

# CHAPTER 1—Solutions

## USES OF ACCOUNTING INFORMATION AND THE FINANCIAL STATEMENTS

### Discussion Questions

DQ1.	The primary purpose of accounting is to provide decision makers with the financial information they need to make intelligent decisions. It is a valuable discipline because of the usefulness of the information it generates.
DQ2.	No. Not all economic events involve exchanges of value between the business and another party. For example, when a customer buys a product from a competitor, it is an economic event, but no exchange of value has taken place with our company and thus our company records no transaction.
DQ3.	Accounting treats sole proprietorships, partnerships, and corporations as entities separate and apart from their owners because each form represents a business (separate entity) for which financial performance must be measured and reported.
DQ4.	Expenses and dividends are the same in that they both reduce the retained earnings component of stockholders' equity. They are different in that expenses are also a component of net income, whereas dividends are a distribution of assets to the stockholders.
DQ5.	GAAP differs from the laws of mathematics in that they are not unchanging but rather are constantly evolving. They may change as business conditions change or as improved methods of accounting are introduced.
DQ6.	Like managers of profit-seeking businesses, managers of government and not-for-profit organizations must report to those who fund them, and they must operate their organizations in a financially prudent way.
DQ7.	CVS and Southwest are comparable in that like all companies they have two main goals: profitability and liquidity. How companies such as CVS and Southwest achieve these goals may make them incomparable in certain ways. For instance, CVS is a retail (pharmacy and related) company, whereas Southwest is a service (air transportation) company. CVS buys and leases retail stores, whereas Southwest buys and leases aircraft.
DQ8.	Unethical ways of accounting include recording and reporting business transactions that did not occur or being dishonest in recording those that did occur. Fraudulent financial reporting is the unethical preparation of financial statements that misrepresent a company's financial situation or contain false information.

## Short Exercises

### SE1. Accounting Concepts

1.	b	4.	b
2.	c	5.	a
3.	a		

### SE2. Forms of Business Organization

1.	a	4.	c
2.	c	5.	a
3.	b	6.	c

### SE3. The Accounting Equation

1.	Assets	=	\$240,000
2.	Stockholders' Equity	=	\$144,000
3.	Liabilities	=	\$200,000

### SE4. The Accounting Equation

1.	Assets	=	Liabilities	+	Stockholders' Equity
	\$240,000	=	\$90,000	+	Stockholders' Equity
	\$240,000	=	\$90,000	+	\$150,000
	Stockholders' Equity	=	\$150,000		
2.	Assets	=	0.2 Assets	+	\$40,000
	Assets - 0.2 Assets	=	\$40,000		
	0.8 Assets	=	\$40,000		
	Assets	=	\$40,000 / 0.8		
	Assets	=	\$50,000		
	Liabilities	=	\$50,000 × 0.2	=	<u>\$10,000</u>

SE5. The Accounting Equation						
1.	Beginning:	\$ 90,000	=	Liabilities	+	\$50,000
		Liabilities	=	\$ 40,000		
		\$ 90,000	=	\$ 40,000	+	\$50,000
	Change:	+ 30,000		+ 5,000		
		\$120,000	=	\$ 45,000	+	Stockholders' Equity
	End:	Stockholders' Equity	=	\$ 75,000		
2.	Beginning:	Assets	=	\$100,000	+	\$96,000
		Assets	=	\$196,000		
		\$196,000	=	\$100,000	+	\$96,000
	Change:	+ 40,000		- 30,000		
		\$236,000	=	\$ 70,000	+	Stockholders' Equity
	End:	Stockholders' Equity	=	\$166,000		
SE6. The Accounting Equation and Net Income						
Net income		=	\$108,000			
Beginning of year:						
Assets	=	Liabilities	+	Stockholders' Equity		
\$280,000	=	\$120,000	+	\$160,000		
During year:						
Investment			\$ 40,000			
Dividends			48,000			
Net Income*			108,000			
End of year:						
\$400,000	=	\$140,000	+	\$260,000		
*(\$260,000 – \$160,000) – \$40,000 + \$48,000 = \$108,000						
SE7. Preparation and Completion of a Balance Sheet						
Manteno Company						
Balance Sheet						
June 30, 2014						
Assets			Liabilities			
Cash	\$11,600 *		Wages payable	\$ 1,400		
Accounts receivable	3,200		Total liabilities	\$ 1,400		
Building	44,000					
			Stockholders' Equity			
			Common stock	\$48,000		
			Retained earnings	9,400		
			Total stockholders' equity		57,400	
			Total liabilities and			
Total assets	\$58,800		stockholders' equity		\$58,800	
*\$58,800 – \$3,200 – \$44,000 = \$11,600						

**SE8. Preparation of Financial Statements**

Randall Company		
Income Statement		
For the Year Ended December 31, 2014		
<b>Revenues:</b>		
Service revenue		<b>\$4,800</b>
<b>Expenses:</b>		
Total expenses		<b><u>2,450</u></b>
Net income		<b><u>\$2,350</u></b>

