Reading 31

ANALYZING BALANCE SHEETS

1. (C) 2.67.

Explanation

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

(Module 31.1, LOS 31.e)

2. (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%.

(Module 31.1, LOS 31.e)

3. (B) amortized cost.

Explanation

Under U.S. GAAP, held-to-maturity securities are carried on the balance sheet at their amortized cost.

(Module 31.1, LOS 31.c)

4. (A) trading securities only.

Explanation

U.S. GAAP requires equity securities to be classified as trading securities. IFRS offers firms an irrevocable choice at the time of purchase to account for equity securities as measured at fair value through other comprehensive income.

(Module 31.1, LOS 31.c)

5. (C) Revenue is taxable when the cash is received from the customer.

Explanation

There may be a temporary timing difference between when a sale is made and when cash is received. If the customer does not pay immediately, the revenue has been recognized in the income statement before it becomes taxable. This will be taxable at a later date and, as a result, a deferred tax liability will be created. If revenue was taxable when a sale is made, there would be no difference between accounting and tax treatment. If revenue was not taxable, this would be a permanent difference. Deferred taxes are only used for temporary timing differences.

(Module 31.1, LOS 31.d)

6. (B) **fair value through profit and loss.**

Explanation

Trading securities are measured at fair value through profit and loss under both U.S. GAAP and IFRS. Any unrealized gain/loss is recognized in the income statement, along with any interest/dividend income and realized gains/losses.

(Module 31.1, LOS 31.c)

7. (A) **Any financial asset.**

Explanation

Under IFRS, firms can make an irrevocable choice to carry any financial asset at fair value through profit and loss.

(Module 31.1, LOS 31.c)

8. (A) **amount by which the purchase price of an acquired firm exceeds its identifiable net assets.**

Explanation

Accounting goodwill is the amount by which the purchase price of an acquired firm is greater than the fair value of its identifiable net assets. Internally generated goodwill is not recognized on a firm's balance sheet. Value from the expected future performance of a firm is referred to as "economic goodwill" to distinguish it from accounting goodwill.

(Module 31.1, LOS 31.b)

9. (C) **Net income will increase.**

Explanation

These bonds will be classified as fair value through other comprehensive income, or available-for-sale securities under U.S. GAAP. Any interest income will increase net income. The bonds will be recognized at fair value ($212,000) at the end of the year, and the unrealized loss of $ 8,000 will be recognized in other comprehensive income.

(Module 31.1, LOS 31.c)

10. (B) **Acquiring Firm X for $500,000, with goodwill calculated at $90,000.**

Explanation

Only acquiring Firm X will result in goodwill being recorded on the balance sheet. Internally generated goodwill is expensed on the income statement. The purchase of Company Z resulted in a gain from a bargain purchase of $100,000 as the amount paid was less than the fair value of net identifiable assets. This gain will be recognized as income on the income statement.

(Module 31.1, LOS 31.b).

11. (C) **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.

(Module 31.1, LOS 31.e)

12. (B) **Overvaluing goodwill and undervaluing the acquired identifiable assets.**

Explanation

Goodwill is not amortized, so it will not impact the income statement (unless subject to impairment). By allocating more of the acquisition price to goodwill and less to the acquired identifiable assets, the firm will charge less depreciation on the identifiable assets—and, as a result, increase net income. In future years, overvaluing goodwill could cause a higher chance of impairment if revalued appropriately. Overvaluing the identifiable assets will lead to higher depreciation and lower net income. Overvaluing both will cause the balance sheet to no longer balance.

(Module 31.1, LOS 31.b)

13. (C) **3.018.**

Explanation

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

(Module 31.1, LOS 31.e)

14. (B) **held to maturity, trading, or available for sale.**

Explanation

Interest/dividend income and realized gains/losses are recognized on the income statement for all three classifications of financial assets. The different accounting treatments relate to unrealized gains/losses and the value on the balance sheet (fair value for trading and available for sale; amortized cost for held to maturity).

(Module 31.1, LOS 31.c)

15. (B) **Neither Statement 1 nor Statement 2.**

Explanation

Unlisted equity securities are measured at amortized cost if the fair value cannot be determined reliably. The default classification for listed equity securities under IFRS is fair value through profit and loss, but the firm can choose at the time of purchase to measure at fair value through other comprehensive income.

(Module 31.1, LOS 31.c)

16. (B) **1.5.**

Explanation

If equity = 40% of assets, total liabilities = 60% of assets, thus 60 / 40 = 1.5.

