows will affect the accounting information reported in the ending balance sheet. The dashed line indicates a secondary flow of the interrelated information; that is, the income-producing activities that the company reports on its income statement also provide a net source of cash from operating activities. We further explain the relationships among the balance sheet, income statement, and statement of cash flows in the remaining sections of this chapter and in later chapters of this book.

PURPOSES OF THE BALANCE SHEET

1 Understand the purposes of the balance sheet.

One objective of financial reporting for a company is to help investors, creditors, and others assess the amounts, timing, and uncertainty of the prospective net cash inflows of the company. To meet this objective, the FASB suggested that a company should provide certain types of accounting information in its financial statements. A specific objective of a company's financial statements is to provide information about its economic resources, obligations, and owners' equity. This information is reported on a balance sheet. **A balance sheet shows the *financial position* of a company at a particular date.** A balance sheet also may be called a **statement of financial position.** The financial position of a company includes its economic resources (i.e., assets), economic obligations (i.e., liabilities), and equity, and their relationships to each other at a moment in time. A corporation's balance sheet, then, discloses its assets, liabilities, stockholders' equity, and related information on a specific date. The statement reports the corporation's *resource structure* (i.e., major classes and amounts of assets) and its *financial structure* (i.e., major classes and amounts of liabilities and equity). Its name evolved because the balance sheet is a detailed summary of the basic accounting equation (which must always remain in balance):

Assets = Liabilities + Stockholders' Equity

The balance sheet does not attempt to show the total fair value of a company. Together with other financial statements and other information, however, it provides information that is useful to external users who want to make their own estimates of the company's fair value. More specifically, a company's balance sheet is intended to help external users (1) assess its liquidity, financial flexibility, and operating capability and (2) evaluate information about its income-producing performance during the period.

Analysis

Liquidity, Financial Flexibility, and Operating Capability

Liquidity refers to how quickly a company can convert an asset into cash to pay its bills. That is, liquidity relates to the "nearness to cash" of a company's economic resources. Information about liquidity is important in evaluating the *timing* of cash flows in the near future. Information about short-term cash inflows is useful because these cash inflows are part of total cash inflows. Also, a company needs short-term cash inflows to take advantage of new investment opportunities as well as to pay its short-term obligations. Liquidity is also one aspect of a company's financial flexibility.

Financial flexibility refers to the ability of a company to use its financial resources to adapt to change. Adaptation may be thought of as being "offensive" or "defensive." A company uses offensive adaptation to take advantage of an unexpected new business opportunity, while it uses defensive adaptation to react to a negative business event. Financial flexibility may come from a quick access to the cash generated from more "liquid" economic resources. But liquidity is only part of financial flexibility. A company's financial flexibility comes from its ability to obtain enough net cash inflows from operations, from additional capital contributed by investors or long-term creditors, or from liquidating long-term economic resources without disrupting continuing operations. Information about a company's financial flexibility is important to external users in assessing the uncertainty of its future cash flows.

Operating capability refers to the ability of a company to maintain a given physical level of operations. This level may be indicated by the quantity of goods or services the company produced in a given period (i.e., inventory) or by the physical capacity of its operating assets (i.e., property, plant, and equipment) used to produce the goods or services. Information about a company's operating capability may be helpful to external users in understanding its performance and predicting future changes in its volume of activity and related cash flows.[3]

Capital and Capital Maintenance

A company's balance sheet provides a basis for evaluating its income-producing performance during a period. Therefore, a company's capital is important. **The capital (or *net assets*) of a company is its economic resources (assets) less its economic obligations (liabilities), or owners' equity.** For a corporation, the stockholders' equity is the capital. The management of the corporation uses this capital in fulfilling its responsibilities to the corporate stockholders. When a stockholder invests in a corporation, the stockholder is interested in a return *of* investment as well as a return *on* investment. To provide for a return of investment, the corporation's stockholders' equity (capital) must be maintained; this is referred to as **capital maintenance.** Once this capital is maintained, any income of the corporation is an increase in stockholders' equity. This increase is the basis for providing a return *on* investment to stockholders. Dividends are a return on investment, as is market price appreciation on the stock. Many investors prefer market price appreciation to dividends. Information about a corporation's capital is important in assessing its profitability and its ability to provide a return on investment. We discuss capital maintenance and income in Chapter 5.

Another way for you to look at Exhibit 4-1 is to think in terms of capital and capital maintenance. You can think of the beginning balance sheet as showing the corporation's capital at the beginning of the accounting period. The income statement and the statement of cash flows disclose the results of management's activities to use, maintain, and increase the capital during the accounting period. The ending balance sheet reports the capital at the end of the accounting period. But before it can be determined whether

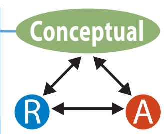
3. *Ibid.*, par. 24, 26, and 27 and "Reporting Income, Cash Flows, and Financial Position of Business Enterprises," *FASB Proposed Statement of Financial Accounting Concepts* (Stamford, Conn.: FASB, 1981), par. 25-32.

capital is maintained or a corporation has earned income, the initial (beginning) and subsequent (ending) capital must be determined.

Capital can be thought of in terms of (1) financial capital or (2) physical capital. **Financial capital is the monetary value of the net assets** from investments by stockholders as well as from earnings retained by the corporation. **Physical capital is a quantitative measure of the physical productive capacity** (e.g., square feet of factory space) of the corporation to provide goods or services. It is related to the concept of operating capability that we discussed in the previous section.[4] The difference between financial capital and physical capital is important in considering whether and when capital is maintained and income is earned (Chapter 5). The difference is not as important for reporting the capital at a point in time because accounting information primarily is expressed in dollars. Thus, a dollar value must be assigned to the physical capital before it is reported on a balance sheet. We discuss the alternative ways of measuring the net assets (capital) of a corporation later in the chapter.

Recognition in the Balance Sheet

A company may disclose an item of information related to its financial position in its balance sheet, in a supporting schedule, or as part of the notes accompanying the financial statements. Recall from Chapter 2 that **recognition is the process of formally recording and reporting an element in the financial statements.** It includes depiction of an element in both words and numbers, with the amount included in the totals. Generally, the most useful (i.e., the best combination of relevance and reliability) information about assets, liabilities, and equity should be recognized and reported in the main body of the balance sheet. There are four basic recognition criteria. To be recognized, an item (and information about it) must meet the definition of an element, and be measurable, relevant, and reliable.[5] Thus, to meet the objectives of a company's balance sheet—to provide relevant and reliable information to assess its liquidity, financial flexibility, and operating capability and to evaluate its income-producing performance during the period—the company must determine what, how, and where to disclose the "elements" of the balance sheet. That is, the company must complete a three-stage process:



1. Identification of what items meet the definitions of the elements
2. Measurement (valuation) of the elements
3. Reporting (classification) of the elements

Elements of the Balance Sheet

2 Define the elements of a balance sheet.

For a company to report an item of information on its balance sheet, the item must meet the definition of an element. **The elements of the balance sheet are the broad classes of items comprising it.** They are the building blocks with which the balance sheet is prepared. The elements of financial statements are defined in **FASB Statement of Concepts No. 6.** We define and discuss each of the elements of a corporate balance sheet—assets, liabilities, and stockholders' equity—in the following sections.[6]

4. For a further discussion, see "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," *FASB Discussion Memorandum* (Stamford, Conn.: FASB, 1976), ch. 6.
5. "Recognition and Measurement in Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 5*, *op. cit.*, par. 58–64.
6. The discussion of the elements in the following sections is a summary of that presented in "Elements of Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, 1985).

Assets

Assets are the probable future economic benefits obtained or controlled by a company as a result of past transactions or events.

Assets are the economic resources used to carry out a company's economic activities of consumption, production, and exchange. The primary attribute of all assets is *service potential*, the capacity to provide services or benefits to the company that uses them. To be considered an asset, an economic resource must have three characteristics:

1. The resource must be able to contribute directly or indirectly to the company's future net cash inflows. This service potential may exist because the asset is expected to be exchanged for something else of value to the company (e.g., accounts receivable), to be used in producing goods (e.g., factory) or services, to increase the value of other assets (e.g., patent), or to be used to settle its liabilities (e.g., cash).
2. The company must be able to obtain the future benefit and control others' access to it. Control means that the company can deny or regulate the ability of others to use the asset.
3. The transaction or event giving the company the right to or control over the benefit must have occurred. As a corollary, once an asset is acquired by a company, it continues to be an asset until it is exchanged or used up, or until some other event destroys the future benefit or removes the company's ability to obtain or control it.

Assets may be natural or man-made, tangible or intangible, and either exchangeable or useful only in the company's activities. Furthermore, they may be acquired by purchase, production, stockholder investments, discovery, or other nonreciprocal (one-way) transfers.

Liabilities

Liabilities are the probable future sacrifices of economic benefits arising from present obligations of a company to transfer assets or provide services in the future as a result of past transactions or events.

An obligation of a company must have three characteristics to be considered a liability:

1. It must involve a responsibility that will be settled by a sacrifice involving the transfer of assets, provision of services, or other use of assets at a specified or determinable date, on occurrence of a specified event, or on demand. The company does not need to know the specific identity of the "creditor" for a liability to exist, as long as a future transfer or use of assets to settle the liability is *probable*.
2. The responsibility must obligate the company so that it has little or no discretion to avoid the future sacrifice. Although most liabilities involve legal rights and duties, some are the result of equitable (ethical or moral) obligations or constructive (inferred from the facts) obligations. Thus, the company must be bound by a legal, equitable, or constructive responsibility to transfer assets or provide services.
3. The transaction or other event obligating the company must have occurred. Once a liability has been incurred, it continues to be a liability until the company settles it or another event removes it from the company's responsibility.

Liabilities arise primarily from purchasing goods or services on credit and from borrowing funds. Other liabilities result from collecting economic resources in advance of providing goods or services to customers. Liabilities also arise from selling products subject to warranties, from regulations imposed by governmental units, and from nonreciprocal transfers to owners or other entities.

Stockholders' Equity

Equity is the residual interest in the assets of a company that remains after deducting its liabilities.

The equity of a company is equal to its net assets (assets minus liabilities). Equity stems from ownership rights, and therefore it is the ownership interest. Since a company generally is not obligated to transfer assets to its owners, owners' equity ranks after liabilities as an interest in the assets and thus is a residual interest. For a corporation, stockholders' equity represents the interest of the stockholders, who bear the risks involved in the company's operations and activities and who obtain the resulting rewards. It is created by stockholders' investments of economic resources and later is modified by additional investments, net income, distributions to owners, and other changes in assets and liabilities. Stockholders' equity may not exist apart from the corporate assets and liabilities, since it is a residual interest.

MEASUREMENT OF THE ELEMENTS OF THE BALANCE SHEET

3 Explain how to measure the elements of a balance sheet.

For a company to report an element on its balance sheet, the element must be reliably measured (valued) in monetary terms. The FASB has identified five alternatives for measuring elements. We show these alternative valuation methods in Exhibit 4-2 and discuss them in the following sections. Later in the chapter, when we discuss specific assets and liabilities, we identify the applicable valuation method. We do not include stockholders' equity in Exhibit 4-2 because it may not exist apart from assets or liabilities. That is, the measurement of assets and liabilities (i.e., net assets) will determine the dollar amount of stockholders' equity. To conserve space, we focus the discussion on the measurement of assets, but our comments generally also apply to liabilities.

Conceptual

R A

Historical Cost

The historical cost of an asset is the exchange price in the transaction in which the asset was acquired. The historical cost is measured by the cash paid for the asset or, in the case of a noncash exchange, by the estimated cash equivalent of the noncash asset or liability exchanged. After acquisition, the historical cost of an asset may be reduced due to the recognition of depreciation, amortization, impairment, or other adjustments.

Current Cost

The current cost of an asset is the amount of cash (or equivalent) that would be required on the date of the balance sheet to obtain the same asset. The "same asset" may be an identical asset or one with equivalent productive capacity. Alternative methods for obtaining the current cost include quoted market prices, the use of specific price indexes, and appraisals. Current cost is an *input value* and is sometimes referred to as *current replacement cost*.

Current Market Value

The current market value of an asset is the amount of cash (or equivalent) that could be obtained on the date of the balance sheet by selling the asset, in its present condition, in an orderly liquidation. An orderly liquidation means the asset is disposed of in a

EXHIBIT 4-2 Measurement (Valuation) of Assets and Liabilities

Alternative	Assets	Liabilities
1. Historical cost/historical proceeds	Initially, the amount of cash (or its equivalent) paid to acquire an asset (historical cost); subsequent to acquisition, the historical amount may be adjusted for depreciation, amortization, or other adjustments.	Initially, the amount of cash (or its equivalent) received when an obligation was incurred (historical proceeds); subsequent to incurrence, the historical amount may be adjusted for amortization.
2. Current cost/current proceeds	Amount of cash (or its equivalent) that would have to be paid if the same asset were acquired currently.	Amount of cash (or its equivalent) that would be obtained if the same obligation were incurred currently.
3. Current market value	Amount of cash (or its equivalent) that could be obtained currently by selling the asset in orderly liquidation.	Amount of cash (or its equivalent) that would be required currently to eliminate the liability.
4. Net realizable value	Amount of cash (or its equivalent) into which the asset is expected to be converted in due course of business less direct costs necessary to make that conversion.	Amount of cash (or its equivalent) expected to be paid to eliminate the liability in due course of business.
5. Present value	Present value of future cash inflows into which the asset is expected to be converted in due course of business less present value of future cash outflows necessary to obtain those inflows.	Present value of future cash outflows to eliminate the liability in due course of business.

Source: Adapted from "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," *FASB Discussion Memorandum* (Stamford, Conn.: FASB, 1976), p. 193 and "Recognition and Measurement in Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 5* (Stamford, Conn.: FASB, 1984), p. 23.

systematic and organized fashion. A current market value would be determined by obtaining a quoted market price for the sale of an asset of similar kind and condition. The term current market value is potentially confusing, because current cost and current market value are both "market values." Therefore, sometimes current market value is referred to as *current exit value*.

Net Realizable Value

The net realizable value of an asset is the amount of cash (or equivalent) into which the asset is expected to be converted in the ordinary operations of the company, less any expected conversion costs (e.g., completion, disposal, or collection costs). Net realizable value differs from current exit value by being based upon expected *future* sales proceeds of the asset (perhaps in a different form) rather than upon the *current* disposal value of an asset in its existing form. Net realizable value is sometimes referred to as *expected exit value*.

Present Value

The present value of an asset is the net amount of discounted future cash inflows less the discounted future cash outflows relating to the asset. Each future cash flow may be a single amount; in this case, the amount is referred to as an *estimated* cash flow. Or, each future cash flow may involve a range of possible amounts. In this case, a "weighted average" amount is determined and is referred to as an *expected* cash flow. When the estimated cash flows are used to determine present value, they are similar to those used to determine net realizable value; the difference between the two alternatives is that under the present value approach the time value of money (i.e., interest) is considered.[7] We discuss discounting and the computation of present value in the Time Value of Money module.

Valuations on Today's Balance Sheet

The valuation method primarily used in a company's balance sheet is historical cost. In general, each asset and liability of the company is recorded at the exchange price of the transaction in which the asset is obtained or the liability is incurred. Usually the company then reports this exchange price in its balance sheet until another exchange has taken place. Certain assets such as property, plant, and equipment are measured and reported at their exchange price (historical cost) adjusted for depreciation. Historical cost is used extensively as a valuation method because it is based on transactions and provides information that has a high degree of *reliability*. It has been criticized, however, because some users of financial statements argue that historical cost is not as *relevant* as the amounts reported under some alternative valuation methods. That is, historical cost may not represent the amount of future cash inflows (or outflows) that the company is likely to obtain (or pay) for the asset (or liability).

The FASB sometimes requires a company to report an asset or liability at its fair value. To clarify how to measure fair value, the FASB has issued a **Proposed FASB Statement of Standards**. This *Proposed Statement* defines **fair value** as the estimated price at which an asset (or liability) could be exchanged in a current transaction between knowledgeable, unrelated willing parties under normal business conditions. It indicates that the objective of determining a fair value is to estimate an exchange price for an asset (or liability) when an actual transaction has not occurred.

