1 ACCOUNTING AND THE FINANCIAL STATEMENTS

DISCUSSION QUESTIONS

1. Accounting is a system for identifying, measuring, recording, and communicating financial information about an organization's activities to permit informed decisions by users of the information. Bookkeeping is the process—made up of mechanical "steps"—of recording transactions and maintaining accounting records. While bookkeeping is part of accounting, accounting is viewed as the complete information system that communicates the economic activities of a company to interested parties. Accounting is often referred to as the "language of business" because it communicates information about economic activities of a company that help people make decisions.

2. Accounting information is demanded or needed by decision-makers both inside and outside the business to provide information about business activities and finances so that informed decisions can be made. Five groups that create the demand for accounting information and their uses of accounting information are described below.

(1) Managers need accounting information to plan and make decisions about the business (e.g., predicting the consequences of their actions and deciding on which actions to take) and to control its operations (e.g., evaluating the effectiveness of their past decisions).

(2) Employees use accounting information about their employer to aid in planning their careers (e.g., judging the future prospects of the company).

(3) Investors (owners) need accounting information about a business to evaluate the future prospects of a business and to decide where to invest their money.

(4) Creditors (lenders) need accounting information to decide whether or not to lend money or extend credit to a business.

(5) Governments need accounting information about businesses to determine taxes owed by businesses, to implement a variety of regulatory objectives, and to make national economic policy decisions.

3. An accounting entity is a company that has an identity separate from that of its owners and managers and for which accounting records are kept. There are three main forms that accounting entities take: a sole proprietorship, a partnership, and a corporation.

4. A sole proprietorship is a business entity owned by one person. A partnership is a business entity owned jointly by two or more individuals. Proprietorships and partnerships are not legally separate from the personal affairs of the owners. That is, the owners are responsible for the debts of the business. A corporation is a separate legal entity formed by one or more persons called stockholders. A corporation is legally separate from the affairs of its owners, which limits the stockholders' legal responsibility for the debt of the business to the amount that the stockholders invested in the business. Corporate shareholders generally pay more taxes than owners of sole proprietorships or partnerships. Although the combined number of sole proprietorships and partnerships greatly outnumber the number of corporations, the majority of business in the United States is conducted by corporations.

5. The three main types of business activities are financing activities, investing activities, and operating activities. Financing activities involve obtaining the funds necessary to begin and operate a business. These funds come from either issuing stock or borrowing money. Investing activities involve buying and selling assets that enable a corporation to operate. Operating activities are the normal business activities that a company engages in as it conducts its business. These activities involve selling products or services, purchasing inventory, collecting amounts due from customers, and paying suppliers.

6. Assets are the economic resources or future economic benefits obtained or controlled by a business. Liabilities are the creditors' claims on the resources of a business. Stockholders' equity is the ownership claims on the resources of a business. Stockholders' equity is considered a residual interest in the assets of a business that remain after deducting the business's liabilities. All three items appear on the balance sheet, forming the following equation:

Assets = Liabilities + Stockholders' Equity

7. Revenues are the increases in assets (resources) that result from the sale of products or services. Expenses are the costs of assets (resources) used, or the liabilities created, in the operation of the business. If revenues are greater than expenses, a corporation has earned net income. If expenses are greater than revenues, a corporation has incurred a net loss.

8. The four primary financial statements are:

(1) The balance sheet: a presentation of information about a company's economic resources (its assets) and the claims against those resources by creditors and owners (liabilities and stockholders' equity) at a specific point in time.

(2) The income statement: a report on how well a company has performed its operations—the profitability of a company—over a period of time.

(3) The retained earnings statement: a report on how much of the company's income was retained in the business and how much was distributed to owners over a period of time.

(4) The statement of cash flows: a report on the changes in a company's cash during a period of time. The statement of cash flows provides information about the company's cash inflows (sources) and outflows (uses) from operating, investing, and financing activities.

9. There are many questions that can be answered based on each of the financial statements:

(1) The balance sheet:

a. What is the total amount of assets (economic resources) of a corporation? What is the total amount of liabilities (claims against the resources) for a corporation?

b. How much equity do the owners of the corporation have in its assets?

c. Is the corporation able to pay its debts as they become due?

(2) The income statement:

a. How much revenue was earned last month? Last quarter? Last year?

b. What was the total amount of expenses incurred to earn that revenue?

c. How much better off is the corporation at the end of the year than it was at the beginning of the year?

d. Was the corporation profitable, and what are the prospects for the corporation's future profitability?

e. What are the prospects for the future growth of the corporation?

(3) The retained earnings statement:
  a. How much income was distributed in dividends by the corporation?
  b. What amount of equity in the business has been generated internally?

(4) The statement of cash flows:
  a. How much cash was taken in or paid out as a result of operations?
  b. How much cash was invested in new equipment?
  c. How much cash was used to pay off business debt?

10. Point-in-time measurement means as of a particular date. The balance sheet is a point-in-time measurement. The period-of-time description applies to what has happened over a time interval. The income statement is a period-of-time measurement that explains the business activities between balance sheet dates. The statement of cash flows and the statement of retained earnings are also period-of-time measurements.

11. The fundamental accounting equation is:

Assets = Liabilities + Stockholders' Equity

The equation is significant because it means that the balance sheet must always balance. This implies that what a company owns (its resources) must always be equal to the claims of its creditors (liabilities) and investors (stockholders' equity).

12. Each financial statement includes a heading that is comprised of (a) the name of the company, (b) the title of the financial statement, and (c) the time period covered—either a point-in-time measurement (an exact date) or a period-of-time description (e.g., a year ended in a specific date).

13. Current assets are cash and other assets that are reasonably expected to be converted to cash within one year or the operating cycle, whichever is longer. Current liabilities are obligations that will be satisfied within one year or the operating cycle, whichever is longer.

Since current assets are presented separately from other assets, statement users can see if the firm is likely to have enough resources available to meet its current liabilities as they come due. If current assets were presented among other assets, such a determination would be difficult.

Current liabilities are separated from long-term liabilities because current liabilities will require asset outflows (or replacement with another liability) much sooner than will long-term liabilities. If all liabilities were presented together, financial statement users would have difficulty in determining the assets (economic resources) required in the near future to satisfy the current liabilities.

14. Current assets are generally listed on the balance sheet in order of liquidity or nearness to cash, whereas current liabilities are usually listed in the order in which they will be paid.

15. The two main components of equity are contributed capital and retained earnings. Contributed capital is increased by investments of new capital in a company by its owners (the issue of common stock to stockholders). Retained earnings is the accumulated net income of a company that has not been distributed to owners. Retained earnings is increased by net income and decreased by net losses and dividends.

16. Net Income = Total Revenues – Total Expenses

17. The single-step income statement format takes into account only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a single step to arrive at net income. The multiple-step income statement format contains three important subtotals: gross margin (gross profit), income from operations, and net income. Gross margin is the difference between net sales and cost of sales (or cost of goods sold). Income from operations is the difference between gross margin and operating expenses. Net income is the difference between income from operations and any nonoperating revenues and expenses.

18. A retained earnings statement summarizes and explains the changes in retained earnings during an accounting period. Retained earnings is the income earned by the company but not paid to the owners in the form of dividends. The retained earnings statement starts with the balance in retained earnings at the beginning of the period. To this balance, add net income (or subtract the net loss) obtained from the income statement. Next, subtract any dividends the company declared during the period. The total is the retained earnings at the end of the period that is reported on the balance sheet.

19. The statement of cash flows classifies cash flows into three categories: (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities. Cash flows from operating activities are the cash flows related to the normal operations of the business in earning income, and include cash sales and collections of accounts receivable less cash paid for goods, services, wages, salaries, and interest. Cash flows from investing activities are cash flows related to the acquisition or sale of investments and long-term assets, including cash received from the sales of property, plant, and equipment; investments; and other long-lived assets less the cash spent to purchase long-term assets. The cash flows from investing activities by a healthy, growing business will usually represent an excess of expenditures over receipts. Cash flows from financing activities are the cash flows related to obtaining the capital of the company, including the cash contributed by owners and borrowed from creditors less amounts paid as dividends and repayments of liabilities. A business can finance its growth either internally with cash generated by operations or externally with cash from owners and creditors.

20. The retained earnings statement describes the changes in retained earnings, a balance sheet account, that occurs between two balance sheet dates. One of the major sources of change in retained earnings is the net income (or net loss) for the year, which is determined on the income statement. The other major source of change in retained earnings is dividends, which are not considered a part of income.