Randall Company		
Statement of Retained Earnings		
For the Year Ended December 31, 2014		
Retained earnings, December 31, 2013		<b>\$ —</b>
Net income for the year		<b><u>2,350</u></b>
Subtotal		<b><u>\$2,350</u></b>
Less dividends		<b><u>410</u></b>
Retained earnings, December 31, 2014		<b><u>\$1,940</u></b>

Randall Company				
Balance Sheet				
December 31, 2014				
Assets		Liabilities		
Cash	<b>\$1,890</b>	Accounts payable		<b>\$ 450</b>
Other assets	<b><u>1,000</u></b>	Total liabilities		<b>\$ 450</b>
		Stockholders' Equity		
		Common stock	<b>\$ 500</b>	
		Retained earnings	<b><u>1,940</u></b>	
		Total stockholders' equity		<b><u>2,440</u></b>
		Total liabilities and		
Total assets	<b><u>\$2,890</u></b>	stockholders' equity		<b><u>\$2,890</u></b>

**SE9. Accounting and Business Enterprises**

1.	g	6.	i
2.	f	7.	d
3.	b	8.	a
4.	c	9.	j
5.	e	10.	h

**SE10. Ethics and Accounting**

1.	b	3.	d
2.	a	4.	c

## Exercises: Set A

### E1A. Business Transactions

- |    |   |
|----|---|
| 1. | No, this is not a business transaction because no economic exchange has taken place.      |
| 2. | Yes, this is an expense of the business.  |
| 3. | Yes, this is an expense of the business.  |
| 4. | Yes, this is an expense of the business (assuming that Austin intends to repay the loan). |

### E2A. Accounting Concepts

- |    |   |     |   |
|----|---|-----|---|
| 1. | c | 6.  | b |
| 2. | c | 7.  | a |
| 3. | b | 8.  | a |
| 4. | a | 9.  | c |
| 5. | b | 10. | a |

### E3A. Money Measure

Company	Sales				
Abril Chip	2,000,000	×	1.000	=	\$2,000,000
Dao	5,000,000	×	0.130	=	\$650,000
Aiko	350,000,000	×	0.012	=	\$4,200,000
Orca	3,000,000	×	1.320	=	\$3,960,000

Company	Assets				
Abril Chip	1,300,000	×	1.000	=	\$1,300,000
Dao	2,400,000	×	0.130	=	\$312,000
Aiko	250,000,000	×	0.012	=	\$3,000,000
Orca	3,900,000	×	1.320	=	\$5,148,000

Aiko is the largest in terms of sales and Orca is the largest in terms of assets.

#### E4A. The Accounting Equation

1.		<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>	
		<b>\$400,000</b>	=	<b>Liabilities</b>	+	<b>\$155,000</b>	
		<b>Liabilities</b>	=	<b><u>\$245,000</u></b>			
2.		<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>	
		<b>Assets</b>	=	<b>\$72,000</b>	+	<b>\$79,500</b>	
		<b>Assets</b>	=	<b><u>\$151,500</u></b>			
3.		<b>Assets</b>	=	<b>1/3 Assets</b>	+	<b>\$160,000</b>	
		<b>2/3 Assets</b>	=	<b>\$160,000</b>			
		<b>Assets</b>	=	<b>\$240,000</b>			
		<b>Liabilities</b>	=	<b>1/3</b>	×	<b>\$240,000</b>	= <b><u>\$80,000</u></b>
4.	<b>Beginning:</b>	<b>\$275,000</b>	=	<b>Liabilities</b>	+	<b>\$150,000</b>	
		<b>Liabilities</b>	=	<b>\$125,000</b>			
		<b>\$275,000</b>	=	<b>\$125,000</b>	+	<b>\$150,000</b>	
	<b>Change:</b>	<b><u>+ 75,000</u></b>		<b><u>- 22,500</u></b>			
		<b>\$350,000</b>	=	<b>\$102,500</b>	+	<b>Stockholders' Equity</b>	
	<b>End:</b>	<b>Stockholders' Equity</b>	=	<b><u>\$247,500</u></b>			

#### E5A. Stockholders' Equity and the Accounting Equation

1.	<b>Net income is:</b>	<b>\$6,250</b>					
		<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>	
	<b>End:</b>	<b>\$275,000</b>	=	<b>\$162,500</b>	+	<b>\$112,500</b>	
	<b>Beginning:</b>	<b>175,000</b>	=	<b>68,750</b>	+	<b><u>106,250</u></b>	
	<b>Net income</b>					<b><u>\$ 6,250</u></b>	
2.	<b>Net income is:</b>	<b>\$33,750</b>					
	<b>Change in stockholders' equity</b>			<b>\$ 6,250</b>			
	<b>+ Dividends</b>			<b><u>27,500</u></b>			
	<b>Net income</b>			<b><u>\$ 33,750</u></b>			
3.	<b>Net loss is:</b>	<b>\$(10,000)</b>					
	<b>Change in stockholders' equity</b>			<b>\$ 6,250</b>			
	<b>- Common stock</b>			<b><u>16,250</u></b>			
	<b>Net loss</b>			<b><u>\$(10,000)</u></b>			
4.	<b>Net income is:</b>	<b>\$21,250</b>					
	<b>Change in stockholders' equity</b>			<b>\$ 6,250</b>			
	<b>+ Dividends</b>			<b><u>27,500</u></b>			
				<b>\$ 33,750</b>			
	<b>- Common stock</b>			<b><u>12,500</u></b>			
	<b>Net income</b>			<b><u>\$ 21,250</u></b>			

