CHAPTER 5

The Balance Sheet and Financial Disclosures

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO1 Describe the purpose of the balance sheet and understand its usefulness and limitations.
- LO2 Distinguish between current and noncurrent assets and liabilities.
- LO3 Identify and describe the various balance sheet asset classifications.
- LO4 Identify and describe the two balance sheet liability classifications.
- LO5 Explain the purpose of financial statement disclosures.
- LO6 Explain the purpose of the management discussion and analysis disclosure.
- LO7 Explain the purpose of an audit and describe the content of the audit report.
- LO8 Identify and calculate the common liquidity and financing ratios used to assess risk.

OVERVIEW

Chapter 1 stressed the importance of the financial statements in helping investors and creditors predict future cash flows. The balance sheet, along with accompanying disclosures, provides relevant information useful not only in helping investors and creditors predict future cash flows but also in the related assessments of liquidity and long-term solvency.

The purpose of this chapter is to provide an overview of the balance sheet and notes to the financial statements and to explore how this information is used by decision makers.

FINANCIAL REPORTING CASE

What's It Worth?

"I can't believe it. Why don't you accountants prepare financial statements that are relevant?" Your friend Jerry is a finance major and is constantly badgering you about what he perceives to be a lack of relevance of financial statements prepared according to generally accepted accounting principles. "For example, take a look at this balance sheet for Leon's Furniture Limited (www.leons.ca) that I just downloaded off the Internet. Leon's is a furniture company with several warehouse showrooms in and around Canada's largest metropolitan areas. Anyway, the shareholders' equity of the company according to the 2002 balance sheet is $232,635. But if you multiply the number of outstanding shares by the most recent share price per share, the company's market value is almost five times that amount. I thought financial statements were supposed to help investors and creditors value a company." You decide to look at the company's balance sheet (see p. 212) and try to set Jerry straight.

By the time you finish this chapter, you should be able to respond appropriately to the questions posed in this case. Compare your response with the solution provided at the end of the chapter.

QUESTIONS

1. Respond to Jerry's criticism that shareholders' equity does not represent the market value of the company. What information does the balance sheet provide?
2. The usefulness of the balance sheet is enhanced by classifying assets and liabilities according to common characteristics. What are the classifications used on Leon's Furniture Limited's balance sheet, and what elements do those categories include?

Leon's Furniture Limited

Consolidated Balance Sheets
As at December 31
($ in thousands)

	2001	2000
Assets		
Current		
Cash and cash equivalents	$29,329	$19,504
Marketable securities	56,685	80,228
Accounts receivable	31,221	20,274
Income taxes recoverable	7,563	821
Inventory	55,047	51,079
Total current assets	179,845	171,906
Future tax assets (note 3)	4,010	4,490
Property, plant, and equipment, net (note 2)	136,584	119,279
	$320,439	$295,675
Liabilities and Shareholders' Equity		
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	$73,151	$67,953
Customers' deposits	6,664	7,426
Dividends payable	2,520	2,035
Future income taxes liabilities (note 3)	5,270	—-
Total current liabilities	87,605	77,414
Redeemable share liability (note 7)	199	139
Total liabilities	87,804	77,553
Shareholders' equity		
Common shares (note 8)	9,535	9,325
Retained earnings	223,100	208,797
Total shareholders' equity	232,635	218,122
	$320,439	$295,675

The income statement and the cash flow statement provide important information to investors and creditors. The balance sheet, along with accompanying notes to financial statements, also provides a wealth of information to external decision makers. The information provided is useful not only in the prediction of future cash flows but also in the related assessments of liquidity and long-term solvency.

This chapter continues our discussion of the financial statements by providing an overview of the balance sheet and the notes to financial statements. The first part of the chapter describes the usefulness and limitations of the balance sheet and illustrates the content of the statement. The second part illustrates financial statement disclosures presented to external users in addition to the basic financial statements. In the third part, we discuss how this information can be used by decision makers to assess business risk. That discussion introduces some common financial ratios used to assess liquidity and long-term solvency.

THE BALANCE SHEET

PART
a

The purpose of the **balance sheet,** sometimes called the **statement of financial position,** is to report a company's financial position on a particular date. Unlike the income statement, which is a change statement reporting events that occurred *during a period of time,* the balance sheet presents an organized array of assets, liabilities, and shareholders' equity *at a point in time.* It is a freeze frame or snapshot of financial position at the end of a particular day marking the end of an accounting period.

LO1

Usefulness and Limitations

Carter Hawley Hale Stores (CHHS), Inc. was one of the largest department store retailers in the United States. In 1991, the company operated over 100 stores in the sunbelt regions of the country. The company's divisions included The Broadway and Emporium. During the 1980s, the company struggled financially and in February 1991 declared bankruptcy. CHHS's February 2, 1991, quarterly balance sheet, filed with the SEC and made publicly available, disclosed the information in Graphic 5–1.

GRAPHIC 5–1
Quarterly Balance Sheet—Carter Hawley Hale Stores, Inc.

Balance Sheet (condensed)
At February 2, 1991
($ in 000s)

Assets	
Current assets	$1,154,064
Property and equipment, net	511,690
Other assets	89,667
Total assets	$1,755,421
Liabilities	
Current liabilities	$ 175,982
Long-term liabilities	1,852,066
Total liabilities	2,028,048
Shareholders' equity	**(272,627)**
Total liabilities and shareholders' equity	$1,755,421

The negative shareholders' equity includes negative retained earnings of nearly $1 billion resulting from operating losses incurred over a number of years.

By the summer of 1991, the company's share price had dropped to $1 per share from a 1989 high of $8. In June 1991, the following (condensed) balance sheet information was reported to the bankruptcy court:

	($ in 000s)
Property	$1,596,312
Debts	1,112,989
Excess of property over debts	$ 483,323

Has the financial position changed this dramatically from February to June? No. Differences in reporting requirements by the SEC and the bankruptcy court cause the apparent discrepancy. First, the property (assets) disclosed to the bankruptcy court does not include accounts receivable and debts do not include the related liabilities for which the receivables had been pledged as collateral. This accounts for the smaller asset and debt figures as compared with those disclosed in the February statement provided to the SEC.

But the striking difference is that the *negative equity* of $272,627,000 disclosed in the SEC report becomes a *positive equity* (excess of assets over liabilities) of $483,323,000 in the information disclosed to the bankruptcy court. This positive equity, divided by the number of common shares outstanding, results in a per share value of nearly $16. Why the discrepancy? The answer relates to the valuation of property. On the balance sheet submitted to the SEC, these assets are valued based on their original cost. However, the bankruptcy court requires assets to be reported at market value.[1] The market value of CHHS's property, which includes some valuable land in such locations as San Francisco, was significantly higher than its original cost.

FINANCIAL REPORTING CASE

Q1, p. 211

Assets minus liabilities, measured according to GAAP, is not likely to be representative of the market value of the entity.

This example illustrates an important limitation of the balance sheet. *The balance sheet does not portray the market value of the entity* as a going concern, nor, as in the CHHS example, its liquidation value. Many assets, such as land and buildings, are measured at their historical costs, rather than their market values. Relatedly, many company resources including its trained employees, its experienced management team, and its reputation are not recorded as assets at all. Also, many items and amounts reported on the balance sheet are heavily reliant on estimates, rather than determinable amounts. For example, companies estimate the amount of receivables they will be able to actually collect and the amount of warranty costs they will eventually incur for products already sold. For these and other reasons, a company's **book value,** its assets minus its liabilities as shown on the balance sheet, usually will not directly measure the company's market value.

Despite these limitations, the balance sheet does have significant value. An important feature of the statement is that it describes many of the resources a company has available for generating future cash flows.

Another way the statement's content is informative is in combination with income statement items. For example, the relation between net income and assets provides a measure of return that is useful in predicting future profitability. In fact, many of the amounts reported on either of the two statements are more informative when viewed relative to an amount from the other statement.[2]

The balance sheet provides information useful for assessing future cash flows, liquidity, and long-term solvency.

The balance sheet does not simply list assets and liabilities. Instead, assets and liabilities are classified (grouped) according to common characteristics. These classifications, which we explore in the next section, along with related notes to financial statements, help the balance sheet provide additional important information about liquidity and long-term solvency. **Liquidity** refers to the period of time before an asset is converted to cash or until a liability is paid. This information is useful in assessing a company's ability to pay its *current* obligations. **Long-term solvency** refers to the riskiness of a company with regard to the amount of liabilities in its capital structure. Other things being equal, the risk to an investor or creditor increases as the percentage of liabilities, relative to equity, increases.

Solvency also provides information about *financial flexibility*—the ability of a company to alter cash flows in order to take advantage of unexpected investment opportunities and needs. For example, the higher the percentage of a company's liabilities to its equity, the more difficult it typically will be to borrow additional funds to take advantage of a promising investment opportunity or to meet obligations. In general, the lower the financial flexibility, the higher the risk is that the enterprise will fail. In a subsequent section of this chapter, we introduce some common ratios used to assess liquidity and long-term solvency.

In summary, even though the balance sheet does not *directly measure* the market value of the entity, it provides valuable information that can be used to help *judge* market value.

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[1]The bankruptcy court requires market value information in order to assess, among other things, the ability of the company to pay its creditors if assets were liquidated.

[2]We explored some of these relationships in Chapter 4.

Classifications

The usefulness of the balance sheet is enhanced when assets and liabilities are grouped according to common characteristics. *The broad distinction made on the balance sheet is the current versus noncurrent classification of both assets and liabilities.* The remainder of Part A provides an overview of the balance sheet. We discuss each of the three primary elements of the balance sheet (assets, liabilities, and shareholders' equity) in the order they are reported on the statement as well as the classifications typically made within the elements. The balance sheet elements were defined in Chapter 1 as follows:

FINANCIAL REPORTING CASE

Q2, p. 211

The key classification of assets and liabilities on the balance sheet is the current versus noncurrent distinction.

BALANCE SHEET ELEMENTS

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

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

Equity or net assets, called **shareholders' equity** for a corporation, is the residual interest in the assets of an entity that remains after deducting liabilities.

Graphic 5–2 lists the balance sheet elements along with their subclassifications.

GRAPHIC 5–2
Classification of Elements within a Balance Sheet

Assets
Current assets
Long-Term investments
Property, plant, and equipment (PP&E)
Goodwill and other intangible assets
Other assets

Liabilities
Current liabilities
Long-term liabilities

Shareholders' Equity
Contributed capital
Retained earnings

We intentionally avoid detailed discussion of the question of valuation in order to focus on an overview of the balance sheet. In later chapters, we look more closely at the nature and valuation of the specific assets and liabilities.

ASSETS

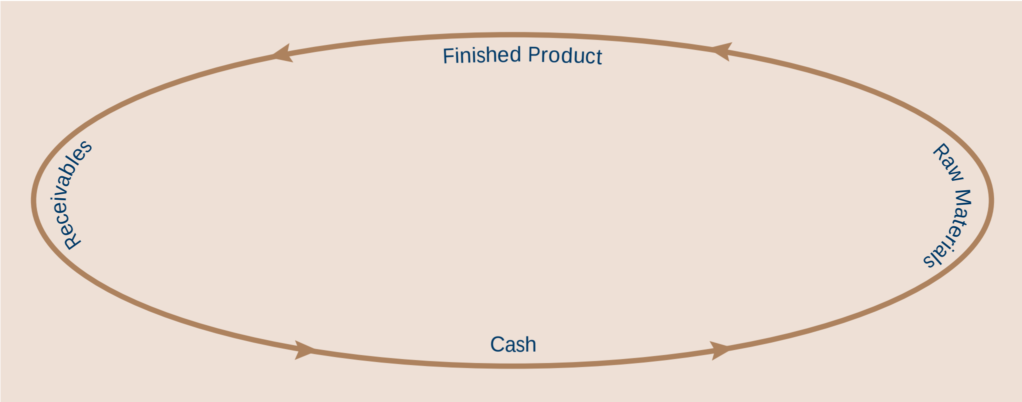
LO2

Current Assets. Current assets include cash and other assets that are reasonably expected to be converted to cash or consumed within the coming year, or within the normal operating cycle of the business if that is longer than one year. The **operating cycle** for a typical manufacturing company refers to the period of time necessary to convert cash to raw materials, raw materials to a finished product, the finished product to receivables, and then finally receivables back to cash. This concept is illustrated in Graphic 5–3.

Current assets include cash and all other assets expected to become cash or be consumed within one year or the *operating cycle,* whichever is longer.

In some businesses, such as shipbuilding or distilleries, the operating cycle extends far beyond one year. For example, if it takes two years to build an oil-carrying supertanker, then the shipbuilder will classify as current those assets that will be converted to cash or consumed within two years. But for most businesses, the operating cycle will be shorter

GRAPHIC 5–3
Operating Cycle of a Typical Manufacturing Company



than one year. In these situations the one-year convention is used to classify both assets and liabilities. Where a company has no clearly defined operating cycle, the one-year convention is used.

Individual current assets are listed according to their liquidity.

Graphic 5–4 presents the current asset section of Indigo Books and Music Inc.'s 2002 and 2001 (www.indigo.ca) balance sheets that also appears in the appendix to Chapter 1. In keeping with common practice, the individual current assets are listed in the order of their liquidity (nearness to cash).

GRAPHIC 5–4
Current Assets—Indigo Books and Music Inc.

Indigo Books and Music Inc.

(thousands of dollars)	As at March 30, 2002	As at March 31, 2001
ASSETS (note 5)		
Current		
Cash and cash equivalents	677	11,394
Short-term investments	—	3,850
Accounts receivable	12,817	11,547
Inventories (note 12)	223,467	193,977
Income taxes receivable	4,950	5,353
Prepaid expenses	4,338	4,863
Future income tax assets (note 4)	6,538	5,281
Total current assets	**252,787**	**236,265**

LO3

Cash and cash equivalents. The most liquid asset, cash, is listed first. Cash includes cash on hand and in banks that is available for use in the operations of the business and such items as bank drafts, cashier's cheques, and money orders. **Cash equivalents** frequently include certain negotiable items, such as commercial papers, money market funds, and treasury bills. These are highly liquid investments that can be quickly converted into cash. Most companies draw a distinction between investments classified as cash equivalents and the next category of current assets, short-term investments, according to the scheduled maturity of the investment. It is common practice to classify investments that have a maturity date of three months or less from the date of purchase as cash equivalents. Indigo Books and Music Inc.'s policy follows this practice and is disclosed in the summary of significant accounting policies disclosure note. The portion of the note from the company's 2002 financial statements is shown in Graphic 5–5.

Summary of Significant Accounting Policies (in part)
Cash and cash equivalents
Cash and cash equivalents consist of cash on hand, balances with banks, and highly liquid investments that are readily convertible to cash with less than three months at the date of acquisition.

GRAPHIC 5–5
Disclosure of Cash Equivalents—Indigo Books and Music Inc.

Indigo Books and Music Inc.

CHECK WITH THE **COACH**

Creditors and other users of financial statements depend on meaningful accounting disclosures to make good decisions. The Coach shows you how lenders and others rely on balance sheet classifications, ratios, and other disclosures. How do you know if a company is a good credit risk? The Coach is waiting to show you. ■

Cash that is restricted for a special purpose and not available for current operations should not be classified as a current asset. For example, if cash is being accumulated to repay a debt due in five years, the cash is classified as investments and funds, a noncurrent asset.[3]

Short-term investments. Liquid investments not classified as cash equivalents are reported as **temporary investments,** sometimes called short-term investments or short-term marketable securities. Investments in shares and debt securities of other corporations are included as short-term investments *if* the company intends to sell those securities within the next 12 months or operating cycle, whichever is longer. If, for example, a company owns 1,000 shares of BCE Corporation shares and intends to hold those shares for several years, the shares are a long-term investment and should be classified as long-term investments, a noncurrent asset.

Investments **are classified as current if management intends to liquidate the investment in the near term.**

Accounts receivable. **Accounts receivable** result from the sale of goods or services on credit. Note in Graphic 5–4 that Indigo's receivables are valued less allowance, that is, net of the amount not expected to be collected. Accounts receivable often are referred to as *trade receivables* because they arise in the course of a company's normal trade. *Nontrade receivables* result from loans or advances by the company to other entities. When receivables are supported by a formal agreement or note that specifies payment terms they are called **notes receivable.**

Accounts receivable usually are due in 30 to 60 days, depending on the terms offered to customers and are, therefore, classified as current assets. Any receivable, regardless of the source, not expected to be collected within one year or the operating cycle, whichever is longer, is classified as long-term investments, a noncurrent asset.