The *Proposed Statement* defines "market inputs" as the assumptions and data that would be used to estimate fair value. It groups these market inputs into a "hierarchy" of five broad categories (levels) for estimating fair value, as follows:

- *Level 1* market inputs are the best information for estimating fair value. These inputs are quoted prices in active markets for identical assets.
- *Level 2* market inputs are quoted market prices for similar assets, adjusted for differences between the assets.
- *Level 3* market inputs are direct market values other than quoted prices (e.g., current appraisals).
- *Level 4* market inputs are indirect market values (e.g., previous appraisals).
- *Level 5* measures are the lowest level of information and are "entity" inputs. These are based on the application of valuation techniques. Whenever possible (without undue cost and effort), multiple valuation techniques consistent with the market approach, income approach, and cost approach should be used. The *market*

7. *FASB Statement of Financial Accounting Concepts No. 5*, *op. cit.*, par. 67, and "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," *FASB Discussion Memorandum*, *op. cit.*, pp. 196–206, and "Using Cash Flow Information and Present Value in Accounting Measurements," *FASB Statement of Financial Accounting Concepts No. 7* (Norwalk, Conn.: FASB, 2000) p. 1.

approach requires observable prices based on actual transactions involving comparable assets. The *income approach* uses present value techniques to convert future amounts to a single present amount. The *cost approach* relates to the amount that would have to be paid to replace an asset's service capacity.

When measuring the fair value, a company must consider whether the asset will continue to be used in the business or will be sold. A company must also disclose certain information about its use of fair value to remeasure assets (and liabilities) reported on its balance sheet. This includes, for instance, how the fair value amount(s) were determined and the impact on the company's earnings for the period.[8]

Depending on the circumstances, to report the fair value of an asset or liability, a company might use current cost, current exit value, net realizable value, or present value. For instance, a company uses current cost for valuing certain "inventories," current exit value for "marketable securities," net realizable value for "receivables," and present value for "bonds payable." We identify the valuation method used for each type of asset and liability in the next section and we discuss these methods more fully in later chapters. As increased emphasis is placed on reporting information concerning a company's liquidity, financial flexibility, and operating capability, it is likely that the FASB will require more fair values to be reported on balance sheets (or related notes). The extent of the use of other valuation methods will depend, among other considerations, on the tradeoff between relevance and reliability. It is possible the FASB may develop GAAP in which "financial" assets and liabilities are valued at fair value while "non-financial" assets and liabilities are valued at historical cost.

LINK TO ETHICAL DILEMMA

As the controller for a struggling manufacturing company, you are in the process of closing the books for the year and notice that the company is going to be in technical violation of its debt covenants. Such a violation could result in bankruptcy, which would result in the loss of hundreds of jobs, including your own. You quickly analyze the financial statements and realize that by changing a few estimates involving accounts receivable, warranties, and pensions, the company will be able to avoid a violation of its debt covenants. While you don't believe the revised estimates would best represent the economic reality of your company's financial position, you also don't believe the estimates are unreasonably aggressive. Do you revise the estimates?

Limitations of the Balance Sheet

In addition to the criticism that the use of historical costs for valuing assets and liabilities does not help users assess the likely amounts of future cash flows relating to these items, there are other limitations of the balance sheet. First, a company's balance sheet does not include all of its economic resources and economic obligations. For instance, "human resources" or "intellectual capital" such as high-quality management or highly creative employees are not included as assets, primarily because of the difficulty of reliably measuring their values. Or, possible legal obligations for air or water pollution may not be reported as liabilities, again due to measurement problems. Second, many of the

8. "Fair Value Measurements," *FASB Proposed Statement of Financial Accounting Standards* (Norwalk, Conn.: FASB, 2004).

amounts that a company reports are based on estimates, which are subject to change. As we discuss in the next section, estimates are involved in determining the amounts for items such as uncollectible accounts and depreciation, as well as warranty and pension liabilities. Finally, in periods of inflation the amounts listed on a company's balance sheet do not show the "purchasing power" of its assets and liabilities. The FASB is aware of these limitations and in certain instances, as we discuss later in the chapter, requires companies to disclose additional information in the notes to the financial statements to help users in their decision making.

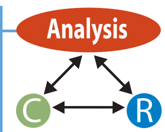
Secure Your Knowledge 4-1

- By providing information about a company's resources and financial structure, the balance sheet should help users:
  - assess a company's liquidity, financial flexibility, and operating capability, and
  - evaluate a company's income-producing performance during a period.
- The elements of a balance sheet that should be recognized are assets, liabilities, and stockholders' equity.
- Various valuation methods can be used to measure elements on a balance sheet, with historical cost being the primary method employed; however, increasing use of fair value measurements is being required by FASB.
- The balance sheet does suffer from several limitations, including the use of historical cost, the exclusion of some economic resources and obligations, the use of estimates, and the lack of purchasing power adjustments.

Reporting Classifications on the Balance Sheet

4 Classify the assets of a balance sheet.

A company's accounting system processes vast amounts of data. When the company prepares the financial statements, it simplifies, condenses, and classifies that data. The classifications are designed to help analysis by grouping items with similar characteristics. The intent is to improve the predictive value, and hence the usefulness, of the financial information for assessing the amounts, timing, and uncertainty of future cash flows.[9] **The arrangement of each company's balance sheet items and subtotals should be designed to be useful to its various external user groups.** But there are differences in companies, industries, and economic conditions. Therefore, there must be flexibility in classifications to ensure that a company's balance sheet is useful. Nonetheless, a general classification scheme may be presented that captures the majority of items reported by most companies.



A corporation usually divides its balance sheet into three sections, and groups the items reported within each section in some informative manner. A common classification would be:

1. *Assets*
   a. Current assets
   b. Long-term investments
   c. Property, plant, and equipment
   d. Intangible assets
   e. Other assets
2. *Liabilities*
   a. Current liabilities
   b. Long-term liabilities
   c. Other liabilities

9. *Ibid., FASB Statement of Financial Accounting Concepts No. 5,* par. 20–22.

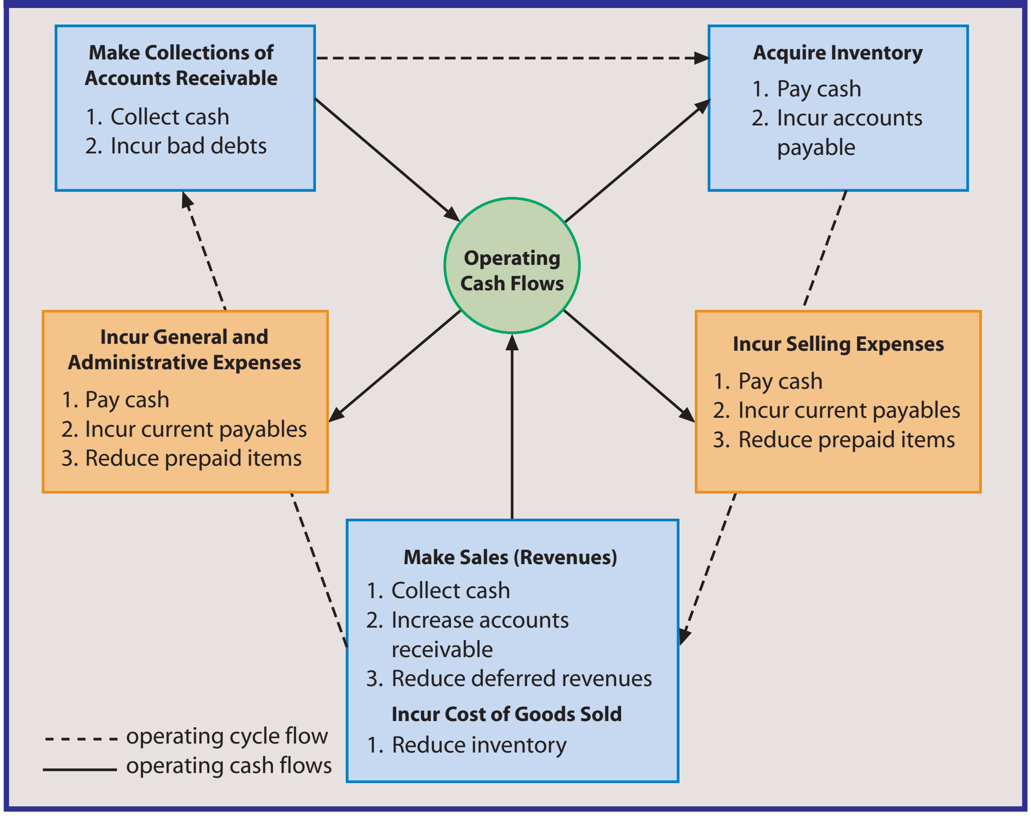
3. *Stockholders' equity*
   a. Contributed capital
      (1) Capital stock
      (2) Additional paid-in capital
   b. Retained earnings
   c. Accumulated other comprehensive income

We discuss each of these groupings in the following sections. We show a comprehensive illustration of a balance sheet at December 31, 2007 for the Caron Manufacturing Company in Example 4-1 on pages 130 and 131. For selected items, we show illustrations of disclosures of actual companies in related exhibits. Appendix A includes **The Coca-Cola Company's** balance sheet at December 31, 2004.

Current Assets

Current assets are cash and other assets that a company expects to convert into cash, sell, or consume within one year or the normal operating cycle, whichever is longer. An *operating cycle* is the average time taken by a company to spend cash for inventory, process and sell the inventory, and collect the receivables, converting them back into cash. We show an example of a company's operating cycle in Exhibit 4-3. Note the relationship between current assets, current liabilities (discussed in the next section), and operating cash flows. Most companies have operating cycles of a year or less. A few, such as construction, lumber, distillery, and tobacco companies, have operating cycles that are longer than

EXHIBIT 4-3 Operating Cycle: Current Assets, Current Liabilities, and Cash Flows



one year. In that case, the longer time period should be used to determine the current assets.[10]

A company's current assets may include five items:

- cash (and cash equivalents),
- temporary investments in marketable securities,
- receivables,
- inventories, and
- prepaid items.

(Companies may use different titles than the ones we use here.) These items usually are presented in the current asset section in the order of their liquidity, as we show in Example 4-1 on pages 130 and 131.

Cash includes cash on hand and readily available in checking and savings accounts. Many companies also include "cash equivalents" with cash. *Cash equivalents* are risk-free securities, such as money market funds and treasury bills that will mature in three months or less from the date acquired by the holder. **Temporary investments in marketable securities** include debt and equity securities that are classified as "trading securities," "available-for-sale securities" that management intends to sell within one year or the normal operating cycle (whichever is longer), and "held-to-maturity" securities that will mature within a year. Also included are "derivative financial instruments," such as options to buy stock. Alternative titles include *short-term marketable securities* and *short-term investments*. They are listed at their fair value (current market value). **Receivables** include accounts receivable and notes receivable with short-term maturity dates. They are listed at their estimated collectible amounts (net realizable values).

Inventories include goods held for resale in the normal course of business plus, in the case of a manufacturing company, raw materials (items to be converted into finished goods) and work in process (partially completed goods) inventories. They are listed at their historical cost or market value (current cost), whichever is lower. The inventory costing method (LIFO, FIFO, average cost) is disclosed parenthetically or in the related notes. To reduce the detail on its balance sheet, a company might show a total inventory amount in current assets and include a schedule of the components in the notes to the financial statements. This procedure is used by **Johnson & Johnson,** as we show in Real Report 4-1 on page 132. **Prepaid items** such as insurance, rent, office supplies, and taxes will not be converted into cash but will be consumed. Conceptually, prepaid items should not be classified as current assets because they do not directly enter into the operating cycle. However, they are included as current assets because had they not been paid in advance, cash would have been paid out within the cycle. Also, even though a two-year prepayment of insurance would extend over more than an annual operating cycle, the payment is usually classified as a current asset because the amount is not material. Prepaid items are listed at the historical cost of the remaining amounts.

Current Liabilities

We discuss current liabilities next because of their close relation to current assets. **Current liabilities are obligations of a company that it expects to liquidate by using existing current assets, or creating other current liabilities within one year or the normal operating cycle, whichever is longer.** Several types of liabilities should be included as current liabilities:

1. Obligations for items (goods or services) that are in the operating cycle. These include, for instance, accounts payable and salaries payable.

10. "Restatement and Revision of Accounting Research Bulletins," *Accounting Research and Terminology Bulletins, Final Edition, No. 43* (New York: AICPA, 1961), ch. 3, sec. A, par. 4 and 5.

2. Advance collections for the future delivery of goods or performance of service—for instance, obligations under short-term derivative financial instruments (such as options to sell stock) as well as unearned rent and unearned ticket sales. These latter items sometimes are referred to as short-term deferred (unearned) revenues.
3. Other obligations that will be paid within one year or the operating cycle, such as short-term notes payable, interest payable, dividends payable, income taxes payable, the estimated liability for short-term product warranties, and the portions of long-term liabilities that mature during this period.[11]

These obligations are listed on the balance sheet at the amount owed (historical proceeds) or estimated to be owed. Example 4-1 shows the current liabilities section of the Caron Manufacturing Company.

EXAMPLE 4-1 Balance Sheet

CARON MANUFACTURING COMPANY

Balance Sheet
December 31, 2007

Assets

Current Assets			
Cash		$ 14,300	
Temporary investments in available for sale securities		19,700	
Accounts receivable	$ 68,200		
Less: Allowance for doubtful accounts	(3,200)	65,000	
Inventories			
Raw materials	$ 32,000		
Work in process	49,500		
Finished goods	66,100	147,600	
Prepaid items			
Insurance	$ 4,800		
Office supplies	2,200	7,000	
Total current assets			$253,600
Long-Term Investments			
Investment in held-to-maturity bonds		$ 17,000	
Fund to retire long-term bonds payable		17,400	
Total long-term investments			34,400
Property, Plant, and Equipment			

	Cost	Accumulated Depreciation	Book Value	
Land	$ 36,000	—	$ 36,000	
Buildings	428,000	$207,000	221,000	
Equipment	192,000	63,700	128,300	
Totals	$656,000	$270,700	$385,300	
Total property, plant, and equipment				385,300

Intangible Assets			
Trademarks		$ 12,600	
Patents (net)		16,900	
Total intangible assets			29,500
Total Assets			$702,800

11. *Ibid.*, par. 7.

An obligation that is due within the next accounting period but which will be refinanced by issuing new long-term liabilities is not classified as a current liability. This obligation is not a current liability, because it will not require the use of current assets to satisfy the debt.

Working Capital

Analysis

The working capital of a company is the financial resources it uses during its operating cycle. **Working capital is the excess of a company's current assets over its current liabilities.** Although a company seldom computes its working capital on the balance sheet, it is often used by creditors and others as an indicator of the short-run liquidity of the company. Often external users use a slightly different computation, the **current ratio** (current assets divided by current liabilities), for the same purpose. Users must be careful when using the current ratio because the liquidity *composition* of the current assets is very important. The FASB has suggested several general guidelines for more homogeneous classifications of assets to help external users assess the nature, amounts, and liquidity of available resources. One classification alternative might be to separate the current assets

EXAMPLE 4-1 (Continued)

Liabilities			
Current Liabilities			
Accounts payable		$ 87,100	
Salaries payable		3,300	
Income taxes payable		27,400	
Advances from customers		19,600	
Current portion of mortgage payable		8,400	
Total current liabilities			$145,800
Long-Term Liabilities			
Bonds payable (10%, due 2020)	$ 90,000		
Less: Unamortized bond discount	(8,200)	$ 81,800	
Mortgage payable (12%, due 2009–2012)		52,600	
Accrued pension cost		34,700	
Total long-term liabilities			169,100
Other Liabilities			
Deferred income taxes			14,300
Total Liabilities			$329,200
Stockholders' Equity			
Contributed Capital (see Example 4-2)			
Common stock, $5 par (20,000 shares authorized, 14,300 shares issued and outstanding)		$ 71,500	
Additional paid-in capital on common stock		173,900	
Total contributed capital			$245,400
Retained Earnings (see Example 4-2)			116,200
Accumulated Other Comprehensive Income			
Unrealized increase in value of available-for-sale securities (see Example 4-2)			12,000
Total Stockholders' Equity			$373,600
Total Liabilities and Stockholders' Equity			$702,800

into two groups. The first group would include the *liquid* assets of cash and temporary investments in marketable securities that are immediately convertible into cash. The second group would include *separable assets*, those assets that can be separated from the company and converted into cash but with some time lag and conversion costs. These would include items such as receivables and inventories.[12] Users can develop alternative groupings of current assets and current liabilities, as well as other ratios for assessing liquidity and financial flexibility.