E6A. Identification of Accounts

1.	a.	A	2.	a.	IS
	b.	L		b.	BS
	c.	A		c.	IS
	d.	SE		d.	BS
	e.	A		e.	IS
	f.	L		f.	BS
	g.	A		g.	RE

E7A. Preparation of a Balance Sheet

Oxford Services Company				
Balance Sheet				
December 31, 2014				
Assets		Liabilities		
Cash	\$ 25,000	Accounts payable		\$ 50,000
Accounts receivable	62,500	Total liabilities		\$ 50,000
Supplies	12,500			
Building	112,500	Stockholders' Equity		
Equipment	<u>50,000</u>	Common stock	\$125,000	
		Retained earnings	<u>87,500</u>	
		Total stockholders' equity		<u>212,500</u>
		Total liabilities and		
Total assets	<u>\$262,500</u>	stockholders' equity		<u>\$262,500</u>

**E8A. Preparation and Integration of Financial Statements**

Dukakis Company			
Income Statement			
For the Year Ended December 31, 2014			
<b>Revenues:</b>			
Service revenue			<b>\$13,200</b>
<b>Expenses:</b>			
Rent expense		<b>\$1,200</b>	
Wages expense		<b>8,340</b>	
Advertising expense		<b>1,350</b>	
Utilities expense		<b>900</b>	
Total expenses			<b><u>11,790</u></b>
Net income			<b><u>\$ 1,410</u></b>

Dukakis Company	
Statement of Retained Earnings	
For the Year Ended December 31, 2014	
Retained earnings, December 31, 2013	<b>\$1,000</b>
Net income for the year	<b><u>1,410</u></b>
Subtotal	<b><u>\$2,410</u></b>
Less dividends	<b><u>700</u></b>
Retained earnings, December 31, 2014	<b><u>\$1,710</u></b>

Dukakis Company			
Balance Sheet			
December 31, 2014			
Assets		Liabilities	
Cash	<b>\$1,550</b>	Accounts payable	<b><u>\$ 450</u></b>
Accounts receivable	<b>750</b>	Total liabilities	<b><u>\$ 450</u></b>
Supplies	<b>100</b>		
Land	<b><u>1,000</u></b>	Stockholders' Equity	
		Common stock	<b>\$1,240</b>
		Retained earnings	<b><u>1,710</u></b>
		Total stockholders' equity	<b><u>2,950</u></b>
		Total liabilities and	
Total assets	<b><u>\$3,400</u></b>	stockholders' equity	<b><u>\$3,400</u></b>



<b>E9A. Statement of Cash Flows</b>		
<b>Arlington Service Company</b> <b>Statement of Cash Flows</b> <b>For the Year Ended December 31, 2014</b>		
<b>Cash flows from operating activities:</b>		
Net income		\$ 32,500
Adjustments to reconcile net income to net cash flows from operating activities:		
Increase in accounts receivable	\$ (7,800)	
Increase in accounts payable	<u>11,700</u>	<u>3,900</u>
Net cash flows from operating activities		\$ 36,400
<b>Cash flows from investing activities:</b>		
Purchase of equipment	<u>\$(117,000)</u>	
Net cash flows used by investing activities		(117,000)
<b>Cash flows from financing activities:</b>		
Borrowings from bank	\$ 78,000	
Dividends paid	<u>(19,500)</u>	
Net cash flows from financing activities		<u>58,500</u>
Net increase (decrease) in cash		\$ (22,100)
Cash at beginning of year		<u>55,900</u>
Cash at end of year		<u>\$ 33,800</u>
<b>E10A. Statement of Retained Earnings</b>		
<b>Mrs. Shah's Cookies</b> <b>Statement of Retained Earnings</b> <b>For the Year Ended January 31, 2014</b>		
Retained earnings, January 31, 2013		\$102,403
Net income for the year		<u>57,087</u>
Subtotal		\$159,490
Less dividends		<u>—</u>
Retained earnings, January 31, 2014		<u>\$159,490</u>
Retained earnings are earnings of the corporation since its inception, less any losses, dividends, or transfers to contributed capital. Retained earnings are reinvested in the business.		
Mrs. Shah's Cookies may have decided not to pay any dividends because they may want to use the funds for other purposes such as to finance the company's growth or pay off debt.		

