CHAPTER 18

UNDERSTANDING BALANCE SHEETS

1. (B) **Proceeds from the issuance of common stock are 20% of total assets.**

Explanation

Common-size balance sheets express each balance sheet item as a percentage of total assets. Contributed capital from issuing common shares may be included in common stock (at par value) or additional paid-in capital (for proceeds in excess of par value). Shareholders' equity is unlikely to consist only of common and preferred stock, as it also includes components such as retained earnings and accumulated other comprehensive income.

(Study Session 6, Module 18.7, LOS 18.g)

Related Material

SchweserNotes - Book 2

2. (C) **presents the net equity of each asset by subtracting its related liability.**

Explanation

A classified balance sheet groups assets and liabilities by subcategories. It distinguishes between current and noncurrent assets and current and noncurrent liabilities. The assets and related liabilities are reported separately, they are not netted.

(Study Session 6, Module 18.2, LOS 18.c)

Related Material

SchweserNotes - Book 2

3. (A) **both are incorrect.**

Explanation

Acquired copyrights and patents are intangible assets that can be separately identified. Identifiable intangible assets are amortized over their useful lives.

(Study Session 6, Module 18.5, LOS 18.e)

Related Material

SchweserNotes - Book 2

4. (B) $3,790 million $3,420 million

Explanation

Liabilities are equal to $3,790 million ($240 million unearned revenue + $1,570 long-term debt + $1,150 accounts payable + $830 accrued expenses). Stockholders' equity is equal to $3,420 million ($30 common stock at par + $440 capital in excess of par - $2,000 treasury stock + $5,160 retained earnings - $210 accumulated other comprehensive loss).

(Study Session 6, Module 18.1, LOS 18.a)

Related Material

SchweserNotes - Book 2

5. (A) market value of the firm's equity.

Explanation

The market value of the firm's common equity (common stock) is not included on the balance sheet. IFRS allows some PP&E assets to be carried at fair value and some types of inventory to be carried at their market values.

(Study Session 6, Module 18.2, LOS 18.b)

Related Material

SchweserNotes - Book 2

6. (C) 600,000 No

Explanation

Shares that were issued previously but are not outstanding are treasury shares (owned by the firm). Thus, there are 600,000 treasury shares (2.4 million issued - 1.8 million outstanding). Treasury shares are reported as a reduction in shareholders' equity on the balance sheet. Treasury stock is not an asset.

(Study Session 6, Module 18.7, LOS 18.f)

Related Material

SchweserNotes - Book 2

7. (C) assets.

Explanation

Assets are resources that are expected to provide future benefits and are controlled as a result of past transactions. Liabilities are obligations resulting from past events that are expected to require a future outflow of resources. Equity is a residual interest in assets after deducting liabilities.

(Study Session 6, Module 18.1, LOS 18.a)

Related Material

SchweserNotes - Book 2

8. (C) historical cost.

Explanation

Unless impairment has been recognized, land is reported at historical cost and is not subject to depreciation. Increases in value are not reflected in balance sheet values under U.S. GAAP.

For Further Reference:

(Study Session 6, Module 18.4, LOS 18.e)

CFA® Program Curriculum, Volume 3, page 69

Related Material

SchweserNotes - Book 2

9. (B) current or non-current items.

Explanation

Classified balance sheets have categories for current assets, non-current assets, current

liabilities, and non-current liabilities.

For Further Reference:

(Study Session 6, Module 18.2, LOS 18.c)

CFA® Program Curriculum, Volume 3, page 67

Related Material

SchweserNotes - Book 2

10. (C) trading securities.

Explanation

The trading securities classification includes the unrealized gain from the bond in net income, which increases retained earnings. Unrealized gains on available-for-sale securities are reported as other comprehensive income for the period and are recorded in accumulated other comprehensive income, a component of owner's equity. Unrealized gains on held-to-maturity securities are not reported on the financial statements.

For Further Reference:

(Study Session 6, Module 18.6, LOS 18.e)

CFA® Program Curriculum, Volume 3, page 69

Related Material

SchweserNotes - Book 2

11. (C) solvency.

