# Chapter 1 The Role of Accounting in Business

## Class Discussion Questions

**1.** The objective of most businesses is to maximize profits. Profit is the difference between the amounts received from customers for goods or services provided and the amounts paid for the inputs used to provide those goods or services.

**2.** A manufacturing business changes basic inputs into products that are then sold to customers. In contrast, a merchandising business purchases products in a form that can be sold to customers without any additional changes. Examples of manufacturing businesses include Alcoa, Boeing, Caterpillar, and Dow Chemical. Examples of merchandising businesses include Best Buy, Macy’s, Target, and Walmart.

**3.** A manufacturing business changes basic inputs into products that are then sold to customers. A service business provides services rather than products to customers. A restaurant such as McDonald’s has characteristics of both a manufacturing and a service business in that McDonald’s takes raw inputs such as cheese, fish, and beef and processes them into products for consumption by its customers. At the same time, McDonald’s provides services of waiting on its customers.

**4.** The corporate form allows the company to obtain large amounts of resources by issuing stock. In addition, in a corporation the stockholders’ liability to creditors for the debts of the company is limited to their   
investment in the corporation. For these reasons, most large companies that require large investments in property, plant, and equipment are organized as corporations.

**5.** The business emphasis of KIA is a low-cost emphasis. In contrast, the business emphasis of BMW is a premium-price emphasis. The difference in emphases is directly  
reflected in the prices of the autos. For  
example, you can purchase a KIA for under $15,000, while the entry-level BMW starts at $30,000.

**6.** Super Walmart will compete for customers using a low-cost strategy. The size and buying power of Walmart Corporation provides Walmart a competitive advantage over your friend in the ability to offer low prices. Thus, your friend should attempt to compete using a premium-price emphasis. For example, your friend could offer personalized service to customers such as knowing customers’ names and providing a friendly atmosphere, home delivery of medicines, help in filing insurance forms, 24-hour call service, etc.

**7.** eBay services its customers by developing a Web-based community in which buyers and sellers are brought together in an efficient format to browse, buy, and sell items such as collectibles, automobiles, high-end or premium art items, jewelry, consumer electronics, and a host of practical and miscellaneous items.

**8.** No. The stakeholders within a group do not always share the same interests. For example, bankers are primarily concerned about the ability of the business to repay its debt, including interest. In contrast, stockholders are more concerned about the long-term profitability of the business, the business’s ability to pay dividends, and the future appreciation of their stock.

**9.** Examples of financing activities for Southwest Airlines could include issuing stock, borrowing from banks, and paying dividends. Examples of investing activities could include purchasing new aircraft, acquiring new terminal facilities, and upgrading its computerized reservation systems. Examples of operating activities could include transporting passengers and freight.

**10.** The role of accounting is to provide information for managers to use in operating the business. In addition, accounting provides information to other stakeholders to use in assessing the economic performance and condition of the business.

**11.** The income statement presents a summary of the revenues and expenses of a business for a specific period of time. The retained earnings statement indicates the changes in retained earnings that have occurred over a specific period of time. The balance sheet presents a listing of the assets, liabilities, and stockholders’ equity of a business as of a specific date. The statement of cash flows presents a summary of the cash receipts and cash payments of a business entity for a specific period of time.

**12.** Net income, $2,929 million ($69,865 million – $66,936 million)

**13.** Net income or net loss will appear on both the income statement and the retained earnings statement. TheRetained Earnings balance at the end of the period will appear on both the retained earnings statement and the balance sheet. Finally, the Cash balance at the end of the period will appear on both the balance sheet and the statement of cash flows.

**14.** No. The business entity concept limits the recording of economic data to transactions directly affecting the activities of the business. The payment of the interest of $5,000 is a personal transaction of Billy Jessop and should not be recorded by Valley Delivery Service.

**15.** The land should be recorded at its cost of $110,000 to Wok Repair Service. This is consistent with the cost concept.

**16.** No. The offer of $975,000 and the increase in the assessed value should not be recognized in the accounting records. This is consistent with the cost concept.