E11A. Preparation and Integration of Financial Statements					
Net income links the income statement and the statement of retained earnings. The ending balance of retained earnings links the statement of retained earnings and the balance sheet.					
Thus, start with (c), which must equal \$3,000 (check: $\$29,000 + \$3,000 - \$2,000 = \$30,000$ ).					
Then, (b) equals (c), or \$3,000. Thus, (a) must equal \$8,100 (check: $\$11,100 - \$3,000 = \$8,100$ ).					
Because (e) equals \$30,000 (ending balance from the statement of retained earnings), (f) must equal \$96,000 (check: $\$16,000 + \$50,000 + \$30,000 = \$96,000$ ). Finally, (d) must equal (f), or \$96,000.					
E12A. Users of Accounting Information and Forms of Business Organization					
People who are interested in Avalon's financial statements are the following:					
•	Management				
•	Investors (stockholders)				
•	Creditors				
•	Tax authorities				
•	Regulators				
•	Employees				
•	Customers				
•	Economic planners				
A partnership is a business that has two or more owners. A corporation is a business unit that has been granted a charter from the state and is legally separate from its owners (stockholders). A major advantage of the corporate form of business over the partnership is that the stockholders' liability is limited to the amount of the stockholders' investments in the company, whereas the personal assets of partners can be called upon to pay the obligations of a partnership. Also, the transfer of ownership is easier with the corporation because the shares owned by a stockholder can be sold to another party. When ownership of a partnership changes, the partnership must be dissolved and another one formed.					
E13A. The Nature of Accounting					
1.	b	5.	l	9.	c
2.	k	6.	f	10.	d
3.	g	7.	a	11.	e
4.	i	8.	j	12.	h

<b>E14A. Accounting Abbreviations</b>	
<b>CPA:</b>	<b>Certified Public Accountant</b>
<b>IRS:</b>	<b>Internal Revenue Service</b>
<b>PCAOB:</b>	<b>Public Company Accounting Oversight Board</b>
<b>GAAP:</b>	<b>Generally Accepted Accounting Principles</b>
<b>FASB:</b>	<b>Financial Accounting Standards Board</b>
<b>SEC:</b>	<b>Securities and Exchange Commission</b>
<b>GASB:</b>	<b>Governmental Accounting Standards Board</b>
<b>IASB:</b>	<b>International Accounting Standards Board</b>
<b>IMA:</b>	<b>Institute of Management Accountants</b>
<b>AICPA:</b>	<b>American Institute of Certified Public Accountants</b>
<b>E15A. Ethics and Accounting</b>	
<b>1.</b>	<b>a</b>
<b>2.</b>	<b>c</b>
<b>3.</b>	<b>b</b>
<b>4.</b>	<b>e</b>
<b>5.</b>	<b>d</b>
<b>Note to Instructor: Solutions for Exercises: Set B are provided separately on the Instructor's Resource CD and website.</b>	

## Problems

### P1. Preparation and Interpretation of Financial Statements

1.	IS	Utilities expense	BS	Accounts payable
	BS	Building	IS	Rent expense
	BS	Common stock	RE	Dividends
	IS/RE	Net income	IS	Fees earned
	BS	Land	BS	Cash
	BS	Equipment	BS	Supplies
	IS	Revenues	IS	Wages expense
	BS	Accounts receivable		

2. The income statement is most closely associated with the goal of profitability.

### P2. Integration of Financial Statements

1.		Set A		Set B		Set C	
	<b>Income Statement</b>						
	Revenue	\$1,100		\$ 6,800	(g)	\$240	
	Expenses	<u>800</u>	(a)	<u>5,200</u>		<u>160</u>	(m)
	Net income	<u>\$ 300</u>	(b)	<u>\$ 1,600</u>	(h)	<u>\$ 80</u>	
	<b>Statement of Retained Earnings</b>						
	Beginning balance	\$2,900		\$24,400		\$340	
	Net income	300	(c)	1,600		80	(n)
	Less dividends	<u>200</u>		<u>10,000</u>	(i)	<u>140</u>	(o)
	Ending balance	<u>\$3,000</u>		<u>\$16,000</u>	(j)	<u>\$280</u>	(p)
	<b>Balance Sheet</b>						
	Total assets	<u>\$6,600</u>	(d)	<u>\$31,000</u>		<u>\$380</u>	(q)
	Total liabilities	\$1,600		\$ 5,000		\$ —	(r)
	Stockholders' equity						
	Common stock	\$2,000		\$10,000		\$100	
	Retained earnings	<u>3,000</u>	(e)	<u>16,000</u>	(k)	<u>280</u>	
	Total liabilities and stockholders' equity	<u>\$6,600</u>	(f)	<u>\$31,000</u>	(l)	<u>\$380</u>	

2. The income statement must be prepared first because the amount of net income is necessary to determine the ending balance of retained earnings. The statement of retained earnings is prepared second because it provides the ending balance of the retained earnings for the balance sheet, which is prepared last.