Inventories. **Inventories** include goods awaiting sale (finished goods), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials). Inventory for a wholesale or retail company consists only of finished goods, but the inventory of a manufacturer will include all three types of goods. Occasionally, a manufacturing company will report all three types of inventory directly on the balance sheet. More often, only the total amount of inventories is shown on the balance sheet and the balances of each type are shown in a disclosure note. For example, the note shown in Graphic 5–6 appears in the 2000 financial statements of Stelco Inc.

Inventories **consist of assets that a retail or wholesale company acquires for resale or goods that manufacturers produce for sale.**

Inventories are reported as current assets because they normally are sold within the operating cycle.

Indigo Books and Music Inc. earns revenues by selling books and other items to its customers, rather than producing the goods. That is why there is only one inventory account listed on the company's balance sheet. The notes to the financial statements only describe the method used to record the inventory amount.

Indigo Books and Music Inc.

[3]If the debt is due in the next year and classified as a current liability, then the cash also would be classified as current.

GRAPHIC 5–6
Inventories Disclosure—Stelco Inc.

5. INVENTORIES ($ in millions)	**2000**	**1999**
Raw materials and supplies	$288	$297
Finished and semifinished products	492	362
	$780	$659

Prepaid expenses. Recall from Chapter 2 that a **prepaid expense** represents an asset recorded when an expense is paid in advance, creating benefits beyond the current period. Examples are prepaid rent and prepaid insurance. Even though these assets are not converted to cash, they would involve an outlay of cash if not prepaid.

Whether a prepaid expense is current or noncurrent depends on when its benefits will be realized. For example, if rent on an office building were prepaid for one year, then the entire prepayment is classified as a current asset. However, if rent were prepaid for a period extending beyond the coming year, a portion of the prepayment is classified as an asset, a noncurrent asset.[4] Indigo Books and Music Inc. lists prepaid expenses with current assets on its balance sheet.

Indigo Books and Music Inc.

Indigo lists one other current asset on its balance sheet, "Future income tax assets." This asset is discussed in Chapter 16.

When assets are expected to provide economic benefits beyond the next year, or operating cycle, they are reported as *noncurrent assets*. Typical classifications of noncurrent assets are (1) long-term investments, (2) property, plant, and equipment, and (3) goodwill and other intangible assets.

***Long-term investments* are nonoperating assets not used directly in operations.**

Long-Term Investments. Most companies occasionally acquire assets that are not used directly in the operations of the business. These "nonoperating" assets include investments in equity and debt securities of other corporations, land held for speculation, noncurrent receivables, and cash set aside for special purposes (such as for future plant expansion). These assets are classified as noncurrent because management does not intend to convert the assets into cash in the next year (or the operating cycle if that is longer).

Tangible, long-lived assets used in the operations of the business are classified as *property, plant, and equipment.*

Property, plant, and equipment. Virtually all companies own assets classified as **property, plant, and equipment.** The common characteristics these assets share are that they are *tangible, long-lived, and used in the operations of the business.* Property, plant, and equipment, along with intangible assets, generally are referred to as **operational assets.** They usually are the primary revenue-generating assets of the business.

Property, plant, and equipment include land, buildings, equipment, machinery, and furniture, as well as natural resources, such as mineral mines, timber tracts, and oil wells. These various assets usually are reported as a single amount on the balance sheet, with details provided in a note. They are reported at original cost less amortization and amounts of any write-down to date. Land often is listed as a separate item in this classification because it has an unlimited useful life and, thus, is not amortized.

***Goodwill and other intangible assets* generally represent exclusive rights that the company can use to generate future revenues.**

Goodwill and Other Intangible Assets. **Goodwill** is the excess of the cost of an acquired enterprise over the net of the amounts assigned to assets acquired and liabilities assumed. **Other intangible assets** are assets used in operations, other than financial assets, that have no physical substance. Generally, these represent the ownership of an exclusive right to something, such as a product, a process, or a name. This right can be a valuable resource in generating future revenues. Patents, copyrights, and franchises are examples. They are reported on the balance sheet net of accumulated amortization. Some companies include in-

[4]Companies often include prepayments for benefits extending beyond one year as current assets when the amounts are not material.

tangible assets as part of property, plant, and equipment, while others report them either in a separate intangible asset classification or as other noncurrent assets.

Quite often, much of the value of intangibles is not reported on the balance sheet. For example, it would not be unusual for the historical cost of a patent to be significantly lower than its market value. As we discuss in Chapter 10, for internally developed intangibles, the costs that are included as part of historical cost are limited. Specifically, none of the research and development costs incurred in developing the intangible are included in cost.

Other Assets. Balance sheets often include a catch-all classification of noncurrent assets called **other assets.** This classification includes long-term prepaid expenses, called *deferred charges*, and any noncurrent asset not falling in one of the other classifications. For instance, if a company's noncurrent investments are not material in amount, they might be reported in the other asset classification, rather than in a separate investments and funds category.

Graphic 5–7 reproduces the noncurrent asset section of Indigo Books and Music Inc.'s 2002 and 2001 balance sheets.

GRAPHIC 5–7
property, plant, and equipment and Other Assets—Indigo Books and Music Inc.

Indigo Books and Music Inc.

(thousands of dollars)	As at March 30, 2002	As at March 31, 2001
Assets	$252,787	$236,265
Property, plant, and equipment, net (note 3)	115,041	138,842
Total Current Assets		
Future income tax assets (note 4)	4,145	5,402
Goodwill, net of accumulated amortization of %5,991 (March 31, 2001—$4,904) (notes 8, 9, and 10)	64,570	8,301
Deferred financing fees, net of accumulated amortization of $886	3,289	—
Total assets	**$439,832**	**$388,810**

Quite often, a company will present only the net amount of property, plant, and equipment on the balance sheet and provide details in a disclosure note.

For Indigo Books and Music Inc., all other noncurrent assets are listed.

We have seen how assets are grouped into current and noncurrent categories and that noncurrent assets always are subclassified further. Let us now turn our attention to liabilities. These, too, are separated into current and noncurrent (long-term) categories.

LIABILITIES

LO4

Liabilities represent obligations owed to other entities. The information value of reporting these amounts is enhanced by classifying them as current liabilities and long-term liabilities. Graphic 5–8 shows the liability section of Indigo Books and Music Inc.'s 2002 and 2001 balance sheets.

Current Liabilities. Current liabilities are those obligations that are expected to be satisfied through the use of current assets or the creation of other current liabilities. So, this classification includes all liabilities that are expected to be satisfied within one year or the operating cycle, whichever is longer. An exception is a liability that management intends to refinance on a long-term basis. For example, if management intends to refinance a six-month note payable by substituting a two-year note payable and has the ability to do so, then the liability would not be classified as current even though it is due within the coming year. This exception is discussed in more detail in Chapter 13.

Current liabilities are expected to be satisfied within one year or the operating cycle, whichever is longer.

GRAPHIC 5–8
Liabilities—Indigo Books and Music Inc.

Indigo Books and Music Inc.

(thousands of dollars)	As at March 30, 2002	As at March 31, 2001
Liabilities		
Current		
Bank indebtedness (note 5)	$ 57,254	$ 52,605
Accounts payable and accrued liabilities (note 13)	198,746	182,942
Deferred revenue	6,625	5,272
Current portion of long-term debt (note 5)	31,000	—
Total current liabilities	**293,625**	**240,819**
Accrued benefit obligations (note 6)	1,306	1,166
Long-term debt (note 5)	53,000	54,000
Convertible debenture (notes 9 and 11)	28,071	—
Noncontrolling interest	—	1,716
Total liabilities	**$376,002**	**$297,701**

Current liabilities usually include *accounts* and *notes payable, accrued liabilities, unearned revenues, current maturities of long-term debt, and the current portion of future income tax liabilities.*

The most common current liabilities are accounts payable, notes payable (short-term borrowings), unearned revenues, accrued liabilities, the currently maturing portion of long-term debt, and the current portion of future income tax liabilities. **Accounts payable** are obligations to suppliers of merchandise or of services purchased on *open account*, with payment usually due in 30 to 60 days. **Notes payable** are written promises to pay cash at some future date (I.O.U.s). Unlike accounts payable, notes usually require the payment of explicit interest in addition to the original obligation amount. Notes maturing in the next year or operating cycle, whichever is longer, will be classified as current liabilities. Unearned revenues represent cash received from a customer for goods or services to be provided in a future period.

Accrued liabilities represent obligations created when expenses have been incurred but will not be paid until a subsequent reporting period. Examples are accrued salaries payable, accrued interest payable, and accrued taxes payable. Indigo Books and Music Inc. reported accounts payable and accrued liabilities (accrued expenses) of $198,746,000 at the end of 2002. In the disclosure note, shown in Graphic 5–9, the company provided some details.

GRAPHIC 5–9
Accrued Expenses Disclosure—Indigo Books and Music Inc.

Indigo Books and Music Inc.

Note 13: RESTRUCTURING AND TAKE-OVER COSTS
(in part)

(a) Restructuring charges for the period ended March 30, 2002, consist of the following:

(thousand of dollars)	
Write-down of property, plant, and equipment	24,052
Provision for store closing and other costs	11,906
Relocation and other costs as a result of acquisition	1,691
Refinancing fee	2,667
	40,316

As at March 30, 2002, approximately $9.75 million of the provision for store closing, relocation, and other costs remain unpaid and have been included in accounts payable and accrued liabilities.

Long-term notes, loans, mortgages, and bonds payable usually are reclassified and reported as current liabilities as they become payable within the next year (or operating cycle if that is longer).[5] Likewise, when long-term debt is payable in installments, the installment payable currently is reported as a current liability. For example, a $1,000,000 note payable requiring $100,000 in principal payments to be made in each of the next 10 years is classified as a $100,000 current liability—**current maturities of long-term debt**—and a $900,000 long-term liability.

Current liabilities include the *current maturities of long-term debt.*

Chapter 13 provides a more detailed analysis of current liabilities.

Long-Term Liabilities. Long-term liabilities are obligations that will *not* be satisfied in the next year or operating cycle, whichever is longer. They do not require the use of current assets or the creation of current liabilities for payment. Examples are long-term notes, bonds, pension obligations, lease obligations, and future income tax liabilities.

Noncurrent, or long-term liabilities, usually are those payable beyond the current year.

But simply classifying a liability as long-term does not provide complete information to external users. For instance, long-term could mean anything from two to 20, 30, or 40 years. Payment terms, interest rates, and other details needed to assess the impact of these obligations on future cash flows and long-term solvency are reported in a disclosure note.

At the end of its 2002 fiscal year, Indigo Books and Music Inc. reported long-term debt, accrued benefit obligations, convertible debentures, and noncontrolling interest. A disclosure note indicated that long-term debt consisted of notes payable, revolving line of credit, and derivative agreement. Each of these liabilities, as well as future income tax liabilities, are discussed in later chapters. The long-term liability category called *other liabilities* relates primarily to deferred gains on certain lease transactions. This topic also is addressed in a later chapter.

SHAREHOLDERS' EQUITY

Recall from our discussions in Chapters 1 and 2 that owners' equity is simply a residual amount derived by subtracting liabilities from assets. For that reason, it is also sometimes called net assets. Also recall that owners of a corporation are its shareholders, so owners' equity for a corporation is referred to as shareholders' equity. Shareholders' equity for a corporation arises primarily from two sources: (1) amounts *invested* by shareholders in the corporation, and (2) amounts *earned* by the corporation (on behalf of its shareholders). These are reported as (1) **contributed capital,** and (2) **retained earnings.** Retained earnings represents the accumulated net income earned from the inception of the corporation and not (yet) paid to shareholders as dividends.

Shareholders' equity is composed of *contributed capital* (invested capital) and *retained earnings* (earned capital).

Graphic 5–10 presents the shareholders' equity section of Indigo Books and Music Inc.'s 2002 and 2001 balance sheets. The company calls this section shareholders' equity.

GRAPHIC 5–10
Shareholders' Equity—Indigo Books and Music Inc.

Indigo Books and Music Inc.

(thousands of dollars)	As at March 30, 2002	As at March 31, 2001
Shareholders' Equity		
Share capital (note 7)	$163,505	$144,775
Equity portion of convertible notes (notes 9 and 11)	1,903	—
Deficit	(101,578)	(53,666)
Total shareholders' equity	**63,830**	**91,109**

From the inception of the corporation through March 31, 2002, Indigo has accumulated a deficit, $101,578,000, which is reported as "deficit." The company's *share capital* is repre-

[5] Payment can be with current assets or the creation of other current liabilities.

GLOBAL PERSPECTIVE

Balance Sheet

A global perspective in Chapter 3 pointed out that there are significant differences from country to country in the accounting methods used to measure income statement amounts. This, of course, pertains to the balance sheet as well. For example, differences in inventory measurement methods affect the calculation of cost of goods sold as well as the inventory balance reported on the balance sheet. Many of these measurement differences are highlighted in the specific chapters that deal with the specific issues.

In terms of balance sheet presentation, the classification of assets and liabilities into current and noncurrent categories is prevalent globally. However, significant differences do exist, particularly with respect to terminology. In the United Kingdom, the term *stocks* refers to inventory. A Canadian investor would interpret shares to mean investments in equity securities of other companies. In Canada, shareholders' equity is composed of contributed capital and retained earnings. In many other countries, shareholders' equity is divided into capital and reserves. For example, in Germany, equity is divided into share capital, capital reserves, and revenue reserves. In India, liabilities whose existence is certain but whose value must be estimated are called *provisions* and are listed separately.

Balance sheet presentation differences also exist. For example, a typical British balance sheet begins with noncurrent assets, called *fixed assets.* Current assets are listed next and current liabilities are subtracted to arrive at net current assets, which is added to fixed assets. Long-term debt is then subtracted from this subtotal to arrive at net assets. The net asset's total is equal to shareholders' interest, which is the last item reported on the balance sheet.

sented by "common shares" and "equity portion of convertible notes," which collectively represent cash invested by shareholders in exchange for ownership interests.

On August 14, 2001 ("date of acquisition"), Indigo acquired all of the issued and outstanding shares in Indigo Books and Music, Inc. ("Old Indigo"). The aggregate purchase price was $11.9 million, pursuant to which Indigo issued 528,268 common shares valued at $41.5 million. The value of the 528,268 common shares issued was determined on the basis of the average market price of Indigo's common shares over a reasonable period before and after the date the terms of the business combination were agreed upon and announced.

In addition to share capital and retained earnings, shareholders' equity also may include a variety of other equity components. We discuss these other equity components in later chapters, Chapter 19 in particular.

CONCEPT REVIEW EXERCISE

Balance Sheet Classification

The following is a post-closing trial balance for the Sepia Paint Corporation at December 31, 2005, the end of the company's fiscal year:

Account Title	Debits	Credits
Cash	80,000	
Accounts receivable	200,000	
Allowance for doubtful accounts		20,000
Inventories	300,000	
Prepaid expenses	30,000	
Note receivable (due in one month)	60,000	
Investments	50,000	
Land	120,000	
Buildings	550,000	
Machinery	500,000	
Accumulated amortization—buildings and machinery		450,000

Account Title	Debits	Credits
Patent (net of amortization)	50,000	
Accounts payable		170,000
Salaries payable		40,000
Interest payable		10,000
Note payable		100,000
Bonds payable (due in 10 years)		500,000
Common shares		400,000
Retained earnings		250,000
Totals	1,940,000	1,940,000

The $50,000 balance in the investment account consists of marketable equity securities of other corporations. The company's intention is to hold the securities for at least three years. The $100,000 note payable is an installment loan. $10,000 of the principal, plus interest, is due on each July 1 for the next 10 years. At the end of the year, 100,000 common shares were issued and outstanding. The company has 50,000 shares authorized.

Required:

Prepare a classified balance sheet for the Sepia Paint Corporation at December 31, 2005.

SOLUTION

SEPIA PAINT CORPORATION
Balance Sheet
At December 31, 2005

Assets		
Current assets:		
Cash		$ 80,000
Accounts receivable	$ 200,000	
Less: Allowance for doubtful amounts	(20,000)	180,000
Note receivable		60,000
Inventories		300,000
Prepaid expenses		30,000
Total current assets		650,000
Investments		50,000
Property, plant, and equipment:		
Land	120,000	
Buildings	550,000	
Machinery	500,000	
	1,170,000	
Less: Accumulated amortization	(450,000)	
Net property, plant, and equipment		720,000
Intangibles:		
Patent		50,000
Total assets		$1,470,000
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable		$ 170,000
Salaries payable		40,000
Interest payable		10,000
Current maturities of long-term debt		10,000
Total current liabilities		230,000
Long-term liabilities:		
Note payable	$ 90,000	
Bonds payable	500,000	
Total long-term liabilities		590,000

continued

Shareholders' equity:		
Common shares, no par, 500,000	400,000	
Shares authorized, 100,000 shares issued and outstanding		
Retained earnings	250,000	
Total shareholders' equity		650,000
Total liabilities and shareholders' equity		$1,470,000

The usefulness of the balance sheet, as well as the other financial statements, is significantly enhanced by financial statement disclosures. We now turn our attention to these disclosures.