## Exercises

E1–1

1. service

2. merchandise

3. manufacturing

4. manufacturing

5. service

6. merchandise

7. manufacturing

8. manufacturing

9. service

10. manufacturing

11. manufacturing

12. service

13. service

14. manufacturing

15. merchandise

##### E1–2

1. a—low-cost

2. a—low-cost

3. b—premium-price

4. a—low-cost

5. a—low-cost

6. b—premium-price

7. a—low-cost

8. b—premium-price

9. b—premium-price

10. a—low-cost

11. b—premium-price

12. b—premium-price

##### E1–3

Best Buy stockholders’ equity: $16,005 – $12,260 = $3,745

Gamestop stockholders’ equity: $4,847 – $1,805 = $3,042

##### E1–4

Apple: $176,064 – $57,854 = $118,210

Dell: $44,533 – $35,616 = $8,917

##### E1–5

a. $160,000 ($70,000 + $90,000)

b. $77,000 ($95,000 – $18,000)

c. $448,000 ($675,000 – $227,000)

E1–6

a. $12,361 ($27,140 – $14,779)

b. $30,809 ($46,630 – $15,821)

c. $193,406 ($117,645 + $75,761)

##### E1–7

It would be incorrect to say that the business had incurred a net loss of $10,000. The excess of the dividends over the net income for the period is a decrease in the amount of retained earnings in the business.

##### E1–8

Company Chang

Stockholders’ equity at end of year ($900,000 – $300,000) $600,000

Stockholders’ equity at beginning of year ($775,000 – $400,000) 375,000

Net income (increase in stockholders’ equity) $225,000

Company Henry

Increase in stockholders’ equity (as determined for Chang) $ 225,000

Add dividends 90,000

Net income $315,000

Company Nagel

Increase in stockholders’ equity (as determined for Chang) $ 225,000

Deduct additional issuance of capital stock 125,000

Net income $ 100,000

Company Wilcox

Increase in stockholders’ equity (as determined for Chang) $ 225,000

Deduct additional issuance of capital stock 125,000

$ 100,000

Add dividends 90,000

Net income $ 190,000

E1–9

a. (1) $6,415,471 ($13,430,622 – $7,015,151)

(2) $6,943,710 ($13,911,667 – $6,967,957)

b. $984,656 ($25,022,192 – $18,280,364 – $5,048,492 – $233,372 – $475,308)

##### E1–10

Balance sheet items: 1, 2, 3, 7, 8

##### E1–11

Income statement items: 4, 5, 6, 9, 10

##### E1–12

1. a—asset

2. b—liability

3. a—asset

4. e—dividend

5. c—revenue

6. a—asset

7. b—liability

8. d—expense

9. d—expense

10. d—expense

E1–13

COIL COMPANY

Retained Earnings Statement

For the Month Ended June 30, 20Y7

Retained earnings, June 1, 20Y7 $615,000

Net income for the month $230,000

Less dividends 45,000

Increase in retained earnings 185,000

Retained earnings, June 30, 20Y7 $800,000

##### E1–14

MOONLIGHT SERVICES

Income Statement

For the Month Ended February 28, 20Y5

Fees earned $925,000

Operating expenses:

Wages expense $400,000

Rent expense 92,000

Supplies expense 13,000

Miscellaneous expense 25,000

Total operating expenses 530,000

Net income $ 395,000

E1–15

In each case, solve for a single unknown, using the following equation:

Stockholders’ Equity (beginning) + Additional Issue of Capital Stock – Dividends + Revenue – Expenses = Stockholders’ Equity (ending)