### P3. Preparation and Interpretation of Financial Statements

1.	<b>Fuel Designs</b>				
	<b>Income Statement</b>				
	<b>For the Year Ended December 31, 2014</b>				
	<b>Revenues:</b>				
	Commission sales revenue				<b>\$400,000</b>
	<b>Expenses:</b>				
	Commissions expense		<b>\$225,000</b>		
	Marketing expense		<b>20,100</b>		
	Office rent expense		<b>36,000</b>		
	Supplies expense		<b>2,600</b>		
	Telephone and computer expenses		<b>5,100</b>		
	Wages expense		<b>32,000</b>		
	Total expenses				<b><u>320,800</u></b>
	Income before income taxes				<b>\$ 79,200</b>
	Income tax expense				<b><u>27,000</u></b>
	Net income				<b><u>\$ 52,200</u></b>
	<b>Fuel Designs</b>				
	<b>Statement of Retained Earnings</b>				
	<b>For the Year Ended December 31, 2014</b>				
	Retained earnings, December 31, 2013				<b>\$35,300</b>
	Net income for the year				<b><u>52,200</u></b>
	Subtotal				<b>\$87,500</b>
	Less dividends				<b><u>33,000</u></b>
	Retained earnings, December 31, 2014				<b><u>\$54,500</u></b>
	<b>Fuel Designs</b>				
	<b>Balance Sheet</b>				
	<b>December 31, 2014</b>				
	<b>Assets</b>		<b>Liabilities</b>		
	Cash	<b>\$ 57,700</b>	Accounts payable	<b>\$ 3,600</b>	
	Accounts receivable	<b>4,500</b>	Commissions payable	<b>22,700</b>	
	Supplies	<b>700</b>	Income tax payable	<b><u>13,000</u></b>	
	Equipment	<b><u>59,900</u></b>	Total liabilities		<b>\$ 39,300</b>
			<b>Stockholders' Equity</b>		
			Common stock	<b>\$29,000</b>	
			Retained earnings	<b><u>54,500</u></b>	
			Total stockholders' equity		<b><u>83,500</u></b>
			Total liabilities and		
	Total assets	<b><u>\$122,800</u></b>	stockholders' equity		<b><u>\$122,800</u></b>

2.	The statement of cash flows is very useful in assessing whether a company's operations are generating sufficient funds to support expansion. The statement tells whether operations are producing enough cash or whether the company will need to obtain outside financing from creditors or owners.
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#### P4. Preparation and Interpretation of Financial Statements

1.	Frequent Ad			
	Income Statement			
	For the Year Ended January 31, 2014			
	Revenues:			
	Advertising service revenue			\$165,200
	Expenses:			
	Equipment rental expense	\$37,200		
	Marketing expense	6,800		
	Salaries expense	86,000		
	Supplies expense	19,100		
	Office rent expense	13,500		
	Total expenses			162,600
	Income before income taxes			\$ 2,600
	Income tax expense			560
	Net income			\$ 2,040
Frequent Ad				
Statement of Retained Earnings				
For the Year Ended January 31, 2014				
	Retained earnings, January 31, 2013			\$ —
	Net income for the year			2,040
	Subtotal			\$2,040
	Less dividends			—
	Retained earnings, January 31, 2014			\$2,040
Frequent Ad				
Balance Sheet				
January 31, 2014				
Assets		Liabilities		
Cash	\$ 1,800	Accounts payable	\$19,400	
Accounts receivable	24,900	Salaries payable	1,300	
Supplies	1,600	Income taxes payable	560	
		Total liabilities		\$21,260
		Stockholders' Equity		
		Common stock	\$ 5,000	
		Retained earnings	2,040	
		Total stockholders' equity		7,040
		Total liabilities and		
Total assets	\$28,300	stockholders' equity		\$28,300
2.	The company is challenged both in terms of profitability and liquidity. Profitability is			
	low in that it has earned only \$2,040 on revenues of \$165,200. Liquidity is low because			
	the company has cash of only \$1,800 and liabilities of \$21,260, but will likely receive			
	\$24,900 from customers.			

<b>P5. Use and Interpretation of Financial Statements</b>	
<b>1.</b>	The income statement shows net income of \$3,050 earned by the company over a month. The amount of net income is necessary for the preparation of the retained earnings statement. The amount of retained earnings shows an ending balance of \$36,125. The ending balance of retained earnings appears in the stockholders' equity section of the balance sheet. The statement of cash flows explains the changes in the cash account during the month, and the ending cash amount should be the cash balance on the balance sheet.
<b>2.</b>	The income statement is most closely associated with the goal of profitability, because it shows the earnings of the business. The cash flow statement is most closely associated with the goal of liquidity, because it shows the changes in cash.
<b>3.</b>	The company appears to be very profitable because it has earned \$3,050 of net income on revenues of \$6,100. The stockholders received a cash dividend of \$2,400. However, the return on total assets (net income divided by total assets) is only 5.71 percent, or \$0.0571 on each dollar of assets invested. Moreover, the company might experience some challenges in its liquidity position in the future because it has liabilities of \$11,250 and cash of only \$5,975.
<b>4.</b>	When deciding whether to make a loan to a company, a banker evaluates the company's ability to pay interest charges and repay the loan at the appropriate time. Accordingly, a banker studies the company's liquidity and cash flows as well as its profitability. That information is represented in financial statements, which are prepared by a company's management and can be falsified for personal gain. To lend credibility to the financial statements, the banker may request an independent audit by a CPA. The audit would determine that the financial statements present the data fairly and conform to GAAP in all material respects.