PART b

FINANCIAL DISCLOSURES

Financial statements are included in the annual report a company mails to its shareholders. They are, however, only part of the information provided. Critical to understanding the financial statements and to evaluating the firm's performance and financial health are disclosure notes and other information included in the annual report.

Notes to Financial Statements

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The full-disclosure principle requires that financial statements provide all material, relevant information concerning the reporting entity.

Notes to financial statements typically span several pages and explain or elaborate on the data presented in the financial statements themselves. Throughout this text, you will encounter examples of items that usually are disclosed this way. For instance, the market values of financial instruments and "off-balance-sheet" risk associated with financial instruments must be disclosed. Information providing details of pension plans, leases, debt, and several assets also is disclosed in the notes. Disclosures must include certain specific notes, such as a summary of significant accounting policies, descriptions of subsequent events, and related third-party transactions, but many notes are fashioned to suit the disclosure needs of the particular reporting enterprise. Additional matters that require note disclosure include economic dependence, going concern, and commitments. Actually, any explanation that contributes to investors' and creditors' understanding of the results of operations, financial position, or cash flows of the company should be included. Some common disclosures are made by some companies in the form of notes, while other companies disclose the same information as separate schedules or in other formats within the annual report. The specific format of disclosure is not important, only that the information is, in fact, disclosed. Let us look at just a few notes to financial statements.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The *summary of significant accounting policies* conveys valuable information about the company's choices from among various alternative accounting methods.

There are many areas where management chooses from among equally acceptable alternative accounting methods. For example, management chooses whether to use accelerated or straight-line amortization, whether to use FIFO, LIFO, or average cost to measure inventories, and whether the completed contract or percentage-of-completion method best reflects the performance of construction operations. It also defines which securities it considers to be cash equivalents and its policies regarding the timing of recognizing revenues. Typically, the first disclosure note consists of a summary of significant accounting policies that discloses the choices the company makes.[6] Graphic 5–11 shows you a portion of a typical summary note from a recent annual report of the Sierra Systems Group Inc. Indigo Books and Music Inc. reports the summary in its notes, shown on page 34 in the appendix for Chapter 1.

Studying this note is an essential step in analyzing financial statements. Obviously, knowing which methods were used to derive certain accounting numbers is critical to assessing the adequacy of those amounts.

[6] "Disclosure of Accounting Policies," *CICA Handbook*, Section 1505.

GRAPHIC 5–11
Summary of Significant Accounting Policies—Sierra Systems Group Inc. (www.sierrasystems.com)

1. Summary of significant accounting policies

Generally accepted accounting principles

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

Principles of consolidation

The consolidated financial statements include the accounts of the company and its wholly owned subsidiaries. Principal operating subsidiaries are Sierra Systems Consultants Inc. and Sierra/Computec Consulting Inc. The Company's 49 percent interest in Donna Cona Inc. is recorded on a proportionate consolidation basis.

Revenue recognition

The Company recognizes its revenue as services are performed. Revenue is recognized on fixed price contracts using the percentage-of-completion method of accounting. Adjustments to fixed price contracts and estimated losses, if any are recorded in the period when such adjustments or losses are known. On risk-sharing contracts, billings from subcontractors on which the Company takes no mark up are recorded directly in accounts receivable and do not flow through the statement of earnings.

Work-in-progress represents services provided which have not yet been billed and is valued at estimated realizable value.

Deferred revenue includes billings and cash received in advance of services performed.

Translation of accounts of foreign subsidiaries

Accounts of foreign subsidiaries are translated into Canadian dollars using the temporal method as follows:

a) monetary assets and liabilities at the year-end rate of exchange
b) nonmonetary assets, liabilities, and capital stock at historical rates of exchange
c) revenue and expenses at average rates for the year, except for amortization, which is translated at exchange rates used in the translation of the relevant asset accounts.

All gains and losses arising from the translation of foreign currencies are included in net earnings for the year.

Temporary investments

Temporary investments are normally held to maturity and comprise cash deposits or short-term money-market securities.

Property, plant, and equipment

Property, plant, and equipment are carried at cost. Amortization is calculated over their estimated useful lives using the declining balance method at the following annual rates:

Furniture and equipment	20–30%
Computer hardware	30%
Computer software	100%
Leasehold improvements	over the remaining life of the lease

One-half of the year's amortization is recognized in the year of acquisition.

Goodwill

Goodwill arising on acquisitions is amortized over seven to 20 years using the straight-line method. Goodwill is written down when declines in value are considered to be permanent, based on estimated future cash flows.

Income Taxes

Effective October 1, 2000, the Company adopted the liability method of accounting for income taxes. Under the liability method, future tax assets and liabilities are determined based upon differences between financial reporting and tax bases of assets and liabilities measured using current income tax rates.

The summary of significant accounting policies tells the analyst which choices were made in preparing the financial statements.

SUBSEQUENT EVENTS

A *subsequent event* is a significant development that takes place after the company's fiscal year-end but before the financial statements are issued.

When an event that has a material effect on the company's financial position occurs after the fiscal year-end but before the financial statements actually are issued, the event is disclosed in a **subsequent event** disclosure note. Examples include the issuance of debt or equity securities, a business combination or the sale of a business, the sale of assets, an event that sheds light on the outcome of a loss contingency, or any other event having a material effect on operations. Graphic 5–12 illustrates the required note to financial statements by showing a note that G-Mac included in its September 30, 2001 financial statements, announcing the closing of a previously announced transaction with Nortel.

We cover subsequent events in more depth in Chapter 13.

GRAPHIC 5–12
Subsequent Events—G-Mac

Subsequent Events
On November 2, 2001 the Company announced the closing of a previously announced transaction with Nortel to supply Systems integration, configuration and testing of DMS circuit-switching products, as well as related supply chain services.

NOTEWORTHY EVENTS AND TRANSACTIONS

Some transactions and events occur only occasionally, but when they do occur are potentially important to evaluating a company's financial statements. In this category are errors and irregularities, illegal acts, and related-party transactions the more frequent of these is related-party transactions.

Sometimes a company will engage in transactions with owners, management, families of owners or management, affiliated companies, and other parties that can significantly influence or be influenced by the company. The potential problem with related party transactions is that their economic substance may differ from their legal form. For instance, borrowing or lending money at an interest rate that differs significantly from the market interest rate is an example of a transaction that could result from a related-party involvement. Financial statement users are particularly interested in more details about these transactions to assess the effect of any differences between economic substance and legal form.

The economic substance of *related-party transactions* should be disclosed, including dollar amounts involved.

When **related-party transactions** occur, companies must disclose (1) the nature (description) of the relationship, (2) a description of the transaction(s), (3) the recorded amount of the transaction(s), (4) the measurement basis used, (5) amounts due to or from related-parties and the terms and conditions, (6) contractual obligations with related-parties, and (7) contingencies involving related parties.[7]

Graphic 5–13 shows a disclosure note from a recent annual report of Telus Communications. The note describes the company's relationship with Verizon Communications Inc., a significant shareholder.

More infrequent are errors, irregularities, and illegal acts; however, when they do occur, their disclosure is important. The distinction between errors and **irregularities** is that errors are unintentional, whereas irregularities are *intentional* distortions of financial statements.[8] Obviously, management fraud might cause a user to approach financial analysis from an entirely different and more cautious viewpoint.

Disclosure notes for some financial statement elements are required. Others are provided when required by specific situations in the interest of full disclosure.

Closely related to irregularities are **illegal acts,** such as bribes, kickbacks, illegal contributions to political candidates, and other violations of the law.

Disclosures of irregularities, illegal acts, and related-party transactions can be quite sensitive. Although auditors must be considerate of the privacy of the parties involved, that consideration cannot be subordinate to users' needs for full disclosure.

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[7]*CICA Handbook*, Section 3840, para. 43.

[8]"The Auditor's Responsibility to Detect and Report Errors and Irregularities," *Statement on Auditing Standards No 53* (New York: AICPA, 1988).

GRAPHIC 5–13
Related-Party Transactions Disclosure—Telus Communications.

Note 1: Related Party Transactions
The company has entered into an agreement with Verizon Communications Inc., a significant shareholder, with respect to acquiring certain rights to Verizon's software, technology, services and, other benefits, thereby replacing and amending a previous agreement between the Company and GTE Corporation. The agreement is renewable annually at the Company's sole option up to December 31, 2008, and it has been renewed for 2002. As of December 31, 2001, $199.3 million of specified software licences and a trademark licence have been acquired and recorded as property, plant, and equipment. These assets were recorded at the transaction price, which represents fair market values as determined by an independent appraisal. In addition, $68.5 million relating to ongoing services and other benefits have been expensed during the year ended December 31, 2001. Assuming renewal through to 2008, the total commitment under the revised agreement is U.S.$3.77 million for the period 2001 to 2008 (see Note 17(b)).

Sales to Verizon Communications Inc. amounted to $15.3 million (2000 – $20.4 million). These transactions were conducted in the normal course of business at prices established and agreed to by both parties.

The Company purchased the former QuébecTel Group from Verizon Communications Inc. in two steps, as further described in Note 4. In 2001, the Company sold substantially all of its directory business to a subsidiary of Verizon Communications Inc. as further described in Note 8.

We have discussed only a few of the disclosure notes most frequently included in annual reports. Other common disclosures include details concerning earnings per share calculations, income taxes, property and equipment, contingencies, long-term debt, leases, pensions, share options, changes in accounting methods, fair values of financial instruments, and exposure to market risk and credit risk. We discuss and illustrate these in later chapters in the context of related financial statement elements.

Management Discussion and Analysis

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Each annual report includes a fairly lengthy discussion and analysis provided by the company's management. In this section, management provides its views on significant events, trends, and uncertainties pertaining to the company's (1) operations, (2) liquidity, and (3) capital resources. Although the **management discussion and analysis (MDA)** section may embody management's biased perspective, it can offer an informed insight that might not be available elsewhere. Graphic 5–14 contains part of the liquidity and capital resources portion of the Stelco Inc.'s MDA that followed a five-page discussion of operations in its 2000 annual report.

GRAPHIC 5–14
Management Discussion and Analysis—Stelco Inc.

The management discussion and analysis provides a biased but informed perspective of a company's (1) operations, (2) liquidity, and (3) capital resources.

Management Discussion and Analysis
(In part: Liquidity, Operating Activities, and Investing Activities)

To cope with the cyclical nature of the steel industry, the Corporation aims to maintain adequate cash balances, lines of credit, and a reasonable debt-to-equity position. The necessity for such an approach was made evident in the second half of 2000. Surging imports of steel products contributed to a sharp decline in shipments and selling prices. As a result, the Cash and cash equivalents balance was $45 million at year-end, down from $176 million at year-end 1999. Available lines of credit, including amounts for subsidiaries and joint ventures, at year-end 2000 totalled $287 million compared with $297 million at year-end 1999. Usage of these lines at year-end was $43 million. At December 31, 2000, debt/equity as a percent of total capital was 37/63.

Management's Responsibilities

Auditors examine financial statements and the internal control procedures designed to support the content of those statements. Their role is to attest to the fairness of the financial statements on the basis of that examination. However, management prepares and is responsible for the financial statements and other information in the annual report. To enhance the awareness of the users of financial statements concerning the relative roles of management and the auditor, annual reports include a management's responsibilities section that asserts the responsibility of management for the information contained in the annual report as well as an assessment of the company's internal control procedures. Wording of this section is fairly standard. A typical disclosure is provided in Graphic 5–15.

GRAPHIC 5–15
Management's Responsibilities—SR Telecom Inc.

The management's responsibilities section avows the responsibility of management for the company's financial statements and internal control system.

Management's Statement of Responsibility

The financial statements and other information contained in this Annual Report are the responsibility of Management. They have been prepared in accordance with generally accepted accounting principles and are deemed to present fairly the consolidated financial position, results of operations and changes in financial position of the Company. Where necessary, Management has made informed judgments and estimates of the outcome of events and transactions, with due consideration given to materiality.

As a means of fulfilling its responsibility for the integrity of financial information included in this Annual Report, Management relies on the Company's system of internal control. This system has been established to ensure, within reasonable limits, that assets are safeguarded, that transactions are properly recorded and executed in accordance with Management's authorisation and that the accounting records provide a solid foundation from which to prepare the financial statements. It is recognised that no system of internal control can detect and prevent all errors and irregularities. Nonetheless, Management believes that the established system provides an acceptable balance between benefits to be gained and the related cost.

The Company's independent public accountants are responsible for auditing the financial statements and giving an opinion on them. As part of that responsibility, they review and assess the effectiveness of internal accounting controls to establish a basis for reliance thereon in determining the nature, timing, and extent of audit tests to be applied. Management emphasises the need for constructive recommendations as part of the auditing process and implements a high proportion of their suggestions.

The Board of Directors carries out its responsibility for the consolidated financial statements principally through its Audit Committee, consisting solely of outside directors, which reviews the financial statements and reports thereon to the Board. The Committee meets periodically with the independent public accountants and Management to review their respective activities and the discharge of each of their responsibilities. The independent public accountants have free access to the Committee, with or without Management, to discuss the scope of their audit, the adequacy of the system of internal control and the adequacy of financial reporting.

Management recognises its responsibility for fostering a strong ethical climate so that the Company's affairs are carried out according to the highest standards of personal and corporate conduct. This responsibility is characterized in the code of business conduct which is publicized throughout the Company. Employee awareness of this code is achieved through regular and continuing written policy statements. Management maintains a systematic program to ensure compliance with these policies.

Pierre St-Arnaud
President and
Chief Executive Officer

David L. Adams
Vice-President, Finance
and Chief Financial Officer

February 1, 2002

Auditors' Report

LO7

One step in financial analysis should be an examination of the **auditors' report.** This is the report issued by the public accountants who audit the financial statements and informs users of their audit findings. Every audit report looks similar to the one prepared by Deloitte & Touche LLP for the financial statements of SR Telecom Inc., as shown in Graphic 5–16.

GRAPHIC 5–16
Auditors' Report—SR Telecom Inc.

The *auditors' report* provides the analyst with an independent and professional opinion about the fairness of the representations in the financial statements.

Auditors' Report

To the Shareholders of SR Telecom Inc.

We have audited the consolidated balance sheets of SR Telecom Inc. as at December 31, 2001 and 2002, and the consolidated statements of earnings, deficit and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 21, 2001 and 2002, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Chartered Accountants
February 1, 2002

The reason for the similarities is that auditors' reports must be in exact compliance with the specifications of the *CICA Handbook.*[9] In most cases, including the report for SR Telecom Inc., the auditors will be satisfied that the financial statements "present fairly" the financial position, results of operations, and cash flows and are "in conformity with generally accepted accounting principles." These situations prompt an **unqualified opinion.** Sometimes, circumstances cause the auditors' report to include an explanatory paragraph in addition to the standard wording, even though the report is unqualified. Most notably, these include:

a. *Lack of consistency* due to a change in accounting policy such that comparability is affected even though the auditor concurs with the desirability of the change.
b. *Uncertainty* as to the ultimate resolution of a contingency for which a loss is material in amount but not necessarily probable or probable but not estimable.
c. *Emphasis* of a matter concerning the financial statements that does not affect the existence of an unqualified opinion but relates to a significant event, such as a related-party transaction.

Some audits result in the need to issue other than an unqualified opinion, in which case the auditor will issue a (an):

The auditors' report calls attention to problems that might exist in the financial statements.

a. **Qualified opinion** This contains an exception to the standard unqualified opinion but not of sufficient seriousness to invalidate the financial statements as a whole.

[9] *CICA Handbook*, Section. 5400.

Examples of exceptions are (i) nonconformity with generally accepted accounting principles, (ii) inadequate disclosures, and (iii) a limitation or restriction of the scope of the examination.

b. **Adverse opinion** This is necessary when the exceptions are so serious that a qualified opinion is not justified. Adverse opinions are rare because auditors usually are able to persuade management to rectify problems to avoid this undesirable report.

c. **Disclaimer** An auditor will disclaim an opinion if insufficient information has been gathered to express an opinion.

The auditor should assess the firm's ability to continue as a going concern.

During the course of each audit, the auditor is required to evaluate the company's ability to continue as a going concern for a reasonable time. If the auditor determines there is significant doubt, an explanation of the potential problem must be included in the auditors' report.[10]

Obviously, the auditors' report is most informative when any of these deviations from the standard unqualified opinion are present. These departures from the norm should raise a red flag to a financial analyst and prompt additional search for information.