21. Other than the financial statements, users will find notes to the financial statements, management's discussion and analysis of the condition of the company, and the auditor's report in the annual report of a company. The notes to the financial statements are an integral part of the financial statements that clarify and expand upon the information in the financial statements. Management's discussion and analysis provides a discussion and explanation of various items reported in the financial statements. Additionally, management uses this opportunity to highlight favorable and unfavorable trends and significant risks facing the company. The auditor's report expresses the opinion of the auditor as to whether the financial statements fairly present the financial position and results of operations of the company.

22. Examples of unethical behavior will differ from one student to another. One example is an accountant who gives in to personal pressure to prepare financial statements that overstate the income of the company by bending or violating generally accepted accounting principles. Overstated income may lead decision-makers to make the wrong choices. Decision-makers both inside and outside the business must be able to rely on the financial information they receive to make proper decisions. Therefore, ethical behavior by accountants is necessary. Acting ethically is not always easy. However, because of the important role of accounting in society, accountants are expected to maintain the highest level of ethical behavior.

MULTIPLE-CHOICE EXERCISES

1-1. **a**

1-2. **b**

1-3. **a ($10,500 – $5,800)**

1-4. **b**

1-5. **d**

1-6. **d**

1-7. **b ($8,200 + $3,700 + $3,900)**

1-8. **c ($5,900 + $12,200)**

1-9. **a**

1-10. **b ($165,500 – $92,100 – $43,850 – $15,000)**

1-11. **c**

1-12. **c**

1-13. **b**

CORNERSTONE EXERCISES

CE 1-14

Scenario 1:	Assets	=	Liabilities	+	Equity
	X	=	$33,000	+	$44,000
	X	=	$77,000		
Scenario 2:	$110,000	=	X	+	$68,000
	X	=	$42,000		
Scenario 3:	$49,000	=	$32,000	+	X
	X	=	$17,000		

CE 1-15

Note: **Be sure to treat situations b. through d. independently.**

a.	Assets	=	Liabilities	+	Equity
	$440,000	=	$285,000	+	X
	X	=	$155,000 at the beginning of the year		

b.	Assets	=	Liabilities	+	Equity
	$525,000 *	=	$323,000 **	+	X
	X	=	$202,000		

* $440,000 + $85,000
** $285,000 + $38,000

c.	Assets	=	Liabilities	+	Equity
	$375,000 *	=	X	+	$200,000 **
	X	=	$175,000		

* $440,000 – $65,000
** $155,000 (from part a) + $45,000

d.	Assets	=	Liabilities	+	Equity
	X	=	$380,000 *	+	$80,000 **
	X	=	$460,000		

* $285,000 + $95,000
** $155,000 (from part a) – $75,000

CE 1-16

a. **Balance sheet (B)**
b. **Statement of cash flows (CF)**
c. **Balance sheet (B)**
d. **Income statement (I)**
e. **Statement of cash flows (CF)**
f. **Income statement (I)**
g. **Balance sheet (B)**
h. **Retained earnings statement (RE)**

CE 1-17

1. d
2. b
3. a
4. f
5. e
6. a
7. c
8. g (*Note:* While net income and dividends are reported on other financial statements, the definition of retained earnings is income that has not been distributed to stockholders. Therefore, by definition, this item is part of a company's retained earnings.)
9. b
10. a

CE 1-18

Cavernous Homes Inc. Balance Sheet December 31, 2011		
Assets		
Cash	$3,200	
Accounts receivable	4,500	
Supplies	8,100	
Total assets		$15,800
Liabilities and Stockholders' Equity		
Liabilities:		
Notes payable	$5,000	
Total liabilities		$5,000
Stockholders' equity:		
Common stock	$7,000	
Retained earnings	3,800	
Total stockholders' equity		10,800
Total liabilities and stockholders' equity		$15,800

CE 1-19

Net Income	=	Total Revenue	–	Total Expenses
Net Income	=	$78,000	–	($33,200 + $20,500)
Net Income	=	$24,300		

Note: The dividends do not appear on the income statement in arriving at net income. Dividends do not affect the income statement. Dividends are a reduction of the balance in retained earnings.

CE 1-20

	Beginning retained earnings	$25,000
+	Net ($74,000 – $57,000)	17,000
–	Dividends	(8,000)
=	Ending retained earnings	$34,000

EXERCISES

E 1-21

1. **Bank (B)**
2. **Government (G)**
3. **Business managers (M)**
4. **Investor (I)**
5. **Labor union (U)**

E 1-22

1. **Sole proprietorship: 1, 2, 4, 5**
   Partnership: 2, 3, 4, 5, 7
   Corporation: 2, 3, 4, 5, 6, 8
2. **There are many advantages and disadvantages to each particular type of business entity as listed below.**

   a. **Sole Proprietorship**
   - **Advantages:**
     - (i) **The business is easily formed**
     - (ii) **Control over the operations of the business is maintained by owner**
     - (iii) **Sole proprietorships pay less taxes relative to corporations**
   - **Disadvantages:**
     - (i) **The owner is personally liable for the debt of the business**
     - (ii) **The life of the business is limited to the owner's life**

   b. **Partnership:**
   - **Advantages:**
     - (i) **Increased access to the financial resources and individual skills of each of the partners**
     - (ii) **Partnerships pay less taxes relative to corporations**
   - **Disadvantages:**
     - (i) **Control over the operations of the business is shared among the partners**
     - (ii) **The partners are personally liable for the debt of the business**
     - (iii) **The life of the business is limited to life of the partners**

   c. **Corporation:**
   - **Advantages:**
     - (i) **Can more easily raise large amounts of money**
     - (ii) **Ownership of the business can be easily transferred by selling stock**
     - (iii) **The owners' liability is limited to the amount invested in the business**
   - **Disadvantages:**
     - (i) **The formation and organization of the business is more complex**
     - (ii) **Corporations generally pay higher taxes**

E 1-23

a. Investing (I)
b. Financing (F)
c. Operating (O)
d. Investing (I)
e. Operating (O)
f. Financing (F)
g. Financing (F)

E 1-24

a. Financing (F)
b. Investing (I)
c. Investing (I)
d. Operating (O)
e. Operating (O)
f. Financing (F)
g. Operating (O)
h. Operating (O)
i. Investing (I)
j. Financing (F)

E 1-25

1. c
2. e
3. b
4. g
5. d
6. f
7. a

E 1-26

	Assets	=	Liabilities	+	Equity
1.	$112,800		$ 61,800*		$ 51,000
2.	275,000		162,500		112,500**
3.	58,200***		15,000		43,200

* $112,800 – $51,000
** $275,000 – $162,500
*** $15,000 + $43,200

E 1-27

1.

Higgins Company Balance Sheet Specific Point in Time
Assets
Current assets:
Cash
Accounts receivable
Inventory
Prepaid insurance
Total current assets
Property, plant, and equipment:
Building
Equipment
Less: Accumulated depreciation
Intangible assets:
Trademarks
Total assets
Liabilities and Stockholders' Equity
Liabilities:
Current liabilities:
Accounts payable
Income taxes payable
Wages payable
Total current liabilities
Long-term liabilities:
Notes payable
Bonds payable
Total long-term liabilities
Total liabilities
Stockholders' equity:
Common stock
Retained earnings
Total stockholders' equity
Total liabilities and stockholders' equity

2. To assess liquidity, it would be helpful to have information on Higgins Company's current assets (cash, accounts receivable, inventory, and prepaid insurance) and current liabilities (accounts payable, income taxes payable, and wages payable). With this information, a user could compute a company's working capital (current assets less current liabilities) and current ratio (current assets ÷ current liabilities). These two measures are helpful in assessing a company's ability to pay its debts as they become due.

E 1-28

1. **Since the operating cycle is six months, Dunn would use one year as the breakpoint between current and noncurrent items.**
   a. **There are 17 months of prepaid rent ($8,500 ÷ $500). Dunn should include $6,000 (12 months × $500 per month) as a current asset and $2,500 (the (remaining 5 months × $500 per month) as a long-term asset.**
   b. **The $9,700 is a current liability.**
   c. **Since all items are expected to be sold within 12 months, the entire $46,230 is a current asset.**
   d. **The $700 portion of marketable securities is a current asset. The remaining $1,200 is a long-term investment.**
   e. **The $1,050 of cash is a current asset.**
   f. **The $60,000 note due in March 2016 is a long-term liability. The $3,750 interest related to 2011 is a current liability. The remaining interest of $750 will not be recognized until 2012 and, therefore, is not on the 2011 balance sheet.**
   g. **The entire $2,850 is a current asset.**
   h. **The store equipment and its accumulated depreciation are not current assets. Instead, they are classified as property, plant, and equipment.**

Dunn Sporting Goods Partial Balance Sheet December 31, 2011		
Current assets:		
Cash	$ 1,050	
Short-term investment in marketable securities	700	
Accounts receivable	2,850	
Inventory	46,230	
Prepaid rent	6,000	
Total current assets		$56,830
Current liabilities:		
Accounts payable	$ 9,700	
Interest payable on equipment loan (see f above)	3,750	
Total current liabilities		$13,450

E 1-28 (Contd)

2. **Working Capital** = Current Assets – Current Liabilities
= $56,830 – $13,450
= $43,380

Current Ratio = Current Assets ÷ Current Liabilities
= $56,830 ÷ $13,450
= 4.23

3. These ratios give users insights into a company's liquidity—that is a company's ability to pay obligations as they become due. These ratios show that Dunn Sporting Goods has adequate current assets to cover all of the current liabilities that will become due in the near future. Comparing these ratios to other companies in the same industry and examining the trend in these measures over time will yield additional insights.