AL Stockholders’ equity at end of year ($800,000 – $450,000) $ 350,000

Stockholders’ equity at beginning of year ($400,000 – $200,000). 200,000

Increase in stockholders’ equity $ 150,000

Deduct increase due to net income ($175,000 – $65,000) 110,000

$ 40,000

Add dividends 50,000

Additional issue of capital stock (a) $ 90,000

CO Stockholders’ equity at end of year ($460,000 – $110,000) $ 350,000

Stockholders’ equity at beginning of year ($300,000 – $130,000). 170,000

Increase in stockholders’ equity $ 180,000

Add dividends 20,000

$ 200,000

Deduct additional issue of capital stock 50,000

Increase due to net income $ 150,000

Add expenses 70,000

Revenue (b) $ 220,000

KS Stockholders’ equity at end of year ($660,000 – $360,000) $ 300,000

Stockholders’ equity at beginning of year ($550,000 – $325,000). 225,000

Increase in stockholders’ equity $ 75,000

Add decrease due to net loss ($115,000 – $130,000) 15,000

$ 90,000

Deduct additional issue of capital stock (100,000)

Dividends (c) $ (10,000)

MT Stockholders’ equity at end of year ($1,200,000 – $700,000) $ 500,000

Add decrease due to net loss ($420,000 – $480,000) 60,000

$ 560,000

Add dividends 90,000

$ 650,000

Deduct additional issue of capital stock 100,000

$ 550,000

Add liabilities at beginning of year 350,000

Assets at beginning of year (d) $ 900,000

E1–16

a. MONTANA INTERIORS

Balance Sheet

October 31, 20Y8

Assets

Cash $110,000

Accounts receivable 75,000

Supplies 15,000

Total assets $200,000

Liabilities

Accounts payable $ 40,000

Stockholders’ Equity

Capital stock $ 60,000

Retained earnings 100,000\* 160,000

Total liabilities and stockholders’ equity $200,000

\*$100,000 = $110,000 + $75,000 + $15,000 – $40,000 – $60,000

MONTANA INTERIORS

Balance Sheet

November 30, 20Y8

Assets

Cash $ 140,000

Accounts receivable 118,000

Supplies 20,000

Total assets $ 278,000

Liabilities

Accounts payable $ 65,000

Stockholders’ Equity

Capital stock $ 60,000

Retained earnings 153,000\*\* 213,000

Total liabilities and stockholders’ equity $ 278,000

\*\*$153,000 = $140,000 + $118,000 + $20,000 – $65,000 – $60,000

E1–16, Concluded

b. Retained earnings, November 30 $ 153,000

Retained earnings, October 31 100,000

Net income $ 53,000

c. Retained earnings, November 30 $ 153,000

Retained earnings, October 31 100,000

Increase in retained earnings $ 53,000

Add dividends 20,000

Net income $ 73,000

##### E1–17

Balance sheet: a, b, c, d, f, g, h, i, j, l, m

Income statement: e, k, n, o

##### E1–18

1. c—financing activity

2. a—operating activity

3. b—investing activity

4. a—operating activity

5. c—financing activity

6. b—investing activity

7. a—operating activity

8. a—operating activity

9. a—operating activity

10. c—financing activity

##### E1–19

1. c—financing activity

2. a—operating activity

3. a—operating activity

4. b—investing activity

E1–20

LOONEY INC.

Statement of Cash Flows

For the Month Ended July 31, Year 1

Cash flows from operating activities:

Cash received from customers $ 600,000

Deduct cash payments for expenses 380,000

Net cash flows from operating activities $220,000

Cash flows from investing activities:

Cash payment for purchase of equipment (95,000)

Cash flows from financing activities:

Cash received from sale of capital stock $200,000

Cash received from note payable 75,000 $275,000

Deduct cash dividends 25,000

Net cash flows from financing activities 250,000

Net increase in cash $375,000

July 1, Year 1 cash balance 0

July 31, Year 1 cash balance $375,000

##### E1–21

*Situation 1:* The income statement of Dell would provide the most useful information on whether the company’s business emphasis is working and thus whether the company will be around to provide warranty and other support services for your personal computer.

*Situation 2:* The statement of cash flows would be a primary focus to determine whether LinkedIn is generating positive cash flows from operations. Because LinkedIn is a relatively new company using an innovative business emphasis, it has generated losses on its income statement. Thus, the income statement does not provide as much useful information as the statement of cash flows. In the long run, LinkedIn must generate positive cash flows from its operations to survive and succeed.