## Alternate Problems

### P6. Preparation and Interpretation of Financial Statements

1.	IS	Wages expense	BS	Accounts payable
	BS	Equipment	IS	Rent expense
	IS	Equipment rental expense	RE	Dividends
	IS/RE	Net income	IS	Fees earned
	BS	Land	BS	Cash
	BS/RE	Retained earnings	BS	Supplies
	IS	Revenues	IS	Utilities expense
	BS	Accounts receivable		

2. The income statement is most closely associated with the goal of profitability.

### P7. Integration of Financial Statements

1.		Set A		Set B		Set C	
	<b>Income Statement</b>						
	Revenues	\$ 2,400		\$13,200	(g)	\$ 480	
	Expenses	<u>1,620</u>	(a)	<u>10,000</u>		<u>184</u>	(m)
	Net income	<u>\$ 780</u>	(b)	<u>\$ 3,200</u>	(h)	<u>\$ 296</u>	
	<b>Statement of Retained Earnings</b>						
	Beginning balance	\$ 5,800		\$48,800		\$ 480	
	Net income	780	(c)	3,200		296	(n)
	Less dividends	<u>400</u>		<u>12,000</u>	(i)	<u>216</u>	(o)
	Ending balance	<u>\$ 6,180</u>		<u>\$40,000</u>	(j)	<u>\$ 560</u>	(p)
	<b>Balance Sheet</b>						
	Total assets	<u>\$10,880</u>	(d)	<u>\$60,000</u>		<u>\$1,160</u>	(q)
	Total liabilities	\$ 3,200		\$10,000		\$ 480	(r)
	Stockholders' equity						
	Common stock	\$ 1,500		\$10,000		\$ 120	
	Retained earnings	<u>6,180</u>	(e)	<u>40,000</u>	(k)	<u>560</u>	
	Total liabilities and stockholders' equity	<u>\$10,880</u>	(f)	<u>\$60,000</u>	(l)	<u>\$1,160</u>	

2. The income statement must be prepared first because the amount of net income is necessary to determine the ending balance of retained earnings. The statement of retained earnings is prepared second because it provides the ending balance of retained earnings for the balance sheet, which is prepared last.



**P8. Preparation and Interpretation of Financial Statements**

1.	<b>Sears Labs</b>			
	<b>Income Statement</b>			
	<b>For the Year Ended November 30, 2014</b>			
	<b>Revenues:</b>			
	Design service revenue			<b>\$248,000</b>
	<b>Expenses:</b>			
	Marketing expense		<b>\$19,700</b>	
	Office rent expense		<b>18,200</b>	
	Salaries expense		<b>96,000</b>	
	Supplies expense		<b><u>3,100</u></b>	
	Total expenses			<b><u>137,000</u></b>
	Income before income taxes			<b>\$111,000</b>
	Income taxes expense			<b><u>38,850</u></b>
	Net income			<b><u>\$ 72,150</u></b>
	<b>Sears Labs</b>			
	<b>Statement of Retained Earnings</b>			
	<b>For the Year Ended November 30, 2014</b>			
	Retained earnings, November 30, 2013			<b>\$ 55,400</b>
	Net income for the year			<b><u>72,150</u></b>
	Subtotal			<b>\$127,550</b>
	Less dividends			<b><u>40,000</u></b>
	Retained earnings, November 30, 2014			<b><u>\$ 87,550</u></b>
	<b>Sears Labs</b>			
	<b>Balance Sheet</b>			
	<b>November 30, 2014</b>			
	<b>Assets</b>		<b>Liabilities</b>	
	Cash	<b>\$115,750</b>	Accounts payable	<b>\$ 7,400</b>
	Accounts receivable	<b>9,100</b>	Salaries payable	<b>2,700</b>
	Supplies	<b><u>800</u></b>	Income taxes payable	<b><u>13,000</u></b>
			Total liabilities	<b>\$ 23,100</b>
			<b>Stockholders' Equity</b>	
			Common stock	<b>\$ 15,000</b>
			Retained earnings	<b><u>87,550</u></b>
			Total stockholders' equity	<b><u>102,550</u></b>
			Total liabilities and	
	Total assets	<b><u>\$125,650</u></b>	stockholders' equity	<b><u>\$125,650</u></b>
2.	The company's ability to pay its bills or its liquidity appears good because it has cash			
	of \$115,750 and total liabilities of only \$23,100.			