Explanation

An analyst can use the balance sheet to assess a firm's solvency and liquidity. Operating profitability can be assessed by examining the income statement. Information on a firm's investing and financing activities appears in a firm's statement of cash flows.

(Study Session 6, Module 18.2, LOS 18.b)

Related Material

SchweserNotes - Book 2

12. (A) $1.8 million No

Explanation

The acquisition goodwill is equal to $1.8 million [$4 million purchase price - $2.2 million fair value of net assets acquired ($3.5 million assets at fair value - $1.3 million liabilities at fair value)]. Under IFRS or U.S. GAAP, goodwill is not amortized but is subject to an annual impairment test.

(Study Session 6, Module 18.5, LOS 18.e)

Related Material

SchweserNotes - Book 2

13. (B) No effect Increase

Explanation

The recognition of bad debt expense has no effect on liabilities, current revenues are reduced by the expected amount of uncollectable accounts. Bad debt expense reduces net income and reduces assets. The recognition of expected warranty expense decreases net income (following the matching principle), and since it is not currently paid (doesn't reduce assets) it creates or increases a liability at the time of sale.

(Study Session 6, Module 18.1, LOS 18.a)

Related Material

SchweserNotes - Book 2

14. (B) $30,000 unrealized gain $980,000

Explanation

Trading securities are reported in the balance sheet at fair value. At the end of the year, the fair value of the securities was $980,000 ($435,000 + $545,000). The unrealized gains and losses from trading securities are recognized in the income statement. Thus, Ponca would recognize an unrealized gain of $30,000 ($980,000 fair value - $950,000 cost).

(Study Session 6, Module 18.6, LOS 18.e)

Related Material

SchweserNotes - Book 2

15. (C) Banking institution.

Explanation

Banks often present liquidity-based balance sheets, which list all assets and liabilities in order of liquidity, because for banks this format is typically more relevant and reliable than a classified balance sheet. Firms in most other industries typically present classified balance sheets.

(Study Session 6, Module 18.2, LOS 18.c)

Related Material

SchweserNotes - Book 2

16. (A) assets and equity.

Explanation

The three elements of a balance sheet are assets, liabilities, and equity.

(Study Session 6, Module 18.1, LOS 18.a)

Related Material

SchweserNotes - Book 2

17. (B) 1.5.

Explanation

If equity = 40% of assets, total liabilities = 60% of assets, thus 60 / 40 = 1.5. (Study Session 6, Module 18.7, LOS 18.h)

Related Material

SchweserNotes - Book 2

18. (A) $2,000 $22,000

Explanation

Unrealized gains and losses from trading securities are recognized in the income statement while unrealized gains and losses from available-for-sale securities bypass the income statement and are reported as other comprehensive income, a component of stockholders' equity. Cash dividends are recognized in the income statement for both trading and available-for-sale securities. Thus, Alpha will recognize only the $2,000 dividend if the shares are considered available-for-sale and will recognize $22,000 ($2,000 dividend + $20,000 unrealized gain) if the shares are considered trading securities.

(Study Session 6, Module 18.6, LOS 18.e)

Related Material

SchweserNotes - Book 2

19. (A) No No

Explanation

Repurchased stock that is not cancelled is called treasury stock. Treasury stock does not have voting rights and does not receive cash dividends.

(Study Session 6, Module 18.7, LOS 18.f)

Related Material

SchweserNotes - Book 2

20. (A) either profit and loss, or other comprehensive income.

Explanation

Under IFRS, firms have an irrevocable choice at the time of purchase to report equity securities at fair value through other comprehensive income. If they do not make this election, equity securities are reported at fair value through profit and loss.

For Further Reference:

(Study Session 6, Module 18.6, LOS 18.e)

CFA® Program Curriculum, Volume 3, page 69

Related Material

SchweserNotes - Book 2

21. (B) Declaring a dividend on common shares.