The auditors' report of Zenith Electronics Corporation, exhibited in Graphic 5–17, included a fourth paragraph after the standard first three paragraphs.

GRAPHIC 5–17
Going Concern Paragraph—Zenith Electronics Corporation

> The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered recurring losses from operations and has negative working capital that raises substantial doubt about the ability to continue as a going concern. Management's plans in regards to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Compensation of Directors and Top Executives

In the early 1990s, the compensation large Canadian and American corporations pay their top executives became an issue of considerable public debate and controversy. Shareholders, employees, politicians, and the public in general began to question the huge pay packages received by company officials, while more and more rank and file employees were being laid off as a result of company cutbacks. Contributing to the debate was the realization that the compensation gap between executives and lower level employees was much wider than in Japan and most other industrialized countries. During this time, it also became apparent that discovering exactly how much compensation corporations paid their top people was nearly impossible.

Part of the problem stemmed from the fact that disclosures of these amounts were meagre; but a large part of the problem was that a substantial portion of executive pay often is in the form of stock options. Executive stock options give their holders the right to buy shares at a specified price, usually equal to the market price when the options are granted. When share prices rise, executives can exercise their options and realize a profit. In some cases, options have made executive compensation seem extremely high. Stock options are discussed in depth in Chapter 18.

The *proxy statement*, which is sent each year to all shareholders, contains disclosures on compensation to directors and executives.

In the United States, to help shareholders and others sort out the content of executive pay packages and better understand the commitments of the company in this regard, recent SEC requirements now provide for more disclosures on compensation to directors and executives, and in particular, concerning stock options. The **proxy statement** which must be sent each year to all shareholders, usually in the same mailing with the annual report, previously served primarily to invite shareholders to the meeting to elect board members and to vote on issues before the shareholders or to vote using an enclosed proxy card. Beginning with 1992 financial statements, the proxy statement assumed a larger role. Graphic 5–18 lists the in-

[10] *CICA Handbook*, Section. 5400.

GLOBAL PERSPECTIVE

Disclosure Practices around the World

Most countries require specific disclosures by companies operating within their borders. Many of these disclosures are similar. However, the amount and types of required and voluntary disclosures differ from country to country. For example, in Israel, companies whose securities are publicly traded are required to disclose any receivable that exceeds 5 percent of total current assets. In Mexico, a disclosure reports the separate identification of long-term liabilities into the following categories: suppliers, affiliates, income tax, employees' profit sharing, and bank loans.

Several supplemental disclosures are uniquely European. These include information about shares and shareholders, certain employee disclosures, and environmental disclosures. An example of an environmental disclosure would be a discussion of safety measures adopted by the company in their manufacturing plants. In France, many enterprises are required to publish an annual social balance sheet. This report covers such matters as employment, training, health and safety conditions, employee benefits, and environmental issues. In general, European companies consider the full-disclosure concept to include a much broader set of information than do Canadian and American companies.

formation that the statement now also reports. In 2002, a number of Canadian and American companies elected to expense stock options in their financial statements.

GRAPHIC 5–18
Proxy Statement Information

A summary compensation table that outlines how much directors and top executives are paid and what retirement benefits they will receive.

A table of options granted that reports information about options given to individually identified executives in the most recent year, including:
- The number of options and dates granted.
- The percent of total options given to each top executive.
- The exercise price and expiration date of options.
- The company's estimate of the options' values.

A table of options holdings that reports information about all options currently held by individually identified executives, including:
- The number of options each executive owns and their value.
- The number of shares acquired in the most recent year by exercising options.
- The amount of profit realized from exercising options.

RISK ANALYSIS

PART C

Investors and creditors use financial information to assess the future risk and return of their investments in business enterprises. The balance sheet provides information useful to this assessment. A key element of risk analysis is investigating a company's ability to pay its obligations when they come due. This type of risk often is referred to as **default risk.** Another aspect of risk is **operational risk** which relates more to how adept a company is at withstanding various events and circumstances that might impair its ability to earn profits. Obviously, these two types of risk are not completely independent of one another. Inability to earn profits certainly increases a company's chances of defaulting on its obligations. Conversely, regardless of a company's long-run prospects for generating profits, if it cannot meet its obligations, the company's operations are at risk.

Assessing risk necessarily involves consideration of a variety of economywide risk factors, such as inflation, interest rates, and the general business climate. Industrywide influences, including competition, labour conditions, and technological forces, also affect a company's risk profile. Still other risk factors are specific to the company itself. Financial ratios often are used in risk analysis to investigate a company's **liquidity** and **long-term solvency.** As we discuss some of the more common ratios in the following paragraphs, keep in mind the inherent relationship between risk and return and, thus, between our profitability analysis in the previous chapter and our risk analysis in this chapter.

LIQUIDITY RATIOS

LO8

Liquidity refers to the readiness of assets to be converted to cash. By comparing a company's liquid assets with its short-term obligations, we can obtain a general idea of the firm's ability to pay its short-term debts as they come due. Usually, current assets are thought of as the most liquid of a company's assets. Obviously, though, some are more liquid than others, so it is important also to evaluate the specific makeup of current assets. Two common measures of liquidity are (1) the current ratio, and (2) the acid-test ratio (or quick ratio) calculated as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\begin{array}{c}\text{Acid-test ratio}\\ \text{(or quick ratio)}\end{array} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

Working capital, **the difference between current assets and current liabilities, is a popular measure of a company's ability to satisfy its short-term obligations.**

Current Ratio. Implicit in the definition of a current liability is the relationship between current assets and current liabilities. The difference between current assets and current liabilities is called **working capital.** By comparing a company's obligations that will shortly become due with the company's cash and other assets that, by definition, are expected to shortly be converted to cash, the ratio offers some indication as to ability to pay those debts. Although used in a variety of decisions, it is particularly useful to those considering whether to extend short-term credit. The **current ratio** is computed by dividing current assets by current liabilities. A current ratio of 2.0 indicates that the company has twice as many current assets available as current liabilities.

Indigo Books and Music Inc.

Indigo Books and Music Inc.'s working capital (in thousands) at the end of its 2002 fiscal year is a negative $40,838 consisting of current assets of $252,787,000 (see Graphic 5–4) minus current liabilities of $293,625,000 (see Graphic 5–8). The current ratio can be computed as follows:

$$\text{Current ratio} = \frac{\$252{,}787{,}000}{\$293{,}625{,}000} = .86$$

Working capital may not present an accurate or complete picture of a company's liquidity.

Care should be taken, however, in assessing liquidity solely on the basis of working capital. Liabilities usually are paid with cash, not other components of working capital. A company could have difficulty paying its liabilities even with a current ratio significantly greater than 1.0. For example, if a significant portion of current assets consisted of inventories, and inventories usually are not converted to cash for several months, there could be a problem in paying accounts payable due in 30 days. On the other hand, a current ratio of less than 1.0, for example, .86 for Indigo, does not necessarily mean the company will have difficulty meeting its current obligations. A line of credit, for instance, which the company can use to borrow funds, provides financial flexibility. That also must be considered in assessing liquidity.

The ***acid-test ratio*** **provides a more stringent indication of a company's ability to pay its current obligations.**

Acid-Test Ratio (or Quick Ratio). Some analysts like to modify the current ratio to consider only current assets that are readily available to pay short-term debts. One such variation in common use is the **acid-test ratio.** This ratio excludes inventories and prepaid items from current assets before dividing by current liabilities. By eliminating current assets less readily convertible into cash, the acid-test ratio provides a more rigorous indication of liquidity than does the current ratio.

ETHICAL DILEMMA

The Raintree Cosmetic Company has several loans outstanding with a local bank. The debt agreements all contain a covenant stipulating that Raintree must maintain a current ratio of at least .9. Jackson Phillips, company controller, estimates that the 2005 year-end current assets and current liabilities will be $2,100,000 and $2,400,000, respectively. These estimates provide a current ratio of only .875. Violation of the debt agreement will increase Raintree's borrowing costs as the loans are renegotiated at higher rates.

Jackson proposes to the company president that Raintree purchase inventory of $600,000 on credit before year-end. This will cause both current assets and current liabilities to increase by the same amount, but the current ratio will increase to .9. The extra $600,000 in inventory will be used over the later part of 2006. However, the purchase will cause warehousing costs and financing costs to increase.

Jackson is concerned about the ethics of his proposal. What do you think?

Indigo Books and Music Inc.

Indigo Books and Music Inc.'s quick assets at the end of its 2002 fiscal year (in thousands) total $29,320,000 ($252,784,000 − $223,467,000). The acid-test ratio can be computed as follows:

$$\text{Acid-test ratio} = \frac{29{,}320{,}000}{293{,}625{,}000} = .10$$

Are these liquidity ratios adequate? It is difficult to say without some point of comparison. As indicated previously, common standards for such comparisons are industry averages for similar ratios or ratios of the same company in prior years. Suppose Indigo Books and Music Inc.'s ratios were less than the industry average. Would that be an indication that liquidity is a problem for Indigo Books? Not necessarily, but it certainly would raise a red flag that calls for caution in analyzing other areas. Remember, each ratio is but one piece of the entire puzzle. For instance, as stated previously, profitability is perhaps the best indication of liquidity in the long run. We discussed ratios that measure profitability in the previous chapter.

Also, recall the discussion of receivables turnover and inventory turnover in Chapter 4. Management may be very efficient in managing current assets so that, for example, receivables are collected faster than normal or inventory is sold faster than normal, making those assets more liquid than they otherwise would be. Higher turnover ratios, say, compared with a competitor, generally indicate a more liquid position for a given level of the current ratio.

Liquidity ratios should be assessed in the context of both profitability and efficiency of managing assets.

FINANCING RATIOS

LO8

Investors and creditors, particularly long-term creditors, are vitally interested in a company's long-term solvency and stability. Financing ratios provide some indication of the riskiness of a company with regard to its ability to pay its long-term debts. Two common financing ratios are (1) the debt-to-equity ratio, and (2) the times interest earned ratio. These ratios are calculated as follows:

$$\text{Debt-to-equity ratio} = \frac{\text{Total liabilities}}{\text{Shareholders' equity}}$$

$$\text{Times interest earned ratio} = \frac{\text{Net income} + \text{Interest expense} + \text{Taxes}}{\text{Interest expense}}$$

Debt-to-Equity Ratio. The **debt-to-equity** ratio compares resources provided by creditors with resources provided by owners. It is calculated by dividing total liabilities (current and noncurrent) by total shareholders' equity (including retained earnings).[11]

[11]A commonly used variation of the debt-to-equity ratio is found by dividing total liabilities by *total assets* (or total equities), rather than by shareholders' equity only. Of course, in this configuration the ratio measures precisely the same attribute of the firm's capital structure but can be interpreted as the percentage of a company's total assets provided by funds from creditors, rather than by owners.

The *debt-to-equity ratio* indicates the extent of reliance on creditors, rather than owners, in providing resources.

The ratio provides a measure of creditors' protection in the event of insolvency. Other things being equal, the higher the ratio, the higher is the risk. The higher the ratio, the greater are the creditor claims on assets, so the higher the likelihood an individual creditor would not be paid in full if the company is unable to meet its obligations. Relatedly, a high ratio indicates not only more fixed interest obligations but probably a higher *rate* of interest as well because lenders tend to charge higher rates as the level of debt increases.

Indigo Books and Music Inc.'s total liabilities (in thousands) are $376,002,000 (see Graphic 5–8), and shareholders' equity totals $63,830,000 (see Graphic 5–10). The debt-to-equity ratio can be computed as follows:

Indigo Books and Music Inc.

$$\text{Debt-to-equity ratio} = \frac{\$376{,}002{,}000}{\$63{,}830{,}000} = 5.89$$

As with all ratios, the debt-to-equity ratio is more meaningful if compared with some standards, such as industry average or competitor. For example, the 2001 debt-to-equity ratio for Reitmans (Canada) Limited, a major retailer, is .21 indicating that Reitmans has significantly less debt in its capital structure than does Indigo Books and Music, Inc. On the other hand, the ratio for Domtar Inc. is 1.24, slightly higher than Reitmans' ratio and much lower than Indigo Books and Music, Inc. Does that mean Reitmans and Domtar's default risk is less than that of Indigo Books and Music Inc.? Other things being equal—yes. Is that good? Not necessarily. As discussed in the next section, it may be that debt is being underutilized by Reitmans and Domtar. More debt might increase the potential for return, but the price would be higher risk. This is a fundamental trade-off faced by virtually all firms when trying to settle on the optimal capital structure.

Relationship between risk and profitability. The proportion of debt in the capital structure also is of interest to shareholders. After all, shareholders receive no return on their investments until after all creditor claims are paid. Therefore, the higher the debt-to-equity ratio, the higher is the risk to shareholders. On the other hand, shareholders have a seemingly discrepant desire for a high ratio in order to make use of leverage. By earning a return on borrowed funds that exceeds the cost of borrowing the funds, a company can provide its shareholders with a total return higher than it could achieve by employing equity funds alone. This is referred to as favourable **financial leverage.**

The debt-to-equity ratio indicates the extent of trading on the equity, or financial leverage.

For illustration, consider a newly formed corporation attempting to determine the appropriate mix of debt and equity. The initial capitalization goal is $50 million. The capitalization mix alternatives have been narrowed to two: (1) $10 million in debt and $40 million in equity, and (2) $30 million in debt and $20 million in equity.

Also assume that regardless of the capitalization mix chosen, the corporation will be able to generate a 16 percent annual return, *before payment of interest and income taxes,* on the $50 million in assets acquired. In other words, income before interest and taxes will be $8 million (16% × $50 million). If the interest rate on debt is 8 percent and the income tax rate is 40 percent, comparative net income for the first year of operations for the two capitalization alternatives can be calculated as follows:

	Alternative 1	Alternative 2
Income before interest and taxes	$8,000,000	$8,000,000
Less: Interest expense	(800,000)[a]	(2,400,000)[b]
Income before taxes	7,200,000	5,600,000
Less: Income tax expense (40%)	(2,880,000)	(2,240,000)
Net income	$4,320,000	$3,360,000

[a]8% × $10,000,000
[b]8% × $30,000,000

Choose alternative 1? Probably not. Although alternative 1 provides a higher net income, the return on the shareholders' investment is higher for alternative 2. Here is why:

Favourable financial leverage means earning a return on borrowed funds that exceeds the cost of borrowing the funds.

		Alternative 1	Alternative 2
Return on shareholders' equity[12]	=	$\frac{\$4{,}320{,}000}{\$40{,}000{,}000}$	$\frac{\$3{,}360{,}000}{\$20{,}000{,}000}$
	=	10.8%	16.8%

Alternative 2 generated a higher return for each dollar invested by shareholders. This is because the company leveraged its $20 million equity investment with additional debt. Because the cost of the additional debt (8%) is less than the return on assets invested (16%), the return to shareholders is higher. This is the essence of favourable financial leverage.

Be aware, though, leverage is not always favourable; the cost of borrowing the funds might exceed the returns they provide. If the return on assets turned out to be less than expected, the additional debt could result in a lower return on equity for alternative 2. If, for example, the return on assets invested (before interest and tax) had been 6 percent, rather than 16 percent, alternative 1 would have provided the better return on equity:

	Alternative 1	Alternative 2
Income before interest and taxes	$3,000,000	$3,000,000
Less: Interest expense	(800,000)[a]	(2,400,000)[b]
Income before taxes	2,200,000	600,000
Less: Income tax expense (40%)	(880,000)	(240,000)
Net income	$1,320,000	$ 360,000

[a]8% × $10,000,000
[b]8% × $30,000,000

		Alternative 1	Alternative 2
Return on shareholders' equity[13]	=	$\frac{\$1{,}320{,}000}{\$40{,}000{,}000}$	$\frac{\$360{,}000}{\$20{,}000{,}000}$
	=	3.3%	1.8%

So, shareholders typically are faced with a trade-off between the risk that high debt denotes and the potential for a higher return from having the higher debt. In any event, the debt-to-equity ratio offers a basis for making the choice.

Times Interest Earned Ratio. Another way to gauge the ability of a company to satisfy its fixed debt obligations is by comparing interest charges with the income available to pay

[12]If return is calculated on *average* shareholders' equity, we are technically assuming that all income is paid to shareholders in cash dividends so that beginning, ending, and average shareholders' equity are the same. On the other hand, if we assume *no* dividends are paid, rates of return would be:

		Alternative 1	Alternative 2
Return on shareholders' equity	=	$\frac{\$4{,}320{,}000}{[\$44{,}320{,}000 + 40{,}000{,}000]/2}$	$\frac{\$3{,}360{,}000}{[\$20{,}000{,}000 + 23{,}360{,}000]/2}$
	=	10.25%	15.50%

In any case, our conclusions are the same.