*Situation 3:* A current balance sheet would be a primary focus to determine whether the grocery store chain has sufficient cash or other assets such as receivables that will enable the chain to repay the credit within 60 days. The balance sheet would also report any other liabilities of the chain.

E1–21, Concluded

*Situation 4:* The income statements of Sears and JCPenney would provide the most useful information on which company’s business emphasis is working best and thus generating profits. Both Sears and JCPenney are under considerable pressure from low-cost retailers such as Walmart.

*Situation 5:* The statement of cash flows would be a primary focus to determine whether the annual cash flows from operating activities is sufficient to pay the interest on a continuing basis. Most large companies like Target will use credit lines to cover cash shortages throughout the year because of the seasonality of the retail industry.

##### E1–22

1. BS

2. BS

3. BS

4. IS

5. IS

6. IS

7. BS

8. SCF

9. SCF

10. IS

11. IS

12. BS

13. IS

14. RE, BS

E1–23

AMAZON.COM INC.

Income Statement

For the Year Ended December 31, 20Y1

(in Millions)

Revenues:

Net sales $48,077

Other income 125

Total revenue $48,202

Expenses:

Cost of sales $37,288

Selling, general, and administrative expenses 9,927

Income tax expense 291

Interest expenses 65

Total expenses 47,571

Net income $ 631

##### E1–24

1. BS

2. BS

3. BS

4. BS, SCF

5. SCF

6. IS

7. IS

8. IS

9. BS

10. BS

11. IS, RE

12. SCF

13. BS

14. BS

15. IS

16. IS

17. BS

18. BS

19. RE, BS

20. IS

E1–25

1. All financial statements should contain the name of the business in their headings. The retained earnings statement is incorrectly headed as “Julie Baxter” rather than Outlaw Realty. The headings of the balance sheet and statement of cash flows need the name of the business.

2. The income statement, retained earnings statement, and statement of cash flows cover a period of time and should be labeled “For the Month Ended   
August 31, Year 1.”

3. The year in the heading for the retained earnings statement should be Year 1 rather than Year 2.

4. The balance sheet should be labeled “August 31, Year 1,” rather than “For the Month Ended August 31, Year 1.”

5. In the income statement, the miscellaneous expense amount should be listed as the last operating expense.

6. In the income statement, the total operating expenses are incorrectly subtracted from the sales commissions, resulting in an incorrect net income amount. The correct net income should be $94,500. This also affects the retained earnings statement and the amount of retained earnings that appears on the balance sheet.

7. In the retained earnings statement, the net income should be presented before the amount of dividends. The dividends should be subtracted from the net income to yield a net increase in retained earnings. Beginning retained earnings should also be zero.

8. Accounts payable should be listed as a liability on the balance sheet.

9. Accounts receivable and prepaid expenses should be listed as assets on the balance sheet.

10. The balance sheet assets should equal the sum of the liabilities and stockholders’ equity.

11. The statement of cash flows omits the cash flows from investing activities section. This section should report cash flows used to purchase land of $60,000.

12. The net cash flow and cash balance should be dated August 31, Year 1, and should be the same as the ending cash reported on the balance sheet of $51,600.

E1–25, Continued

Corrected financial statements appear as follows:

OUTLAW REALTY

Income Statement

For the Month Ended August 31, Year 1

Sales commissions $408,400

Operating expenses:

Office salaries expense $272,600

Rent expense 31,200

Automobile expense 7,900

Miscellaneous expense 2,200

Total operating expenses 313,900

Net income $ 94,500

OUTLAW REALTY

Retained Earnings Statement

For the Month Ended August 31, Year 1

Retained earnings, August 1, Year 1 $ 0

Net income for August $94,500

Less dividends during August 12,000

Increase in retained earnings 82,500

Retained earnings, August 31, Year 1 $82,500

OUTLAW REALTY

Balance Sheet

August 31, Year 1

Assets

Cash $ 51,600

Accounts receivable 81,200

Prepaid expenses 7,200

Land 60,000

Total assets $ 200,000

Liabilities

Accounts payable $ 17,500

Stockholders’ Equity

Capital stock $100,000

Retained earnings 82,500 182,500

Total liabilities and stockholders’ equity $ 200,000

E1–25, Concluded

OUTLAW REALTY

Statement of Cash Flows

For the Month Ended August 31, Year 1

Cash flows from operating activities:

Cash received from customers $327,200

Cash paid for operating expenses 303,600

Net cash flows from operating activities $ 23,600

Cash flows from investing activities:

Cash paid for purchase of land (60,000)

Cash flows from financing activities:

Cash received from issuance of capital stock $100,000

Dividends paid to stockholders (12,000)

Net cash flows from financing activities 88,000

Net cash flows and cash balance as of August 31, Year 1 $ 51,600

##### E1–26

1. G

2. D

3. M

4. B

5. O

6. D

7. C

8. U

9. O

10. P

##### E1–27

1. C

2. C

3. X

4. C

5. B

6. C

7. B

8. M

9. X

10. M

## PROBLEMS

P1–1

1. UTAH TRAVEL SERVICE

Income Statement

For the Year Ended April 30, 20Y6

Fees earned $ 1,594,200

Operating expenses:

Wages expense $890,200

Rent expense 226,800

Utilities expense 135,000

Supplies expense 42,600

Taxes expense 33,600

Miscellaneous expense 16,000

Total operating expenses 1,344,200

Net income $ 250,000

2. UTAH TRAVEL SERVICE

Retained Earnings Statement

For the Year Ended April 30, 20Y6

Retained earnings, May 1, 20Y5 $ 300,000

Net income for the year $250,000

Less dividends 75,000

Increase in retained earnings 175,000

Retained earnings, April 30, 20Y6 $ 475,000

3. UTAH TRAVEL SERVICE

Balance Sheet

April 30, 20Y6

Assets

Cash $ 428,300

Accounts receivable 188,100

Supplies 20,100

Total assets $ 636,500

Liabilities

Accounts payable $ 71,500

Stockholders’ Equity

Capital stock $ 90,000

Retained earnings 475,000 565,000

Total liabilities and stockholders’ equity $ 636,500

P1–2

1. Realty businesses, such as Paradise Realty, are service businesses that aid their clients in buying or selling real estate.

2. a. Wages expense, $29,850 ($69,300 – $14,400 – $12,000 – $8,100 – $4,950)

b. Net income, $80,000 ($149,300 – $69,300)

c. Net income for November, $80,000

d. Dividends, $36,000

e. Retained earnings, November 30, 20Y3, $44,000 ($80,000 – $36,000)

f. Land, $216,000

g. Total assets, $321,200 ($99,200 + $6,000 + $216,000)

h. Capital stock, $270,000

i. Retained earnings, $44,000 [see (e)]

j. Total stockholders’ equity, $314,000 ($270,000 + $44,000)

k. Total liabilities and stockholders’ equity, $321,200 ($7,200 + $314,000)

l. Cash received from customers, $149,300 ($81,200 + $68,100)

m. Net cash flows from operating activities, $81,200 ($149,300 – $68,100)   
or ($99,200 – $234,000 + $216,000)

n. Net cash flows from financing activities, $234,000 ($270,000 – $36,000)

o. Net cash flow and November 30, 20Y3, cash balance, $99,200

P1–3

1. TARGET CORPORATION

Income Statement

For the Year Ended January 28, 20Y2

(in millions)

Sales $68,466

Other credit card revenue 1,399

Total revenue $69,865

Expenses:

Cost of goods sold $47,860

Selling, general, and administrative expenses 14,106

Income tax expense 1,527

Interest expense 866

Other expenses 2,577

Total expenses 66,936

Net income $ 2,929

2. TARGET CORPORATION

Retained Earnings Statement

For the Year Ended January 28, 20Y2

(in millions)

Retained earnings, January 29, 20Y1 $ 12,698

Add net income $2,929

Less dividends and other reductions\* 2,668

Increase in retained earnings 261

Retained earnings, January 28, 20Y2 $ 12,959

\**Note to Instructors*: Other reductions in retained earnings include repurchase of stock, which is discussed in a later chapter.