E 1-29

1.

Hanson Construction
Partial Balance Sheet
December 31, 2011

Current assets:	
Cash	$ 475
Accounts receivable	8,000
Notes receivable	1,200
Supplies	8,800
Total current assets	$18,475
Current liabilities:	
Accounts payable	$ 1,800
Notes payable	7,600
Total current liabilities	$ 9,400

The accounts receivable of $4,000 due in 18 months will be classified as a long-term asset. The construction equipment and related accumulated depreciation are classified as property, plant, and equipment (a noncurrent asset).

2. Hanson Construction's liquidity may be evaluated by examining its current ratio and working capital. Its current ratio is 1.97 ($18,475 ÷ $9,400) and its working capital is $9,075 ($18,475 – $9,400). Because current assets well exceed the current liabilities, Hanson appears to be able to pay its debts that become due within the next year.

E 1-30

The balance sheet at December 31, 2011, will show equipment at its historical cost of $425,000 reduced by accumulated depreciation (a contra-asset) of $40,000. Therefore, the net book value (or carrying value) of the equipment is $385,000. (*Note:* The concepts of *book value* and *carrying value* will be covered in more detail in later chapters.) The equipment and accumulated depreciation will be reported under the caption "Property, plant, and equipment" in the asset section of the balance sheet.

The 2011 income statement will show depreciation expense of $40,000. In a multiple-step income statement, depreciation expense will be reported as an operating expense.

E 1-31

Mulcahy Manufacturing Inc.
Partial Balance Sheet
December 31, 2011

Stockholders' equity:		
Common stock	$135,600	
Retained earnings	25,300	
Total stockholders' equity		$160,900

***Note:* Transactions among stockholders do not change stockholders' equity balances.**

E 1-32

1.

College Spirit
Balance Sheet
December 31, 2011

Assets		
Current assets:		
Cash	$ 13,300	
Accounts receivable	6,700	
Inventory	481,400	
Prepaid rent	54,000	
Total current assets		$555,400
Long-term investments:		
Investment		110,900
Property, plant, and equipment:		
Furniture	$ 88,000	
Less: Accumulated depreciation	(23,700)	64,300
Total assets		$730,600

E 1-32 (Contd)

Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$104,700	
Notes payable	50,000	
Income taxes payable	11,400	
Total current liabilities		$166,100
Long-term liabilities:		
Bonds payable		180,000
Total liabilities		$346,100
Stockholders' equity:		
Common stock	$300,000	
Retained earnings	84,500	
Total stockholders' equity		384,500
Total liabilities and stockholders' equity		$730,600

2. College Spirit has working capital of $389,300 ($555,400 – $166,100) and a current ratio of 3.34 ($555,400 ÷ $166,100).

3. The working capital and current ratios show that College Spirit has adequate current assets to cover all of the current liabilities that will become due in the near future. Therefore, College Spirit's liquidity should not be a major concern. Comparing these items to those of other companies in the same industry and examining the trends in these measures over time will yield additional insights.

E 1-33

1.

Jerrison Company
Balance Sheet
December 31, 2011

Assets		
Current assets:		
Cash	$ 11,400	
Investments (short-term)	21,000	
Accounts receivable	95,500	
Prepaid insurance	5,700	
Inventory	187,900	
Total current assets		$321,500
Long-term investments:		
Investment		32,700
Property, plant, and equipment:		
Land		$ 41,000
Building	$419,900	
Less: Accumulated depreciation	(216,800)	203,100
Trucks	$106,100	
Less: Accumulated depreciation	(31,200)	74,900
Equipment (data processing)	$309,000	
Less: Accumulated depreciation	(172,400)	136,600
Total property, plant & equipment		455,600
Total assets		$809,800

E 1-33 (Contd)

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 65,100	
Notes Payable (due June 1, 2012)	150,000	
Salaries payable	14,400	
Interest payable	12,600	
Income taxes payable	21,600	
Total current liabilities		$263,700
Long-term liabilities:		
Bonds payable (due 2015)		200,000
Total liabilities		$463,700
Stockholders' equity:		
Common stock	$150,000	
Retained earnings*	196,100	
Total stockholders' equity		346,100
Total liabilities and stockholders' equity		$809,800

* *Note:* Retained earnings is computed using the concepts implied by the fundamental accounting equation. Because assets must equal liabilities plus stockholders' equity, retained earnings is computed by determining the amount that causes both sides of the accounting equation to remain equal. This amount is computed as:

First, compute stockholders' equity as:

Total assets = Total liabilities + Total stockholders' equity
$809,800 = $463,700 + X
X = $346,100

Next, compute retained earnings:

Total stockholders' equity = Common stock + Retained earnings
$346,100 = $150,000 + Y
Y = $196,100

2. Jerrison has working capital of $57,800 ($321,500 – $263,700) and a current ratio of $1.22 ($321,500 ÷ $263,700).

3. While Jerrison appears to be liquid, inventory is its largest current asset at $187,900. If a large portion of inventory cannot be sold, Jerrison will most likely not generate sufficient cash flow to pay its obligations as they become due.

E 1-34

1.

Butler Company Income Statement For a Period of Time
Revenues:
Sales revenue
Expenses:
Cost of goods sold
Advertising expense
Salaries expense
Utilities expense
Depreciation expense
Interest expense
Income taxes expense
Net income

2. Information contained on the income statement can be used to predict a company's ability to generate future income. Specifically, by examining a company's net profit margin (net income ÷ sales revenue), a financial statement user can gain insights into management's ability to control expenses, a critical factor to achieve future profitability.

E 1-35

1.

ERS Inc. Income Statement For the year ended December 31, 2011		
Revenues:		
Service revenue		$933,800
Expenses:		
Wages expense	$448,300	
Salaries expense	195,600	
Supplies expense	66,400	
Rent expense	58,400	
Utilities expense	26,100	
Advertising expense	24,200	
Depreciation expense	16,250	
Insurance expense	11,900	
Interest expense	10,100	
Income taxes expense	15,150	
Total expenses		872,400
Net income		$ 61,400

2. Net profit margin is 6.58% ($61,400 net income ÷ $933,800 service revenue). This indicates that $0.066 of each sales dollar is profit. If ERS were to increase revenues by $100,000, an additional $6,600 of profit would be recognized. If ERS wanted to achieve larger profits, it should focus on controlling its expenses.

3. A declining profit margin implies that ERS is having difficulty maintaining control over its expenses. While further investigation is warranted to determine the cause of the growing expenses (e.g., is it due to increasing costs that are within management control or are the cost increases due to economic factors beyond ERS short-term control), the declining profit margin signals that ERS may have difficulty generating future profits that are comparable with its past performance.

E 1-36

Bergin Pastry Shop Income Statement For the year ended December 31	
Net sales	$85,300
Cost of goods sold*	50,600
Gross margin	$34,700
Operating expenses**	25,500
Income from operations	$ 9,200
Other expenses and losses:	
Interest expense	1,800
Income before taxes	$ 7,400
Income taxes expense***	1,110
Net income	$ 6,290

* Cost of goods sold is computed as net sales ($85,300) less gross margin ($34,700).

** Operating expenses are computed as gross margin ($34,700) less income from operations ($9,200).

*** 0.15 × $7,400

E 1-37

1.

Wright Auto Supply Income Statement For the year ended December 31, 2011		
Revenues:		
Sales revenue		$583,900
Expenses:		
Cost of goods sold	$277,000	
Wages expense	98,250	
Salaries expense	32,000	
Depreciation expense	29,000	
Rent expense	18,000	
Interest expense	2,700	
Income taxes expense	38,085	
Total expenses		495,035
Net income		$ 88,865

2.

Wright Auto Supply Income Statement For the year ended December 31, 2011		
Sales revenue		$583,900
Cost of goods sold		277,000
Gross margin		$306,900
Operating expenses:		
Wages expense	$ 98,250	
Salaries expense	32,000	
Depreciation expense	29,000	
Rent expense	18,000	177,250
Income from operations		$129,650
Other expenses and losses:		
Interest expense		2,700
Income before taxes		$126,950
Income taxes expense		38,085
Net income		$ 88,865

3. Both a single-step income statement and a multiple-step income statement report the same amount for net income. However, a single-step income statement only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step income statement provides three important classifications that financial statement users find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

E 1-38

1.

