

P5-3

Side Kicks Company
Balance Sheet
December 31, 2007

<u>Assets</u>			
<u>Current assets</u>			
Cash.....		\$ 41,000	
Accounts receivable.....	\$163,500		
Less: Allowance for doubtful accounts.....	8,700	154,800	
Inventory—at LIFO cost.....		308,500	
Prepaid insurance.....		5,900	
Total current assets.....			\$ 510,200
 <u>Long-term investments</u>			
Investments in stocks and bonds, of which investments of \$120,000 have been pledged as security for notes payable—at fair value.....			339,000
 <u>Property, plant, and equipment</u>			
Cost of uncompleted plant facilities			
Land.....	85,000		
Building in process of construction.....	124,000	209,000	
Equipment.....	400,000		
Less: Accum. depreciation.....	140,000	260,000	469,000
 <u>Intangible assets</u>			
Patents—at cost less amortization.....			36,000
Total assets.....			\$1,354,200

PROBLEM 5-3 (Continued)

Liabilities and Stockholders' Equity

Current liabilities

Notes payable, secured by investments of \$120,000.....	\$ 94,000	
Accounts payable.....	148,000	
Accrued expenses.....	<u>49,200</u>	
Total current liabilities.....		\$ 291,200

Long-term liabilities

8% bonds payable, due January 1, 2018.....	400,000	
Less: Unamortized discount on bonds payable.....	<u>20,000</u>	<u>380,000</u>
Total liabilities.....		671,200

Stockholders' equity

Common stock Authorized 600,000 shares of \$1 par value; issued and outstanding, 500,000 shares.....	\$500,000		
Premium on common stock.....	<u>45,000</u>	545,000	
Retained earnings.....		<u>138,000</u>	<u>683,000</u>
Total liabilities and stockholders' equity.....			<u>\$1,354,200</u>

Item 1

The staff auditor reviewing the loan agreement misinterpreted its requirements. Retained earnings are restricted in the amount of \$420,000, which was the balance of retained earnings at the date of the agreement. The nature and amount of the restriction should be disclosed in the balance sheet or a note to the financial statements.

Item 2

Unless cumulative preferred dividends are involved, no recommendation by the CPA is required. Common stock dividend policy is understood by readers of financial statements to be discretionary on the part of the board of directors. The company need not commit itself to a prospective common stock dividend policy or explain its historical policy in the financial statements, particularly since dividend policy is to be discussed in the president's letter. If cumulative preferred dividends are omitted, this should be disclosed in the financial statements or a note.

Note that the SEC encourages companies to disclose their dividend policy in their annual report. Those that: (1) have earnings but fail to pay dividends or (2) do not expect to pay dividends in the foreseeable future are encouraged to report this information. In addition, companies that show a consistent pattern of paying dividends are encouraged to indicate whether they intend to continue this practice in the future.

Item 3

A competitive development of this nature normally is considered to be the type of subsequent event that provides evidence with respect to a condition that did not exist at the date of the balance sheet. In some circumstances the auditor might conclude that Rem's poor competitive situation was evident at year-end. In any event, the development should be disclosed to users of the financial statements because the economic recoverability of the new plant and inventory are in doubt and Rem may incur substantial expenditures to modify its facilities. Because the economic effects probably cannot be determined, the usual disclosure will be in a note to the financial statements. If the present recoverable value of the plant can be determined, Rem should consider disclosure of the company's revised financial position in a pro-forma balance sheet, assuming that this event is concluded to be evidence of a condition that did not exist at year-end. (Only if circumstances were such that it was concluded that this condition did exist at year-end should the financial statements for the year ended December 31, 2007, be adjusted for the ascertainable economic effects of this development.)