Reporting

Real Report 4-1 Inventory Disclosures

JOHNSON & JOHNSON

At January 2, 2005 and December 28, 2003	**2004**	**2003**
(in millions)		
Current assets (in part):		
Inventories (Notes 1 and 2)	$3,744	$3,588

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):

2 Inventories

At the end of 2004 and 2003, inventories were comprised of:

(Dollars in Millions)	**2004**	**2003**
Raw materials and supplies	$ 964	$ 966
Goods in process	1,113	981
Finished goods	1,667	1,641
	$3,744	$3,588

Questions:

1. **What is the percentage of each type of inventory for 2004 and 2003?**
2. **Why might you be concerned (or optimistic) in regard to the changes in the percentages?**

Long-Term Investments

Companies make investments for several reasons. They may be interested in appreciation of the investment (the company expects the market value of the investment to increase), in income from interest or dividends, in exercising control over certain other companies, as in the case of a subsidiary or a major supplier, and in using the investment for specific future purposes such as the acquisition of property, plant, and equipment for expansion. Whether or not the investment is readily marketable, **if the company expects to hold the item for more than one year or the operating cycle, whichever is longer, it is classified as a long-term (noncurrent) investment.**

Long-term investments include holdings of available-for-sale debt and equity securities that the company does not intend to convert into cash within one year or the normal operating cycle (if longer than a year). Long-term investments also include investments in debt securities (e.g., bonds) expected to be held to maturity, noncurrent notes receivable from unaffiliated companies, long-term advances to unconsolidated affiliated companies, and financial instruments (such as options to buy stock) that are noncurrent. Investments in property and equipment being held for future operations, such as land being held for a future building site, also are included. Special funds established to retire

12. For a further discussion, see "Reporting Funds Flows, Liquidity, and Financial Flexibility," *FASB Discussion Memorandum* (Stamford, Conn.: FASB, 1980), ch. 8 and 9.

bonds payable or preferred stock (often called sinking funds) or to acquire future facilities are included as long-term investments. Finally, miscellaneous investments, including the cash surrender value of life insurance policies, should be listed in this section of the balance sheet. Investments are listed at their fair value, historical cost, book value, or present value, depending on the type of investment. The method of valuation for each long-term investment should be disclosed either parenthetically or in the notes to the financial statements. Example 4-1 illustrates the long-term investments section of Caron Manufacturing Company.

Property, Plant, and Equipment

The property, plant, and equipment section of a company's balance sheet includes the tangible assets used in its operations. Often these are called *fixed assets* because of their relative permanency in the company's operations. A merchandising company sometimes will title this section Property and Equipment because it does not have manufacturing (plant) facilities. Assets that have a physical existence, such as land, buildings, equipment, machinery, furniture, and natural resources are listed in this category. Except for land, all the fixed assets are depreciable or depletable (in the case of natural resources). Land is listed at its historical cost, while the remaining fixed assets are listed at their book values (historical cost less accumulated depreciation or depletion). A *contra-asset* account, such as accumulated depreciation, usually is used to reduce fixed assets to their book values while still disclosing the historical cost. The method of depreciating the fixed assets is disclosed in the notes to the financial statements. In the case where the earning power of a fixed asset has been impaired, it is reported at a reduced fair value. Example 4-1 illustrates the property, plant, and equipment section of Caron Manufacturing Company. Some companies show a total amount of property, plant, and equipment on their balance sheets and a breakdown in the related notes. This procedure is used by **Campbell Soup Company** for its plant assets, as we show in Real Report 4-2.

Real Report 4-2 Plant Assets

Reporting

A C

CAMPBELL SOUP COMPANY

	August 1, 2004	August 3, 2003
(in millions)		
Assets (in part):		
Plant assets, net of depreciation (Note 14)	$1,901	$1,893

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):

14 Plant Assets (in part):

	2004	2003
Land	$ 70	$ 66
Buildings	1,009	974
Machinery and equipment	2,977	2,827
Projects in progress	192	145
	4,248	4,012
Accumulated depreciation	(2,347)	(2,169)
	$1,901	$1,843

Questions:

1. **What percentage of the total cost is "projects in progress" on August 3, 2003, and August 1, 2004?**
2. **What might this indicate?**

Certain long-term lease contracts relating to leased property, plant, and equipment also are included in this section. Long-term leases of assets are a popular way for a lessee to acquire the rights to the use of the assets without a large cash down payment. In the case of a *capital lease*, one that has many of the characteristics of a purchase, both the assets and the liabilities sections of the lessee's balance sheet are affected. Since the lease allows the lessee company relatively unrestricted rights to the use of the asset for an extended period, the rights are economic resources to the company, even though the asset is not legally owned. The lessee initially records a capital lease as an asset, Leased Equipment, at the present value of the future lease payments. It is amortized in a manner similar to other legally owned assets of the company. The book value of the leased asset is reported in the property, plant, and equipment section. Similarly, since the capital lease payments are noncancelable over an extended number of years, these payments are a long-term liability of the lessee company. The obligation for a capital lease also is recorded initially at the present value of the future lease payments and then reduced by the amount of each lease payment (after adjustment for interest). As we discuss later in this chapter, the capital lease liability is reported in the long-term liabilities section of the balance sheet. We discuss the accounting for capital leases in Chapter 21.

Intangible Assets

Intangible assets are those noncurrent economic resources that a company uses in its operations but have no physical existence. They generally derive their value from the rights held by the company for their use. A company may have three categories of intangible assets: (1) intangible assets with finite useful lives, (2) intangible assets with indefinite lives, and (3) goodwill. Intangible assets with finite useful lives (such as patents, franchises, and computer software costs) are amortized over their useful lives and reported on the balance sheet at their book values (historical cost less accumulated amortization). The accumulated amortization of these intangibles is disclosed in the notes to the financial statements. Intangible assets with indefinite useful lives (such as trademarks) are not amortized, but are reviewed for impairment annually. Impairment arises when the earning power of an intangible asset has been reduced to the point where its fair value is less than its historical cost. These intangible assets are reported on the balance sheet at their historical cost or, if impaired, at their lower fair value. Goodwill, another type of intangible asset, is not amortized but is also reviewed for impairment annually. Goodwill is also reported on the balance sheet at its historical cost or, if impaired, at its lower fair value. Many companies have valuable "intangible assets," such as their human resources and intellectual capital (employees), but these resources are not reported on the balance sheet because of the difficulty in reliably measuring their value. Example 4-1 illustrates the intangibles section of Caron Manufacturing Company. We discuss the acounting for intangible assets in Chapter 12.

Other Assets

Finally an "Other Assets" section occasionally is used to report miscellaneous assets that may not "fit" in one of the previous sections. This section sometimes is referred to as *deferred charges*. Examples of items that have been classified in this section include long-term prepayments (such as for rent or insurance), deferred tax assets, prepaid pension costs, bond issue costs, assets of a component of the company that is being discontinued, advances to officers, idle fixed assets, cash from customers' security deposits on returnable containers, assets leased to others, and assets temporarily restricted by foreign countries. Classification within this section should be made judiciously. Many items that are listed in this section might be classified correctly in one of the previous sections.

Long-Term Liabilities

5 Classify the liabilities of a balance sheet.

Long-term liabilities are those obligations of a company that it does not expect to liquidate using current assets or creating current liabilities within one year or the normal operating cycle (whichever is longer). Long-term liabilities may be called **noncurrent liabilities.** Many of these obligations may be outstanding for several years. Items such as long-term notes payable, capital lease obligations, mortgages payable, obligations under noncurrent financial instruments (e.g., options to sell stock), estimated liabilities from long-term warranties, accrued pension cost (i.e., obligation for future pension payments), and bonds payable are included in this category.

To finance its activities, a corporation may issue long-term bonds (sometimes called debentures or notes). A bond is a written promise to repay a specific amount (its *face value*) at some future maturity date. Nearly all bonds also pay a specified interest rate (either semiannually or annually) that may vary from company to company. Many bonds sell in a bond market similar to that of a stock market. Frequently a corporation may issue a bond at more or less than its face value. This occurs when the bond pays a stated interest rate greater or less than the yield rate investors can earn elsewhere on a similar security, making it more or less valuable.

When a bond is issued for more than its face value, it is sold at a *premium*; when it is issued for less, it is sold at a *discount*. At the time of sale the Bonds Payable account is recorded at the face value of the bond, and an adjunct account called Premium on Bonds Payable (or a *contra* account called Discount on Bonds Payable) is used to record the amount by which the selling price is greater than (or less than) the face value. Then, each period this premium (or discount) is amortized as an adjustment to interest expense (generally by use of a present value approach), and at the maturity date only the face value of the bonds payable remains. Whenever a balance sheet is prepared, the remaining premium is added to (or the discount is subtracted from) the face value of the bonds payable to determine the book value. Most long-term liabilities are reported at their present value, but some are listed at cost. Any applicable interest rates, maturity values, and other provisions are disclosed parenthetically on the balance sheet or in the notes to the financial statements. Example 4-1 illustrates the long-term liabilities section of Caron Manufacturing Company. Some companies show a total amount of long-term liabilities on their balance sheets and a schedule of the individual amounts in the related notes. This procedure is used by **Kimberly-Clark** for its long-term debt, as we show in Real Report 4-3.

Real Report 4-3 Long-Term Debt

Reporting

KIMBERLY-CLARK CORPORATION

Liabilities and Stockholders' Equity (in part):

	December 31	
	2004	**2003**
(in millions)		
Long-term Debt	$2,298.0	$2,733.7

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):

Note 4. Debt (in part)

Long-term debt is composed of the following:

	Weighted-Average Interest Rate	Maturities	December 31 2004	2003
Notes and debentures	5.77%	2005–2038	$2,309.8	$2,342.9
Industrial development revenue bonds	2.58%	2006–2037	300.7	381.3
Bank loans and other financings in various currencies	7.22%	2005–2031	272.9	194.9
Total long-term debt			2,883.4	2,919.1
Less current portion			585.4	185.4
Long-term portion			$2,298.0	$2,733.7

Continued

Fair value of total long-term debt, based on quoted market prices for the same or similar debt issues, was approximately $3.0 billion and $3.1 billion at December 31, 2004 and 2003, respectively. Scheduled maturities of long-term debt for the next five years are $585.4 million in 2005, $64.8 million in 2006, $336.7 million in 2007, $19.7 million in 2008, and $5.1 million in 2009.

At December 31, 2004, the Corporation had $1.2 billion of revolving credit facilities. These facilities, unused at December 31, 2004, permit borrowing at competitive interest rates and are available for general corporate purposes, including backup for commercial paper borrowings. The Corporation pays commitment fees on the unused portion but may cancel the facilities without penalty at any time prior to their expiration. Of these facilities, $600 million expires in September 2005 and the balance expires in November 2009.

Debt payable within one year is as follows:

	December 31	
	2004	**2003**
	(Millions of dollars)	
Commercial paper	$ 526.3	$533.5
Current portion of long-term debt	585.4	185.4
Other short-term debt	103.0	145.4
Total	$1,214.7	$864.3

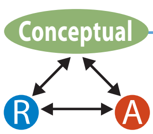
At December 31, 2004 and 2003, the weighted-average interest rate for commercial paper was 2.3 percent and 1.0 percent, respectively.

Questions:

1. **What information regarding cash flows is available in the note but is not available in the balance sheet?**
2. **Compute the approximate interest expense on the notes and debentures for the year ended December 31, 2004.**
3. **Provide an estimate of what the interest expense on the notes and debentures will be for the year ended December 31, 2005. What assumptions must be made to provide this estimate?**

Other Liabilities

A final section sometimes is used to report miscellaneous liabilities. This section might include items such as deferred tax liabilities, obligations of a component of the company that is being discontinued, and long-term advances from customers. As in the case of other assets, this category should be used judiciously.



Conceptual Guidelines for Reporting Assets and Liabilities

In the previous sections we discussed the typical classifications of assets and liabilities in a balance sheet. A company, however, should classify its assets and liabilities in the most informative manner for its external user groups. In addition to the "liquid" and "separable" subclassifications of current assets we discussed earlier, the FASB has suggested several guidelines for developing *homogeneous classes* of assets and liabilities. These guidelines include:

1. Reporting assets according to their type or expected function in the central operations or other activities of the company. For example, assets held for resale (inventory) should be reported separately from assets held for use in production (property, plant, and equipment).

2. Reporting as separate items assets and liabilities that affect the financial flexibility of the company differently; for example, assets used in operations, assets held for investment, and assets subject to restrictions (such as leased equipment).
3. Reporting assets and liabilities according to the fair value method used to value the items; for example, assets and liabilities measured at net realizable value versus those measured at current cost.

These general guidelines are intended to result in asset and liability classifications that help users assess the nature, amounts, and liquidity of available resources. This includes the intentions of management regarding their use, and the amounts and timing of obligations that require liquid resources for settlement.

The AICPA Special Committee on Financial Reporting extends these guidelines by suggesting that companies distinguish between "core" and "non-core" assets and liabilities. Core assets and liabilities result from a company's usual and recurring activities, transactions, and events. Conversely, non-core assets result from unusual or non- recurring activities, transactions, or events. For instance, non-core assets might include a receivable related to an unusually large sale of inventory that is not expected to recur in the future. Non-core liabilities might include those related to a discontinued component.[13]

Stockholders' Equity

Stockholders' equity is the residual interest of the stockholders in the assets of the corporation. A company may be organized in three different ways: as a sole proprietorship, a partnership, or a corporation.

A sole proprietorship is a single-owner company. This is usually a small company where the owner acts as manager and has direct access to the accounting records. Therefore, separate accounts typically are not used for the owner's investment and retained earnings. Normally, the total owner's equity is summarized in a single *capital* account.

A partnership involves two or more persons who have agreed to combine their capital and efforts in the operations of a company. The partnership generally has a *partnership agreement*, a legal document that includes the investment requirements, allocation of income, and withdrawal provisions for each partner. Separate capital accounts are used for each partner to summarize the partner's equity.

The corporation is the most complex business organization. Usually there is *absentee* ownership, where most of the stockholders are not involved in managing the corporation. To protect these absentee owners, state laws have been established, many of which relate to the accounting for stockholders' equity. Stockholders' equity consists of three components: (1) contributed capital, (2) retained earnings, and (3) accumulated other comprehensive income.

6 Report the stockholders' equity of a balance sheet.

Contributed Capital

The owners of a corporation hold shares of stock in that corporation. A stockholder may acquire shares directly from the corporation or by purchasing them on the stock market from another investor. The corporation's balance sheet is affected only in the first case. Most state laws protecting stockholders and creditors require a certain amount of legal capital. **Legal capital is the minimum amount of stockholders' equity that the corporation may not distribute as dividends;** it is one element of the total amount of contributed capital. Accounting for contributed capital follows these legal requirements. Contributed capital frequently is separated into two components, capital stock (relating to the legal capital) and additional paid-in capital.

13. "Reporting Income, Cash Flows, and Financial Position of Business Enterprises," *FASB Proposed Statement of Financial Accounting Concepts, op. cit.*, par. 50, 51, and 170, and "Improving Business Reporting—A Customer Focus," *AICPA Special Committee on Financial Reporting* (New York: AICPA, 1994), App. II, pp. 138–139.

Capital Stock and Additional Paid-In Capital

©Getty Images/PhotoDisc

Corporations may issue two types of capital stock, preferred stock and comon stock. **Preferred stock** has different ownership features (which some investors consider more attractive) from common stock, including the first right to a specified dividend, if one is paid. **Common stock** carries the right to vote at the annual stockholders' meeting and to share in residual profits. The corporate charter includes the number of shares that a corporation is legally authorized to issue, as well as the types and characteristics of its capital stock. Common stock is the most prevalent type of capital stock. Each of these types of stock typically sells on a stock market, which establishes its *market value* per share.

Based upon state laws, a corporation may issue (1) par value, (2) stated value, or (3) no-par (no stated value) capital stock. Legally, capital stock may be required to carry a par value or a stated value. Par value or stated value refers to a specific dollar amount per share that is printed on the stock certificate.[14] Often this par value is a very small amount, say $1 or $5 per share, because states generally do not allow a corporation to issue stock at less than par. For instance, the par value of **Honeywell**'s common stock is $1 per share. The par value of a share of stock has no direct relationship to the share's market value. Nonetheless, the legal (par) value must be accounted for separately.

When a corporation issues par value capital stock (common or preferred), it must allocate the amount it receives (market price) between a capital stock account for the par value and another contributed capital account for the difference between the par and the market value. This latter account has a title such as Additional Paid-in Capital, Paid-in Capital in Excess of Par, or Premium on Common (or Preferred) Stock. For instance, if a corporation sold 100 shares of its $5 par common stock for $30 per share, the journal entry to record the transaction is as follows (the number of shares issued in the transaction is also recorded):

Cash	**3,000**	
Common Stock, $5 par		**500**
Additional Paid-in Capital on Common Stock		**2,500**

Many states allow corporations to issue no-par capital stock. When a corporation issues no-par capital stock, the amount it receives from the sale usually is the legal capital, and the corporation records the entire amount in the capital stock account. Due to various other stock transactions, it is possible for a corporation issuing no-par stock to have certain additional paid-in capital accounts.