Explanation

Declaring a dividend decreases shareholders' equity and is reflected on the statement of changes in shareholders' equity. Buying a machine is unlikely to change shareholders' equity at the time of purchase. Investing cash in a security is an exchange of one asset for another and is also unlikely to change shareholders' equity at the time of the investment.

(Study Session 6, Module 18.7, LOS 18.f)

Related Material

SchweserNotes - Book 2

22. (C) 20%.

Explanation

On a common-size balance sheet, each line item is stated as a percentage of total assets: 2,000 / 10,000 = 20%.

(Study Session 6, Module 18.7, LOS 18.g)

Related Material

SchweserNotes - Book 2

23. (A) accounts receivable.

Explanation

The accrual process refers to accounting for transactions when revenue or expense recognition does not coincide with the exchange of cash. Accounts receivable, for example, represent sales of goods and services that have been recognized as revenue, but for which the firm has not yet been paid cash. Cash equivalents are highly liquid marketable securities, such as Treasury bills, in which a firm typically invests its short-term cash balances.

(Study Session 6, Module 18.3, LOS 18.e)

Related Material

SchweserNotes - Book 2

24. (C) 2.67.

Explanation

Quick ratio = [100(cash) + 750(AR) + 300(marketable securities)] / [300(AP) + 130 (short-term debt)] = (1,150 / 430) = 2.67

(Study Session 6, Module 18.7, LOS 18.h)

Related Material

SchweserNotes - Book 2

25. (A) \$3 million.

Explanation

Under IFRS, research costs must be expensed but development costs, under certain circumstances, may be capitalized.

(Study Session 6, Module 18.5, LOS 18.e)

Related Material

SchweserNotes - Book 2

26. (B) assets.

Explanation

Common size balance sheets express all balance sheet items as a percentage of assets. Common size income statements express all income statement items as a percentage of sales.

(Study Session 6, Module 18.7, LOS 18.g)

Related Material

SchweserNotes - Book 2

27. (A) Both should be classified as current.

Explanation

The commercial paper should be classified as current because it will be converted to cash in less than a year. A liability that is held primarily for trading purposes, such as this short position, should also be classified as current.

(Study Session 6, Module 18.6, LOS 18.d)

Related Material

SchweserNotes - Book 2

28. (A) bank.

Explanation

The liquidity-based format of balance sheet presentation is most common in the banking industry.

(Study Session 6, Module 18.2, LOS 18.c)

Related Material

SchweserNotes - Book 2

29. (A) obligations that are expected to require a future outflow of resources.

Explanation

Liabilities are obligations resulting from past events that are expected to require a future outflow of resources. Assets are resources that are expected to provide future benefits. Equity is residual ownership interest in an entity's assets (i.e., assets minus liabilities).

(Study Session 6, Module 18.1, LOS 18.a)

Related Material

SchweserNotes - Book 2

30. (B) $515,000

Explanation

As of December 31, 2007, Carpenter's accumulated other comprehensive income is $515,000 [$450,000 beginning balance - $25,000 unrealized loss from available for sale securities ($225,000 fair value - $250,000 cost) + $90,000 unrealized translation gain]. There is no impact on accumulated other comprehensive income from unrealized gains and losses on held-to-maturity securities since the securities are not reported at fair value on the balance sheet. The purchase of treasury stock does not affect comprehensive income because it is a transaction with shareholders.

(Study Session 6, Module 18.7, LOS 18.f)

Related Material

SchweserNotes - Book 2

31. (B) Yes No

Explanation

An asset is recognized on the balance sheet only if it is probable that it will provide future economic benefits. Assets can be tangible or intangible. In some cases, assets are acquired without cost, but will be reported to the extent that they will provide future economic benefit, and thus have value.

(Study Session 6, Module 18.1, LOS 18.a)

Related Material

SchweserNotes - Book 2

32. (B) only statement #1 is correct.

Explanation

The par value of common stock is the stated or nominal value assigned to the stock. Par value has no relationship to market value. The amount the corporation receives from the issuance of common stock is equal to the par value plus the additional paid-in-capital (proceeds in excess of par).

(Study Session 6, Module 18.7, LOS 18.f)

Related Material

SchweserNotes - Book 2

33. (C) 3.018.