	Beginning retained earnings	$18,240
+	Net income ($837,400 – $792,100)	45,300
–	Dividends	(38,650)
=	Ending retained earnings	$24,890

2. Sherwood is paying 85% ($38,650 ÷ $45,300) of its income to its shareholders in the form of dividends. This large dividend payout will result in investors receiving relatively more of the company's earnings in the form of cash during the year rather than in share appreciation. Financial statement users should examine the dividend payout ratio in relation to the firm's current ratio and working capital to ensure that Sherwood is not paying too much in dividends so that it will be able to repay its debts when they become due.

E 1-39

1.

Cash flow from operating activites:		
Cash received from customers	$ 139,800	
Cash paid for advertising	(34,200)	
Cash paid to employees for salaries	(46,400)	
Cash paid for supplies	(28,700)	
Net cash provided by operating activities		$ 30,500
Cash flow from investing activities:		
Cash paid for purchase of land and building	$(128,700)	
Cash paid to purchase machine	(32,000)	
Net cash used by investing activities		(160,700)
Cash flow from financing activities:		
Cash received from owners	$ 201,500	
Cash paid for dividends to stockholders	(37,500)	
Net cash provided by financing activities		164,000

2. Walters has positive cash flow, especially from operations, showing the company is in a good financial position to pay its debts as they come due. The negative cash flow (cash outflow) in investing is a sign of a growing company that is investing in revenue-producing assets. In addition, from the large amount of cash received from financing activities, it appears that Walters is able to raise large amounts of capital to finance its operations.

E 1-40

Cash at the end of the year:

Cash flow from operating activites	$857,300
Cash outflow for investing activities	(994,500)
Cash flow from financing activities	156,600
Change in cash	$ 19,400
Add: Cash at 12/31/10	17,400
Cash at 12/31/11	$ 36,800

Retained earnings at end of 2011:

Retained earnings at 12/31/10	$103,600
Add: 2011 net income ($673,900 – $587,100)	86,800
Less: 2011 dividends	(34,200)
Retained earnings at 12/31/11	$156,200

E 1-41

From the information given in the problem and the fundamental accounting equation:

	Assets	=	Liabilities	+	Equity
12/31/2010	$72,400	=	$12,100	+	($50,000 + Retained Earnings)
12/31/2011	$78,500	=	$9,800	+	($50,000 + Retained Earnings)

For each year, solve for retained earnings:

12/31/2010	Retained Earnings	=	Assets – Liabilities – Common Stock
	Retained Earnings	=	$72,400 – $12,100 – $50,000
	Retained Earnings	=	$10,300
12/31/2011	Retained Earnings	=	Assets – Liabilities – Common Stock
	Retained Earnings	=	$78,500 – $9,800 – $50,000
	Retained Earnings	=	$18,700

Using the computed amounts for retained earnings, dividends can be determined using the relationships found in the retained earnings statement.

	Beginning retained earnings	$10,300
+	Net income	14,300
−	Dividends	?
=	Ending retained earnings	$18,700

Dividends = $5,900

E 1-42

From the information given in the problem and the fundamental accounting equation:

	Assets	=	Liabilities	+	Equity
12/31/2010	$144,200	=	$52,600	+	($60,000 + Retained Earnings)
12/31/2011	$178,100	=	$59,700	+	($60,000 + Retained Earnings)

For each year, solve for retained earnings:

12/31/2010	Retained Earnings	=	$144,200 – $52,600 – $60,000 = $31,600
12/31/2011	Retained Earnings	=	$178,100 – $59,700 – $60,000 = $58,400

Using the computed amounts for retained earnings, net income can be determined using the relationships found in the retained earnings statement.

Beginning retained earnings…………………………	$31,600
+ Net income…………………………………	?
– Dividends……………………………………	(14,500)
= Ending retained earnings…………………	$58,400

Net income = $41,300

E 1-43

a. Management's discussion and analysis
b. Notes to the financial statements
c. Notes to the financial statements
d. Financial statements (balance sheet)
e. Management's discussion and analysis
f. Financial statements (retained earnings statement)
g. Report of independent accountants
h. Financial statements (income statement)

E 1-44

a. Unethical (U)
b. Ethical (E)
c. Unethical (U)
d. Ethical (E)
e. Ethical (E)
f. Unethical, and probably illegal (U)
g. Ethical (E)
h. Unethical (U)

PROBLEM SET A

P 1-45A

The fundamental accounting equation requires that there be an equality between assets and liabilities plus stockholders' equity. Therefore, the amount of liabilities that Huffer must have at the end of 2011 can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

The amount of Huffer's assets at 12/31/11 is $278,200. Huffer's stockholders' equity at the end of 2011 is the amount of stockholders' equity at the beginning of the year plus (minus) net income (loss) less dividends plus the sale of common stock.

	Common Stock	+	Retained Earnings	=	Stockholders' Equity
Equity, 1/1/11	$80,000	+	$62,600	=	$142,600
Net income			42,750		
Dividends			(11,900)		
Common stock issued	12,800				
Equity, 12/31/11	$92,800	+	$93,450	=	$186,250

The amount of liabilities that Huffer must have at the end of 2011 is determined by using the balance sheet equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/11	$278,200	=	?	+	$186,250

Liabilities = $278,200 – $186,250 = $91,950

P 1-46A

It is necessary to answer these questions out of order because of the way the relationships among the accounts work.

(a)	**Assets**	**=**	**Liabilities**	**+**	**Stockholders' Equity (all at end of the year)**			
	Assets	**=**	**$126,900**	**+**	**$104,100**			
	Assets	**=**	**$231,000**					
(b)	**Assets**	**=**	**Liabilities**	**+**	**Stockholders' Equity (all at the beginning of the year)**			
	$145,200	**=**	**$92,600**	**+**	**Stockholders' Equity**			
	Stockholders' Equity	**=**	**$52,600**					
(c)	**Beginning Stockholders' Equity**	**+**	**Net Income**	**–**	**Dividends**	**=**	**Ending Stockholders' Equity**	
	$52,600	**+**	**$77,500**	**–**	**Dividends**	**=**	**$104,100**	
	Dividends	**=**	**$26,000**					
(d)	**Revenues**	**–**	**Expenses**	**=**	**Net Income**			
	$554,800	**–**	**Expenses**	**=**	**$77,500**			
	Expenses	**=**	**$477,300**					

P 1-47A

Powers Wrecking Service Income Statement For the year ended December 31, 2011		
Revenues:		
Service revenue	**$425,000**	
Sales revenue	**137,000**	
Interest income	**1,575**	
Total revenues		**$563,575**
Expenses:		
Wages expense	**$243,200**	
Rent expense	**84,000**	
Supplies expense	**48,575**	
Depreciation expense	**24,150**	
Miscellaneous expense	**17,300**	
Income taxes expense	**43,900**	
Total expenses		**461,125**
Net income		**$102,450**

P 1-48A

Floyd:	**Revenues**	**–**	**Expenses**	**=**	**Net Income**	
	$125	**–**	**$92**	**=**	**$33**	**(a)**
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**	
	$905	**=**	**$412**	**+**	**$493**	**(b)**
Slater:	**Revenues**	**–**	**Expenses**	**=**	**Net Income**	
	$715	**–**	**$531 (c)**	**=**	**$184**	
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**	
	$1,988	**=**	**$1,165 (d)**	**+**	**$823**	
Wooderson:	**Revenues**	**–**	**Expenses**	**=**	**Net Income**	
	$72 (e)	**–**	**$54**	**=**	**$18**	
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**	
	$197 (f)	**=**	**$117**	**+**	**$80**	
O'Bannion:	**Revenues**	**–**	**Expenses**	**=**	**Net Income (Loss)**	
	$2,475	**–**	**$3,075 (g)**	**=**	**(600)**	
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**	
	$8,140	**=**	**$2,280**	**+**	**$5,860**	**(h)**

P 1-49A

Rogers Enterprises
Income Statement
For the year ended December 31, 2011

Revenues:		
Service revenue		**$463,500**
Expenses:		
Salaries expense	**$235,200**	
Rent expense	**135,000**	
Supplies expense	**34,400**	
Interest expense	**16,000**	
Income taxes expense	**12,800**	**433,400**
Net income		**$ 30,100**

P 1-49A (Contd)

Rogers Enterprises Balance Sheet December 31, 2011		
Assets		
Current assets:		
Cash	$ 13,240	
Accounts receivable	72,920	
Supplies	42,000	
Prepaid rent	31,500	
Total current assets		$159,660
Property, plant, and equipment		90,000
Total assets		$249,660
Liabilities and Stockholders' Equity		
Current liabilities:		
Salaries payable	$ 14,800	
Income taxes payable	4,150	
Total current liabilities		$ 18,950
Long-term liabilities:		
Notes payable (due in 10 years)		25,000
Total liabilities		$ 43,950
Stockholders' equity:		
Common stock (10,000 shares)	$ 70,000	
Retained earnings*	135,710	
Total stockholders' equity		205,710
Total liabilities and stockholders' equity		$249,660

* Retained earnings is computed as the amount needed to make the fundamental accounting equation balance.