A corporation sometimes will repurchase its own capital stock. When it does, the number of shares outstanding is reduced. The corporation usually records the *cost* of the reacquisition in a contra stockholders' equity account entitled **Treasury Stock.** This account has a debit balance and the corporation deducts the amount from the total of

14. There are certain legal differences between par value and stated value. We discuss these in Chapter 16. Since the accounting for stated value stock generally is identical to that for par value stock, here we focus on par value stock.

contributed capital, retained earnings, and accumulated other comprehensive income to determine its total stockholders' equity.

Regardless of whether a corporation issues par or no-par stock, the corporation lists the balances in the Preferred Stock, Common Stock, and Additional Paid-in Capital accounts separately on its balance sheet and sums the amounts to determine the total amount of its contributed capital. The par value or stated value per share, as well as the number of shares authorized, issued, and outstanding, should be disclosed either parenthetically in the contributed capital section or in the notes to the financial statements. Example 4-1 illustrates the contributed capital section of Caron Manufacturing Company.

Retained Earnings

Retained earnings is the total amount of corporate net income that has not been distributed to stockholders as dividends. A corporation may retain the assets generated from this net income to use in its daily operations, to maintain its productive facilities, or for growth. In any event, a retained earnings balance has no relationship to the cash that is available for dividends. The resources generated by net income are invested in all assets. The Retained Earnings account balance is an addition in stockholders' equity. A negative (debit) retained earnings balance (due to cumulative net losses and dividends exceeding cumulative net income), called a *deficit*, is subtracted in stockholders' equity.

Sometimes a company *restricts* or *appropriates* a portion of retained earnings to indicate that it cannot be reduced by the distribution of dividends. This may occur as a result of a legal or contractual requirement. Usually, such a restriction is disclosed in the notes to the financial statements.

Accumulated Other Comprehensive Income

As we discuss in Chapter 5, a company is required to report its total comprehensive income for the accounting period. Comprehensive income includes both net income and "other comprehensive income." Other comprehensive income (loss) may include four items: (1) unrealized increases (gains) or decreases (losses) in the market (fair) value of investments in available-for-sale securities, (2) translation adjustments from converting the financial statements of a company's foreign operations into U.S. dollars, (3) certain gains and losses on "derivative" financial instruments, and (4) certain pension liability adjustments.

A corporation includes its total net income earned to date in its retained earnings amount reported in stockholders' equity. The corporation includes its other comprehensive income (or loss) accumulated to date in its **accumulated other comprehensive income (or loss)** amount reported in stockholders' equity. If a corporation has more than one item of other comprehensive income, it has a choice. It may report the amount of accumulated other comprehensive income for each item in stockholders' equity. Or, it may report the total amount of accumulated other comprehensive income for all the items in stockholders' equity. If the corporation uses this approach, it must disclose the amounts for each of the items in the notes to its financial statements.[15]

General Motors Corporation uses the first approach. In the stockholders' equity section of its December 31, 2004 balance sheet, General Motors reported an accumulated other comprehensive loss of $2,285 million, consisting of four items as follows:

Accumulated foreign currency translation adjustments	$(1,194)
Net unrealized gains on derivatives	589
Net unrealized gains on securities	751
Minimum pension liability adjustment	(3,031)
Accumulated other comprehensive loss	$(2,885)

15. "Reporting Comprehensive Income," *FASB Statement of Financial Accounting Standards No. 130* (Norwalk, Conn.: FASB, 1997), par. 17 and 26.

The Caron Manufacturing Company has one item of accumulated other comprehensive income, as we show in Example 4-1. Unless a corporation has miscellaneous items of equity (discussed next), it adds the totals for contributed capital, retained earnings, and accumulated other comprehensive income to determine the total stockholders' equity.

Miscellaneous Items

In rare instances a company may increase its assets without a corresponding outflow of assets, increase in liabilities, recognition of income, or issuance of capital stock. For instance, a company may receive donated assets from a governmental unit or it may discover previously unrecorded assets. In either case, when the company records the asset's fair value it also increases stockholders' equity. These items are listed separately in stockholders' equity.

Secure Your Knowledge 4-2

- When presenting the elements of a balance sheet, a company will simplify, condense, and classify the financial information in order to improve the usefulness of the information for the external users.
- The classification of assets and liabilities as current and noncurrent is a key distinction made on a company's balance sheet that allows users to more easily assess its liquidity and financial flexibility.
- Assets that are expected to provide economic benefits for more than one year or the operating cycle, whichever is longer, are classified as noncurrent assets and include long-term investments, property, plant, and equipment, and intangible assets.
- Obligations that will not be satisfied within one year or the operating cycle, whichever is longer, are classified as noncurrent liabilities and include long-term notes payable, bonds, and capital lease contracts.
- Stockholders' equity, the residual interest in the assets of the corporation, consists of contributed capital, retained earnings, and accumulated other comprehensive income.

Statement of Changes in Stockholders' Equity

7 Prepare a statement of changes in stockholders' equity.

When a corporation issues financial statements, it must disclose the changes in its stockholders' equity accounts. This disclosure may be in a financial statement, a supporting schedule, or a note to the financial statements.[16] This reporting is consistent with the FASB's suggestion that a full set of financial statements should show, among other information, investments by and distributions to owners during the period. The intent is to help report on the changes in a company's financial structure to help users in assessing its financial flexibility.

FASB Statement of Concepts No. 6 defines investments by owners and distributions to owners, as follows:

> **Investments by owners are increases in the equity of a company resulting from transfers of something valuable to the company from other entities to obtain or increase ownership interests.**
>
> **Distributions to owners are decreases in the equity of a company caused by transferring assets, rendering services, or incurring liabilities to owners.**

Assets are the economic resources most commonly received by a company from investments by owners, but the items received may include services or the conversion of liabilities

16. "Omnibus Opinion—1967," *APB Opinion No. 12* (New York: AICPA, 1967), par. 10.

of the company. Through investments by owners, a company obtains the resources it needs to begin or expand operations, to retire liabilities, or for other business purposes. Distributions by a company to its owners decrease its net assets and decrease or terminate ownership interests of those who receive them.[17]

To disclose investments by and distributions to owners, many companies will prepare a statement of changes in stockholders' equity, which combines the retained earnings changes and the changes in accumulated other comprehensive income with the other capital account changes. Example 4-2 illustrates this statement. Note that the totals of the columns in this example are the same as those shown in the stockholders' equity section of Example 4-1.

EXAMPLE 4-2 Statement of Changes in Stockholders' Equity

SCHEDULE A
CARON MANUFACTURING COMPANY

Statement of Changes in Stockholders' Equity
For Year Ended December 31, 2007

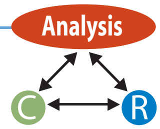
	Common Stock, $5 par	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, January 1, 2007	$65,000	$143,400	$ 64,900	$10,000	$283,300
Unrealized increase in value of available-for-sale securities				2,000	2,000
Net income			62,500		62,500
Cash dividends paid			(11,200)		(11,200)
Common stock issued	6,500	30,500			37,000
Balance, December 31, 2007	$71,500	$173,900	$116,200	$12,000	$373,600

Other Disclosure Issues

A company cannot report all the relevant financial information about its activities directly in the body of the financial statements because some items do not meet the recognition criteria we discussed earlier in the chapter. As indicated throughout the balance sheet discussion, a company may make many disclosures in the notes accompanying its financial statements. We discuss other significant disclosure issues here.

8 Understand the other disclosure issues for a balance sheet.

Summary of Accounting Policies



To understand a company's financial statements, an external user needs to know the company's accounting policies, practices, and methods. For this reason, generally accepted accounting principles require the disclosure of certain information in a company's annual report.

APB Opinion No. 22 requires that a company include a description of all its significant accounting policies. The disclosure should include principles relating to revenue recognition and asset allocation, particularly when these principles and methods involve (1) a selection from existing acceptable alternatives, (2) principles and methods peculiar to the industry in which the company operates, and (3) unusual or innovative applications of generally accepted accounting principles. Examples cited include, among others, those policies related to the basis for consolidation, depreciation methods, amortization of intangibles,

17. *FASB Statement of Financial Accounting Concepts No. 6, op. cit.*, par. 66–69.

inventory pricing, recognition of profits on long-term contracts, and revenue recognition from franchise and leasing operations. Although allowing for flexibility, the disclosure is particularly useful when made in a separate *Summary of Significant Accounting Policies* preceding the notes to the financial statements or as the initial note.[18] We show this summary (in part) for the **Black & Decker Corporation** in Real Report 4-4. We include a complete summary in the **Coca-Cola Company's** notes to its financial statements in Appendix A.

Real Report 4-4 Summary of Accounting Policies

BLACK & DECKER CORPORATION

Notes to Consolidated Financial Statements (in part)

Note 1: Summary of Accounting Policies (in part):

Principles of Consolidation: The Consolidated Financial Statements include the accounts of the Corporation and its subsidiaries. Intercompany transactions have been eliminated.

Inventories: Inventories are stated at the lower of cost or market. The cost of United States inventories is based primarily on the last-in, first-out (LIFO) method; all other inventories are based on the first-in, first-out (FIFO) method.

Property and Depreciation: Property, plant, and equipment is stated at cost. Depreciation is computed generally on the straight-line method for financial reporting purposes.

Questions:

1. **Why is it important to disclose the accounting method used to compute the cost of inventory and to compute depreciation?**
2. **If the company used accelerated deprecation for financial reporting purposes, how would the income statement and balance sheet be affected?**

Fair Value and Risk of Financial Instruments

Some companies, many of which are banks and brokerage firms, deal in financial instruments. These *financial instruments* include items such as notes payable and receivable, contracts for loan commitments, collateralized mortgages, interest rate swaps, and put and call options on stocks. In recent years, both the types and uses of financial instruments have increased to the point where the FASB has addressed the reporting and disclosure of their fair values and risk. **FASB Statement No. 107** requires a company to disclose the fair value of all its financial instruments (both assets and liabilities), whether or not they are reported on its balance sheet. The *Statement* also requires a company to disclose all significant concentrations of credit risk due to its financial instruments. A company typically makes these disclosures in the notes to its financial statements.

FASB Statement No. 133 requires a company to report all *derivative financial instruments* as either assets or liabilities on its balance sheet, and to measure these items at their fair value. A derivative financial instrument is, for example, an option to buy stock where the value of the option depends on the price of the stock. The *Statement* also requires a company to disclose information such as the types of derivative instruments it holds, its objectives in holding the instruments, and its strategies for achieving these objectives. The description must indicate the company's risk management policy in regard to each type of instrument. The intent of these disclosures is to improve the reporting of a company's *risk, liquidity, and financial flexibility*.[19] We discuss disclosures about fair values and risks of financial instruments in Chapter 13 and the Appendix to Chapter 15.

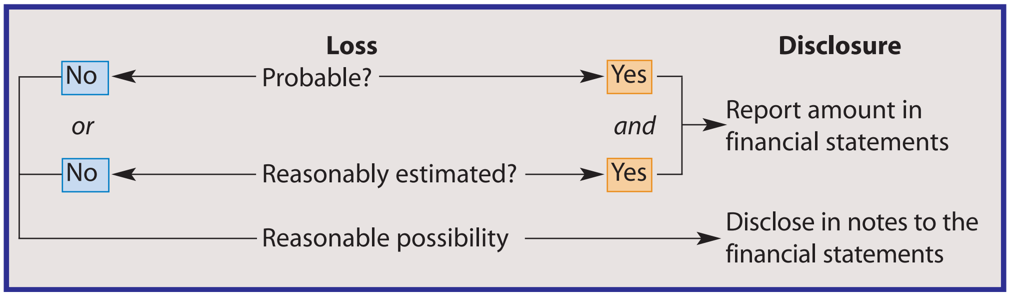
18. "Disclosure of Accounting Policies," *APB Opinion No. 22* (New York: AICPA, 1972), par. 8, 12, 13, and 15.
19. "Disclosures About Fair Value of Financial Instruments," *FASB Statement of Financial Accounting Standards No. 107* (Norwalk, Conn.: FASB, 1991) and "Accounting for Derivative Instruments and Hedging Activities," *FASB Statement of Financial Accounting Standards No. 133* (Norwalk, Conn.: FASB, 1998).

Loss and Gain Contingencies

Certain situations may exist for a company on its balance sheet date that involve uncertainty as to possible losses or gains that the company may incur if some future event(s) occurs or fails to occur. These are known as **loss contingencies** or **gain contingencies** and may need to be included directly in the company's financial statements by recording a journal entry, or disclosed in a note accompanying the financial statements.[20]

A company accrues (reports a loss and a liability or a reduction of an asset) an estimated loss (or expense) from a loss contingency if (1) it is *probable* that a liability has been incurred (or an asset impaired) and (2) the amount of the loss can be *reasonably estimated*. Examples of this type of loss contingency include product warranties and uncollectible accounts receivable. If either of these conditions is *not* met—that is, if there is only a reasonable possibility that the loss may have been incurred or if the amount of the loss cannot be reasonably estimated—the company discloses the loss contingency in the notes to its financial statements.

The following diagram illustrates the alternative ways of accounting for loss contingencies:



The disclosure of any loss contingencies of a company is important to provide external users with additional information for helping predict its use of its financial resources in the future. Examples of a loss contingency that are disclosed in the notes to the financial statements include guarantees of the debts of others and pending litigation against the company, where either the outcome of the litigation or the amount of possible loss is uncertain. An illustration of this type of contingency for **Pinnacle Entertainment Inc.** is shown in Real Report 4-5. Gain contingencies are not reported in a company's financial statements and, if disclosed in a note, should be carefully explained to avoid misleading implications as to the likelihood of future revenues or gains.[21] We discuss loss and gain contingencies in Chapter 13.

Real Report 4-5 Contingency

PINNACLE ENTERTAINMENT INC.

Notes to Financial Statements (in part)

Note 11. Commitments and Contingencies

Legal

Columbia Sussex Litigation. On January 26, 2005, Columbia Sussex Corporation and three other plaintiffs filed a petition against the Missouri Gaming Commission and Casino One Corporation, a wholly owned subsidiary of the Company, in the Circuit Court of Cole County, Missouri. The plaintiffs seek to undo the Missouri Gaming Commission's approval of Casino One's docking site on the St. Louis riverfront under a claim for judicial review by

Continued

20. "Accounting for Contingencies," *FASB Statement of Financial Accounting Standards No. 5* (Stamford, Conn.: FASB, 1975), par. 1.
21. *Ibid*., par. 8–17.

original writ, declaratory judgment, and writ of prohibition. The factual allegations for each claim are that the Commission could not grant approval to Casino One because the facility's planned gaming floor is allegedly not within 1,000 feet of the main channel of the Mississippi River, as required under the Missouri constitution. While the Company cannot predict the outcome of this litigation, management intends to defend it vigorously.

Question:

1. **What possible impact might settlement of this litigation have on Pinnacle Entertainment's future financial position or results of operations?**

Subsequent Events

A company usually does not issue its annual report for several weeks or months after the end of the accounting period because of the time needed for adjusting and closing the books and auditing the financial statements. During this time it is possible for significant business events and transactions to occur which, if not disclosed in the company's annual report, would cause this report to be misleading. Subsequent events are discussed more fully in an auditing book; we briefly summarize them here.

A subsequent event is one that occurs between a company's balance sheet date and the date when it issues its annual report, as we illustrate in the following time diagram:

End of Accounting Period — **Annual Report Publication Date**

Subsequent Events

If a subsequent event occurs that (1) provides additional evidence about conditions that *existed* on the balance sheet date and (2) significantly affects the estimate(s) used in preparing the company's financial statements, the company must make an adjustment to the financial statements. For instance, if a company obtains additional information indicating that a major customer's account receivable is unlikely to be collected, it makes an adjustment to the allowance for doubtful accounts and the bad debt expense.

When a subsequent event occurs that provides evidence concerning conditions that did *not* exist on the company's balance sheet date, but instead occurred after that date, the company does *not* adjust its financial statements. Instead, the information is disclosed in a note, pro forma ("as if") statement, or an explanatory paragraph in the audit report, depending upon the materiality of the financial impact. Examples of these events include a fire or flood loss, a litigation settlement, and the sale of a bond or stock issue after the balance sheet date.[22]

Related Party Transactions

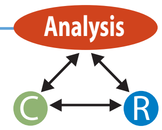
Transactions between related parties frequently occur in the normal course of business. Related parties of a company include affiliated entities such as subsidiaries, trusts for the benefit of employees, its management, and its principal owners or immediate families. Relationships between related parties may enable one of the parties to influence the other so that it is given preferential treatment. To provide sufficient information for external users to understand a company's financial statements, **FASB Statement No. 57** requires certain disclosures by the company. For related party transactions these include (1) the

22. *AICPA Professional Standards,* Volume 1 (New York: AICPA, 2004), sec. 560.03–560.09.

nature of the relationship involved, (2) a description of the transactions, (3) the dollar amounts of the transactions, and (4) any amounts due to or from the related parties on the balance sheet date.[23]

Comparative Financial Statements

Examples 4-1 and 4-2 show the ending balance sheet and the statement of changes in stockholders' equity of the Caron Manufacturing Company for one year. Many external users are interested in comparing the current financial statements with those of the previous year. Also, many times *trend* information about a company will reveal useful insights about its past performance and future success. For this reason, nearly all companies present **comparative financial statements** for the current and preceding accounting periods. Additionally, in a supplemental schedule, most companies will present a summary of key accounting information for, say, the past 5 to 10 years. For instance, some companies report their **debt ratio** (total liabilities ÷ total assets) to help external users (creditors and stockholders) assess the risk of their investment in the company. We show the **Coca-Cola Company's** comparative financial statements Debt Ratio in Appendix A.