[13]If we assume *no* dividends are paid, rates of return would be:

		Alternative 1	Alternative 2
Return on shareholders' equity	=	$\frac{\$1{,}320{,}000}{[\$41{,}320{,}000 + 40{,}000{,}000]/2}$	$\frac{\$360{,}000}{[\$20{,}000{,}000 + 20{,}360{,}000]/2}$
	=	3.25%	1.78%

Again, our conclusions are the same.

The *times interest earned ratio* indicates the margin of safety provided to creditors.

those charges. The **times interest earned ratio** is designed to do this. It is calculated by dividing income before subtracting either interest expense or taxes by interest expense.

Bondholders, noteholders, and other creditors can measure the margin of safety they are accorded by a company's earnings. If income is many times greater than interest expense, creditors' interests are more protected than if income just barely covers this expense. For this purpose, income should be the amount available to pay interest which is income before subtracting either interest or taxes, calculated by adding back to net income the interest and taxes that were deducted.

Indigo Books and Music Inc.

As an example, Indigo Books and Music Inc.'s 2002 financial statements report the following items:

	($ in 000s)
Net loss	$(47,912)
Interest expense*	14,358
Income taxes benefit	(600)
Income before interest and taxes	$(34,154)

*This amount actually is interest expense net of interest income. No separate disclosure of the components is provided in the financial statements.

The times interest earned ratio can be computed as follows:

$$\text{Times interest earned ratio} = \frac{\$34,154}{\$14,358} = -2.37 \text{ times}$$

The ratio of −2.37 times indicates no margin of safety for creditors. With a loss, the company is not able to meet its interest payment obligations.[14] In comparison, Domtar's times interest earned ratio for 2001 is 3.47 times. Domtar has more interest-bearing debt in its capital structure than does Indigo, but it earned higher income.

Especially when viewed alongside the debt-to-equity ratio, the coverage ratio seems to indicate a comfortable safety cushion for creditors. It also indicates a degree of financial mobility if the company were to decide to raise new debt funds to "trade on the equity" and attempt to increase the return to shareholders through favourable financial leverage.

FINANCIAL REPORTING CASE **SOLUTION**

1. **Respond to Jerry's criticism that shareholders' equity does not represent the market value of the company. What information does the balance sheet provide? *(p. 214)*** Jerry is correct. The financial statements are supposed to help investors and creditors value a company. However, the balance sheet is not intended to portray the market value of the entity. The assets of a company minus its liabilities as shown on the balance sheet (shareholders' equity) usually will not equal the company's market value for several reasons. For example, many assets are measured at their historical costs, rather than their market values. Also, many company resources including its trained employees, its experienced management team, and its reputation are not recorded as assets at all. The balance sheet must be used in conjunction with other financial statements, disclosure notes, and other publicly available information.

   The balance sheet does, however, provide valuable information that can be used by investors and creditors to help determine market value. After all, it is the balance sheet that describes many of the resources a company has available for generating future cash flows. The balance sheet also provides important information about liquidity and long-term solvency.
2. **The usefulness of the balance sheet is enhanced by classifying assets and liabilities according to common characteristics. What are the classifications used on Leon's Furniture Limited's balance sheet, and what elements do those categories include? *(p. 215)***

[14]Of course, interest is paid with cash not with "income." The times interest earned ratio often is calculated by using cash flow from operations before subtracting either interest payments or tax payments as the numerator and interest payments as the denominator.

Leon's Furniture's balance sheet contains the following asset and liability classifications:

Assets:

1. **Current assets** include cash and several other assets that are reasonably expected to be converted to cash or consumed within the coming year, or within the normal operating cycle of the business if that's longer than one year.
2. **Property, plant, and equipment** are the tangible long-lived assets used in the operations of the business. This category includes land, buildings, equipment, machinery, and furniture, as well as natural resources.
3. **Future income tax assets**

Liabilities:

1. **Current liabilities** are those obligations that are expected to be satisfied through the use of current assets or the creation of other current liabilities. Usually, this means liabilities that are expected to be paid within one year or the operating cycle, whichever is longer
2. **Redeemable share liability.** ■

THE BOTTOM LINE

1. The balance sheet, also known as the statement of financial position, is a position statement that presents an organized array of assets, liabilities, and shareholders' equity at a particular point in time. The statement does not portray the market value of the entity. However, the information in the statement can be useful in assessing market value, as well as in providing important information about liquidity and long-term solvency.
2. Current assets include cash and other assets that are reasonably expected to be converted to cash or consumed during one year, or within the normal operating cycle of the business if the operating cycle is longer than one year. All other assets are classified as various types of noncurrent assets. Current liabilities are those obligations that are expected to be satisfied through the use of current assets or the creation of other current liabilities. All other liabilities are classified as long term.
3. In addition to cash and cash equivalents, current assets include short-term investments, accounts receivable, inventories, prepaid expenses, and current portion of future income tax assets. Other asset classifications include investments and funds, property, plant, and equipment, intangible assets, and other assets.
4. Current liabilities include notes and accounts payable, accrued liabilities, unearned revenues, the current maturities of long-term debt, and current portions of future income tax liabilities. Long-term liabilities include long-term notes, loans, mortgages, bonds, pension and lease obligations, as well as future income tax liabilities.
5. Financial disclosures are used to convey additional information about the account balances in the basic financial statements as well as to provide supplemental information. This information is disclosed parenthetically in the basic financial statements or in notes or supplemental financial statements.
6. Annual financial statements will include management's discussion and analysis of key aspects of the company's business. The purpose of this disclosure is to provide external parties with management's insight into certain transactions, events, and circumstances that affect the enterprise, including their financial impact.
7. The purpose of an audit is to provide a professional, independent opinion as to whether or not the financial statements are prepared in conformity with GAAP. The audit report contains three paragraphs; the first two deal with the scope of the audit, and the third paragraph states the auditors' opinion.
8. The balance sheet provides information that can be useful in assessing risk. A key element of risk analysis is investigating a company's ability to pay its obligations when they come due. Liquidity ratios and financing ratios provide information about a company's ability to pay its obligations. ■

APPENDIX 5

REPORTING SEGMENT INFORMATION

Many companies operate in several business segments as a strategy to achieve growth and to reduce operating risk through diversification.

Financial analysis of diversified companies is especially difficult. Consider, for example, a company that operates in several distinct business segments, including computer peripherals, home health-care systems, textiles, and consumer food products. The results of these distinctly different activities will be aggregated into a single set of financial statements, making difficult an informed projection of future performance. It may well be that the five-year outlook differs greatly among the areas of the economy represented by the different segments. To make matters worse for an analyst, the integrated financial statements do not reveal the relative investments in each of the business segments nor the success the company has had within each area. Given the fact that so many companies these days have chosen to balance their operating risks through diversification, aggregated financial statements pose a widespread problem for analysts, lending and credit officers, and other financial forecasters.

Reporting by Operating Segment

Segment reporting facilitates the financial statement analysis of diversified companies.

To address the problem, the accounting profession requires companies engaged in more than one significant line of business to provide supplemental information concerning individual operating segments. The supplemental disaggregated data does not include complete financial statements for each reportable segment, only certain specified items.

The Accounting Standards Board (AcSB) and the U.S. Financial Accounting Standards Board (FASB) co-operated in developing the standards in section 1701 of the *CICA Handbook*, and the two boards reached the same conclusions.[15]

WHAT IS A REPORTABLE OPERATING SEGMENT?

The new standard employs a management approach in determining which segments of a company are reportable. This approach is based on the way that management organizes the segments within the enterprise for making operating decisions and assessing performance. The segments are, therefore, evident from the structure of the enterprise's internal organization.

More formally, the following characteristics define an **operating segment:**[16]

An operating segment is a component of an enterprise

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

The AcSB hopes that this new approach provides insights into the risk and opportunities management sees in the various areas of company operations. Also, reporting information on the basis of the enterprise's internal organization should reduce the incremental cost to companies of providing the data. In addition, the board added quantitative thresholds to the definition of an operating segment to limit the number of reportable segments. Only segments of certain size (10 percent or more of total company revenues, assets, or net income) must be disclosed. However, a company must account for at least 75 percent of consolidated revenue through segment disclosures.

WHAT AMOUNTS ARE REPORTED BY AN OPERATING SEGMENT?

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

a. General information about the operating segment.

[15] *CICA Handbook*, Section 1701, para. 01.
[16] *CICA Handbook*, Section 1701, para. 10.

GRAPHIC 5A–1
Business Segment Information Disclosure—BCE Inc.
www.bce.ca

Segment Information

Business Segments

	Bell Canada	Bell Globemedia	BCE Teleglobe	BCE Emergis	BCE Ventures
For the year ended December 31, 2001					
Operating Revenues					
External customers	17,038	1,175	1,745	451	1,403
Intersegment	216	28	320	205	267
Total operating revenues	17,254	1,203	2,065	656	1,670
Amortization expense	2,934	265	614	452	405
Interest income	11	2	8	5	31
Interest expense	1,118	35	93	33	484
Equity in losses of significantly influenced companies	(26)	(4)	—	—	—
Income taxes recovery [expense]	(870)	(15)	174	(21)	6
Earning [loss] from continuing operations[a]	689	(150)	(607)	(281)	(310)
Segment assets	26,989	5,139	12,189	1,107	8,348
Capital expenditures	4,815	114	2,206	57	409
For the year ended December 31, 2000					
Operating revenues	15,800	98	326	468	1,402
Amortization expense	2,829	7	52	346	272
Interest income	14	1	4	6	23
Interest expense	1,028	4	39	36	367
Equity in net earning [losses] of significantly influenced companies	3	15	(122)	---	(9)
Income taxes recovery [expense]	(1,241)	(7)	(27)	6	(17)
Earnings [loss] from continuing operations[a]	994	(78)	(241)	(209)	(361)

(a) Represents each sement's contribution to BCE's net earning.

Reconciliation

For the year ended December 31	2001	2000
Revenues		
Total revenues for reportable segments	22,848	18,094
Corporate and other [including elimination of intersegment revenues]	(1,137)	(662)
Total consolidated revenues	21,711	17,432
Earnings from continuing operations		
Total earnings [loss] from continuing operations for reportable segments	(659)	105
Corporate and other [including elimination of intersegment earnings]	3,078	207
Total consolidated earnings from continuing operations	2,419	312

b. Information about reported segment profit or loss, including certain revenues and expenses included in reported segment profit or loss, segments assets, and the basis of measurement.
c. Reconciliations of the totals of segment revenues, reported profit or loss, assets, and other significant items to corresponding enterprise amounts.
d. Interim period information.[17]

Graphic 5A–1 shows the business segment information reported by BCE Inc. in its 2001 annual report.

REPORTING BY GEOGRAPHIC AREA

In today's global economy it is sometimes difficult to distinguish domestic and foreign companies. Most large Canadian firms conduct significant operations in other countries in addition to having substantial export sales from this country. Differing political and economic environments from country to country means risks and associated rewards sometimes vary greatly among the various operations of a single company. For instance, manufacturing facilities in a South American country embroiled in political unrest pose different risks from having a plant in Ontario, or even in the United States. Without disaggregated financial information, these differences cause problems for analysts.

The *CICA Handbook*, Section 1701, requires an enterprise to report certain geographic information unless it is impracticable to do so. This information includes:

a. Revenues from external customers (1) attributed to the enterprise's country of domicile, and (2) attributed to all foreign countries in total from which the enterprise derives revenues,
b. Property, plant, and equipment, goodwill and other intangibles (1) located in the enterprise's country of domicile, and (2) located in all the foreign countries in total in which the enterprise holds assets.[18]

BCE Inc. reported its geographic area information separately in a table reproduced in Graphic 5A–2. Note that both the business segment (see Graphic 5A–1) and geographic information disclosures include a reconciliation to company totals. For example, in both graphics, year 2001 revenues of both the segments and the geographic areas are reconciled to the company's total revenues of $21,711 (thousand of dollars).

Indigo Books and Music Inc.

For another example of business segment disclosures, see the Indigo Books and Music Inc. segment information on pages 44 and 45, note 15, in the appendix to Chapter 1.

GRAPHIC 5A–2
Geographic Area Information Disclosure—BCE Inc.

Geographic Information[(a)]

For the year ended December 31	2001		2000	
	Revenues External Customers	Capital Assets & Goodwill	Revenues External Customers	Capital Assets & Goodwill
Canada	18,514	30,306	16,119	25,218
United States	1,137	6,191	555	10,169
Other foreign countries	2,060	6,177	758	3,218
Total	21,711	42,674	17,432	38,605

(a) The point of origin [the location of the selling organization] of revenues and the location of capital asset sand goodwill determine the geographic areas.

[17]*CICA Handbook*, Section 1701, para. 28.
[18]*CICA Handbook*, Section 1701, para. 40.

GLOBAL PERSPECTIVE

There is more international uniformity regarding disaggregated disclosures than with many other accounting issues. More than 30 countries adopted *International Accounting Standard No. 14,* "Reporting Financial Information by Segment," issued in 1981 by the International Accounting Standards Committee. Under this standard, companies report revenues, operating profit or loss, and identifiable assets for both industry segments and geographic segments.

Recently, the AcSB worked closely with the FASB in the United States and the International Accounting Standards Board (IASC) to develop similar new standards in this area.

INFORMATION ABOUT MAJOR CUSTOMERS

Revenues from major customers must be disclosed.

Some companies in the defence industry derive substantial portions of their revenues from contracts with the Defence Department. When cutbacks occur in national defence or in specific defence systems, the impact on a company's operations can be considerable. Obviously, financial analysts are extremely interested in information concerning the extent to which a company's prosperity depends on one or more major customers, such as in the situation described here. For this reason, if 10 percent or more of the revenues of an enterprise are derived from transactions with a single customer, the enterprise must disclose that fact, the total amount of revenues from each such customer, and the identity of the operating segment or segments earning the revenues.

The identity of the major customer or customers need not be disclosed, although companies routinely provide that information. In its 2001 annual report, BCE Inc. did not report any major customer information. As an example of this type of disclosure, Procter & Gamble Company's business segment disclosure included information on its largest customer, Wal-Mart, as shown in Graphic 5A–3.

GRAPHIC 5A–3
Major Customer Disclosure—Procter & Gamble Company

Note: 12 Segment Information (in part)
The Company's largest customer, Wal-Mart Stores, Inc., and its affiliates accounted for 14 percent, 12 percent, and 11 percent of consolidated net sales in 2000, 1999, and 1998, respectively. These sales occurred primarily in the United States.

QUESTIONS FOR REVIEW OF KEY TOPICS

Q 5–1 Describe the purpose of the balance sheet.

Q 5–2 Explain why the balance sheet does not portray the market value of the entity.

Q 5–3 Define current assets and list the typical asset categories included in this classification.

Q 5–4 Define current liabilities and list the typical liability categories included in this classification.

Q 5–5 Describe what is meant by an operating cycle for a typical manufacturing company.

Q 5–6 Explain the difference(s) between investments in equity securities classified as current assets versus those classified as noncurrent assets.

Q 5–7 Describe the common characteristics of assets classified as property, plant, and equipment and identify some assets included in this classification.

Q 5–8 Distinguish between property, plant, and equipment and goodwill and other intangible assets.

Q 5–9 Explain how each of the following liabilities would be classified on the balance sheet:
- A note payable of $100,000 due in five years.
- A note payable of $100,000 payable in annual installments of $20,000 each, with the first installment due next year.

Q 5–10 Define the terms *contributed capital* and *retained earnings.*

Q 5–11 Disclosure notes are an integral part of the information provided in financial statements. In what ways are the notes critical to understanding the financial statements and to evaluating the firm's performance and financial health?

Q 5–12 A summary of the company's significant accounting policies is a required disclosure. Why is this disclosure important to external financial statement users?

Q 5–13 Define a subsequent event.

Q 5–14 Every annual report includes an extensive discussion and analysis provided by the company's management. Specifically, which aspects of the company must this discussion address? Isn't management's perspective too biased to be of use to investors and creditors?

Q 5–15 The auditors' report provides the analyst with an independent and professional opinion about the fairness of the representations in the financial statements. What are the four main types of opinion an auditor might issue? Describe each.

Q 5–16 What is a proxy statement? What information does it provide?

Q 5–17 Define the terms *working capital*, *current ratio*, and *acid-test ratio* (or quick ratio).

Q 5–18 Show the calculation of the following financing ratios: (1) the debt-to-equity ratio, and (2) the times interest earned ratio.