P 1-50A

Dittman Expositions
Retained Earnings Statement
For the Years Ended December 31, 2011, and December 31, 2012

	2011	2012
Retained earnings, beginning of year*......................................	$16,900	$41,850
Add: Net income**...	33,200	29,800
Less: Dividends..	(8,250)	(9,910)
Retained earnings, end of year...	$41,850	$61,740

* The ending retained earnings balance for 2011 becomes the beginning retained earnings balance for 2012.

** Net income computed as follows:

	2011	2012
Revenue.......................................	$419,700	$442,400
Less: Expenses.............................	(386,500)	(412,600)
Net income......................................	$ 33,200	$ 29,800

P 1-51A

(a) $30,700 – Dividends (a) = $27,200
Dividends = $3,500

(b) Retained Earnings, Beginning (2011) = Retained Earnings, Ending (2010) = $27,200

(c) Retained Earnings, Beginning (b) + Net Income = (c)
$27,200 + $10,100 = $37,300

You must solve for (e) prior to solving for (d):

(e) Retained Earnings, Ending (2011) = Retained Earnings, Beginning (2012) = $33,600

(d) Retained Earnings, Ending (e) = (c) – Dividends (d)
$33,600 = $37,300 – (d)
(d) = $3,700

You must solve for (g) prior to solving for (f):

(g) Retained Earnings, Ending = (g) – Dividends
$41,200 = (g) – $3,900
(g) = $45,100

(f) Retained Earnings, Beginning + Net Income (f) = (g)
$33,600 + (f) = $45,100
(f) = $11,500

P 1-52A

1.

Ashton Appliances
Income Statement
For the year ended December 31, 2011

Revenues:		
Sales revenue……		$948,670
Expenses:		
Cost of goods sold……	$511,350	
Wages expense ……	127,710	
Salaries expense……	101,000	
Rent expense……	80,800	
Insurance expense……	36,610	
Interest expense……	15,500	
Depreciation expense (furniture)……	12,000	
Depreciation expense (building)……	11,050	
Income taxes expense……	16,650	
Total expenses……		912,670
Net income……		$ 36,000

Ashton Appliances
Retained Earnings Statement
For the year ended December 31, 2011

Beginning retained earnings, 12/31/10 or 1/1/11……	$ 54,000
Add: Net income*……	36,000
Ending retained earnings, 12/31/11……	$ 90,000

* From the income statement

P 1-52A (Contd)

Ashton Appliances Balance Sheet December 31, 2011			
Assets			
Current assets:			
Cash……		$ 41,450	
Accounts receivable……		69,900	
Inventory……		59,850	
Total current assets……			$171,200
Property, plant & equipment:			
Building……	$300,000		
Less: Accumulated depreciation……	(104,800)	$195,200	
Furniture……	$130,000		
Less: Accumulated depreciation……	(27,600)	102,400	
Total property, plant & equipment ……			297,600
Other assets……			92,800
Total assets……			$561,600
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable……		$ 16,800	
Income taxes payable……		12,000	
Salaries payable……		7,190	
Total current liabilities……		$ 35,990	
Long-term liabilities:			
Bonds payable……		192,000	
Total liabilities ……			$227,990
Stockholders' equity:			
Common stock……		$243,610	
Retained earnings*……		90,000	
Total stockholders' equity……			333,610
Total liabilities and stockholders' equity……			$561,600

* From the retained earnings statement

2. Both a single-step income statement and a multiple-step income statement report the same amount for net income. However, a single-step income statement only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step income statement provides three important classifications that financial statement users find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

P 1-53A

Berko Company:

(a) $62,100 ($50,000 + $12,100)
(b) $17,100 ($12,100 + $7,000 – $2,000)
(c) $67,100 ($17,100 + $50,000)
(d) $25,400 ($92,500 – $67,100)

Manning Company:

(e) $9,300 ($44,300 – $35,000)
(f) $7,500 ($9,300 – $1,800)
(g) $42,500 ($35,000 + $7,500)
(h) $57,300 ($42,500 + $14,800)

Lucas Company:

(i) $40,000 ($66,400 – $26,400)

Must solve for (k) before (j):

(k) $29,500 ($84,500 – $55,000)
(j) $2,900 ($26,400 + $6,000 – $29,500)
(l) $14,700 ($99,200 – $84,500)

Corey Company:

(m) $7,100 ($27,600 – $21,900 + $1,400)
(n) $42,600 ($15,000 + $27,600)
(o) $53,300 ($10,700 + $42,600)

P 1-54A

First, use the fundamental accounting equation to determine stockholders' equity:

	Assets	=	Liabilities	+	Stockholders' Equity	
Beginning	$392,500	=	$148,550	+	$243,950	*
End	$415,100	=	$149,600	+	$265,500	**

* $392,500 – $148,550 = $243,950
** $415,100 – $149,600 = $265,500

Next, use these fundamental relationships to solve for each situation:

Stockholders' Equity = Common Stock + Retained Earnings

Change in Stockholders' Equity = Change in Common Stock + Change in Retained Earnings

Change in Retained Earnings = Net Income – Dividends

Therefore,
Change in Stockholders' Equity = Change in Common Stock + Net Income – Dividends

1. ($265,500 – $243,950) = $0 + Net Income – $0
   Net Income = $21,550
2. ($265,500 – $243,950) = $33,000 + Net Income – $0
   Net Loss = $11,450
3. ($265,500 – $243,950) = $0 + Net Income – $11,000
   Net Income = $32,550
4. ($265,500 – $243,950) = $29,000 + Net Income – $17,000
   Net Income = $9,550

PROBLEM SET B

P 1-45B

The fundamental accounting equation requires that there be an equality between assets and liabilities plus stockholders' equity. Therefore, the amount of liabilities that KJ Corporation must have at the end of 2011 can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

The amount of KJ's assets at 12/31/11 is $721,800. KJ's stockholders' equity at the end of 2011 is the amount of stockholders' equity at the beginning of the year plus (minus) net income (loss) less dividends plus the sale of common stock.

	Common Stock	+	Retained Earnings	=	Stockholders' Equity
Equity, 1/1/11	$139,000	+	$152,900	=	$291,900
Net income			225,200		
Dividends			(74,400)		
Common stock issued	94,000				
Equity, 12/31/11	$233,000	+	$303,700	=	$536,700

The amount of liabilities that KJ must have at the end of 2011 is determined by using the balance sheet equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/11	$721,800	=	?	+	$536,700

Liabilities = $721,800 – $536,700 = $185,100

P 1-46B

It is necessary to answer these questions out of order because of the way the relationships between the accounts work.

(a) Assets = Liabilities + Stockholders' Equity (all at the beginning of the year)
Assets = $368,200 + $272,900
Assets = $641,100

P 1-46B (Contd)

Note: **Item (d) is found prior to finding items (b) and (c).**

(d)	**Net Income**	**=**	**Revenues**	**–**	**Expenses**		
	Net Income	**=**	**$929,440**	**–**	**$835,320**		
	Net Income	**=**	**$94,120**				

Note: **Item (c) is found prior to finding item (b).**

(c)	**Beginning Stockholders' Equity**	**+**	**Net Income**	**–**	**Dividends**	**=**	**Ending Stockholders' Equity**
	$272,900	**+**	**$94,120**	**–**	**$35,500**	**=**	**Ending Stockholders' Equity**
	Ending Stockholders' Equity			**=**	**$331,520**		
(b)	**Assets**	**=**	**Liabilities**	**+**	**Stockholders' Equity (all at end of year)**		
	$758,150	**=**	**Liabilities**	**+**	**$331,520**		
	Liabilities	**=**	**$426,630**				

P 1-47B

Parker Renovation Inc.
Income Statement
For the year ended December 31, 2011

Revenues:		
Service revenue	**$763,400**	
Interest income.	**5,475**	
Total revenues		**$768,875**
Expenses:		
Wages expense	**$222,900**	
Depreciation expense	**135,000**	
Utilities expense	**109,300**	
Insurance expense	**65,850**	
Miscellaneous expense	**31,000**	
Income taxes expense	**61,400**	
Total expenses		**625,450**
Net income		**$143,425**