P1–3, Concluded

3. TARGET CORPORATION

Balance Sheet

January 28, 20Y2

(in millions)

Assets

Cash $ 794

Receivables 5,927

Inventories 7,918

Property, plant, and equipment 29,149

Other assets 2,842

Total assets $46,630

Liabilities

Accounts payable $ 6,857

Debt and other borrowings……………………………….. 17,483

Other liabilities 6,469

Total liabilities $30,809

Stockholders’ Equity

Capital stock $ 2,862

Retained earnings 12,959

Total stockholders’ equity 15,821

Total liabilities and stockholders’ equity $46,630

P1–4

GOOGLE INC.

Statement of Cash Flows

For the Year Ended December 31, 20Y1

(in millions)

Net cash flows from operating activities $ 14,565

Cash flows from investing activities:

Cash purchases for property, plant, and equipment, etc. $(67,787)

Receipts from sale of investments (net) 48,746

Net cash flows used for investing activities (19,041)

Cash flows from financing activities:

Cash receipts from issuing debt, etc. 829

Net decrease in cash during year ended

December 31, 20Y1 $ (3,647)

Cash as of January 1, 20Y1 13,630

Cash as of December 31, 20Y1 $ 9,983

P1–5

1. CASSANDRA CORPORATION

Income Statement

For the Year Ended December 31, Year 1

Revenue:

Sales $800,000

Expenses:

Cost of sales $435,000

Selling and administrative expenses 80,000

Income tax expense 53,000

Interest expense 2,000 570,000

Net income $230,000

2. CASSANDRA CORPORATION

Retained Earnings Statement

For the Year Ended December 31, Year 1

Retained earnings, January 1, Year 1 $ 0

Net income $230,000

Less dividends 30,000

Increase in retained earnings 200,000

Retained earnings, December 31, Year 1 $200,000

P1–5, Continued

3. CASSANDRA CORPORATION

Balance Sheet

December 31, Year 1

Assets

Cash $ 40,000

Accounts receivable 110,000

Inventories 115,000

Property, plant, and equipment 265,000

Total assets $530,000

Liabilities

Accounts payable $ 20,000

Income taxes payable 8,000

Note payable (due in 2019) 50,000

Total liabilities $ 78,000

Stockholders’ Equity

Capital stock $252,000

Retained earnings 200,000

Total stockholders’ equity 452,000

Total liabilities and stockholders’ equity $530,000

P1–5, Concluded

4. CASSANDRA CORPORATION

Statement of Cash Flows

For the Year Ended December 31, Year 1

Cash flows from operating activities:

Cash receipts from operating activities $ 690,000

Cash payments for operating activities (657,000)

Net cash flows from operating activities $ 33,000

Cash flows used for investing activities:

Investments in property, plant, and equipment (265,000)

Cash flows from financing activities:

Cash receipt from issuance of note payable $ 50,000

Cash receipt from issuance of capital stock 252,000

Cash payments for dividends (30,000)

Net cash flows from financing activities 272,000

Net increase in cash during Year 1 $ 40,000

Cash as of January 1, Year 1 0

Cash as of December 31, Year 1 $ 40,000

*Note to Instructors:* The determination of cash receipts and payments from operating activities is not discussed in Chapter 1 and is beyond the student level of understanding or comprehension at this point in the text. This topic will be covered in later chapters. However, for completeness of the solution, the cash receipts and payments for operating activities are computed as follows:

Cash receipts from operating activities: $800,000 (sales) – $110,000 (accounts receivable) = $690,000

Cash payments from operating activities: $570,000 (total expenses) – $20,000 (accounts payable) – $8,000 (income taxes payable) + $115,000 (inventories) = $657,000

## FINANCIAL Analysis

#### FA1–1

1. $6,644

2. $3,784

3. $661

4. 57.0% ($3,784 ÷ $6,644) (Rounded)

5. 75.6% (Rounded)