(Module 31.1, LOS 31.e)

17. (C) **A trademark.**

Explanation

Identifiable intangible assets are nonmonetary assets that lack physical substance, which can be acquired separately. Goodwill cannot be acquired separately; therefore, it is an unidentifiable intangible asset. Securities are considered tangible rather than intangible assets.

(Module 31.1, LOS 31.a)

18. (C) Two under U.S. GAAP, and all three under IFRS.

Explanation

The derivative assets and trading securities will be held at FVTPL under both IFRS and U.S. GAAP. The debt securities being held to maturity will be measured at amortized cost under U.S. GAAP. These will commonly be measured at amortized cost under IFRS, but firms can make an irrevocable choice to carry any financial assets at FVTPL—and could, therefore, measure all three at FVTPL under IFRS.

(Module 31.1, LOS 31.c)

19. (C) IFRS, but not U.S. GAAP.

Explanation

If an active market exists for a purchased intangible asset, IFRS permits companies to report its value using the revaluation model. U.S. GAAP requires the cost model for purchased intangible assets.

(Module 31.1, LOS 31.a)

20. (C) recognized in the income statement.

Explanation

Under U.S. GAAP, unrealized gains and losses on trading securities are recognized in the income statement.

(Module 31.1, LOS 31.c)

21. (A) $ 80,000.

Explanation

Under U.S. GAAP, intangible assets must be held under the cost model. The revaluation model is not allowed; therefore, the asset cannot be revalued to $ 83,000, unlike under IFRS. Some intangibles that have indefinite lives, such as goodwill, are not amortized and remain at cost, with annual impairment reviews. This asset has a useful life of five years and will be amortized by $ 20,000 ($ 100,000 / 5) for the year, giving a balance sheet value of $ 80,000 at December 13, 20X7.

(Module 31.1, LOS 31.a)

22. (C) £ 875,000.

Explanation

Total expenses = £780,000 initial testing costs + £95,000 training costs = £875,000. Under IFRS, any costs incurred during the research phase should be expensed (the initial £780,000). Costs incurred during development are capitalized. Heath Ltd. moved from research to development at the point where the vaccine was proven technically feasible, a market exists for the product (the contract with the government), and it has the intention and resources to complete and sell the vaccine. Training costs are always expensed, regardless of whether they are incurred during research or development. The development costs for materials, direct labor, and production overhead will be capitalized. Note that if the firm incurred any costs for administrative overhead, these would also be expensed.

(Module 31.1, LOS 31.a)

23. (B) **amortized cost.**

Explanation

Non-current liabilities are usually carried at amortized cost, which is the issue price minus any principal payments, plus any amortized discount or minus any amortized premium.

(Module 31.1, LOS 31.d)

24. (A) **Remove goodwill from the balance sheet and remove any income statement impact.**

Explanation

Goodwill is subjective and should be removed from the balance sheet for analytical purposes. Even though goodwill is not amortized, it can impact the income statement if it is impaired, or if a gain from a bargain purchase has occurred. Any income statements impact should also be removed.

(Module 31.1, LOS 31.b)

25. (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%	8.0%
Current assets	32.4%	26.1%
Land	1.1%	1.1%
Property, plant and equipment	66.5%	72.7%
Noncurrent assets	67.6%	72.7%
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%	53.4%
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.

(Module 31.1, LOS 31.e)

26. (C) recognized in other comprehensive income.

Explanation

Under U.S. GAAP, unrealized gains and losses on available-for-sale securities are recognized in other comprehensive income.

(Module 31.1, LOS 31.c)

27 (A) The carrying value considers both the past acquisition cost and the future expected performance.

Explanation

While the initial recognition of purchased goodwill is based on the acquisition cost compared to the net identifiable assets obtained, goodwill must be tested for impairment at least annually. One key indicator of impairment would be where the expected future excess returns to be earned from the acquired business have fallen compared to when initially purchased. Therefore, the carrying value considers both the past and the future. Economic goodwill only looks at the expected future performance of the firm and does not appear in the financial statements.

(Module 31.1, LOS 31.b)

28. (A) an increase in net income.

Explanation

The bond will be initially recorded at its issue price on the balance sheet. This will be amortized and gradually reduce to par over the life of the bond. This amortization will reduce the liability and be recognized as a gain in the income statement, thereby increasing net income.

(Module 31.1, LOS 31.d)

29. (A) Derivatives.

Explanation

Derivatives can be financial assets or liabilities and are recognized at fair value on the balance sheet. Bank loans will most likely be issued at face value and reported on the balance sheet at the same amount. If a bond is issued at a premium or discount to par, it will be held at amortized cost.

(Module 31.1, LOS 31.d)

30. (C) 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.

(Module 31.1, LOS 31.e)