P 1-48B

Crick:	**Net Income**	**=**	**Revenues**	**–**	**Expenses**
	$81 (a)	**=**	**$925**	**–**	**$844**
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**
	$709	**=**	**$332**	**+**	**$377 (b)**
Pascal:	**Net Income**	**=**	**Revenues**	**–**	**Expenses**
	$289	**=**	**$533**	**–**	**$244 (c)**
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**
	$1,810	**=**	**$860 (d)**	**+**	**$950**
Eiffel:	**Net Income**	**=**	**Revenues**	**–**	**Expenses**
	$126	**=**	**$503 (e)**	**–**	**$377**
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**
	$552 (f)	**=**	**$454**	**+**	**$98**
Hilbert:	**Net Income (Loss)**	**=**	**Revenues**	**–**	**Expenses**
	($340)	**=**	**$1,125**	**–**	**$1,465 (g)**
	Assets	**=**	**Liabilities**	**+**	**Stockholders' Equity**
	$3,150	**=**	**$2,267**	**+**	**$883 (h)**

P 1-49B

Ross Airport Auto Service
Income Statement
For the year ended December 31, 2011

Revenues:		
Service revenue (parking)	**$232,600**	
Service revenue (repair)	**198,500**	
Interest income	**4,100**	
Total revenues		**$435,200**
Expenses:		
Wages expense	**$246,100**	
Rent expense	**103,500**	
Supplies expense	**36,900**	
Interest expense	**21,300**	
Depreciation expense	**12,450**	
Income taxes expense	**2,700**	
Total expenses		**422,950**
Net income		**$12,250**

P 1-49B (Contd)

Ross Airport Auto Service Balance Sheet December 31, 2011		
Assets		
Current assets:		
Cash	$ 7,700	
Accounts receivable	39,200	
Inventory	6,100	
Prepaid rent	27,300	
Total current assets		$ 80,300
Long-term investments:		
Investments		35,000
Property, plant, and equipment:		
Equipment	$270,800	
Less: Accumulated depreciation	(42,300)	228,500
Total assets		$343,800
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 17,200	
Wages payable	12,500	
Income taxes payable	1,100	
Interest payable	4,800	
Total current liabilities		$ 35,600
Long-term liabilities:		
Notes payable		160,000
Total liabilities		$195,600
Stockholders' equity:		
Common stock	$100,000	
Retained earnings	48,200	
Total stockholders' equity		148,200
Total liabilities and stockholders' equity		$343,800

Note: **Dividends do not appear on the income statement or the balance sheet. Instead, dividends are reported on the retained earnings statement.**

P 1-50B

Magical Experiences Vacation Company
Retained Earnings Statement
For the years ended December 31, 2011, and December 31, 2012

	2011	2012
Retained earnings, beginning of year*	$ 47,100	$ 93,500
Add: Net income**	59,600	82,800
Less: Dividends	(13,200)	(15,900)
Retained earnings, end of year	$ 93,500	$160,400

* The ending retained earnings balance for 2011 becomes the beginning retained earnings balance for 2012.

** Net income computed as follows:

	2011	2012
Revenue	$244,900	$391,400
Less: Expenses	(185,300)	(308,600)
Net income	$ 59,600	$ 82,800

P 1-51B

(a) $26,900 – $11,100 = $15,800

(b) Retained Earnings, Ending (2010) = Retained Earnings, Beginning (2011) = $19,500

You must solve for (e) prior to solving for (c) or (d):

(e) Retained Earnings, Ending (2011) = Retained Earnings, Beginning (2012) = $26,700

You must solve for (d) prior to solving for (c):

(d) $26,700 (e) + $5,200 = $31,900

(c) $31,900 (d) – $19,500 = $12,400

(f) $26,700 + $9,500 = $36,200

(g) $36,200 (f) – $34,100 = $2,100

P 1-52B

McDonald Marina Income Statement For the year ended December 31, 2011		
Revenues:		
Service revenue (docking)………	$1,460,000	
Service revenue (cleaning)………	472,300	
Total service revenues………		$1,932,300
Expenses:		
Wages expense………	$ 987,200	
Depreciation expense (equipment)………	246,300	
Utilities expense ………	239,400	
Interest expense………	236,000	
Supplies expense………	89,100	
Depreciation expense (building)………	21,500	
Rent expense………	14,600	
Income taxes expense………	21,700	
Total expenses………		1,855,800
Net income………		$ 76,500

McDonald Marina Retained Earnings Statement For the year ended December 31, 2011	
Retained earnings, 12/31/10………	$ 128,600
Add: Net income for 2011………	76,500
Less: Dividends………	(25,300)
Retained earnings, 12/31/11………	$ 179,800

P 1-52B (Contd)

McDonald Marina Balance Sheet December 31, 2011			
Assets			
Current assets:			
Cash		$ 22,300	
Accounts receivable		268,700	
Supplies		9,800	
Total current assets			$ 300,800
Property, plant, and equipment:			
Land		$ 875,000	
Building	$ 197,300		
Less: Accumulated depreciation	(64,500)	132,800	
Equipment	$2,490,000		
Less: Accumulated depreciation	(950,400)	1,539,600	
Total property, plant, and equipment			2,547,400
Total assets			$2,848,200
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable		$ 26,400	
Wages payable		21,600	
Interest payable		18,000	
Rent payable		2,400	
Total current liabilities			$ 68,400
Long-term liabilities:			
Bonds payable			2,000,000
Total liabilities			$2,068,400
Stockholders' equity			
Common stock		$ 600,000	
Retained earnings		179,800	
Total stockholders' equity			779,800
Total liabilities and stockholders' equity			$2,848,200

2. Both a single-step income statement and a multiple-step income statement report the same amount for net income. However, a single-step income statement only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step income statement provides three important classifications that financial statement users find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

P 1-53B

Stackhouse Company:

(a) $5,000 ($21,700 – $18,800 + $2,100)
(b) $66,700 ($45,000 + $21,700)
(c) $81,100 ($14,400 + $66,700)

Compton Company:

(d) $54,300 ($39,000 + $15,300)
(e) $21,600 ($15,300 + $7,100 – $800)
(f) $60,600 ($21,600 + $39,000)
(g) $27,600 ($88,200 – $60,600)

Bellefleur Company:

Must solve for (i) first.

(i) $15,300 ($95,300 – $80,000)
(h) $1,300 ($6,900 + $9,700 – $15,300)
(j) $18,100 ($113,400 – $95,300)

Merlotte Company:

(k) $13,900 ($38,900 – $25,000)
(l) $9,400 ($13,900 – $4,500 – $0)
(m) $34,400 ($25,000 + $9,400)
(n) $50,100 ($15,700 + $34,400)

P 1-54B

First, use the fundamental accounting equation to determine stockholders' equity:

	Assets	=	Liabilities	+	Stockholders' Equity	
Beginning	**$231,500**	**=**	**$84,550**	**+**	**$146,950**	*****
End	**$348,100**	**=**	**$125,900**	**+**	**$222,200**	******

* $231,500 – $84,550 = $146,950
** $348,100 – $125,900 = $222,200

Next, use these fundamental relationships to solve for each situation:

Stockholders' Equity = Common Stock + Retained Earnings

Change in Stockholders' Equity = Change in Common Stock + Change in Retained Earnings

Change in Retained Earnings = Net Income – Dividends

Therefore,

Change in Stockholders' Equity = Change in Common Stock + Net Income – Dividends

1. **($222,200 – $146,950) = $0 + Net Income – $0**
   Net Income = $75,250
2. **($222,200 – $146,950) = $12,000 + Net Income – $0**
   Net Income = $63,250
3. **($222,200 – $146,950) = $0 + Net Income – $8,000**
   Net Income = $83,250
4. **($222,200 – $146,950) = $15,000 + Net Income – $11,000**
   Net Income = $71,250

CASES

Case 1-55

Answers to this question may vary; however, many students will focus on income. If Jim had kept track of his revenues (his earnings from the summer job, the small scholarship, and the fixed amount from his parents) and his expenses (e.g., tuition, books, apartment, entertainment) during earlier semesters, he might have been able to budget for the spring term. Many of his expenses will be the same or very similar from term to term. Jim could use the information from the fall term to predict what his revenues and expenses would be for the spring term. He would then have a better idea of how much he could spend on entertainment without "maxing out" his credit card. In addition, Jim could keep track of his assets and liabilities. He could track which assets were current (e.g., cash in his bank account) and which liabilities would be coming due in the near term (e.g., spring tuition, living expenses). He could then know prior to the spring term which bills would be coming due and if he had enough liquid assets to pay these bills. Keeping better track of his revenues, expenses, income, assets, and liabilities may have allowed Jim to avoid overspending his resources.