**P9. Preparation and Interpretation of Financial Statements**

1.	<b>Bachino's Pizza</b>			
	<b>Income Statement</b>			
	<b>For the Year Ended September 30, 2014</b>			
	<b>Revenues:</b>			
	Pizza revenue			<b>\$164,000</b>
	<b>Expenses:</b>			
	Equipment rental expense	<b>\$ 2,600</b>		
	Marketing expense	<b>3,000</b>		
	Salaries expense	<b>112,000</b>		
	Supplies expense	<b>8,200</b>		
	Delivery truck rent expense	<b>14,400</b>		
	Total expenses			<b>140,200</b>
	Income before income taxes			<b>\$ 23,800</b>
	Income taxes expense			<b>6,000</b>
	Net income			<b>\$ 17,800</b>
	<b>Bachino's Pizza</b>			
	<b>Statement of Retained Earnings</b>			
	<b>For the Year Ended September 30, 2014</b>			
	Retained earnings, September 30, 2013			<b>\$ —</b>
	Net income for the year			<b>17,800</b>
	Subtotal			<b>\$17,800</b>
	Less dividends			<b>2,000</b>
	Retained earnings, September 30, 2014			<b>\$15,800</b>
	<b>Bachino's Pizza</b>			
	<b>Balance Sheet</b>			
	<b>September 30, 2014</b>			
	<b>Assets</b>		<b>Liabilities</b>	
	Cash	<b>\$ 15,600</b>	Accounts payable	<b>\$21,000</b>
	Accounts receivable	<b>26,400</b>	Salaries payable	<b>1,400</b>
	Supplies	<b>800</b>	Income taxes payable	<b>6,000</b>
	Equipment	<b>9,400</b>	Total liabilities	<b>\$28,400</b>
			<b>Stockholders' Equity</b>	
			Common stock	<b>\$ 8,000</b>
			Retained earnings	<b>15,800</b>
			Total stockholders' equity	<b>23,800</b>
			Total liabilities and	
	Total assets	<b>\$52,200</b>	stockholders' equity	<b>\$52,200</b>
2.	The owner of a sole proprietorship receives all the profit (or losses) of the company and is liable for all obligations of the firm. A corporation is chartered by the state and legally separated from its owners (stockholders). A corporation's profits are distributed to stockholders (owners) only when dividends are declared.			

<b>P10. Use and Interpretation of Financial Statements</b>	
1.	The income statement shows net income of \$2,900 earned by the company over a period of time. The amount of net income is necessary for the preparation of the statement of retained earnings. The statement of retained earnings shows an ending balance of \$35,375. The ending balance of retained earnings appears in the retained earnings section of the balance sheet. The statement of cash flows explains the changes in the cash balance during the year, and the ending cash shown should match the cash balance that appears on the balance sheet.
2.	The income statement is most closely associated with the goal of profitability, because it shows the earnings of the business. The cash flow statement is most closely associated with the goal of liquidity, because it shows the changes in cash.
3.	The company appears to be very profitable because it has earned \$2,900 of net income on revenues of \$5,925. The company paid dividends in the amount of \$2,500. However, the return on total assets (net income divided by total assets) is only 5.40 percent, or \$0.0540 on each dollar of assets invested. Moreover, the company might experience some challenges in its liquidity position in the future because it has liabilities of \$13,350 and cash of only \$6,325.
4.	When deciding whether to make a loan to a company, a banker evaluates the company's ability to pay interest charges and repay the loan at the appropriate time. Accordingly, a banker studies the company's liquidity and cash flows as well as its profitability. That information is represented in financial statements, which are prepared by a company's management and can be falsified for personal gain. To lend credibility to the financial statements, the banker may request an independent audit by a CPA. The audit would determine that the financial statements present the data fairly and conform to GAAP in all material respects.

<b>Cases</b>
<b>C1. Conceptual Understanding: Business Activities and Management Functions</b>
<p>The three basic activities in which Costco will engage to achieve its goals are financing activities (obtaining adequate funds or capital to operate its business), investing activities (spending the capital it receives so that it will be productive), and operating activities (running its business). Financing activities include obtaining capital from stockholders and from creditors, such as banks and suppliers. They also include repaying creditors and paying a return to the stockholders (in the form of dividends). Investing activities include buying land, buildings, equipment, and other long-lived resources needed in the operation of the business and the sale of these resources when they are no longer needed by the business. Operating activities include selling merchandise and services to customers; employing managers and workers; buying, producing, and selling goods and services; and paying taxes to the government.</p> <p>Costco's management is the group of people who have overall responsibility for operating the business and for meeting the company's profitability and liquidity goals. The functions management must perform to fulfill its responsibilities are obtaining financial resources (assets) so the company can continue operating (financial management); investing the financial resources of the business in productive assets that support the company's goals (asset management); developing and producing goods and services (operations management); selling, advertising, and distributing goods and services (marketing management); hiring, evaluating, and compensating employees (human resource management); and capturing, organizing, and communicating data about all aspects of the company's operations (information management). Accounting is covered by the last function.</p>
<b>C2. Conceptual Understanding: Concept of an Asset</b>
<p>Assets are economic resources owned by a business that are expected to benefit future operations. The people in an organization are not assets of the business because they are not owned by the business. Businesses pay their employees on a periodic basis (hourly, weekly, monthly, or annually); they do not buy employees. Salaries, wages, and other costs associated with employment are considered expenses and appear on the income statement.</p> <p>Southwest Airlines considers its people to be its most important asset because of the costs of hiring, training, motivating, and compensating high-quality employees who will benefit future operations. Airlines depend on their ability to develop and keep competent and motivated individuals. And their success in attracting and retaining high-quality employees depends on the opportunities and compensation they provide.</p>