Auditor's Report

Many major financial decisions by investors, bankers, other creditors, and other users are based on the financial information presented in a company's financial statements and related notes. These financial statements are the responsibility of the company's management. To help ensure a fair presentation of corporate financial resources, obligations, and activities, companies' financial statements and accompanying notes presented to external users are audited by an independent certified public accountant. In an audit, the certified public accountant is responsible for making an examination of a company's internal control, accounting system, records, and reports *in accordance with generally accepted auditing standards*. Based on this examination, the auditor expresses an *opinion* as to the *fairness in accordance with generally accepted accounting principles* of the company's financial statements and accompanying notes. Although this opinion is *not* itself part of the financial statements, it is an extremely important item of information, and one on which external users place much significance. We discuss the auditor's report in Chapter 6.

SEC Integrated Disclosures

9 Describe the SEC integrated disclosures.

As we noted in Chapter 1, the Securities and Exchange Commission has the legal authority to prescribe accounting principles and reporting practices for all regulated ("publicly-held") companies. Each year, within 60 days of its fiscal year-end, a regulated company must file a *Form 10-K* annual report with the SEC. This report must be filed electronically according to the EDGAR requirements. Each company's chief executive and chief financial officer both must "certify" that the company's annual report within the Form 10-K (or interm report within the company's Form 10-Q) is both complete and accurate. The SEC has also developed an "integrated" set of disclosure requirements that enable a company to satisfy certain Form 10-K disclosure requirements by referring to its stockholders' annual report, provided the latter report includes certain items. Since many regulated companies now include these items in their annual reports, we briefly summarize the items as follows. For a more detailed discussion, see *Regulation S-X* of the SEC.

23. "Related Party Transactions," *FASB Statement of Financial Accounting Standards No. 57* (Stamford, Conn.: FASB, 1982), par. 2.

Comparative Financial Statements

As we discussed in the previous section, most companies present comparative financial statements for at least two years. The SEC requires comparative balance sheets for *two* years and comparative income statements and statements of cash flows for *three* years.

Selected Financial Data

As we discussed in the previous section, most companies present a summary of important accounting information for several years. The SEC requires *specific* disclosures for a *five-year period*. These include net sales or operating revenues, income (loss) from continuing operations and related earnings per share, total assets, long-term obligations and redeemable stock, and cash dividends declared per share. The SEC encourages the inclusion of other information that will help users understand and highlight trends.

Analysis

Management's Discussion and Analysis

A company's management must include a discussion and analysis (MD&A) of the company's financial condition, changes in financial condition, and results of operations. The intent is to give investors the opportunity to look at the company from management's perspective. Management is asked to discuss the dynamics of the company's business and to analyze the financial statements. The discussion is intended to provide "forward-looking" information that does not clearly appear in the financial statements but is useful in evaluating cash flows from operations and from outside sources. The major items covered should include, for instance, specific information about short-term and long-term liquidity and capital resources, a narrative discussion of the impact of inflation on sales and on income from continuing operations, a description of any significant unusual events and their effect on revenues and expenses, explanations of material changes in financial statement items between years, and known events and uncertainties expected to affect future operations. Other kinds of forward-looking information (e.g., trends) are required as well.

Common Stock Market Prices And Dividends

Several disclosures must be made. These include the principal trading markets for the company's common stock, the high and low market prices for each quarter in the last two years, the approximate number of stockholders, the dividends paid in the last two years, and any dividend restrictions.

Miscellaneous Disclosures

In addition to the disclosures discussed throughout this chapter, a company must make many other disclosures to provide adequate information concerning its activities. These include information about items such as the company's stock (share) option, pension, and insurance plans, long-term lease and purchase commitments, bond indenture provisions, notes receivable, and notes payable provisions. We discuss specific disclosure requirements as we address each topic in the remaining chapters.

Secure Your Knowledge 4-3

- A statement of changes in stockholders' equity discloses investments by and distributions to owners, as well as changes in retained earnings and accumulated other comprehensive income.
- The notes accompanying the financial statements contain relevant information about a company's activities that cannot be reported in the body of the financial statements.

(continued)

- Examples of disclosures made in the notes include the accounting policies, practices, and methods used by a company, the fair values and risks of financial instruments, contingent losses and gains, the existence of subsequent events, and any related party transactions.

LINK TO INTERNATIONAL DIFFERENCES

One of the objectives of the IASB is to ensure, to the extent possible, that a company's published financial statements comply with international accounting standards. The financial statements required by the IASB are similar to those in the United States. They include a balance sheet, statement of changes in equity, income statement, and statement of cash flows, as well as related notes and other explanatory materials. However, International Accounting Standards do not *require* a particular format; the appropriate format depends on the type of company.

A company may classify its assets on the balance sheet into noncurrent assets and current assets, with noncurrent assets presented first. Noncurrent assets include property, plant, and equipment, as well as other items (investments, long-term receivables, intangibles). These classifications are similar to those in the United States. Current assets are also similar to those under U.S. GAAP.

The ordering of the liabilities and owners' equity sections is usually different than under U.S. GAAP, with "capital and reserves" listed first. The capital and reserves section includes issued capital, reserves, and accumulated profits (losses). The issued capital includes share capital and share premium. A company is required to disclose the par value, as well as the number of shares authorized, issued and fully paid, and issued but not fully paid. It must also disclose dividends that have been proposed but not formally approved for payment. Reserves may result from revaluations of properties and investments, as well as currency translation differences. A company must also provide a description of the nature and purpose of each reserve.

Noncurrent liabilities are usually listed next and include items such as interest-bearing borrowings, deferred income, deferred taxes, and retirement benefit obligations. Deferred income may include government grants, which are a form of financial assistance to a company for compliance with certain conditions. On the other hand, some government grants for the construction of assets are treated as a reduction in the book value of the asset. Current liabilities are listed last and are similar to those under U.S. GAAP. As with U.S. GAAP, a company is not required to separate its assets and liabilities into current and noncurrent classifications; it decides on the disclosures based on their usefulness.

A company's statement of changes in equity includes the changes in share capital and share premium, as well as any changes in the company's reserves due to, for instance, a surplus on the revaluation of properties or a deficit on the revaluation of investments. A company must also disclose any changes in accumulated profits (losses) due to changes in accounting policies, corrections of fundamental errors, net income, and dividends.

In the notes to its financial statements, a company is required to disclose items similar to those required under U.S. GAAP. These disclosures include its accounting policies, narrative descriptions of financial statement items, and contingencies. For revaluations, they also include the measurement basis used. Furthermore, companies in "hyperinflationary" economies (e.g., the cumulative inflation rate over three years exceeds 100 percent) are required to prepare general price-level-adjusted financial statements. In the following chapters, we briefly discuss the major differences between international and U.S. accounting standards as they apply to specific assets, liabilities, and income.[24]

24. For a more complete discussion, see Carrie Bloomer (editor), *The IASC—U.S. Comparison Project: A Report on the Similarities and Defferences between IASC Standards and U.S. GAAP,* 2nd ed. (Norwalk, Conn.: FASB, 1999).

Reporting Techniques

10 Explain the reporting techniques used in an annual report.

Companies use several reporting techniques in the presentation of their annual reports. We discuss the major ones relating to the financial statement presentations next.

Statement Format (Balance Sheet)

The format that a company uses for its balance sheet depends upon its size, the industry in which it operates, certain regulatory requirements, and tradition. Two basic formats are used: the report form or the account form.

Most companies use the **report form.** Here the balance sheet is shown in a vertical format. The asset accounts are listed first, and the liability and stockholders' equity accounts are listed in sequential order directly below the assets. In contrast, the **account form** of the balance sheet is organized in a horizontal fashion, with the asset accounts listed on the left-hand side and liabilities and stockholders' equity accounts on the right-hand side. This is the format used in Example 4-1. Of 600 companies surveyed, the report form and account form are used by 506 and 94, respectively.[25]

Combined Amounts

To reduce the size of a company's financial statements, it may combine certain related amounts. For instance, a company may list a single amount for property and equipment on the face of its balance sheet and then itemize the amounts applicable to land, buildings, and equipment in a note to the financial statements. Frequently the amounts for inventories are similarly combined and itemized, as illustrated in Real Report 4-1 for **Johnson & Johnson**. Generally, it is *not* proper to offset asset and liability accounts. For instance, the amount in a special Bond Sinking Fund account to retire long-term bonds would not be offset against the Bonds Payable account balance. In a few circumstances, a *right of offset* exists whereby a debtor (Company A) has a legal right to discharge all or some of the liability owed to another party (Company B) by applying an amount that the other party (Company B) owes to the debtor (i.e., a receivable of Company A) against the liability.[26] For instance, when a bank loans money to a company in exchange for the company's accounts receivable that are assigned to the bank, the company would offset the assigned accounts receivable on its balance sheet against the liability owed to the bank. We discuss the right of offset in Chapter 7.

Rounding

In Examples 4-1 and 4-2 the amounts presented for each account, subtotal and total, were rounded to the nearest hundred dollars. Rounding is usually done to increase readability and to reduce the likelihood that readers will attach more precision to the numbers than is warranted. In fact, many major companies round to the nearest million dollars. In the **Coca-Cola Company** financial statements shown in Appendix A, the amounts are rounded as indicated.

25. *Accounting Trends and Techniques*, (New York: AICPA, 2004), p. 149.

26. For the criteria to be met for a right of offset to exist, see "Offsetting of Amounts Related to Certain Contracts," *FASB Interpretation No. 39* (Norwalk, Conn.: FASB, 1992), par. 5 and "Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements," *FASB Interpretation No. 41* (Norwalk, Conn.: FASB, 1994), par. 3.

Notes, Supporting Schedules, and Parenthetical Notations

Additional information not included in the accounts reported on a company's financial statements is disclosed in a note, supporting schedule, or parenthetical notation.

The **notes** (sometimes called *footnotes*) accompanying the financial statements are extremely useful ways of presenting additional information. Generally accepted accounting principles *require* that a company disclose certain information (for instance, contingent liabilities that are reasonably possible) in the notes to the financial statements, and it is good accounting practice to include additional note disclosures when they add to the completeness of the annual report. Notes usually contain narrative discussion, additional monetary amounts, and sometimes supplemental schedules.

We illustrated several notes of actual companies earlier in this chapter. We discuss required and suggested disclosures in notes throughout this book as they apply to specific topics. Because notes must communicate technical accounting information in a narrative format, there are several ways to improve their clarity and readability. When preparing and writing financial reporting notes, the accountant should (a) specify what data are to be disclosed, (b) outline the desired format of the note, (c) construct and use short sentences in the note, (d) use terminology understandable to the external user, and (e) be concise but complete.

Supporting schedules may be freestanding or part of the notes. A supporting schedule may complement an entire financial statement (such as the retained earnings statement) or may explain a summary amount on a specific financial statement (such as the categories of inventories, as we showed in Real Report 4-1). We discuss and illustrate supporting schedules throughout the book.

Parenthetical notations following specific accounts are used to explain items such as the method of valuation (e.g., cost, lower of cost or market) or of determining the ending inventory (e.g., average cost), or to cross-reference certain related asset and liability accounts (e.g., bond sinking fund and bonds payable).

Illustrative Statements

Appendix A shows the actual financial statements and accompanying notes of the **Coca-Cola Company** for the year ended December 31, 2004. Although you may not understand all of these items at this point, pay particular attention to each statement's format and content and, in particular, to the notes accompanying the reports. Your understanding will increase as you study this book.

Summary

At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

1. **Understand the purposes of the balance sheet.** A balance sheet summarizes the *financial position* of a corporation on a specific date by reporting on its assets, liabilities, and stockholders' equity. The balance sheet reports a corporation's *resource structure* and its *financial structure*.
2. **Define the elements of a balance sheet.** The elements of a balance sheet are the broad classes of items comprising it. The elements include assets, liabilities, and stockholders' equity. Briefly, assets are a corporation's economic resources, liabilities are its present obligations, and stockholders' equity is the residual interest in the assets.

3. **Explain how to measure the elements of a balance sheet.** There are five alternatives for measuring the elements (assets and liabilities) of a balance sheet. These include: (1) historical cost/historical proceeds (2) current cost/current proceeds, (3) current market value, (4) net realizable value, and (5) present value. Alternatives (2) through (4) are ways of measuring the fair value of an element. Each of these alternatives is used under specific circumstances for measuring certain assets and liabilities.
4. **Classify the assets of a balance sheet.** The assets of a balance sheet may be classified into five groups: (1) current assets, (2) long-term investments, (3) property, plant, and equipment, (4) intangible assets, and (5) other assets.
5. **Classify the liabilities of a balance sheet.** The liabilities of a balance sheet may be classified into three groups: (1) current liabilities, (2) long-term liabilities, and (3) other liabilities.
6. **Report the stockholders' equity of a balance sheet.** The stockholders' equity of a balance sheet consists of contributed capital (capital stock and additional paid-in capital), retained earnings, and accumulated other comprehensive income.
7. **Prepare a statement of changes in stockholders' equity.** A statement of changes in stockholders' equity starts with the beginning balances of capital stock, additional paid-in capital, retained earnings, and accumulated other comprehensive income. It then reconciles these beginning balances to the ending balances by showing the changes (and reasons for the changes) in each of these items.
8. **Understand the other disclosure issues for a balance sheet.** To help users understand the elements of its balance sheet (and other financial statements), a company also discloses useful information in the notes to the financial statements. This information includes a summary of the company's accounting policies, the fair value and risk of its financial instruments, any contingent liabilities and assets, any subsequent events, and any related party transactions. The company also includes comparative financial statements, all of which must be audited.
9. **Describe the SEC integrated disclosures.** A company can satisfy certain SEC 10-K disclosure requirements by including an "integrated" set of disclosures in its annual report. The company must include comparative financial statements, selected financial information for a five-year period, a management's discussion and analysis (MD&A), and common stock market prices and dividends.
10. **Explain the reporting techniques used in an annual report.** A company may use various reporting techniques in its annual report. It may use a *report form* or *account form* of balance sheet. It may combine amounts of certain elements, and may round the reported numbers. It may provide additional information in the notes to the financial statements, supporting schedules, or parenthetical notations.

Answers to Real Report Questions

Real Report 4-1 Answers

1. Below are the percentages of each type of inventory (calculated by dividing the type of inventory by total inventory for each respective year)

	2004	2003
Raw materials and supplies	26%	27%
Goods in process	30%	27%
Finished goods	44%	46%

2. The reduction of finished goods inventory, coupled with the increase in the goods in process inventory, could be interpreted as a signal that Johnson & Johnson is expecting higher future demand and sales, and is increasing production to meet this forecast.

Real Report 4-2 Answers

1. Projects in progress represent 4.5% and 3.6% of the total cost of projects as of August 3, 2003, and August 1, 2004, respectively.
2. This indicates that Campbell's capital expenditures on new projects have remained fairly steady and represent a small portion of its fixed assets.

Real Report 4-3 Answers

1. Kimberly Clark has access to a significant source of cash through revolving credit facilities ($1.2 billion) which should be considered when evaluating the company's liquidity and financial flexibility. Additionally, the company, absent any refinancing of debt, will incur cash outflows of approximately $1.2 billion within the next year relating to the settlement of debt (both current maturities of long-term debt and other current debt). Finally, information on the scheduled maturities of long-term debt for the next five years is provided.
2. Interest expense (computed by multiplying the weighted average interest rate by the average debt outstanding) was approximately $134.2 million.
3. Assuming that the weighted average interest rate for 2005 remains the same as for 2004 and the average value of the notes and debentures for 2005 is equal to the value at December 31, 2004, interest expense relating to the notes and debentures is estimated to be $133.3 million ($2,309,800,000 × 5.77%). These assumptions can be modified to take into account predicted economic activity (e.g., rising interest rates).