Q 5–19 [based on Appendix 5] Segment reporting facilitates the financial statement analysis of diversified companies. What determines whether an operating segment is a reportable segment for this purpose?

Q 5–20 [based on Appendix 5] For segment reporting purposes, what amounts are reported by each operating segment?

EXERCISES

E 5–1
Balance sheet; missing elements

The following December 31, 2005, fiscal year-end account balance information is available for the Stonebridge Corporation:

Cash and cash equivalents	$ 5,000
Accounts receivable (net)	20,000
Inventories	60,000
Property, plant, and equipment (net)	120,000
Accounts payable	44,000
Wages payable	15,000
Contributed capital	100,000

The only asset not listed is short-term investments. The only liabilities not listed are a $30,000 note payable due in two years and related accrued interest of $1,000 due in four months. The current ratio at year-end is 1.5:1.

Required:

Determine the following at December 31, 2005:

1. Total current assets
2. Short-term investments
3. Retained earnings

E 5–2
Balance sheet classification

The following are the typical classifications used in a balance sheet:

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. Contributed capital
i. Retained earnings

Required:

For each of the following balance sheet items, use the letters above to indicate the appropriate classification category. If the item is a contra account (valuation account), place a minus sign before the chosen letter.

1. _____ Equipment
2. _____ Accounts payable
3. _____ Allowance for doubtful accounts
4. _____ Land, held for investment
5. _____ Note payable, due in five years
6. _____ Unearned rent revenue
7. _____ Note payable, due in six months
8. _____ Income less dividends, accumulated
9. _____ Investment in XYZ Corp., long-term
10. _____ Inventories
11. _____ Patent
12. _____ Land, in use
13. _____ Accrued liabilities
14. _____ Prepaid rent
15. _____ Common shares
16. _____ Building, in use
17. _____ Cash
18. _____ Income taxes payable

E 5–3
Balance sheet classification

The following are the typical classifications used in a balance sheet:

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. Contributed capital
i. Retained earnings

Required:

For each of the following 2005 balance sheet items, use the letters above to indicate the appropriate classification category. If the item is a contra account (valuation account), place a minus sign before the chosen letter.

1. _____ Accrued interest payable
2. _____ Franchise
3. _____ Accumulated amortization
4. _____ Prepaid insurance, for 2007
5. _____ Bonds payable, due in 10 years
6. _____ Current maturities of long-term debt
7. _____ Note payable, due in three months
8. _____ Long-term receivables
9. _____ Bond sinking fund, will be used to retire bonds in 10 years
10. _____ Supplies
11. _____ Machinery
12. _____ Land, in use
13. _____ Unearned revenue
14. _____ Copyrights
15. _____ Preferred shares
16. _____ Land, held for speculation
17. _____ Cash equivalents
18. _____ Wages payable

E 5–4
Balance sheet preparation

The following is a December 31, 2005, post-closing trial balance for the Jackson Corporation.

Account Title	Debits	Credits
Cash	30,000	
Accounts receivable	34,000	
Inventories	75,000	
Prepaid rent	6,000	
Marketable securities (short term)	10,000	
Machinery	145,000	
Accumulated amortization—machinery		11,000
Patent (net of amortization)	83,000	
Accounts payable		8,000
Wages payable		4,000
Income taxes payable		32,000
Bonds payable (due in 10 years)		200,000
Common shares		100,000
Retained earnings		28,000
Totals	383,000	383,000

Required:

Prepare a classified balance sheet for Jackson Corporation at December 31, 2005.

E 5–5
Balance sheet preparation

The following is a December 31, 2005, post-closing trial balance for the Valley Pump Corporation.

Account Title	Debits	Credits
Cash	25,000	
Accounts receivable	62,000	
Inventories	81,000	
Interest payable		5,000
Marketable securities	38,000	
Land	120,000	
Buildings	300,000	
Accumulated amortization—buildings		100,000
Equipment	75,000	
Accumulated amortization—equipment		25,000
Copyright (net of amortization)	12,000	
Prepaid expenses	32,000	
Accounts payable		65,000
Unearned revenues		20,000
Notes payable		250,000

Allowance for doubtful accounts		5,000
Common shares		200,000
Retained earnings		75,000
Totals	745,000	745,000

Additional information:

1. The $120,000 balance in the land account consists of $100,000 for the cost of land where the plant and office buildings are located. The remaining $20,000 represents the cost of land being held for speculation.
2. The $38,000 in the marketable securities account represents an investment in the common shares of another corporation. Valley intends to sell one-half of the shares within the next year.
3. The notes payable account consists of a $100,000 note due in six months and a $150,000 note due in three annual installments of $50,000 each, with the first payment due in August of 2006.

Required:

Prepare a classified balance sheet for the Valley Pump Corporation at December 31, 2005.

E 5–6
Balance sheet preparation; errors

The following balance sheet for the Los Gatos Corporation was prepared by a recently hired accountant. In reviewing the statement you notice several errors.

LOS GATOS CORPORATION
Balance Sheet
At December 31, 2005

Assets	
Cash	$ 40,000
Accounts receivable	80,000
Inventories	65,000
Machinery (net)	120,000
Franchise (net)	20,000
Total assets	$325,000
Liabilities and Shareholders' Equity	
Accounts payable	$ 60,000
Allowance for doubtful accounts	5,000
Note payable	55,000
Bonds payable	100,000
Shareholders' equity	105,000
Total liabilities and shareholders' equity	$325,000

Additional information:

1. Cash includes a $20,000 bond sinking fund to be used for repayment of the bonds payable in 2009.
2. The cost of the machinery is $190,000.
3. Accounts receivable includes a $20,000 note receivable from a customer due in 2008.
4. The note payable includes accrued interest of $5,000. Principal and interest are both due on February 1, 2006.
5. The company began operations in 2000. Income less dividends since inception of the company totals $35,000.
6. 50,000 no-par common shares were issued in 2000. 100,000 shares are authorized.

Required:

Prepare a corrected, classified balance sheet.

E 5–7
Balance sheet; current versus noncurrent classification

The Cone Corporation is in the process of preparing its December 31, 2005, balance sheet. There are some questions as to the proper classification of the following items:

a. $50,000 in cash set aside in a savings account to pay bonds payable. The bonds mature in 2009.
b. Prepaid rent of $24,000, covering the period January 1, 2006, through December 31, 2007.
c. Note payable of $200,000. The note is payable in annual installments of $20,000 each, with the first installment payable on March 1, 2006.
d. Accrued interest payable of $12,000 related to the note payable.
e. Investment in marketable securities of other corporations, $60,000. Cone intends to sell one-half of the securities in 2006.

Required:
Prepare a partial classified balance sheet to show how each of the above items should be reported.

E 5–8
Financial disclosures

The following are typical disclosures that would appear in the notes accompanying financial statements. For each of the items listed, indicate where the disclosure would likely appear—either in (A) the significant accounting policies note or (B) a separate note.

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

E 5–9
Notes to financial statements

The Hallergan Company produces car and truck batteries that it sells primarily to auto manufacturers. Don Hawkins, the company's comptroller, is preparing the financial statements for the year ended December 31, 2005. Hawkins asks for your advice concerning the following information that has not yet been included in the statements.

1. Hallergan leases its facilities from the brother of the chief executive officer.
2. On January 8, 2006, Hallergan entered into an agreement to sell a tract of land that it had been holding as an investment. The sale, which resulted in a material gain, was completed on February 2, 2006.
3. Hallergan uses the straight-line method to determine amortization on all of the company's amortizable assets.
4. On February 8, 2006, Hallergan completed negotiations with its bank for a $10,000,000 line of credit.
5. Hallergan uses the first-in, first-out (FIFO) method to value inventory.

Required:
For each of the above items, discuss any additional disclosures that Hawkins should include in Hallergan's financial statements.

E 5–10
Concepts; terminology

Listed below are several terms and phrases associated with the balance sheet and financial disclosures. Pair each item from List A (by letter) with the item from List B that is most appropriately associated with it.

List A	List B
____ 1. Balance sheet	a. Will be satisfied through the use of current assets.
____ 2. Liquidity	b. Items expected to be converted to cash or consumed within one year or the operating cycle.
____ 3. Current assets	c. The statements are presented fairly in conformity with GAAP.
____ 4. Operating cycle	d. An organized array of assets, liabilities, and equity.
____ 5. Current liabilities	e. Important to a user in comparing financial information across companies.
____ 6. Cash equivalent	f. Scope limitation or a departure from GAAP.
____ 7. Intangible asset	g. Recorded when an expense is incurred but not yet paid.
____ 8. Working capital	h. Relates to the amount of time before an asset is converted to cash or a liability is paid.
____ 9. Accrued liabilities	i. Occurs after the fiscal year-end but before the statements are issued.
____ 10. Summary of significant accounting policies	j. Cash to cash.
____ 11. Subsequent events	k. One-month certificate of deposit.
____ 12. Unqualified opinion	l. Current assets minus current liabilities.
____ 13. Qualified opinion	m. Lacks physical existence.

E 5–11
Calculating ratios

The 2005 balance sheet for Hallbrook Industries, Inc. is shown below.

HALLBROOK INDUSTRIES, INC.
Balance Sheet
December 31, 2005
($ in 000s)

Assets	
Cash	$ 100
Short-term investments	150
Accounts receivable	200
Inventories	400
Property, plant, and equipment (net)	1,000
Total assets	$1,850
Liabilities and Shareholders' Equity	
Current liabilities	$ 400
Long-term liabilities	350
Contributed capital	700
Retained earnings	400
Total liabilities and shareholders' equity	$1,850

The company's 2005 income statement reported the following amounts ($ in 000s):

Net sales	$4,600
Interest expense	20
Income tax expense	100
Net income	160

Required:
Determine the following ratios for 2005:
1. Current ratio
2. Acid-test ratio
3. Debt-to-equity ratio
4. Times interest earned ratio

E 5–12
Calculating ratios; solve for unknowns

The current asset section of the Excalibur Tire Company's balance sheet consists of cash, marketable securities, accounts receivable, and inventories. The December 31, 2005, balance sheet revealed the following:

Inventories	$ 420,000
Total assets	2,800,000
Current ratio	2.25
Acid-test ratio	1.2
Debt-to-equity ratio	1.8

Required:
Determine the following 2005 balance sheet items:
1. Current assets
2. Shareholders' equity
3. Noncurrent assets
4. Long-term liabilities

E 5–13
Effects of management decisions on ratios

Most decisions made by management impact the ratios analysts use to evaluate performance. Indicate (by letter) whether each of the actions listed below will immediately increase (I), decrease (D), or have no effect (N) on the ratios shown. Assume each ratio is less than 1.0 before the action is taken.

Action	Current Ratio	Acid-Test Ratio	Debt-to-Equity Ratio
1. Issuance of long-term bonds	_____	_____	_____
2. Issuance of short-term notes	_____	_____	_____
3. Payment of accounts payable	_____	_____	_____
4. Purchase of inventory on account	_____	_____	_____
5. Purchase of inventory for cash	_____	_____	_____
6. Purchase of equipment with a four-year note	_____	_____	_____
7. Retirement of bonds	_____	_____	_____

continued

8. Sale of common shares	______	______	______
9. Write-off of obsolete inventory	______	______	______
10. Purchase of short-term investment for cash	______	______	______
11. Decision to refinance on a long-term basis some currently maturing debt	______	______	______

PROBLEMS

P 5–1
Balance sheet preparation

Presented below is a list of balance sheet accounts presented in alphabetical order:

Accounts payable	Inventories
Accounts receivable	Land (in use)
Accumulated amortization—buildings	Long-term investments
Accumulated amortization—equipment	Notes payable (due in six months)
Allowance for doubtful accounts	Notes receivable (due in two years)
Bond sinking fund	Patent
Bonds payable (due in 10 years)	Preferred shares
Buildings	Prepaid expenses
Cash	Rent payable (current)
Common shares	Retained earnings
Copyright	Short-term investments
Equipment	Income taxes payable
Interest receivable (due in three months)	Wages payable

Required:
Prepare a classified balance sheet, ignoring monetary amounts.

P 5–2
Balance sheet preparation; missing elements

The data listed below are taken from a recent balance sheet of Amdahl Corporation. Some amounts, indicated by question marks, have been intentionally omitted.

	($ in 000s)
Cash and cash equivalents	$ 239,186
Short-term investments	353,700
Accounts receivable (net of allowance)	504,944
Inventories	?
Prepaid expenses (current)	83,259
Total current assets	1,594,927
Long-term receivables	110,800
Property, plant, and equipment (net)	?
Total assets	?
Notes payable and short-term debt	31,116
Accounts payable	?
Accrued liabilities	421,772
Other current liabilities	181,604
Total current liabilities	693,564
Long-term debt and future income tax liability	?
Total liabilities	956,140
Shareholders' equity	1,370,627

Required:
1. Determine the missing amounts.
2. Prepare Amdahl's classified balance sheet.

P 5–3
Balance sheet preparation

The following is a December 31, 2005, post-closing trial balance for Almway Corporation.

Account Title	Debits	Credits
Cash	45,000	
Investments	110,000	
Accounts receivable	60,000	
Inventories	200,000	

continued

Prepaid insurance	9,000	
Land	90,000	
Buildings	420,000	
Accumulated amortization—buildings		100,000
Equipment	110,000	
Accumulated amortization—equipment		60,000
Patents (net of amortization)	10,000	
Accounts payable		75,000
Notes payable		130,000
Interest payable		20,000
Bonds payable		240,000
Common shares		300,000
Retained earnings		129,000
Totals	1,054,000	1,054,000

Additional information:

1. The investment account includes an investment in common shares of another corporation of $30,000 which management intends to hold for at least three years.
2. The land account includes land which cost $25,000 that the company has not used and is currently listed for sale.
3. The cash account includes $15,000 set aside in a fund to pay bonds payable that mature in 2008 and $23,000 set aside in a three-month certificate of deposit.
4. The notes payable account consists of the following:
   a. a $30,000 note due in six months.
   b. a $50,000 note due in six years.
   c. a $50,000 note due in five annual installments of $10,000 each, with the next installment due February 15, 2006.
5. The $60,000 balance in accounts receivable is net of an allowance for doubtful accounts of $8,000.
6. The common shares account represents 100,000 common shares of no-par value issued and outstanding. The corporation has 500,000 shares authorized.

Required:

Prepare a classified balance sheet for the Almway Corporation at December 31, 2005.

P 5–4
Balance sheet preparation; construction accounting

S

The following is a June 30, 2005, post-closing trial balance for Vital Construction Company.

Account Title	Debits	Credits
Cash	83,000	
Short-term investments	65,000	
Accounts receivable	180,000	
Construction in progress	300,000	
Prepaid expenses	32,000	
Land	75,000	
Buildings	320,000	
Accumulated amortization—buildings		160,000
Equipment	265,000	
Accumulated amortization—equipment		120,000
Accounts payable		173,000
Accrued expenses		45,000
Notes payable		100,000
Billings on construction contract		215,000
Mortgage payable		250,000
Common shares		100,000
Retained earnings		157,000
Totals	1,320,000	1,320,000

Additional information:

1. The company is in the business of constructing office buildings. The construction in progress account represents the costs incurred to date in constructing an office building for a customer

under a long-term contract. The building will be completed early in 2005. The company uses the completed contract method to recognize gross profit on its projects.

2. The short-term investments account includes $18,000 in treasury bills purchased in May. The bills mature in July.
3. The accounts receivable account consists of the following:

a.	Amounts owed by customers	$125,000
b.	Allowance for doubtful accounts—trade customers	(15,000)
c.	Nontrade note receivable (due in three years)	65,000
d.	Interest receivable on note (due in four months)	5,000
	Total	$180,000

4. The notes payable account consists of two notes of $50,000 each. One note is due on September 30, 2005, and the other is due on November 30, 2006.
5. The mortgage payable is payable in *semiannual* installments of $5,000 each plus interest. The next payment is due on October 31, 2005. Interest has been properly accrued and is included in accrued expenses.
6. Five hundred thousand common shares of no-par value are authorized, of which 200,000 shares have been issued and are outstanding.
7. The land account includes $50,000 representing the cost of the land on which the company's office building resides. The remaining $25,000 is the cost of land on which the company is constructing the office building for sale.

Required:

Prepare a classified balance sheet for the Vital Construction Company at June 30, 2005.

P 5–5
Balance sheet preparation

The following is a December 31, 2005, post-closing trial balance for Nuage Publishing Company.