<b>C3. Conceptual Understanding: Generally Accepted Accounting Principles</b>	
<p><b>Generally accepted accounting principles (GAAP) encompass the conventions, rules, and procedures necessary to define accepted practice at a particular time. When financial statements are prepared in accordance with GAAP and audited by an independent CPA, financial analysts will understand the significance of the amounts in the financial statements and will be able to assess a company's performance with confidence.</b></p>	
<p><b>Some bodies that influence GAAP are as follows:</b></p>	
•	<b>Public Company Accounting Oversight Board (PCAOB): Regulates audits of public companies. The SEC has oversight authority over the PCAOB. The PCAOB was created by the Sarbanes-Oxley Act of 2002.</b>
•	<b>Financial Accounting Standards Board (FASB): The most important body that issues GAAP and the accounting standards codification (ASC).</b>
•	<b>American Institute of Certified Public Accountants (AICPA): Influences accounting practice through its senior technical committees.</b>
•	<b>Governmental Accounting Standards Board (GASB): Issues accounting standards for government entities.</b>
•	<b>Internal Revenue Service (IRS): Influences practice through rules for determining income tax liabilities. These rules sometimes conflict with GAAP. As a result, companies have book (GAAP) financial statements and tax financial statements.</b>

C4. Interpreting Financial Reports: Analysis of Four Basic Financial Statements					
1.	The names CVS gives its four basic financial statements are as follows:				
	•	Consolidated statements of income			
	•	Consolidated balance sheets			
	•	Consolidated statements of cash flows			
	•	Consolidated statements of shareholders' equity			
2.	The accounting equation for CVS on December 31, 2011, is as follows:				
	(in millions)				
	Assets	=	Liabilities	+	Stockholders' Equity
	\$64,543	=	\$26,492	+	\$38,051
3.	Total revenues of CVS for the year ended December 31, 2011 were \$107,100 million.				
4.	Yes. The company earned \$3,457 million. This was an increase from net earnings of \$3,424 million for the year ended December 31, 2010.				
5.	No, the company's cash and cash equivalents decreased by \$14 million. This number can be found toward the bottom of the statement of cash flows or can be computed by taking the difference of the cash and cash equivalents from the December 31, 2011 and December 31, 2010 balance sheets.				
6.	Cash flows from operating activities increased from 2010 to 2011. Cash flows used in investing activities increased from 2010 to 2011, and cash flows used in financing activities increased from 2010 to 2011.				
7.	CVS was audited by Ernst & Young LLP. The auditors' report is important because it tells whether or not the company's financial statements and accompanying information are prepared in accordance with generally accepted accounting principles. If this is so, then the reader of the financial statements can rely on them and analyze them. The auditors' report lends credibility to the financial statements.				

<b>C5. Comparison Analysis: Performance Measures and Financial Statements</b>	
<b>1.</b>	<p>With sales of \$107,100 million and total assets of \$64,543 million, CVS is much larger than Southwest, which has revenues of \$15,658 million and total assets of \$18,068 million. Note that CVS generates 6.8 times as much sales on about 3.6 times the total assets of Southwest.</p> <p>Neither assets nor revenues are better than the other to measure the size of a company. Assets tell how large a company's resources are, and revenues tell how well the company is able to generate revenue. Both are useful measures of a company's size.</p>
<b>2.</b>	<p>CVS has net income (earnings) of \$3,457 million, which is about 19 times more than Southwest's earnings of \$178 million. CVS's net income declined from 2009 to 2010, but increased slightly from 2010 to 2011. Southwest's net income increased significantly from 2009 to 2010 but then decreased greatly from 2010 to 2011.</p>
<b>3.</b>	<p>CVS has cash and cash equivalents of \$1,413 million compared to Southwest's cash and cash equivalents of \$829 million. CVS's cash decreased by \$14 million compared to the \$432 million decrease by Southwest. CVS had cash flows from operating activities of \$5,856 million compared with Southwest's cash flows from operating activities of \$1,385 million.</p>

**C6. Ethical Dilemma: Professional Situations**

The ethical situations are presented for discussion purposes. Students are likely to have many different viewpoints.

1. The alternative courses of action are to disclose or not to disclose the employee's hourly rate. The information should not be disclosed because of its confidential nature.
2. The alternative courses of action are to ignore the inappropriate expenses or to report them to the home office. It might also be possible to discuss them with the manager in private. This is a difficult situation because of the possibility of retribution. If the manager does not take appropriate remedial action, the accountant should report his actions, even if it means having to look for another job.
3. The alternative courses of action are to accept the gift or to return it. To avoid a conflict of interest, the appropriate action would be to return the gift.
4. This is a common problem faced by young accountants. The alternative courses of action are to do the work and not report it, to do the work and report it, or to talk to a superior as soon as the problem is recognized. The third alternative is the best because there may be some other reason that the job cannot be done in the allotted time. Underreporting hours usually is not tolerated by CPA firms.
5. The alternative courses of action are to report or not to report the \$200 in cash. Accountants must maintain their integrity, which means being honest. The \$200 should be reported; it would be illegal not to report it.
6. The courses of action are to disclose the investment or not to disclose the investment. A CPA must avoid even the appearance of a conflict of interest. To be independent, the CPA should disclose the investment and then sell the stock.

**C7. Continuing Case: Annual Report Project**

**Note to Instructor:** Answers will vary depending on company selected.