Real Report 4-4 Answers

1. Users of financial statements need to understand the accounting methods used in the preparation of the financial statements to facilitate intercompany as well as intracompany comparisons. Because the use of different accounting methods can result in different valuations in the financial statements, the comparability and consistency of the information presented would be compromised if such disclosures were not made.
2. If the company had used accelerated depreciation instead of straight-line depreciation, the company would have recorded more depreciation expense than currently recorded. This additional expense would have resulted in lower income. Additionally, the book value of the company's assets (property, plant, and equipment) and equity (retained earnings) would be lower.

Real Report 4-5 Answer

1. If Pinnacle Entertainment were to lose this litigation, the company would lose approval for the docking site of its casino on the St. Louis riverfront. The loss of this docking site could result in (1) a write-down of assets that make up the docking site (since the assets' future benefits are certainly in doubt); (2) the relocation of the casino to another location at considerable cost; and (3) the loss of income due to the inability to operate the casino until an approved location is found.

QUESTIONS

Q4-1 What are the major financial statements of a company and what do they show?

Q4-2 What does a company's financial position include?

Q4-3 What are two purposes of a company's balance sheet?

Q4-4 Define liquidity, financial flexibility, and operating capability.

Q4-5 What is financial capital? Why is capital maintenance important?

Q4-6 What does "recognition" mean in accounting?

Q4-7 Define an asset. What are the three characteristics of an asset?

Q4-8 Define a liability. What are the three characteristics of a liability?

Q4-9 What is stockholders' equity?

Q4-10 Identify the five alternatives for measuring (valuing) assets. What is the fair value of an asset? Which valuation method is usually used in a company's balance sheet?

Q4-11 List the major sections (and the components of each section) of a company's balance sheet.

Q4-12 How are current assets defined and what are the major items that may be included in current assets? How are current liabilities defined? Give three examples of such liabilities.

Q4-13 Define a company's operating cycle. How does working capital relate to this cycle? How is working capital computed?

Q4-14 What items are classified as (a) long-term investments, (b) property, plant, and equipment, and (c) intangible assets?

Q4-15 What items are classified as (a) long-term liabilities and (b) other liabilities?

Q4-16 What is a bond? Give an illustration of how bonds payable would be disclosed on a company's balance sheet.

Q4-17 Define (a) capital stock, (b) additional paid-in capital in excess of par, (c) treasury stock, (d) retained earnings, (e) deficit, and (f) accumulated other comprehensive income.

Q4-18 What are investments by owners? Distributions to owners? In what statement do many companies report these items?

Q4-19 What accounting policies are disclosed in the notes accompanying a company's financial statements? Why is this disclosure important?

Q4-20 Give several examples of financial instruments and identify the required *disclosures* for a company's financial instruments.

Q4-21 What is a loss contingency? What criteria have to be met for a company to accrue a loss contingency? If these criteria are not met, how does a company disclose a loss contingency?

Q4-22 Why is it necessary for a company to disclose subsequent events? What kinds of subsequent events are disclosed by an adjustment to the company's financial statements and what kinds are disclosed in a note?

Q4-23 What must a company disclose for related party transactions?

Q4-24 Why are comparative financial statements important?

Q4-25 What is an audit and why is the auditor's report an important item of information?

Q4-26 Briefly describe the SEC "integrated" disclosures that most regulated companies include in their annual reports.

Q4-27 Briefly list the format of a company's balance sheet under international accounting standards.

Q4-28 What is the difference between the report form and the account form of the balance sheet?

Q4-29 What alternative methods are used to disclose additional information not included in the accounts reported on a company's financial statements? Give examples of the types of information disclosed by each method.

Q4-30 What factors should be considered when an accountant prepares and writes financial reporting notes?

MULTIPLE CHOICE (AICPA Adapted)

Select the best answer for each of the following.

M4-1 *APB Opinion No. 22*, "Disclosure of Accounting Policies"
a. Requires a description of every accounting policy followed by a reporting entity
b. Provides a specific listing of all types of accounting policies that must be disclosed
c. Requires disclosure of the format for the statement of cash flows
d. Requires a description of all significant accounting policies to be included as an integral part of the financial statements

M4-2 Which of the following contingencies should generally be accrued on the balance sheet when the occurrence of the contingent event is reasonably possible and its amount can be reasonably estimated?

	Gain Contingency	Loss Contingency
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M4-3 A donated fixed asset (from a governmental unit) for which the fair value has been determined should be recorded as a debit to fixed assets and a credit to
a. Unrealized capital
b. Retained earnings
c. Deferred income
d. Other income

M4-4 On October 2, 2005, a company borrowed cash and signed a 3-year interest-bearing note on which both the principal and interest are payable on October 2, 2008. At December 31, 2007 the accrued interest should
a. Be reported on the balance sheet as a current liability
b. Be reported on the balance sheet as a noncurrent liability
c. Be reported on the balance sheet as part of long-term notes payable
d. Not be reported on the balance sheet as a liability

M4-5 Financial statements that are expressed assuming a stable monetary unit are
a. General-price-level financial statements
b. Historical-dollar financial statements
c. Current-value financial statements
d. Fair-value financial statements

M4-6 Rent revenue collected one month in advance should be accounted for as
a. Revenue in the month collected
b. A current liability
c. A separate item in stockholders' equity
d. An accrued liability

M4-7 Which of the following should be disclosed in the Summary of Significant Accounting Policies?
a. Rent expense amount
b. Maturity dates of long-term debt
c. Methods of amortizing intangibles
d. Composition of plant assets

M4-8 A company receives an advance payment for special-order goods to be manufactured and delivered within six months. The advance payment should be reported on the company's balance sheet as a
a. Deferred charge
b. Contra-asset account
c. Current liability
d. Noncurrent liability

M4-9 The FASB has identified five alternatives for measuring balance sheet elements. Which of the following alternatives may be used?

	Net Realizable Value	Present Value
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M4-10 The balance sheet provides information about each of the following items, except
a. Operating capability of entity
b. Results of entity's operations
c. Entity's liquidity
d. Financial flexibility of entity

EXERCISES

E4-1 ***Current Assets*** Listed here are certain accounts of the Jenkins Company at the end of 2007:

Account	Debit (Credit)
Land	$12,000
Prepaid insurance	1,530
Cash on hand	1,120
Notes receivable (due 2010)	4,300
Cash in bank	5,400
Allowance for doubtful accounts	(1,100)
Marketable securities (short-term)	3,380
Accumulated depreciation	(8,700)
Accounts receivable	15,600
Office supplies	970
Buildings	27,200
Inventory	19,700

Required
Prepare the current asset section of Jenkins' balance sheet.

E4-2 ***Plant and Equipment*** Your analysis of the fixed asset accounts at the end of 2007 for the Moen Corporation reveals the following information:

1. The company owns two tracts of land. The first, which cost $18,000, is being held as a future building site. It has a current market value of $20,000. The second, which cost $19,000, was purchased 10 years ago. On this site were built the current office and factory buildings. The land has a current market value of $56,000.
2. The company owns two buildings. The office building and the factory building were both built 10 years ago at a cost of $50,000 and $120,000, respectively. At that time each was expected to have a life of 30 years, and a residual value of 10% of original cost. They are being depreciated on a straight-line basis.
3. The company owns factory machinery with a total cost of $51,000 and accumulated depreciation of $35,300. Included in factory machinery is one machine that cost $7,000 and has accumulated depreciation of $4,200. This machine is being held for resale and is not being used in operations.
4. The company owns office equipment that cost $14,500 and has a book value of $6,300. It owns office furniture that cost $17,900 and has a book value of $11,400.

Required
Prepare the property, plant, and equipment section of Moen's 2007 ending balance sheet.

E4-3 ***Stockholders' Equity*** The following are several accounts of the Graf Corporation at the end of 2007:

Account	Credit Balance
Common stock, $10 par	$ 47,100
Bonds payable (due 2014)	126,000
Premium on preferred stock	39,600
Retained earnings	209,000
Premium on bonds payable	12,300
Unearned rent	4,800
Preferred stock, $100 par	65,400
Premium on common stock	53,900
Unfunded accrued pension cost	18,400
Treasury stock (cost)	(7,600) debit
Accumulated other comprehensive income	8,200

Required
Prepare the stockholders' equity section of Graf's 2007 ending balance sheet.

E4-4 ***Classifications on Balance Sheet*** A balance sheet may contain the following major sections:

A. Current assets
B. Long-term investments
C. Property, plant, and equipment
D. Intangible assets

E. Other assets
F. Current liabilities
G. Long-term liabilities
H. Other liabilities
I. Contributed capital
J. Retained earnings
K. Accumulated other comprehensive income

Required
The following is a list of fifteen accounts. Using the letters A through K, indicate in which section of the balance sheet each account would most likely be classified. Place a check mark (√) beside each item that is a contra account. If an account cannot be classified in any of the preceding sections, indicate with an X and explain.

_____ 1. Temporary investments in marketable securities
_____ 2. Discount on bonds payable (bonds due in 5 years)
_____ 3. Additional paid-in capital on common stock
_____ 4. Accounts receivable
_____ 5. Notes payable (due in 5 years)
_____ 6. Patents (net)
_____ 7. Unrealized decrease in value of available-for-sale securities
_____ 8. Preferred stock
_____ 9. Unearned rent (to be earned within next 6 months)
_____ 10. Accrued pension cost
_____ 11. Trademarks
_____ 12. Deficit
_____ 13. Salaries payable
_____ 14. Land
_____ 15. Investment in Ace Company preferred stock (to be held for 3 years)

E4-5 ***Classifications on Balance Sheet*** The balance sheet contains the following major sections:

A. Current assets
B. Long-term investments
C. Property, plant, and equipment
D. Intangible assets
E. Other assets
F. Current liabilities
G. Long-term liabilities
H. Other liabilities
I. Contributed capital
J. Retained earnings
K. Accumulated other comprehensive income

Required
The following is a list of several accounts. Using the letters A through K, indicate in which section of the balance sheet each of the accounts would be classified. Place a check mark (√) beside each item that is a contra account. If an account cannot be classified in any of the preceding sections, indicate with an X and explain.

_____ 1. Cash
_____ 2. Bonds payable (due in 8 years)
_____ 3. Machinery
_____ 4. Deficit
_____ 5. Unexpired insurance
_____ 6. Franchise (net)
_____ 7. Fund to retire preferred stock
_____ 8. Current portion of mortgage payable
_____ 9. Accumulated depreciation
_____ 10. Copyrights
_____ 11. Investment in held-to-maturity bonds
_____ 12. Allowance for doubtful accounts
_____ 13. Notes receivable (due in 3 years)
_____ 14. Property taxes payable
_____ 15. Deferred taxes payable
_____ 16. Premium on preferred stock
_____ 17. Premium on bonds payable (due in 8 years)
_____ 18. Work in process
_____ 19. Common stock, $1 par
_____ 20. Land
_____ 21. Treasury stock (at cost)
_____ 22. Unrealized increase in value of available-for-sale securities

E4-6 ***Balance Sheet*** The balance sheet accounts and amounts of the Baggett Company as of December 31, 2007 are shown in random order as follows:

Account	Debit (Credit)	Account	Debit (Credit)
Income taxes payable	$ (3,800)	Premium on preferred stock	$ (7,900)
Prepaid items	1,800	Allowance for doubtful accounts	(1,600)
Premium on common stock	(9,300)	Bonds payable (due 2017)	(23,000)
Land	12,200	Buildings	57,400
Notes payable (due 2010)	(6,000)	Sinking fund to retire bonds payable	5,000
Notes receivable (due 2009)	16,400	Advances from customers (long-term)	(2,600)
Accounts receivable	12,600	Cash	4,300
Premium on bonds payable	(1,400)	Accumulated depreciation: equipment	(9,700)

Account	Debit (Credit)	Account	Debit (Credit)
Accounts payable	(13,100)	Retained earnings	(18,300)
Inventory	7,400	Preferred stock, $100 par	(18,600)
Accumulated depreciation: buildings	(21,000)	Wages payable	(1,400)
Patents (net)	4,600	Common stock, $10 par	(12,700)
Equipment	28,700		

Required

1. Prepare a December 31, 2007 balance sheet for the Baggett Company.
2. Compute the debt ratio.

E4-7 ***Balance Sheet*** The December 31, 2007 balance sheet accounts of the Hitt Company are shown here in alphabetical order:

Accounts payable	$ 22,400	Current taxes payable	$ 10,400
Accounts receivable	21,500	Discount on bonds payable	6,900
Accumulated depreciation: buildings	53,000	Equipment	72,400
Accumulated depreciation: equipment	35,100	Inventory	37,200
Additional paid-in capital on common stock	24,000	Land	30,000
		Marketable securities (short-term)	6,100
Additional paid-in capital on preferred stock	11,500	Patents (net)	9,800
		Preferred stock, $100 par	21,000
Allowance for doubtful accounts	800	Retained earnings	46,200
Bonds payable (due 2021)	77,000	Salaries payable	2,000
Buildings	144,000	Trademarks	3,700
Cash	2,900	Unrealized increase in value of marketable securities	1,100
Common stock, $10 par	30,000		

Required

1. Prepare the December 31, 2007 balance sheet of the Hitt Company.
2. Compute the working capital and the current ratio.

E4-8 ***Balance Sheet Calculations*** The balance sheet information at the end of 2007 and 2008 for the Dawson Company is as follows:

	2007	2008
Current assets	$ (a)	$25,000
Long-term liabilities	(b)	34,900
Total contributed capital	(c)	(g)
Long-term investments	19,200	(h)
Retained earnings	50,000	60,000
Total liabilities	(d)	(i)
Intangible assets	10,400	9,200
Current liabilities	14,500	12,300
Capital stock, $5 par	(e)	20,000
Total assets	142,200	(j)
Additional paid-in capital	15,000	(k)
Property, plant, and equipment (net)	85,700	92,800
Accumulated other comprehensive income	6,900	7,000
Total stockholders' equity	(f)	(l)

Additional information: The company did not issue any common stock during 2008.

Required

Fill in the blanks labeled (a) through (l). All the necessary information is provided. (*Hint*: It is not necessary to calculate your answers in alphabetical order.)

E4-9 ***Balance Sheet Calculations*** The balance sheet information of the Fermer Company at the end of 2007 and 2008 is as follows:

	2007	2008
Total stockholders' equity	$ (1)	$100,700
Accumulated other comprehensive income	4,800	5,000
Current liabilities	(2)	9,800
Intangible assets	12,600	12,000
Property, plant, and equipment (net)	(3)	87,500
Current assets	19,100	(8)
Total contributed capital	51,000	(9)
Long-term liabilities	(4)	30,200
Retained earnings	40,900	(10)
Total assets	(5)	(11)
Common stock, $10 par	(6)	(12)
Working capital	9,900	10,200
Additional paid-in capital	(7)	36,000
Long-term investments	23,700	(13)
Total liabilities	38,100	(14)

Additional information: At the end of 2007, additional paid-in capital is twice the amount of capital stock. In 2008, the company issued (sold) 100 shares of common stock.

Required
Fill in the blanks numbered (1) through (14). All the necessary information is provided. (*Hint*: It is not necessary to calculate your answers in numerical order.)

E4-10 ***Correction of Balance Sheet*** On December 31, 2007, the Stevens Company bookkeeper prepared the following erroneously classified balance sheet:

STEVENS COMPANY
Balance Sheet
For Year Ended December 31, 2007

Current Assets		Current Liabilities	
Inventory	$ 6,000	Accounts payable	$ 9,900
Accounts receivable	5,900	Allowance for doubtful accounts	800
Cash	2,300	Salaries payable	1,500
Treasury stock (at cost)	3,300	Taxes payable	2,500
Long-Term Investments		Long-Term Liabilities	
Temporary investments in marketable securities	3,200	Bonds payable (due 2014)	11,000
		Unearned rent (for 3 months)	900
Investment in held-to-maturity bonds	10,000		
Plant and Equipment			
Land	8,100		
Office supplies	800	Owners' Equity	
Buildings and equipment	35,600	Retained earnings	24,200
Intangibles		Accumulated depreciation on buildings and equipment	9,200
Patents (net)	5,000		
Prepaid insurance (for 6 months)	1,200	Premium on common stock	10,400
Discount on bonds payable	1,000	Common stock, $10 par	12,000
Total Assets	$82,400	Total Credits	$82,400

Required
You determine that the account balances listed on the balance sheet are correct but, in certain cases, incorrectly classified. Prepare a properly classified balance sheet for the Stevens Company as of December 31, 2007.