Explanation

Current ratio = (CA / CL) = (1,660 / 550) = 3.018

(Study Session 6, Module 18.7, LOS 18.h)

Related Material

SchweserNotes - Book 2

34. (A) Increase Increase

Explanation

Dividends received from trading securities and available-for-sale securities are recognized in the income statement. The difference in trading and available-for-sale classifications relates to the treatment of any unrealized gains and losses.

(Study Session 6, Module 18.6, LOS 18.e)

Related Material

SchweserNotes - Book 2

35. (A) repayment of bond principal.

Explanation

The statement of changes in equity shows a firm's comprehensive income (net income and other comprehensive income) and transactions with shareholders, such as dividends paid and issuance or repurchases of stock. Repayment of bond principal is not a change in equity: assets (cash) decrease and liabilities (long-term debt) decrease.

(Study Session 6, Module 18.7, LOS 18.f)

Related Material

SchweserNotes - Book 2

36. (A) Historical cost

Explanation

Equipment is reported in the balance sheet at historical cost less accumulated depreciation. (Study Session 6, Module 18.4, LOS 18.e)

Related Material

SchweserNotes - Book 2

37. (C) Equity securities purchased by the firm.

Explanation

Listed equity securities are measured at fair value through profit and loss, unless the firm chooses at the time of purchase to measure them at fair value through other comprehensive income. Debt securities issued by the firm, and debt securities that the firm intends to hold until maturity, are both reported at amortized cost unless the firm chooses to report them at market value.

For Further Reference:

(Study Session 6, Module 18.6, LOS 18.e)

CFA® Program Curriculum, Volume 3, page 69

Related Material

SchweserNotes - Book 2

38. (A) has a greater investment in working capital than Brevis Company.

Explanation

Common-size balance sheets for the two firms are as follows:

	Amplus, Inc.	Brevis, Inc.
Cash and equivalents	10.3%	5.7%
Accounts receivable	6.5%	8.0%
Inventories	15.7%	12.5%
Current assets	32.4%	26.1
Land	1.1%	1.1%
Property, plant and equipment	66.5%	72.7%
Noncurrent assets	67.6%	73.9%
Total assets	**100.0%**	**100.0%**
Accounts payable	4.9%	4.5%

Unearned revenue	1.6%	1.1%
Current liabilities	6.5%	5.7%
Long-term borrowing	25.9%	37.5%
Total liabilities	32.4%	43.2%
Common stock	4.1%	3.4%
Retained earnings	63.5%	53.4%
Total equity	67.6%	56.8%
Total liabilities and equity	**100.0%**	**100.0%**

Working capital (current assets minus current liabilities) is 32.4% - 6.5% = 25.9% of assets for Amplus and 26.1 % - 5.7% = 20.4% of assets for Brevis. Fixed assets (property, plant, and equipment) are relatively larger for Brevis than for Amplus. Based on long-term borrowing and total liabilities, Brevis is significantly more leveraged than Amplus.

(Study Session 6, Module 18.7, LOS 18.g)

Related Material

SchweserNotes - Book 2

38. (A) different balance sheet items may be measured differently.

Explanation

Balance sheet values may use a mixture of measurement bases (historical cost, fair value, etc.). As a result, balance sheet values of assets, liabilities, and equity may not reflect their intrinsic values. Balance sheets provide the information necessary to calculate the firm's solvency and liquidity ratios. Items are recognized on the balance sheet only if a flow of future economic benefits to or from the firm is probable.

(Study Session 6, Module 18.2, LOS 18.b)

Related Material

SchweserNotes - Book 2

40. (B) IFRS only.

Explanation

Liquidity-based balance sheet presentation is an exception, under IFRS only, to the requirement (under both IFRS and U.S. GAAP) for assets and liabilities to be classified as current or non-current. Under IFRS, a firm may present a liquidity-based balance sheet if this format is more reliable and relevant than a classified balance sheet.

(Study Session 6, Module 18.2, LOS 18.c)

Related Material

SchweserNotes - Book 2