Account Title	Debits	Credits
Cash	65,000	
Accounts receivable	160,000	
Inventories	285,000	
Prepaid expenses	148,000	
Property, plant, and equipment	320,000	
Accumulated amortization—PP&E		110,000
Investments	140,000	
Accounts payable		60,000
Interest payable		20,000
Unearned revenue		80,000
Income taxes payable		30,000
Notes payable		200,000
Allowance for doubtful accounts		16,000
Common shares		400,000
Retained earnings		202,000
Totals	1,118,000	1,118,000

Additional information:

1. Prepaid expenses include $120,000 paid on December 31, 2005, for a two-year lease on the building that houses both the administrative offices and the manufacturing facility.
2. Investments include $30,000 in treasury bills purchases on November 30, 2005. The bills mature on January 30, 2006. The remaining $110,000 includes investments in marketable equity securities that the company intends to sell in the next year.
3. Unearned revenue represents customer prepayments for magazine subscriptions. Subscriptions are for periods of one year or less.
4. The notes payable account consists of the following:
   a. a $40,000 note due in six months.
   b. a $100,000 note due in six years.
   c. a $60,000 note due in three annual installments of $20,000 each with the next installment due August 31, 2006.
5. The common shares account represents 400,000 common shares of no-par value issued and outstanding. The corporation has 800,000 shares authorized.

Required:
Prepare a classified balance sheet for Nuage Publishing Company at December 31, 2005.

P 5–6
Balance sheet preparation; errors

The following balance sheet for the Hubbard Corporation was prepared by the company:

HUBBARD CORPORATION
Balance Sheet
At December 31, 2005

Assets	
Buildings	$ 750,000
Land	250,000
Cash	60,000
Accounts receivable (net)	120,000
Inventories	240,000
Machinery	280,000
Patent (net)	100,000
Investment in marketable equity securities	60,000
Total assets	$1,860,000
Liabilities and Shareholders' Equity	
Accounts payable	$ 215,000
Accumulated amortization	255,000
Notes payable	500,000
Appreciation of inventories	80,000
Common shares, authorized and issued 100,000 shares of no-par value	430,000
Retained earnings	380,000
Total liabilities and shareholders' equity	$1,860,000

Additional information:
1. The buildings, land, and machinery are all stated at cost except for a parcel of land that the company is holding for future sale. The land originally cost $50,000 but, due to a significant increase in market value, is listed at $120,000. The increase in the land account was credited to retained earnings.
2. Marketable equity securities consist of shares of other corporations and are recorded at cost, $20,000 of which will be sold in the coming year. The remainder will be held indefinitely.
3. Notes payable are all long-term. However, a $100,000 note requires an installment payment of $25,000 due in the coming year.
4. Inventories are recorded at current resale value. The original cost of the inventories is $160,000.

Required:
Prepare a corrected classified balance sheet for the Hubbard Corporation at December 31, 2005.

P 5–7
Balance sheet preparation

Presented below is the balance sheet for HHD, Inc., at December 31, 2005.

Current assets	$ 600,000	Current liabilities	$ 400,000
Investments	500,000	Long-term liabilities	1,100,000
Property, plant, and equipment	2,000,000	Shareholders' equity	1,800,000
Intangible assets	200,000		
Total assets	$3,300,000	Total liabilities and shareholders' equity	$3,300,000

The captions shown in the summarized statement above include the following:

a. Current assets: cash, $150,000; accounts receivable, $200,000; inventories, $225,000; and prepaid insurance, $25,000.
b. Investments: investments in common shares, short term, $90,000, and long term, $160,000; and bond sinking fund, $250,000.
c. Property, plant, and equipment: buildings, $1,500,000 less accumulated amortization, $600,000; equipment, $500,000 less accumulated amortization, $200,000; and land, $800,000.
d. Intangible assets: patent, $110,000; and copyright, $90,000.
e. Current liabilities: accounts payable, $100,000; notes payable, short term, $150,000, and long term, $90,000; and income taxes payable, $60,000.
f. Long-term liabilities: bonds payable due 2005.

g. Shareholders' equity: preferred shares, $450,000; common shares, $1,000,000; retained earnings, $350,000.

Required:

Prepare a corrected classified balance sheet for HHD, Inc., at December 31, 2005.

P 5–8
Income statement and balance sheet preparation

The Melody Lane Music Company was started by John Ross early in 2005. Initial capital was acquired by issuing common shares to various investors and by obtaining a bank loan. The company operates a retail store that sells records, tapes, and compact discs. Business was so good during the first year of operations that John is considering opening a second store on the other side of town. The funds necessary for expansion will come from a new bank loan. In order to approve the loan, the bank requires financial statements.

John asks for your help in preparing the balance sheet and presents you with the following information for the year ending December 31, 2005:

a. Cash receipts consisted of the following:

From customers	$360,000
From issue of common shares	100,000
From bank loan	100,000

b. Cash disbursements were as follows:

Purchase of inventory	$300,000
Rent	15,000
Salaries	30,000
Utilities	5,000
Insurance	3,000
Purchase of equipment and furniture	40,000

c. The bank loan was made on March 31, 2005. A note was signed requiring payment of interest and principal on March 31, 2006. The interest rate is 12 percent.

d. The equipment and furniture were purchased on January 3, 2005, and have an estimated useful life of 10 years with no anticipated salvage value. Amortization per year is $4,000.

e. Inventories on hand at the end of the year cost $100,000.

f. Amounts owed at December 31, 2005, were as follows:

To suppliers of inventory	$20,000
To the utility company	1,000

g. Rent on the store building is $1,000 per month. On December 1, 2005, four months' rent was paid in advance.

h. Net Income for the year was $76,000. Assume that the company is not subject to federal and provincial income taxes.

Required:

Prepare a balance sheet at December 31, 2005.

P 5–9
Creating a balance sheet from ratios; Chapters 4 and 5

The Cadux Candy Company's income statement for the year ended December 31, 2005, reported interest expense of $2 million and income tax expense of $12 million. Current assets listed on its balance sheet include cash, accounts receivable, and inventories. Property, plant, and equipment are the company's only noncurrent assets. Financial ratios for 2005 are listed below. Profitability and turnover ratios with balance sheet items in the denominator were calculated using year-end balances, rather than averages.

Debt-to-equity ratio	1.0
Current ratio	2.0
Acid-test ratio	1.0
Times interest earned ratio	17 times
Return on assets	10%
Return on shareholders' equity	20%
Profit margin on sales	5%
Gross profit margin (gross profit divided by net sales)	40%
Inventory turnover	8 times
Receivables turnover	20 times

continued

Required:

Prepare a December 31, 2005, balance sheet for the Cadux Candy Company.

P 5–10
Compare two companies in the same industry

Presented below are condensed financial statements adapted from those of two fictitious companies competing as the primary players in a specialty area of the food manufacturing and distribution industry. ($ in millions, except per share amounts.)

Balance Sheets

Assets	**Company A**	**Company B**
Cash	$ 179.3	$ 37.1
Accounts receivable (net)	422.7	325.0
Short-term investments		4.7
Inventories	466.4	635.2
Prepaid expenses and other current assets	134.6	476.7
Current assets	1,203.0	1,478.7
Property, plant, and equipment (net)	2,608.2	2,064.6
Intangibles and other assets	210.3	464.7
Total assets	$ 4,021.5	$4,008.0
Liabilities and Shareholders' Equity		
Accounts payable	$ 467.9	$ 691.2
Short-term notes	227.1	557.4
Accruals and other current liabilities	585.2	538.5
Current liabilities	1,280.2	1,787.1
Long-term debt	535.6	542.3
Future income tax liability	384.6	610.7
Other long-term liabilities	104.0	95.1
Total liabilities	2,304.4	3,035.2
Common shares	144.9	335.0
Retained earnings	2,476.9	1,601.9
Less: treasury shares	(904.7)	(964.1)
Total liabilities and shareholders' equity	$4,021.5	$4,008.0

Income Statements

	Company A	Company B
Net sales	$5,698.0	$7,768.2
Cost of goods sold	(2,909.0)	(4,481.7)
Gross profit	2,789.0	3,286.5
Operating expense	(1,743.7)	(2,539.2)
Interest expense	(56.8)	(46.6)
Income before taxes	988.5	700.7
Income tax expense	(394.7)	(276.1)
Net income	$ 593.8	$ 424.6
Net income per share	$2.40	$6.50

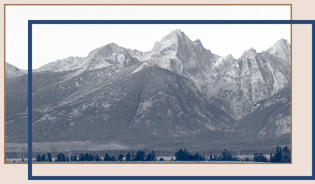
Required:

Evaluate and compare the two companies by responding to the following questions:

Note: Because comparative statements are not provided you should use year-end balances in place of average balances, as appropriate.

1. Which of the two firms had greater earnings relative to resources available?
2. Have the two companies achieved their respective rates of return on assets with similar combinations of profit margin and turnover?
3. From the perspective of a common shareholder, which of the two firms provided a greater rate of return?
4. Which company is most highly leveraged and which has made most effective use of financial leverage?
5. Of the two companies, which appears riskier in terms of its ability to pay short-term obligations?
6. How efficiently are current assets managed?
7. From the perspective of a creditor, which company offers the most comfortable margin of safety in terms of its ability to pay fixed interest charges?

BROADEN YOUR PERSPECTIVE



Apply your critical-thinking ability to the knowledge you have gained. These cases will provide you with an opportunity to develop your research, analysis, judgment, and communication skills. You also will work with other students, integrate what you have learned, apply it in real world situations, and consider its global and ethical ramifications. This practice will broaden your knowledge and further develop your decision-making abilities.

Communication Case 5–1
Current versus noncurrent classification

A first-year accounting student is confused by a statement made in a recent class. Her instructor stated that the assets listed on the balance sheet of the IBM Corporation include computers that are classified as current assets as well as computers that are classified as noncurrent assets. In addition, the instructor stated that investments in marketable securities of other corporations could be classified on the balance sheet as either current or noncurrent assets.

Required:
Explain to the student the distinction between current and noncurrent assets pertaining to the IBM computers and the investments in marketable securities.

Analysis Case 5–2
Current versus noncurrent classification

The usefulness of the balance sheet is enhanced when assets and liabilities are grouped according to common characteristics. The broad distinction made on the balance sheet is the current versus noncurrent classification of both assets and liabilities.

Required:
1. Discuss the factors that determine whether an asset or liability should be classified as current or noncurrent on a balance sheet.
2. Identify six items that under different circumstances could be classified as either current or noncurrent. Indicate the factors that would determine the correct classification.

Communication Case 5–3
Inventory or property, plant, and equipment

The Red Hen Company produces, processes, and sells fresh eggs. The company is in the process of preparing financial statements at the end of its first year of operations and has asked for your help in determining the appropriate treatment of the cost of its egg-laying flock. The estimated life of a laying hen is approximately two years, after which they are sold to soup companies.

The comptroller considers the company's operating cycle to be two years and wants to present the cost of the egg-producing flock as inventory in the current asset section of the balance sheet. He feels that the hens are "goods awaiting sale." The chief financial officer does not agree with this treatment. He thinks that the cost of the flock should be classified as property, plant, and equipment because the hens are used in the production of product—the eggs.

The focus of this case is the balance sheet presentation of the cost of the egg-producing flock. Your instructor will divide the class into from two to six groups depending on the size of the class. The mission of your group is to reach consensus on the appropriate presentation.

Required:
1. Each group member should deliberate the situation independently and draft a tentative argument prior to the class session for which the case is assigned.
2. In class, each group will meet for 10 to 15 minutes in different areas of the classroom. During that meeting, group members will take turns sharing their suggestions for the purpose of arriving at a single group treatment.
3. After the allotted time, a spokesperson for each group (selected during the group meetings) will share the group's solution with the class. The goal of the class is to incorporate the views of each group into a consensus approach to the situation.

Judgment Case 5–4
Balance sheet; errors

You recently joined the internal auditing department of Marcus Clothing Corporation. As one of your first assignments, you are examining a balance sheet prepared by a staff accountant.

MARCUS CLOTHING CORPORATION
Balance Sheet
At December 31, 2005

Assets

Current assets:	
Cash	$ 137,000
Accounts receivable, net	80,000
Note receivable	53,000
Inventories	240,000
Investments	66,000
Total current assets	576,000

continued

Other assets:		
Land	$200,000	
Equipment, net	320,000	
Prepaid expenses	27,000	
Patent	22,000	
Total other assets		569,000
Total assets		$1,145,000

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable		$ 125,000
Salaries payable		32,000
Total current liabilities		157,000
Long-term liabilities:		
Note payable	$100,000	
Bonds payable	300,000	
Interest payable	20,000	
Total long-term liabilities		420,000
Shareholders' equity:		
Common shares	500,000	
Retained earnings	68,000	
Total shareholders' equity		568,000
Total liabilities and shareholders' equity		$1,145,000

In the course of your examination you uncover the following information pertaining to the balance sheet:

1. The company rents its facilities. The land that appears on the statement is being held for future sale.
2. The note receivable is due in 2007. The balance of $53,000 includes $3,000 of accrued interest. The next interest payment is due in July 2006.
3. The note payable is due in installments of $20,000 per year. Interest on both the notes and bonds is payable annually.
4. The company's investments consist of marketable equity securities of other corporations. Management does not intend to liquidate any investments in the coming year.

Required:

Identify and explain the deficiencies in the statement prepared by the company's accountant. Include in your answer items that require additional disclosure, either on the face of the statement or in a note.

Integrating Case 5–5
Balance sheet and income statement

The Rice Corporation is negotiating a loan for expansion purposes and the bank requires financial statements. Before closing the accounting records for the year ended December 31, 2005, Rice's comptroller prepared the following financial statements:

RICE CORPORATION
Balance Sheet
At December 31, 2005
($ in 000s)

Assets

Cash	$ 275
Marketable securities	78
Accounts receivable	487
Inventories	425
Allowance for doubtful accounts	(50)
Property, plant, and equipment, net	160
Total assets	$1,375

Liabilities and Shareholders' Equity

Accounts payable and accrued liabilities	$ 420
Notes payable	200
Common shares	260
Retained earnings	495
Total liabilities and shareholders' equity	$1,375

RICE CORPORATION
Income Statment
For the Year Ended December 31, 2005
($ in 000s)

Net sales		$1,580
Expenses:		
Cost of goods sold	$755	
Selling and administrative	385	
Miscellaneous	129	
Income taxes	100	
Total expenses		1,369
Net income		$ 211

Additional information:

1. The company's common shares are traded on the Toronto Stock Exchange.
2. The investment portfolio consists of short-term investments valued at $57,000. The remaining investments will not be sold until the year 2008.
3. Miscellaneous expense represents the before-tax loss from damages caused by an earthquake. The event is considered to be both unusual and infrequent.
4. Notes payable consist of two notes:
   Note 1: $80,000 face value dated September 30, 2005.
   Principal and interest at 10 percent are due on September 30, 2006.
   Note 2: $120,000 face value dated April 30, 2007. Principal is due in two equal installments of $60,000 plus interest on the unpaid balance. The two payments are scheduled for April 30, 2006, and April 30, 2007.

   Interest on both loans has been correctly accrued and is included in accrued liabilities on the balance sheet and selling and administrative expenses on the income statement.
5. Selling and administrative expenses include a $90,000 charge incurred by the company in restructuring some of its operations. The amount of the charge is material.

Required:

Identify and explain the deficiencies in the presentation of the statements prepared by the company's comptroller. Do not prepare corrected statements. Include in your answer a list of items that require additional disclosure, either on the face of the statement or in a note.

Judgment Case 5–6
Financial disclosures

You recently joined the auditing staff of Best, Best, and Krug, CAs. You have been assigned to the audit of Clearview, Inc. and have been asked by the audit senior to examine the balance sheet prepared by Clearview's accountant.

CLEARVIEW, INC.
Balance Sheet
At December 31, 2005
($ in millions)

Assets	
Current assets:	
Cash	$ 10.5
Accounts receivable	112.1
Inventories	220.6
Prepaid expenses	5.5
Total current assets	348.7
Investments	22.0
Property, plant, and equipment, net	486.9
Total assets	$857.6
Liabilities and Shareholders' Equity	
Current liabilities:	
Accounts payable	$ 83.5
Income taxes and interest payable	25.5
Current maturities of long-term debt	20.0
Total current liabilities	129.0
Long-term liabilities:	420.0
Total liabilities	549.0

continued

Shareholders' equity:		
Common shares	$100.0	
Retained earnings	208.6	
Total shareholders' equity		308.6
Total liabilities and shareholders' equity		$857.6

Required:

Identify the items on the statement that most likely would require further disclosure either on the face of the statement or in a note. Further identify those items that would require disclosure in the significant accounting policies note.