E4-11 ***Changes in Stockholders' Equity*** On January 1, 2007 the Powder Company listed the following stockholders' equity section of its balance sheet:

Contributed Capital	
Preferred stock, $100 par	$ 92,800
Common stock, $5 par	37,400
Additional paid-in capital on preferred stock	21,500
Additional paid-in capital on common stock	58,700
Total contributed capital	$210,400
Retained Earnings	185,700
Total Stockholders' Equity	$396,100

During 2007, the following transactions and events occurred and were properly recorded:

1. The company issued 1,800 shares of common stock at $13 per share.
2. The company issued 340 shares of preferred stock at $130 per share.
3. The company earned net income of $38,950.
4. The company paid a $7 per share dividend on the preferred stock and a $1 per share dividend on the common stock outstanding at the end of 2007.

Required

Prepare a statement of changes in stockholders' equity of the Powder Company for 2007. (Include retained earnings.)

E4-12 ***Changes in Stockholders' Equity*** On January 1, 2007 the Osborne Company reported the following alphabetical list of stockholders' equity items:

Additional paid-in capital on common stock	$170,000
Additional paid-in capital on preferred stock	12,000
Common stock, $2 par	80,000
Preferred stock, $100 par	60,000
Retained earnings	209,000

During 2007, the company sold 3,000 shares of common stock for $10 per share and 500 shares of preferred stock for $125 per share. It also earned income of $99,000 and paid dividends of $8 per share on the preferred stock and $1.50 per share on the common stock outstanding at the end of 2007.

Required

Prepare a statement of changes in stockholders' equity of the Osborne Company for 2007. (Include retained earnings.)

PROBLEMS

P4-1 ***Classifications on Balance Sheet*** The current balance sheet of Day Company contains the following major sections:

A. Current assets
B. Long-term investments
C. Property, plant, and equipment
D. Intangible assets
E. Other assets
F. Current liabilities
G. Long-term liabilities
H. Other liabilities
I. Contributed capital
J. Retained earnings
K. Accumulated other comprehensive income

The following is a list of 37 accounts. Using the letters A through K, indicate in which section each account would most likely be classified. Place a check mark (√) beside each item that is a contra account. If an account cannot be classified in any of the preceding sections, indicate with an X and explain.

_____ 1. Patents (net)
_____ 2. Income taxes payable
_____ 3. Notes receivable (due in 5 months)
_____ 4. Unearned rent
_____ 5. Discount on bonds payable (long-term bonds)
_____ 6. Data processing center
_____ 7. Furniture
_____ 8. Land held for future expansion
_____ 9. Timberland (net)
_____ 10. Treasury stock, at cost
_____ 11. Advances to sales personnel
_____ 12. Idle machinery

_____ 13. Deferred taxes payable
_____ 14. Raw materials
_____ 15. Investment in held-to-maturity bonds
_____ 16. Pollution control facilities
_____ 17. Cash from security deposits of customers on returnable containers
_____ 18. Donated capital for industrial park building site from Toma City
_____ 19. Trademarks
_____ 20. Finished goods
_____ 21. Cash dividends payable
_____ 22. Bond sinking fund
_____ 23. Temporary investments
_____ 24. Retained earnings
_____ 25. Advances to affiliated company (long-term)
_____ 26. Cash surrender value of life insurance
_____ 27. Leased equipment under capital lease
_____ 28. Additional paid-in capital on preferred stock
_____ 29. Interest receivable (due in 5 months)
_____ 30. Office supplies
_____ 31. Accrued pension cost
_____ 32. Capital lease obligation
_____ 33. Investment in 8-year certificates of deposit
_____ 34. Unearned ticket sales
_____ 35. Estimated warranty (6-months) obligations
_____ 36. Unrealized decrease in value of available-for-sale securities
_____ 37. Cash

P4-2 ***Balance Sheet without Amounts*** The following is an alphabetical list of the accounts of the Oliver Manufacturing Company as of December 31, 2007:

Accounts payable
Accounts receivable
Accrued pension cost
Accumulated depreciation: buildings
Accumulated depreciation: equipment
Accumulated depreciation: machinery
Additional paid-in capital on common stock
Additional paid-in capital on preferred stock
Administrative expenses
Allowance for doubtful accounts
Bond sinking fund
Bonds payable (due 2019)
Buildings
Cash in bank
Cash on hand
Cash surrender value of life insurance
Common stock
Cost of goods sold
Deferred taxes payable
Dividends payable
Equipment
Estimated warranty (1-year) obligations
Finished goods
General expenses
Income tax expense
Income taxes payable
Interest expense
Interest payable
Interest receivable
Interest revenue
Investment in available-for-sale securities
Land
Land for future plant site
Loss on sale of equipment
Machinery
Mortgage payable (20 equal annual payments)
Notes payable (short-term)
Notes receivable (short-term)
Office supplies
Patents (net)
Preferred stock
Premium on bonds payable
Prepaid insurance
Raw materials
Retained earnings
Salaries payable
Sales
Sales discounts taken
Sales returns
Selling expenses
Temporary investments in marketable securities Trademarks
Treasury stock, at cost
Unearned rent
Unrealized increase in value of available-for-sale securitie
Work in process

Required
Prepare a balance sheet (without amounts) in proper format for the Oliver Manufacturing Company.

P4-3 ***Balance Sheet*** The following is an alphabetical list of the December 31, 2007 balance sheet accounts and amounts for the Green Manufacturing Company:

Accounts payable	$20,900	Accumulated depreciation: machinery and equipment	30,000
Accounts receivable	15,300	Allowance for doubtful accounts	1,000
Accrued pension cost	13,300	Bond sinking fund	7,700
Accumulated depreciation: buildings	32,400		

Bonds payable (due 2021)	29,000	Marketable securities (short-term)	8,400
Buildings	92,500	Notes payable (short-term)	5,000
Cash	7,200	Patents (net)	8,600
Common stock, $10 par	44,100	Preferred stock, $100 par	30,000
Deferred taxes payable	2,800	Premium on common stock	16,300
Discount on bonds payable	2,500	Premium on preferred stock	7,000
Dividends payable	5,600	Prepaid insurance	2,600
Finished goods	23,800	Raw materials	10,100
Income taxes payable	8,900	Retained earnings	28,100
Interest payable	500	Unearned rent	5,000
Investment in available-for-sale stock	16,400	Unrealized increase in value of available-for-sale stock	2,000
Land	17,000	Wages payable	2,700
Machinery and equipment	57,800	Work in process	14,700

Required

Prepare a properly classified balance sheet for the Green Manufacturing Company on December 31, 2007. List the additional parenthetical or note disclosures (if any) that should be made for each item. Compute the working capital and the current ratio.

P4-4 ***Balance Sheet*** The following is a list (in random order) of the December 31, 2007 balance sheet accounts of the Midwest Company:

Additional paid-in capital on preferred stock	$ 1,600	Accounts payable	$16,500
Accounts receivable	13,800	Prepaid insurance	900
Dividends payable	1,800	Discount on bonds payable	2,000
Buildings	50,000	Common stock, $10 par	15,000
Bonds payable (due 2013)	29,000	Equipment	29,000
Retained earnings	25,800	Allowance for doubtful accounts	700
Office supplies	1,900	Preferred stock, $50 par	10,000
Current income taxes payable	4,200	Accumulated depreciation: buildings	12,400
Accumulated depreciation: equipment	8,300	Current interest payable	2,900
Patents (net)	2,400	Investment in held-to-maturity bonds	9,000
Notes payable (due January 1, 2010)	17,000	Cash	8,200
Inventory	24,400	Treasury stock (at cost)	1,500
Additional paid-in capital on common stock	7,700	Accrued wages	3,700
Sinking fund for bond retirement	4,000	Land	9,500

Required

Prepare a properly classified balance sheet for the Midwest Company on December 31, 2007.

P4-5 ***Balance Sheet from Adjusted Trial Balance*** The following is the alphabetical adjusted trial balance of the Meadows Company on December 31, 2007:

	Debits	Credits
Accounts payable		$ 9,800
Accounts receivable	$ 18,000	
Accrued payables		6,500
Accumulated depreciation		44,000
Additional paid-in capital		50,600
Cash	7,900	
Common stock, $5 par		29,600
Cost of goods sold	175,500	
Current portion of long-term debt		6,200
Deferred taxes payable		12,500
Dividends distributed	7,000	
General expenses	27,560	
Income tax expense	12,340	

	Debits	Credits
Income taxes payable		7,500
Interest expense	4,300	
Inventories	32,000	
Investment in held-to-maturity bonds	36,000	
Long-term debt		56,300
Long-term receivables	38,600	
Marketable securities (short-term)	10,100	
Patents (net)	13,000	
Prepaid insurance	5,000	
Property, plant, and equipment	148,000	
Retained earnings, 1/1/07		64,800
Sales		278,000
Sales returns	8,000	
Selling expenses	21,500	
Unrealized decrease in value of available-for-sale securities	1,000	
	$565,800	$565,800

Required
Prepare the December 31, 2007 balance sheet of the Meadows Company. Compute the debt ratio.

P4-6 ***Balance Sheet and Notes*** Listed here in random order are the balance sheet accounts and related ending balances of the Eubanks Company as of December 31, 2007:

Income taxes payable	$ 24,700	Temporary investments	$19,100
Cash surrender value of life insurance	8,900	Bonds payable	80,000
Preferred stock	40,000	Additional paid-in capital on common stock	30,300
Premium on bonds payable	4,800	Inventories	98,500
Cash	11,600	Accounts receivable	32,300
Property, plant, and equipment (net)	229,300	Patents (net)	18,200
Accounts payable	58,000	Investment in bonds	25,000
Common stock	62,800	Additional paid-in capital on preferred stock	23,400
Retained earnings	123,400	Miscellaneous current payables	6,200
Land held for building site	19,500	Estimated liability for product warranties	7,300
Allowance for doubtful accounts	1,500		

Additional information:

1. The company uses control accounts for inventories and property, plant, and equipment and lists the latter at its book value.
2. The straight-line method is used to depreciate buildings, machinery, and equipment, based upon their cost and estimated residual values and lives. A breakdown of property, plant, and equipment shows the following: land at a cost of $32,000, buildings at a cost of $182,400 and a book value of $120,200, machinery at a cost of $63,900 and related accumulated depreciation of $18,600, and equipment (40% depreciated) at a cost of $53,000.
3. Patents are amortized on a straight-line basis directly to the patent account.
4. Inventories are listed at the lower of cost or market value using an average cost. The inventories include raw materials $22,200, work in process $34,700, and finished goods $41,600.
5. Common stock has a $10 par value per share, 12,000 shares are authorized, 6,280 shares have been issued.
6. Preferred stock has a $100 par value per share, 1,000 shares are authorized, 400 shares have been issued.
7. The investment in bonds is carried at the original cost, which is the face value, and is being held to maturity.
8. Temporary investments in marketable securities were purchased at year-end.
9. The bonds payable mature on December 31, 2012.
10. The company attaches a one-year warranty on all the products it sells.

Required

1. Prepare the December 31, 2007 balance sheet of the Eubanks Company (including appropriate parenthetical notations).
2. Prepare notes to accompany the balance sheet that itemize company accounting policies, inventories, and property, plant, and equipment.
3. Compute the current ratio. Which current assets would you classify as *liquid* and which as *separable* according to the FASB's conceptual guidelines? Why might these classifications be useful?

P4-7 ***Comprehensive: Balance Sheet, Schedules, and Notes*** The following is an alphabetical listing of the balance sheet accounts and account balances of the Blazer Company on December 31, 2007:

Accounts payable	$ 44,200	Income taxes payable	$ 19,700
Accounts receivable	37,100	Inventory	85,300
Accumulated depreciation	109,300	Investment in affiliate	30,000
Additional paid-in capital on common stock	20,000	Long-term liabilities (book value)	91,000
Additional paid-in capital on preferred stock	3,200	Miscellaneous current payables	6,800
Allowance for doubtful accounts	1,600	Notes receivable	17,000
Bond sinking fund	12,500	Preferred stock	32,000
Cash	13,800	Property and equipment	296,700
Common stock	80,000	Retained earnings	84,600

Additional information:

1. The company uses a control account for property and equipment, accumulated depreciation, and for long-term liabilities. The latter account is listed at its book value.
2. The straight-line method is used to depreciate property and equipment based upon cost, estimated residual value, and estimated life. The costs of the assets in this account are: land $29,500, buildings $164,600, store fixtures $72,600, and office equipment $30,000.
3. The accumulated depreciation breakdown is as follows: buildings $54,600, store fixtures $37,400, and office equipment $17,300.
4. The long-term debt includes 12%, $36,000 face value bonds that mature on December 31, 2012 and have an unamortized bond discount of $1,000; 11%, $48,000 face value bonds that mature on December 31, 2016, have a premium on bonds payable of $1,800, and whose retirement is being funded by a bond sinking fund; and a 13% note payable that has a face value of $6,200 and matures on January 1, 2010.
5. The noninterest-bearing note receivable matures on June 1, 2008.
6. Inventory is listed at lower of cost or market; cost is determined on the basis of average cost.
7. The investment in affiliate is carried at cost. The company has guaranteed the interest on 12%, $50,000, 15-year bonds issued by this affiliate, the Jay Company.
8. Common stock has a $10 par value per share, 10,000 shares are authorized, and 1,000 shares were issued during 2007 at a price of $13 per share, resulting in 8,000 shares issued at year-end.
9. Preferred stock has a $50 par value per share, 2,000 shares are authorized, and 140 shares were issued during 2007 at a price of $55 per share, resulting in 640 shares issued at year-end.
10. On January 15, 2008, before the December 31, 2007 balance sheet was issued, a building with a cost of $20,000 and a book value of $7,000 was totally destroyed. Insurance proceeds will amount to only $5,000.
11. Net income and dividends paid during the year were $50,500 and $21,000, respectively.

Required

1. Prepare the December 31, 2007 balance sheet (including appropriate parenthetical notations) of the Blazer Company.
2. Prepare a statement of changes in stockholders' equity for 2007. (*Hint*: Work back from the *ending* account balances.)
3. Prepare notes that itemize the balance sheet control accounts and those necessary to disclose any company accounting policies, contingent liabilities, and subsequent events.
4. Compute the debt ratio at the end of 2007. What is your evaluation of this ratio if it was 39% at the end of 2006?

P4-8 ***Corrections to Balance Sheet*** The Cable Company prepared the following balance sheet:

CABLE COMPANY
Balance Sheet For Year Ended December 31, 2007

Working capital	$ 22,800	Noncurrent liabilities	$ 62,000
Other assets	152,000	Stockholders' equity	112,800
Total	$174,800	Total	$174,800

Your analysis of these accounts reveals the following information:

1. Working capital consists of:

Land	$ 12,000
Accounts due from customers	18,000
Accounts due to suppliers	(22,700)
Inventories, including office supplies of $3,500	35,500
Income taxes owed	(16,400)
Wages owed	(3,600)
Note owed to bank (due December 31, 2009)	(17,000)
Securities held as a temporary investment	17,000
	$ 22,800

2. Other assets include:

Cash	$ 12,300
Prepaid insurance	2,400
Buildings and equipment	100,000
Discount on bonds payable	3,000
Investment in available-for-sale stock	29,000
Treasury stock (at cost)	5,300
	$152,000

3. Noncurrent liabilities consist of:

Bonds payable (due 2017)	$ 33,000
Allowance for doubtful accounts	1,400
Premium on preferred stock	2,600
Common stock, $5 par	25,000
	$ 62,000

4. Stockholders' equity includes:

Accumulated depreciation: buildings and equipment	$ 40,000
Preferred stock, $100 par	12,000
Premium on common stock	15,600
Retained earnings	40,000
Accrued pension cost	6,500
Unrealized decrease in value of available-for-sale securities	(1,300)
	$112,800

Required

Based on your analysis, prepare a properly classified December 31, 2007 balance sheet for the Cable Company.

P4-9 ***Corrections to Balance Sheet*** The Brandt Company presents the following December 31, 2007 balance sheet:

BRANDT COMPANY
Sheet of Balances
For Year Ended December 31, 2007

Current assets	$ 44,300	Current liabilities	$ 66,600
Long-term investments	13,600	Long-term liabilities	24,100
Property and equipment	123,500	Contributed capital	17,000
Intangible assets	7,700	Unrealized capital	22,500
Other assets	13,600	Retained earnings	72,500
Total assets	$202,700	Total equities	$202,700

The following information is also available:

1. Current assets include cash $3,800, accounts receivable $18,500, notes receivable (maturity date July 1, 2009) $10,000, and land $12,000.
2. Long-term investments include a $4,600 investment in available-for-sale securities that is expected to be sold in 2008 and a $9,000 investment in Dray Company bonds that are expected to be held until their December 31, 2016 maturity date.
3. Property and equipment include buildings costing $63,400, inventory costing $30,500, and equipment costing $29,600.
4. Intangible assets include patents that cost $8,200 and on which $2,300 amortization has accumulated, and treasury stock that cost $1,800.
5. Other assets include prepaid insurance (which expires on November 30, 2008) $2,900, sinking fund for bond retirement $7,000, and trademarks that cost $3,700 and are not impaired.
6. Current liabilities include accounts payable $19,400, bonds payable (maturity date December 31, 2018) $40,000, and accrued income taxes payable $7,200.
7. Long-term liabilities include accrued wages $4,100 and mortgage payable (which is due in five equal annual payments starting December 31, 2008) $20,000.
8. Contributed capital includes common stock ($5 par) $11,000 and preferred stock ($100 par) $6,000.
9. Unrealized capital includes premium on bonds payable $4,300, premium on preferred stock $2,400, premium on common stock $14,700, and unrealized increase in value of securities available for sale $1,100.
10. Retained earnings includes unrestricted retained earnings, $37,800, allowance for doubtful accounts $700, and accumulated depreciation on buildings and equipment of $21,000 and $13,000, respectively.