The markup percentage is computed as follows:

Cost of Sales + (Markup % × Cost of Sales) = Sales

$3,784 + (Markup % × $3,784) = $6,644

Markup % =  =  = 75.6% (Rounded)

6. 9.9% ($661 ÷ $6,644) (Rounded)

7. $1,111 ($661 + $354 + $96)

8. Rate of Return on Assets = $1,111 ÷ [($4,754 + $4,412) ÷ 2]

= $1,111 ÷ $4,583 = 24.2%

FA1–2

1. 68.7% ($366 ÷ $533) (Rounded)

2. 45.6% (Rounded)

The markup percentage is computed as follows:

Cost of Sales + (Markup % × Cost of Sales) = Sales

$366 + (Markup % × $366) = $533

Markup % =   = 45.6% (Rounded)

3. 8.3% ($44 ÷ $533) (Rounded)

4. Rate of Return on Assets = $61 ÷ $858 = 7.1%

FA1–2, Concluded

5. Hershey’s markup percentage of 75.6% is significantly higher than Tootsie Roll’s markup percentage of 45.6%. As a result, Hershey earns 9.9 cents per sales dollar compared to 8.3 cents for Tootsie Roll. In addition, Hershey’s rate of return on assets is 24.2% compared to only 7.1% for Tootsie Roll. Overall, Hershey is more profitable than Tootsie Roll.

**FA1–3**

**1. *Note to Instructors:* The purpose of this requirement is to get students thinking about businesses and their profitability. This is done by focusing on real-world companies and their products with which students are familiar.   
Requirements (2) and (3) provide the opportunity for students to compare their rankings with real world results.**

**2. Pfizer:**

**Rate of Return on Total Assets = $12,762 ÷ [($195,014 + $188,002) ÷ 2]**

**= $12,762 ÷ $191,508 = 6.7%**

**Ford:**

**Rate of Return on Total Assets = $13,112 ÷ [($164,687 + $178,348) ÷ 2]**

**= $13,112 ÷ $171,518 = 7.6%**

**Microsoft:**

**Rate of Return on Total Assets = $22,267 ÷ [($108,704 + $121,271) ÷ 2]**

**= $22,267 ÷ $114,988 = 19.4%**

**From highest to lowest, the companies are ranked with Microsoft as the highest followed by Ford and Pfizer.**

**3. Microsoft has the highest rate of return on total assets of 19.4%. This is due to the widespread acceptance and use of its products. However, in recent years Microsoft has been challenged by Google and others. Ford has the next highest rate of return of 7.6%. Ford is slowly rebounding from a depressed worldwide economy. Pfizer has the lowest rate of return of 6.7%. Pfizer operates in a research-intensive industry where it spends years developing and testing new drugs. Recently, one of Pfizer’s most profitable drugs, Lipitor, lost its patent protection and has suffered significantly decreasing sales as a result of competing generic drugs.**

**FA1–4**

**1. *Note to Instructors:* The purpose of this requirement is to get students thinking about businesses and their profitability. This is done by focusing on real-world companies and their products with which students are familiar.   
Requirements (2) and (3) provide the opportunity for students to compare their rankings with real world results.**

**2. ExxonMobil:**

**Rate of Return on Total Assets = $73,504 ÷ [($302,510 + $331,052) ÷ 2]**

**= $73,504 ÷ $316,781 = 23.2%**

**Coca-Cola:**

**Rate of Return on Total Assets = $11,856 ÷ [($72,921 + $79,974) ÷ 2]**

**= $11,856 ÷ $76,448 = 15.5%**

**Walmart:**

**Rate of Return on Total Assets = $26,720 ÷ [($180,782 + $193,406) ÷ 2]**

**= $26,720 ÷ $187,094 = 14.3%**

**From highest to lowest, the companies are ranked as shown above with   
ExxonMobil the highest followed by Coca-Cola and Walmart.**