Case 1-56

1. The following examples are illustrative:

a. Nonbusiness entities (including governments and educational institutions):

The Accounting Review **(university and college educators), American Accounting Association**

Issues in Accounting Education **(university and college educators), American Accounting Association**

The GAO Journal **(governmental accountants), U.S. General Accounting Office**

b. Business entities:

Strategic Finance **(management accountants and finance professionals), Institute of Management Accountants**

Financial Executive **(controllers, treasurers, and senior financial executives), Financial Executives Institute**

Internal Auditor **(internal auditors), Institute of Internal Auditors**

Case 1-56 (Contd)

c. **Public practice:**

Journal of Accountancy (certified public accountants), American Institute of Certified Public Accountants

The CPA Journal (certified public accountants), New York State Society of CPAs

2. **Activities and events in one segment of the accounting profession affect activities and events in other segments of the profession. Education affects preparedness for public practice. New business activities require new auditing procedures. Accounting research affects the practice of accounting, and accounting practice influences the form of accounting research. Information about developments outside one's own segment of accounting can help one better understand and, perhaps, shape developments inside one's own segment.**

Case 1-57

Student responses to this assignment will vary widely, but it is a good basis for classroom discussion. Some students will have interests in various accounting careers; others will have interests in other business careers or perhaps graduate professional degrees. Of those with plans for graduate education, some intend to work for several years before returning for additional education; others will plan to go directly into graduate school. Some will plan to start their careers in one field and then move into another after several years. Some may have plans to start their own business. The steps necessary to implement these plans can be an interesting basis for discussion.

Case 1-58

1.	**Current assets (1/31/11)**	**=**	**$4,850 + $27,409 + $6,864**	**=**	**$39,123**
	Current liabilities (1/31/11)	**=**	**$18,602**		
	Current assets (1/31/10)	**=**	**$3,408 + $30,989 + $7,440**	**=**	**$41,837**
	Current liabilities (1/31/10)	**=**	**$33,384**		

Agency Rent-A-Car reported a current ratio of 2.10 ($39,123 ÷ $18,602) in 2011 and a current ratio of 1.25 ($41,837 ÷ $33,384) in 2010. Its working capital is 20,521 ($39,123 – $18,602) in 2011 and 8,453 ($41,837 – $33,384) in 2010. These ratios show that the company has adequate current assets to cover the current liabilities in both years. In addition, its liquidity is improving between 2010 and 2011.

Case 1-58 (contd)

2. **Net Income = Stockholders' Equity (1/31/2011) – Stockholders' Equity (1/31/2010) + Dividends***

   $157,515 – $147,288 + $18,100 = $28,327

   * **Beg. Stockholders' Equity $147,288 + Net Income – Dividends $18,100 = End. Stockholders' Equity $157,515**

Case 1-59

1. **Trends:**
   - **(a) Revenues decreased dramatically from 2009 to 2010.**
   - **(b) Operating income (loss) has fluctuated dramatically in the five-year period, but shows some improvement (less of a loss) in 2011.**
   - **(c) Net income (loss) took a major hit in 2010 and seems to be slowly recovering in 2011 with a much smaller loss.**
2. **In 2007 and 2008, Wright Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in 2009, 2010, and 2011, causing current liabilities to be much larger than current assets. It seems as though Wright Brothers used its assets to pay down its long-term debt in 2009.**
3. **Yes, the company has shown a considerable decrease throughout the five-year period in net income and also shows that it may have difficulty in paying current liabilities with the small amount of current assets it has.**

Case 1-60

Ethical behavior by accountants is important to society because capital markets and businesses cannot operate efficiently or effectively without reliable financial information. Financial information determines the way in which resources are deployed and distributed. Thus, individuals who stand to benefit from changes in resource deployment or distribution have an incentive to misrepresent financial information or to pressure accountants to do so. Such individuals may even create financial incentives for accountants to bias or misrepresent the facts. Unethical behavior by an accountant, once revealed, usually brings loss of employment and frequently loss of professional credentials as well.

Case 1-61

There are many ethical implications involved with the discussion between Lola and Frank. It is not ethical to change items in the financial statements simply to appear better to the public. This can be very misleading to both creditors and investors, and could potentially cause harm to these parties who based their expectations of future performance on the past numbers that have been changed. If the company doesn't perform as well as expected, these creditors and investors will likely blame the accounting numbers that have been misrepresented. If management intends to pay off accounts within a year, they need to be classified as current liabilities. Also, investments that have been purchased with the intent to hold them for a long period of time should be considered long-term investments. Management should not reclassify these unless their intent changes and they plan to sell the investments within the next year. In addition, the company should follow generally accepted accounting principles and record its assets at historical cost. Management cannot pick and choose which assets to present at their market value. Management should not use the excuse of "judgment" to alter numbers in order to make the company appear better on paper.

Case 1-62

1. **Apple's fiscal year ended on September 26, 2009. This year-end is different than from previous years for the simple reason that Apple has a floating year-end. Apple's year-end always falls on the last Saturday of the month of September, so the actual date changes from year to year.**

2. **Apple presents two years of balance sheet information and three years of income statement information.**

3. **As explained in an explanatory note on page 2 of the amended 10-K/A, Apple restated its financial statements because it changed its policy on revenue recognition. Under a new accounting standard, Apple could elect to retrospectively (retroactively) adopt this new standard, and it chose to do so. This new standard changes how Apple recognizes revenue on contracts that involve both hardware and software elements. This accounting choice caused an increase in 2009 sales of $6,368,000,000.**

4. **Balance sheet information:**

   a. **For 2009, Apple reported total assets of $47,501,000,000, total liabilities of $15,861,000,000, and total stockholders' equity of $31,640,000,000.**

   b. **The dollar amounts for all three categories have changed in the past year. For 2008, Apple reported total assets of $36,171,000,000, total liabilities of $13,874,000,000, and total stockholders' equity of $22,297,000,000. This represented an increase in total assets of $11,330,000,000 ($47,501,000,000 – $36,171,000,000), an increase in total liabilities of $1,987,000,000 ($15,861,000,000 – $13,874,000,000), and an increase in total stockholders' equity of $9,343,000,000 ($31,640,000,000 – $22,297,000,000). Apple experienced significant growth in its resources and claims against those resources during 2009.**

   c. **For 2009, Apple reported current assets of $31,555,000,000 and current liabilities of $11,506,000,000. For 2008, Apple reported current assets of $30,006,000,000 and current liabilities of $11,361,000,000.**

   d. **Apple reported working capital of $20,049,000,000 ($31,555,000,000 – $11,506,000,000) for 2009 and working capital of $18,645,000,000 ($30,006,000,000 – $11,361,000,000) for 2008. Apple's current ratio was 2.74 ($31,555,000,000 ÷ $11,506,000,000) for 2009 and 2.64 ($30,006,000,000 ÷ $11,361,000,000) for 2008. Apple's current assets are greater than its current liabilities for both years, which indicates that Apple should be able to pay the liabilities that become due within the next year. The growth in both of these numbers reveals that Apple's liquidity has improved during 2009 relative to 2008.**

Case 1-62 (Contd)

5. **Income statement information:**
   a. **For 2009, Apple reported revenues (net sales) of $42,905,000,000 and expenses of $34,670,000,000 ($25,683,000,000 + $5,482,000,000 + $3,831,000,000 – $326,000,000). Note: The $326,000,0000 is a combination of other income and expenses and was subtracted from expenses. Apple's net income was $8,235,000,000.**
   b. **Sales have been steadily increasing throughout the three-year period shown in the comparative income statements. This has caused cost of sales (an expense) to increase as well. However, the sales increases have been larger than the cost of sales increases, which have led to increases in gross margin and net income. Both gross margin and net income have increased steadily in each of the three years shown.**
6. **Statement of cash flows information:**
   a. **For 2009, Apple reported a net cash inflow from operating activities of $10,159,000,000, a net cash outflow from investing activities of $17,434,000,000, and a net cash inflow from financing activities of $663,000,000.**
   b. **In 2009, Apple paid $1,144,000,000 for the acquisition of property, plant, and equipment.**
7. **Management's discussion and analysis information:**
   a. **Apple's management considers several accounting policies critical, including: following generally accepted accounting principles, revenue recognition, allowance for doubtful accounts, inventory valuation, warranty costs, valuation of marketable securities, income taxes, and contingencies policy. This information was found in the management's discussion and analysis section of the annual report. More detail on significant accounting policies can also be found in the notes to the financial statements (Note 1).**
   b. **The company does believe that it has performed well during the current year. Its analysis can be found in the management's discussion and analysis section (Item 7 of the 10-K). Management lays out its beliefs on current operations as well as future prospects in this part of the financial statements.**
8. **The financial statements are audited by Ernst & Young. Note there was an auditor change from KPMG to Ernst & Young in 2009.**

Case 1-63

1. a. The fiscal year-end for Abercrombie & Fitch is January 30, 2010, and the fiscal year-end for Aeropostale is January 30, 2010. We would expect these year-ends to be the same or similar because they are in the same industry and follow the same major trends in sales.

   b. As explained in footnote 1 of each company's financial statements, both companies' fiscal year ends on the Saturday nearest to January 31. This typically results in a fifty-two week year, but a fiscal year may occasionally contain an additional week, resulting in a fifty-three week year. This practice is quite common. Note that the company refers to the fiscal year ending on January 30, 2010, as "Fiscal 2009," while "Fiscal 2008" is the fiscal year ended January 31, 2009.