Required

Based on the preceding information, prepare a properly classified December 31, 2007 balance sheet for the Brandt Company.

P4-10 ***Balance Sheet Calculations*** The balance sheet information of the John Company at the end of 2007 and 2008 is as follows:

	2007	2008
Long-term liabilities	$ (a)	$ 33,100
Accumulated other comprehensive income	8,000	8,900
Working capital	17,900	19,800
Intangible assets	19,100	18,600

	2007	2008
Common stock, $10 par	(b)	(i)
Total stockholders' equity	(c)	$179,000
Accumulated depreciation	$(37,500)	(48,600)
Total liabilities	51,900	(j)
Current assets	(d)	39,800
Retained earnings	83,300	(k)
Total contributed capital	66,700	(l)
Total assets	(e)	(m)
Additional paid-in capital	(f)	(n)
Long-term investments	40,100	(o)
Current liabilities	(g)	(p)
Property, plant, and equipment	(h)	180,000

Additional information: At the end of 2007, (a) the amount of long-term liabilities is twice the amount of current liabilities, and (b) there are 2,900 shares of common stock outstanding. During 2008, the company (a) issued 100 shares of common stock for $25 per share, (b) earned net income of $20,600, and (c) paid dividends of $1 per share on the common stock outstanding at year-end.

Required
Fill in the blanks lettered (a) through (p). All of the necessary information is provided. (*Hint*: It is not necessary to calculate your answers in alphabetical order.)

P4-11 ***Erroneous Balance Sheet*** The Cutler Corporation prepared the following balance sheet:

CUTLER CORPORATION
Balance Report For Year Ended December 31, 2007

Current Assets			Current Liabilities		
Cash		$ 6,300	Accounts payable		$13,000
Accounts receivable		15,900	Accumulated depreciation: buildings		17,100
Inventory, at higher of cost or market			Wages payable		3,000
(cost $27,200)		28,000	Additional paid-in capital		
Long-Term Investments			on common stock		23,200
Treasury stock (at cost)		1,400	Long-Term Liabilities		
Investment in D Company bonds			Bonds payable	$46,000	
(at book value)		7,300	Less: Sinking fund to retire		
Marketable securities,			bonds	(6,000)	40,000
short-term at market value		10,000	Preferred stock, $50 par		15,000
Property, Plant, and Equipment			Premium on preferred stock		5,100
Land		11,300	Accumulated depreciation: equipment		7,000
Patents	$8,000		Current taxes payable		9,600
Less: Accumulated amortization	(2,800)	5,200	Owners' Equity:		
Buildings		40,800	Common stock, $2 par		8,000
Equipment		19,000	Unrealized gain on write-up		
Intangibles			of marketable securities		
Trademarks		5,700	to market value		1,300
Other Assets			Unrealized gain on write-up		
Cash surrender value of life insurance		5,000	of inventory to market value		800
Discount on bonds payable		3,900	Retained earnings		16,000
Total Assets		$159,800	Allowance for doubtful accounts		700
			Total Equities		$159,800

Required
1. Identify the errors made in the Cutler balance sheet.
2. Prepare a corrected, properly classified balance sheet.

P4-12 **AICPA Adapted** ***Complex Balance Sheet*** Presented below is the unaudited balance sheet as of December 31, 2007, prepared by the bookkeeper of Zues Manufacturing Corporation.

ZUES MANUFACTURING CORPORATION
Balance Sheet For the Year Ended December 31, 2007

Assets		Liabilities & Stockholders' Equity	
Cash	$ 225,000	Accounts payable	$ 133,800
Accounts receivable (net)	345,700	Mortgage payable	900,000
Inventories	560,000	Notes payable	500,000
Prepaid income taxes	40,000	Lawsuit liability	80,000
Investments	57,700	Income taxes payable	61,200
Land	450,000	Deferred tax liability	28,000
Building	1,750,000	Accumulated depreciation	420,000
Machinery and equipment	1,964,000	Total Liabilities	$2,123,000
Goodwill	37,000	Common stock, $50 par; 40,000	
Total Assets	$5,429,400	shares issued	2,231,000
		Retained earnings	1,075,400
		Total Stockholders' Equity	$3,306,400
		Total Liabilities and	
		Stockholders' Equity	$5,429,400

Your firm has been engaged to perform an audit, during which the following data are found:

1. Checks totaling $14,000 in payment of accounts payable were mailed on December 31, 2007 but were not recorded until 2008. Late in December 2007, the bank returned a customer's $2,000 check, marked "NSF," but no entry was made. Cash includes $100,000 restricted for building purposes.
2. Included in accounts receivable is a $30,000 note due on December 31, 2010 from Zues' president.
3. During 2007, Zues purchased 500 shares of common stock of a major corporation that supplies Zues with raw materials. Total cost of this stock was $51,300, and market value on December 31, 2007 was $47,000. The decline in market value is considered temporary. Zues plans to hold these shares indefinitely.
4. Treasury stock was recorded at cost when Zues purchased 200 of its own shares for $32 per share in May 2007. This amount is included in investments.
5. On December 31, 2007, Zues borrowed $500,000 from a bank in exchange for a 10% note payable, maturing December 31, 2012. Equal principal payments are due December 31 of each year, beginning in 2008. This note is collateralized by a $250,000 tract of land acquired as a potential future building site, which is included in land.
6. The mortgage payable requires $50,000 principal payments, plus interest, at the end of each month. Payments were made on January 31 and February 28, 2008. The balance of this mortgage was due June 30, 2008. On March 1, 2008, prior to issuance of the audited financial statements, Zues consummated a noncancelable agreement with the lender to refinance this mortgage. The new terms require $100,000 annual principal payments, plus interest, on February 28 of each year, beginning in 2009. The final payment is due February 28, 2016.
7. The lawsuit liability will be paid in 2008.
8. Of the total deferred tax liability, $5,000 is considered a current liability.
9. The current income tax expense reported in Zues' 2007 income statement was $61,200.
10. The company was authorized to issue 100,000 shares of $50 par value common stock.

Required

Prepare a corrected classified balance sheet as of December 31, 2007. This financial statement should include a proper heading, format, and necessary descriptions.

P4-13 ***Changes in Stockholders' Equity*** On January 1, 2007 the Knox Company showed the following alphabetical list of stockholders' equity balances:

Additional paid-in capital on common stock	$130,000
Additional paid-in capital on preferred stock	6,000
Common stock, $10 par	100,000
Preferred stock, $100 par	50,000
Retained earnings	224,000

During 2007, the following events occurred and were properly recorded by the company:

1. The company purchased an investment in available-for-sale securities. At year-end the market value of the securities had increased by $9,000.
2. The company issued 2,000 shares of common stock for $25 per share.

3. The company issued 110 shares of preferred stock for $116 per share.
4. The company reaccquired 400 shares of its common stock as treasury stock at a cost of $26 per share. (*Hint*: Record the reacquisition cost in a Treasury Stock account.)
5. The company earned net income of $57,000.
6. The company paid a $7 per share dividend on the preferred stock and a $1.25 per share dividend on the common stock outstanding at the end of 2007 (treasury stock is not entitled to dividends).

Required
Prepare a statement of changes in stockholders' equity for 2007. (Include retained earnings.)

P4-14 ***Analyzing Coca-Cola's Balance Sheet Disclosures*** Review the financial statements and related notes of the Coca-Cola Company in Appendix A.

Required
Answer the following questions. (*Note*: You do not need to make any calculations. All answers may be found in the financial report.) Indicate on what page of the annual report you located the answer.

1. What was the amount of the current assets on December 31, 2004?
2. What was the amount in the allowance for doubtful accounts on December 31, 2004?
3. What is the par value of the company's common stock? How many shares had been issued at the end of 2004?
4. What was the total amount of inventories on December 31, 2004? What were the principal categories of inventory on this date?
5. What was the long-term debt on December 31, 2004? Of this total, how much was for the $5\frac{3}{4}$%, U.S. dollar notes due 2011?
6. What was the allowance for depreciation on December 31, 2004? What method does the company use to depreciate its property, plant, and equipment?
7. What was the amount of accounts payable and accrued expenses on December 31, 2004? How much was for accrued marketing expenses?
8. What inventory costing method was used for most inventories in 2004?
9. What was the reinvested (retained) earnings on December 31, 2004?
10. What was the total property, plant, and equipment before and after allowance for depreciation on December 31, 2004?
11. What were the total assets on December 31, 2004?
12. What were the current liabilities on December 31, 2004?
13. What were the number of shares and cost of the treasury stock held by the company on December 31, 2004?
14. What was the amount of marketable securities on December 31, 2004? What was the unrealized gain (loss) on available for sale securities on December 31, 2004?
15. How much was the company contingently liable for guarantees of indebtedness owed by third parties on December 31, 2004?

CASES

COMMUNICATION

C4-1 Alternative Valuation Methods

A friend of yours who had a bookkeeping course in high school and who is currently a business major says, "I thought that assets were always reported at their historical cost on a company's balance sheet. Recently, however, I heard several accounting majors discussing 'alternative valuation methods' for measuring the value of assets. I know that historical cost is the exchange price paid for an asset, so I cannot understand how there can be any other 'value' for the asset."

Required
Write a short memo that identifies and briefly explains the valuation methods (other than historical cost) that a company could use to measure the value of an asset. For each valuation method, include in your discussion examples of assets whose values are often reported based on the use of that method.

C4-2 Contingencies and Subsequent Events

The bookkeeper of a company you are auditing states, "Our balance sheet is dated December 31, the end of our accounting period. I don't understand loss contingencies and subsequent events. Also, I see no reason for disclosing these items on the company's balance sheet because they deal with events that might occur or have occurred *after* the balance sheet date."

Required
Write a short report to the bookkeeper that explains loss contingencies and subsequent events, as well as the importance of their disclosure on the company's balance sheet.

C4-3 Securities and Exchange Commission Disclosures

CMA Adapted The Securities and Exchange Commission (SEC) has encouraged managements of public companies to disclose more information in the shareholders' annual report. As a consequence, a significant amount of the information required in the SEC's Form 10-K now appears in published annual reports.

At the same time, the SEC has made the annual financial reporting process simpler and more efficient by approving an integrated disclosure system.

Required

1. Identify the major classes of information that must be included in both the annual report to shareholders and Form 10-K filed with the SEC.
2. The integrated disclosure system is intended to simplify the annual reporting process with the SEC by expanding the ability to incorporate by reference.
   a. Define what is meant by *incorporating by reference* and identify the documents that are involved when incorporating by reference.
   b. Explain how the integrated disclosure system reduces managements' efforts in filing annual reports with the SEC.
   c. Explain the SEC's principal reasons for making the changes in the annual reporting process.
   d. Identify and explain potential problems the integrated disclosure system could have on the annual reporting process from the aspect of users of financial information.

C4-4 Asset Valuation

It is the end of 2007 and you are an accountant for the Stone Company. During 2007, sales of the company's products slumped and the company's earnings are expected to be much less than those of 2006. The president comes to you with an idea. He says, "Our company's property, plant, and equipment cost $300,000, and that is the amount we usually report on our balance sheet. However, I just had these assets appraised by an independent appraiser, and she says they are worth $400,000. I think that the company should report the property, plant, and equipment at this amount on its December 31, 2007 balance sheet, and should report the $100,000 increase in value as a gain on the 2007 income statement. If we use this approach, it will show how much our company is really worth and increase our earnings. This will make our stockholders happy. What do you think?"

Required

Prepare a written response to the president.

CREATIVE AND CRITICAL THINKING

C4-5 Valuation of Assets and Stock

A friend has come to you for advice. He states that he owns several shares of stock in a corporation. He has examined the most recent balance sheet of the corporation and has found that the common stock issued and outstanding totals 40,000 shares, and the market price per share is $25 on the balance sheet date. He is sure that the balance sheet must be in error because, in his words, "the total assets are $1,100,000 and this current value should be the same as the $1,000,000 total value of the outstanding common stock."

Required

Explain to your friend how the "values" of the various assets of the corporation typically are measured and reported on its balance sheet, and how the "value" of the $1,100,000 total assets is determined. Continue the discussion by explaining to your friend why the "values" of the assets and the stock are not the same.

C4-6 Valuation of Assets

AICPA Adapted Valuation of assets is an important topic in accounting theory. Suggested valuation methods include the following:

Historical cost (past purchase price)
Historical cost adjusted to reflect general price-level changes
Discounted cash flow (future exchange price)
Market price (current selling price)
Replacement cost (current purchase price)

Required

1. Why is the valuation of assets a significant issue?
2. Explain the basic theory underlying each of the valuation methods cited, including the effect on earnings. Do not discuss advantages and disadvantages of each method.

C4-7 Analyzing Coca-Cola's Accounting Policies

A company must include a summary of its accounting policies in the notes to its financial statements. The Coca-Cola Company includes this summary as the first of its notes to the consolidated financial statements shown in Appendix A.

Required

1. Explain what is required to be disclosed about the accounting policies of a company.
2. Review the Coca-Cola Company's note on its accounting policies and answer the following questions:
   a. When does the company recognize revenue?
   b. What items are classified as cash equivalents?
   c. How are inventories valued, and generally what inventory costing method(s) is used?
   d. How are property, plant, and equipment stated, and what depreciation method is used?
   e. How are trademarks and other intangible assets amortized?
   f. How does the company account for production costs of print, radio, television, and other advertisements?

What was the amount of advertising and production costs included in prepaid expenses and other assets and noncurrent other assets as of December 31, 2004?

C4-8 Ethics and Accounts Receivable Adjustment

It is February 16, 2008 and you are auditing the Davenport Corporation's financial statements for 2007 (which will be issued in March, 2008). You read in the newspaper that Travis Corporation, a major customer of Davenport, is in financial difficulty. Included in Davenport's accounts receivable is $50,000 (a material amount) owed to it by Travis. You approach Jim Davenport, president, with this information and suggest that a reduction of accounts receivable and recognition of a loss for 2007 might be appropriate. Jim replies, "Why should we make an adjustment? Ted Travis, the president of Travis Corporation, is a friend of mine; he will find a way to pay us, one way or another. Furthermore, this occurred in 2008, so let's wait and see what happens; we can always make an adjustment later this year. Our 2007 income and year-end working capital are not that high; our creditors and stockholders wouldn't stand for lower amounts than they already are."

Required

From financial reporting and ethical perspectives, prepare a response to Jim Davenport regarding this issue.

C4-9 Ethics and Note Due from President

You are the accountant for Spaedy Company and are preparing the financial statements for 2007. Near the end of 2007, Spaedy Company loaned its president $100,000 (a material amount) because she was having financial difficulties. The note was properly recorded as a note receivable by Spaedy Company. You are unsure of how to classify this note on the 2007 ending balance sheet and ask the president when the note is due. She replies, "We never really set a due date; I might repay it in 2008 or maybe in a couple of years when I get more financially secure. It would be best to classify this note as a current asset in the usual manner because that will increase our working capital and current ratio, which will make our creditors and stockholders happy."

Required

From financial reporting and ethical perspectives, what do you think of the president's suggestion?

RESEARCH SIMULATION

R4-1 Researching GAAP

Situation

You are the assistant accountant for Tyler Corporation. It is mid-January, 2008 and you are helping to prepare the Tyler Corporation's balance sheet for December 31, 2007. Tyler will publish this balance sheet on March 1, 2008, after the auditors have completed their work. Tyler has a $100,000 note payable that was issued in 2006 and that is due March 6, 2008. On January 5, 2008, Tyler sold 2,000 shares of its $10 par common stock for $80,000. Its intent is to use these proceeds (plus $20,000 cash it already has on hand) to repay the note payable on March 6. The head accountant says "I'm not sure how to classify the $100,000 note payable on the December 31, 2007 balance sheet. Check this out for me."

Directions

Research the related generally accepted accounting principles and prepare a short memo to the head accountant that explains how Tyler Corporation should report the $100,000 note payable on its December 31, 2007 balance sheet.