Real World Case 5–7
Balance sheet and significant accounting policies disclosure

The balance sheet and disclosure of significant accounting policies taken from the 2000 annual report of International Business Machines Corporation (IBM) appear below. Use this information to answer the following questions:

1. What are the asset classifications contained in IBM's balance sheet?
2. What amounts did IBM report for the following items for 2000?
   a. Total assets
   b. Current assets
   c. Current liabilities
   d. Total shareholders' equity
   e. Retained earnings
   f. Inventories
3. What is the par value of IBM's common shares? How many common shares are authorized and issued at the end of 2000?
4. Compute IBM's current ratio for 2000.
5. Identify the following items:
   a. The company's inventory valuation method.
   b. The company's amortization method.
   c. The definition of cash equivalents.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
($ in millions)

		At December 31	
	Notes	**2000**	**1999**
Assets			
Current assets:			
Cash and cash equivalents		$ 3,563	$ 5,043
Marketable securities	K	159	788
Notes and accounts receivable—trade net of allowances		10,447	9,103
Short-term financing receivable	F	18,705	17,156
Other accounts receivable		1,574	1,359
Inventories	E	4,765	4,868
Deferred taxes	O	2,701	2,907
Prepaid expenses and other current assets		1,966	1,931
Total current assets		43,880	43,155
Plant, rental machines, and other properties	G	38,455	39,616
Less: Accumulated amortization		21,741	22,026
Plant, rental machines, and other properties—net		16,714	17,590
Long-term financing receivables	F	13,308	13,078
Investments and sundry assets	H	14,447	13,672
Total assets		$88,349	$ 87,495
Liabilities and Stockholders' Equity			
Current liabilities			
Taxes	G	$ 4,827	$ 4,792
Short-term debt	J & K	10,205	14,230
Accounts payable		8,192	6,400
Compensation and benefits		3,801	3,840

continued

Deferred income		4,516	4,529
Other accrued expenses and liabilities		4,865	5,787
Total current liabilities		36,406	39,578
Long-term debt	J & K	18,371	14,124
Other liabilities	L	12,948	13,282
Total liabilities		67,725	66,984
Contingencies	N		
Stockholders' equity:			
Preferred shares, par value $.01 per share—	M		
shares authorized: 150,000,000			
shares issued and outstanding: 2,546,011		247	247
Common shares, par value $.20 per share—	C		
shares authorized: 4,687,500,000			
shares issued: 2000—1,893,940,595;			
1999 –1,876,665,245		12,400	11,762
Retained earnings		23,784	16,878
Treasury shares, at cost (shares : 2000—131,041,411;			
1999—72,449,015)		(13,800)	(7,375)
Employee benefits trust, at cost (20,000,000 shares)		(1,712)	(2,162)
Accumulated gains and losses not affecting			
Retained earnings		(295)	1,161
Total stockholders' equity		20,624	20,511
Total liabilities and stockholders' equity		$88,349	$ 87,495

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS INTERNATIONAL BUSINESS MACHINES CORPORATION AND SUBSIDIARY COMPANIES

A. Significant Accounting Policies (in part)

Revenue

The company recognizes revenue when it is realized or realizable and earned. The company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable and collectibility is reasonably assured. The company reduces revenue for estimated customer returns.

Cash Equivalents

All highly liquid investments with a maturity of three months or less at date of purchase are carried at fair value and considered to be cash equivalents.

Inventories

Raw materials, work in process, and finished goods are stated at the lower of average cost or market.

Amortization

Plant, rental machines, and other properties are carried at cost, and amortized over their estimated useful lives using the straight-line method.

Research Case 5–8
Related party disclosures, locate and extract relevant information and authoritative support for a financial reporting issue, Enron Corporation

Enron Corporation provides products and services related to natural gas, electricity, and communications to wholesale and retail customers. The company was a darling in the energy provider arena, and in January 2001, its share price rose above $100 per share. A collapse of investor confidence in 2001 and revelations of accounting irregularities led to second largest bankruptcy in American history. By the end of year, its share price had plummeted to less than $1 per share. Investigations and lawsuits followed. One problem area concerned transactions with related parties that were not adequately disclosed in the company's financial statements. Critics stated that the lack of information about these transactions made it difficult for analysis following Enron to identify problems the company was experiencing

Required:

1. Consult the Summaries of FASB pronouncements at www.accounting.rutgers.edu/raw/fasb/public/index.html or access the pronouncement from some other source. What authoritative pronouncement requires the disclosure of related party transactions? When did the requirement become effective?
2. Describe the disclosures required for related party transactions.
3. Use Edgarscan (www.edgarscan.pwcglobal.com) or another method to locate the December 31, 2000, financial statements of Enron. Search for the related party disclosure. Briefly describe the relationship central to the numerous transactions described.

4. Why is it important that companies disclose related party transactions? Use the Enron disclosure of the sale of dark fibre inventory in your answer.

Judgment Case 5–9
Post fiscal year-end events

The fiscal year-end for the Norbert Distribution Corporation is December 31. The company's 2005 financial statements were issued on March 15, 2006. The following events occurred between December 31, 2005, and March 15, 2006.

1. On January 22, 2006, the company negotiated a major merger with Robert Industries. The merger will be completed by the middle of 2006.
2. On February 3, 2006, Norbert negotiated a $10 million long-term note with the National Bank. The amount of the note is material.
3. On February 25, 2006, a flood destroyed one of the company's manufacturing plants causing $600,000 of uninsured damage.

Required:

Determine the appropriate treatment of each of these events in the 2005 financial statements of Norbert Distribution Corporation.

Research Case 5–10
Disclosure of debt covenants

Classifying a liability as short or long term provides useful cash flow information to financial statement users. Additional cash flow information is contained in a disclosure note that provides information about the payment terms, interest rates, collateral, and scheduled maturity amounts of long-term debt. Quite often, debt agreements contain certain constraints placed by the lender on the borrower in order to protect the lender's investment. Many of these constraints, called *debt covenants,* are based on accounting information. Professors Press and Weintrop in "Financial Statement Disclosure of Accounting-Based Debt Covenants" investigate the adequacy of debt covenant disclosures in financial statements.

Required:

1. In your library or from some other source, locate the indicated article in *Accounting Horizons*, March 1991.
2. Describe the two types of accounting-based debt covenants—affirmative covenants and negative covenants—discussed by the authors.
3. What is the authors' conclusion about the adequacy of disclosure of accounting-based covenants in financial statements?

International Case 5–11
Comparison of audit reports in the United Kingdom and Canada

British Airways PLc is the largest international passenger airline in the world. The following is the Report of the Auditors accompanying the company's 2000 financial statements:

Report of the Auditors to the Members of British Airways PLc.

We have audited the accounts, which have been prepared under the historical cost convention as modified by the revaluation of certain fixed assets and on the basis of the accounting policies set out here.

Respective responsibilities of directors and auditors (in part)

The directors are responsible for preparing the annual report. As described above, this includes responsibility for preparing the accounts in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of the Financial Services Authority and by our profession's ethical guidance. We report to you our opinion as to whether the accounts give a true and fair view and are properly prepared in accordance with the Companies Act.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the accounts and of whether the accounting policies are appropriate to the group's circumstances consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which were considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the accounts.

Opinion

In our opinion, the accounts give a true and fair view of the state of affairs of the Company and of the Group at March 31, 2000, and of the loss of the group for the year then ended and have been properly prepared in accordance with the Companies Act of 1985.

Ernst & Young
Registered Auditor
London
May 23, 2000

Required:

Compare the auditors' report in the United Kingdom with that in Canada.

Judgment Case 5–12
Accounting policies and ethical issues

Cobalt Company is a medium-sized retail business that has shown consistent growth over the past several years. The shareholders of Cobalt believe it is important to maintain a steady growth in earnings to attract additional financing from prospective shareholders and lending agencies. During the current fiscal year, Cobalt has implemented a management incentive plan that pays a bonus to key management personnel on the basis of the annual net income of Cobalt. The managers have indicated that they prefer accounting policies that will maximize the earnings of Cobalt and their bonuses in the current year.

It is anticipated that the sales of Cobalt will increase moderately over the next few years and be matched with similar increases in expenses. The cost of inventory purchases is expected to rise due to an anticipated shortage in the industry.

Cobalt recently made a major capital asset acquisition that will benefit operations over the next several years. An amortization policy for the new capital asset has yet to be determined. Management is unsure about which amortization method to adopt and has not estimated the useful life of the new capital asset and its residual value.

Cobalt has negotiated a significant sales contract with a new customer. There is some uncertainty with respect with the collectibility of the contract, but management has decided the potential long-term benefit could be significant to the long-term growth of Cobalt. The sales contract may be set up on an installment sales basis or a cost recovery basis.

Required:

The objectives of financial accounting require the accountant to use professional judgment when choosing among alternative accounting policies. Depending on who the user is, the objectives can vary.

a. Prepare a brief report indicating the accounting policies that would be appropriate for Cobalt. In your report, you should comment on the preferences for different accounting policies that the different users of Cobalt financial reports might have.
b. Discuss the ethical considerations for a professional accountant related to the selection of alternative accounting policies.

(*CGA-Canada adapted*)

Judgment Case 5–13
Debt versus equity

A common problem facing any business entity is the debt versus equity decision. When funds are required to obtain assets, should debt or equity financing be used? This decision also is faced when a company is initially formed. What will be the mix of debt versus equity in the initial capital structure? The characteristics of debt are very different from those of equity as are the financial implications of using one method of financing as opposed to the other.

Cherokee Plastics Corporation is formed by a group of investors to manufacture household plastic products. Their initial capitalization goal is $50,000,000. That is, the incorporators have decided to raise $50,000,000 to acquire the initial operating assets of the company. They have narrowed down the financing mix alternatives to two:

1. All equity financing.
2. $20,000,000 in debt financing and $30,000,000 in equity financing.

No matter which financing alternative is chosen, the corporation expects to be able to generate a 10 percent annual return, before payment of interest and income taxes, on the $50,000,000 in assets acquired. The interest rate on debt would be 8 percent. The effective income tax rate will be approximately 50 percent.

Alternative 2 will require specified interest and principal payments to be made to the creditors at specific dates. The interest portion of these payments (interest expense) will reduce the taxable income of the corporation and hence the amount of income tax the corporation will pay. The all-equity alternative requires no specified payments to be made to suppliers of capital. The corporation is not legally liable to make distributions to its owners. If the board of directors does decide to make a distribution, it is not an expense of the corporation and does not reduce taxable income and hence the taxes the corporation pays.

Required:

1. Prepare abbreviated income statements that compare first-year profitability for each of the two alternatives.
2. Which alternative would be expected to achieve the highest first-year profits? Why?
3. Which alternative would provide the highest rate of return on shareholders' equity? Why?
4. What other related implications of the decision should be considered?

Judgment Case 5–14
Relationships among ratios

You are a part-time financial advisor. A client is considering an investment in common shares of a waste recycling firm. One motivation is a rumour the client heard that the company made huge investments in a new fuel creation process. Unable to confirm the rumour, your client asks you to determine whether the firm's assets had recently increased significantly.

Because the firm is small, information is sparse. Last quarter's interim report showed total assets of $324 million, approximately the same as last year's annual report. The only information more current than that is a press release last week in which the company's management reported "record net income for the year of $21 million, representing a 14 percent return on shareholders' equity. Performance was enhanced by the Company's judicious use of financial leverage on a debt–equity ratio of 2 to 1."

Required:

Use the information available to provide your client with an opinion as to whether the waste recycling firm invested in the new fuel creation process during the last quarter of the year.

Judgment Case 5–15
Using ratios to test reasonableness of data

You are a new staff accountant with a large regional accounting firm participating in your first audit. You recall from your auditing class that accountantss often use ratios to test the reasonableness of accounting numbers provided by the client. Because ratios reflect the relationships among various account balances, if it is assumed that prior relationships still hold, prior years' ratios can be used to estimate what current balances should approximate. However, you never actually performed this kind of analysis until now. The accountant in charge of the audit of Covington Pike Corporation brings you the list of ratios shown below and tells you these reflect the relationships maintained by Covington Pike in recent years.

Profit margin on sales = 5%
Return on assets = 7.5%
Gross profit margin = 40%
Inventory turnover ratio = 6 times
Receivables turnover ratio = 25 times
Acid-test ratio = .9
Current ratio = 2 to 1
Return on shareholders' equity = 10%
Debt-to-equity ratio = 1/3
Times interest earned ratio = 12 times

Jotted in the margins are the following notes:

- Net income $15,000.
- Only one short-term note ($5,000); all other current liabilities are trade accounts.
- Property, plant, and equipment are the only noncurrent assets.
- Bonds payable are the only noncurrent liabilities.
- The effective interest rate on short-term notes and bonds is 8 percent.
- No investment securities.
- Cash balance totals $15,000.

Required:

You are requested to approximate the current year's balances in the form of a balance sheet and income statement, to the extent the information allows. Accompany those financial statements with the calculations you use to estimate each amount reported.

Analysis Case 5–16
Obtain and critically evaluate an actual annual report

Financial reports are the primary means by which corporations report their performance and financial condition. Financial statements are one component of the annual report mailed to their shareholders and to interested others.

Required:

Obtain an annual report from a corporation with which you are familiar. Using techniques you learned in this chapter and any analysis you consider useful, respond to the following questions:

1. Do the firm's auditors provide a clean opinion on the financial statements?
2. Has the company made changes in any accounting methods it uses?
3. Have there been any subsequent events, errors and irregularities, illegal acts, or related-party transactions that have a material effect on the company's financial position?
4. What are two trends in the company's operations or capital resources that management considers significant to the company's future?
5. Is the company engaged in more than one significant line of business? If so, compare the relative profitability of the different segments.
6. How stable are the company's operations?
7. Has the company's situation deteriorated or improved with respect to liquidity, solvency, asset management, and profitability?

Note: You can obtain a copy of an annual report from a local company, from a friend who is a shareholder, from the investor relations department of the corporation, from a friendly stockbroker, or from SEDAR (System for Electronic Document Analysis and Retrieval) on the Internet (www.sedar.com).

Analysis Case 5–17
Obtain and compare annual reports from companies in the same industry

Insight concerning the performance and financial condition of a company often comes from evaluating its financial data in comparison with other firms in the same industry.

Required:

Obtain annual reports from three corporations in the same primary industry. Using techniques you learned in this chapter and Chapter 4 and any analysis you consider useful, respond to the following questions:

1. Are there differences in accounting methods that should be taken into account when making comparisons?
2. How do earnings trends compare in terms of both the direction and stability of income?
3. Which of the three firms had greater earnings relative to resources available?
4. Has each of the companies achieved its respective rate of return on assets with similar combinations of profit margin and turnover?
5. Which corporation has made most effective use of financial leverage?
6. Of the three firms, which seems riskiest in terms of its ability to pay short-term obligations? Long-term obligations?
7. What factors might account for differences among price-earnings ratios for the companies' shares?

Note: You can obtain copies of annual reports from friends who are shareholders, from the investor relations department of the corporations, from a friendly stockbroker, or from SEDAR (System for Electronic Document Analysis and Retrieval) on the Internet (www.sedar.com).

Analysis Case 5–18
Balance sheet information

Indigo Books and Music Inc.

Refer to the financial statements and related disclosure notes of Indigo Books and Music Inc. in the appendix to Chapter 1.

Required:

1. What categories does the company use to classify its assets? Its liabilities?
2. What purpose do the disclosure notes serve?

Analysis Case 5–19
[based on Appendix 5]
Segment reporting concepts

Levens Co. operates in several distinct business segments. The company does not have any reportable foreign operations or major customers.

Required:

1. What is the purpose of operating segment disclosures?
2. Define an operating segment.
3. List the amounts to be reported by operating segment.

Ethics Case 5–20
[based on Appendix 5]
Segment reporting

You are in your third year as an accountant with McCarver-Lynn Industries, a multidivisional company involved in the manufacturing, marketing, and sales of surgical prosthetic devices. After the fiscal year-end, you are working with the comptroller of the firm to prepare supplemental business segment disclosures. Yesterday, you presented her with the following summary information:

	($ in millions)					
	Domestic	Union of South Africa	Egypt	France	Denmark	Total
Revenues	$ 845	$222	$265	$343	$311	$1,986
Capital expenditures	145	76	88	21	42	372
Assets	1,005	301	290	38	285	1,919

Upon returning to your office after lunch, you find the following memo:

Nice work. Let's combine the data this way:

	($ in millions)			
	Domestic	Africa	Europe	Total
Revenues	$ 845	$487	$654	$1,986
Capital expenditures	145	164	63	372
Assets	1,005	591	323	1,919

Some of our shareholders might react unfavourably to our recent focus on South African operations.

Required:

Do you perceive an ethical dilemma? What would be the likely impact of following the comptroller's suggestions? Who would benefit? Who would be harmed?