2. Balance sheet information:

   a. Abercrombie & Fitch (at January 30, 2010):

      Assets = $2,821,866,000
      Liabilities = $993,949,000 ($449,372,000 + $544,577,000)
      Stockholders' equity = $1,827,917,000

      Aeropostale (at January 30, 2010):

      Assets = $792,309,000
      Liabilities = $357,820,000 ($792,309,000 – $434,489,000)
      Stockholders' equity = $434,489,000

   b. Abercrombie & Fitch (at January 30, 2010):

      Current assets = $1,235,846,000
      Current liabilities = $449,372,000

      Aeropostale (at January 30, 2010):

      Current assets = $530,017,000
      Current liabilities = $241,840,000

   c. Abercrombie & Fitch's current assets are almost three times that of its current liabilities. Abercrombie & Fitch reported working capital of $786,474,000 ($1,235,846,000 – $449,372,000) and a current ratio of 2.75 ($1,235,846,000 ÷ $449,372,000). This indicates that Abercrombie & Fitch should be able to pay off liabilities that come due in the next year. The liquidity picture of Aeropostale is similar. Aeropostale reports working capital of $288,177,000 ($530,017,000 – $241,840,000) and a current ratio of 2.19 ($530,017,000 ÷ $241,840,000). Both companies appear to be able to pay off their debts as they become due.

Case 1-63 (Contd)

d. **Abercrombie & Fitch's financial statements show a much larger amount of assets, but also a much larger amount of liabilities than Aeropostale. Another difference you can notice from these figures is that Abercrombie & Fitch is financed relatively more by stockholders' equity, whereas a relatively larger portion of Aeropostale's financing has been done by liabilities. Another trend to notice is that a large portion of each of the companies' assets are current assets, showing relatively good liquidity for both of the companies.**

3. **Income statement information:**

a. **Abercrombie & Fitch (for the year ending Jan. 30, 2010, or Fiscal 2009):**

Revenues……	**$2,943,757,000**	*
Expenses……	**2,943,503,000**	**
Net income……	**$ 254,000**	

Aeropostale (for the fiscal year ending Jan. 30, 2010, or Fiscal 2009):

Revenues……	**$2,230,226,000**	***
Expenses……	**2,000,769,000**	****
Net income……	**$ 229,457,000**	

* $2,928,626,000 + $13,533,000 + $1,598,000

** $1,045,028,000 + $1,425,950,000 + $353,269,000 + $40,557,000 + $78,699,000

*** $2,230,105,000 + $121,000

**** $1,382,958,000 + $464,462,000 + $153,349,000

b. **For Aeropostale, revenues show an increasing trend through the three years presented. With that, the cost of sales and other expenses have also continued to increase throughout the period shown. Also, as you can see from the earnings per share information, Aeropostale has continually increased the returns they are providing for their investors. Abercrombie & Fitch, however, has shown a decreasing trend in revenue and earnings per share over the three years. One contributing factor to this decreasing income was a decrease in gross profit as a percentage of sales. This indicates that Abercrombie & Fitch's cost of goods sold is rising relative to sales, leaving less profit available to cover other expenses. Abercrombie must focus on controlling the cost of the merchandise it is selling if it wants to increase profitability. In addition, Abercrombie & Fitch is intent on closing stores that are contributing negatively to profit (as can be seen by the discontinued operations line item on the income statement). Finally, Abercrombie had significant noncash charges that reduced income (obtained from a reading of the Management Discussion and Analysis section of the annual report). It appears that Abercrombie & Fitch faces significant hurdles to improve its profitability.**

Case 1-63 (Contd)

4. **Obtained from the statements of cash flows for each of the companies:**

   Abercrombie & Fitch: In addition to operating activities, its major sources of cash include proceeds of sales of marketable securities, borrowings from credit agreements, and its operations. Major uses of cash include capital expenditures, repayment of borrowings, and dividends to stockholders.

   Aeropostale: Its major sources of cash arise from its operations. Major uses of cash include the purchase of treasury stock and capital expenditures.

5. **You can find this information in the management's discussion and analysis in each of the companies' annual reports. Aeropostale management feels the results for the current year are good and sees good prospects for future earnings. On the other hand, Abercrombie & Fitch management is in the process of restoring the company to profitability. While it believes its efforts to increase gross profit through closing unprofitable stores and international growth will result in a return to historic levels of profitability and growth, management also realizes that there may be future profit deterioration before this occurs.**

Case 1-64

1. **The first concern for Front Row Entertainment is to obtain financing for the business. Normally, a concert promoter must pay a significant amount of up-front cash to secure the venue and advertise the tour. Therefore, it is critical that Front Row Entertainment raise a large amount of cash if the business is to succeed. This cash may be raised by issuing debt (e.g., notes payable, bonds payable), shares of stock (e.g., common stock), or a combination of both. Next, Front Row Entertainment must purchase the assets necessary to operate. Because a concert promoter provides a service, the initial investment in property, plant, and equipment is likely to be relatively small and involve typical office equipment (e.g., desks, telephones, computers). These assets are normally combined and reported as equipment on the balance sheet. The business can now begin to operate. Revenues (e.g., sales revenue, service revenue) will be generated as Front Row Entertainment fulfills its contractual duties (e.g., sells tickets). One of the major expenses for a concert promoter would be the fees paid to the musical artist upon completion of the event (reported as cost of sales). In addition, Front Row Entertainment will likely incur large expenses initially as it books the venue and advertises the concert. Typical expenses may include rent expense (for office space of the business as well as a rental fee on the venue), utilities expense, salaries expense (for Cam and Anna's salaries), advertising expense, and insurance expense. Some of these expenses may be prepaid (resulting in accounts such as prepaid advertising or prepaid rent) while payment for others may be delayed (resulting in accounts such as accounts payable, salaries payable, and rent payable).**

2. **Cam and Anna can choose to organize Front Row Entertainment as either a partnership or a corporation. Relative to the corporate form of organization, partnerships are easier to organize. In addition, the control of the partnership would be shared by Cam and Anna, and the business would have access to the financial resources and skills of each partner. Finally, a partnership would also pay less taxes than a corporation. This is because the corporate tax rate is higher than the individual tax rate and the corporation's income is taxed twice—once at the corporate level and again at the stockholder level as earnings are distributed. However, the corporate form also has advantages. First, it can raise larger amounts of resources through the issuance of stock. Second, the corporate form limits the liability of its stockholders to the amount they have invested in the business. If the business were to fail, shareholders would only lose their investment. On the other hand, creditors could attempt to recover their losses from the personal assets of the partners. Finally, corporations have an unlimited life, with**

Case 1-64 (Contd.)

ownership easily transferred by the sale of stock. However, partnerships are dissolved when any partner leaves the partnership. Cam and Anna need to carefully weigh the advantages and disadvantages of each form of business organization and select the form that best fits their needs.

3. **Cam and Anna will need to prepare four basic financial statements: a balance sheet, an income statement, a retained earnings statement, and a statement of cash flows. A balance sheet reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time. By providing information about the structure of assets, liabilities, and stockholders' equity, a balance sheet provides users insights into whether a company can pay its obligations as they become due (liquidity). An income statement reports how well a company has performed its operations (revenues, expenses, and income) over a period of time. By providing information about a company's current profitability, users are better able to judge a company's ability to generate future income and growth potential. Such information impacts the decision of whether to make a loan to the company or invest in the company. A retained earnings statement reports how much of a company's income was retained in the business and how much was distributed to owners over a period of time. Insights into a company's dividend policy assist investors in determining a company's ability to pursue future growth opportunities. Finally, a statement of cash flows reports the sources and uses of a company's cash over a period of time. This information allows investors and creditors to judge the ability of a company to generate cash in the future, as well as to assess the creditworthiness of a company and its ability to pay future dividends.**