**3. ExxonMobil has the highest rate of return on total assets of 23.2%. This is due to the high demand for petroleum based products. At the same time, Exxon-Mobil’s operations have the most risks. These risks include such factors as oil spills with their resulting fines and clean-up costs as well as the uncertainty of exploration and changing political climates in countries where Exxon-Mobil has operations. Walmart has the lowest rate of return primarily due to the strong competitive nature of the retail industry. Like Walmart, Coca-Cola operates in a strong competitive market. However, Coca-Cola has a strong product identity due to the unique nature of its product, which helps it earn a slightly higher rate of return than Walmart.**

**FA1–5**

**1. Rate of Return on Total Assets = $5,325 ÷ [($43,705 + $46,630) ÷ 2]**

**= $5,325 ÷ $45,168 = 11.8%**

**2. Target’s rate of return on total assets of 11.8% is lower than Walmart’s rate of return of 14.3%. Target’s recent strategy of adding more upscale merchandise to its product lines hasn’t enabled it to earn a higher rate of return than Walmart.**

## CASES

Case 1–1

Management’s actions are ethical. Management has a responsibility to the company’s stockholders to remain competitive and profitable. Similarly, many companies have moved their production offshore to take advantage of cheaper labor. Other candymakers have already moved nonchocolate candies that do not have to be refrigerated offshore. However, management should consider the impact of its proposal on workers’ attitudes, including their motivations to innovate and be productive. Workers will be particularly upset if Hershey later decides not to invest the $30 million to modernize the plants or if future work is not forthcoming. In the latter case, it would be unethical for management to pledge modernization and future work with no intention of fulfilling its promises.

##### Case 1–2

1. Acceptable professional conduct requires that Loretta Smith supply City  
National Bank with all the relevant financial statements necessary for the bank to make an informed decision. Therefore, Loretta should provide the complete set of financial statements. These can be supplemented with a discussion of the net loss in the past year or other data explaining why granting the loan is a good investment by the bank.

2. a. Owners are generally willing to provide bankers with information about the operating and financial condition of the business, such as the following:

Operating Information:

* description of business operations
* results of past operations
* preliminary results of current operations
* plans for future operations

Financial Condition:

* list of assets and liabilities (balance sheet)
* estimated current values of assets
* stockholders’ investment in the business
* stockholders’ commitment to invest additional funds in the business

Owners are normally reluctant to provide proprietary operating information to bankers. Such information, which could hurt the business if it becomes known by competitors, might include special processes used by

**Case 1–2, Concluded**

the business or future plans to expand operations into areas that are not currently served by a competitor.

b. Bankers typically want as much information as possible about the ability of the business to repay the loan with interest. Examples of such information are described in the preceding answer.

c. Both bankers and business owners share the common interest of the business doing well and being successful. If the business is successful, the bankers will receive their loan payments on time with interest and the owners (and stockholders) will be rewarded.

Case 1–3

1. In a commodity business like poultry production, the dominant business emphasis is a low-cost emphasis. This is because customers cannot differentiate between chickens produced by different companies. The implication of a low-cost emphasis is that you would put most of your emphasis on designing and running efficient operations. In addition, you would spend significant amounts of monies in research and development activities trying to discover and develop new ways to breed and raise bigger chickens with less feed.

2. A major business risk includes the selling of contaminated chickens and the possibility that competitors will develop lower-cost methods of breeding and raising chickens. Also, a major cost of raising chickens is the cost of feed. Thus, fluctuations in feed costs such as corn can dramatically influence the profitability of chicken production. To manage feed cost risk, chicken producers enter into hedging transactions for feed that involve commodity futures and options. Finally, another major risk is that consumer tastes may change, with the result that the demand for chicken products may decrease significantly.

3. The company could try to differentiate its products by emphasizing that it raises its chickens with only “natural” feeds without the use of artificial ingredients such as steroids, etc. The company could then sell its products as the “healthy choice” products and probably use a premium-price strategy.

##### Case 1–4

The difference in the two bank balances, $175,000 ($215,000 – $40,000), may not be pure profit from an accounting perspective. To determine the accounting profit for the 8-month period, the revenues for the period would need to be matched with the related expenses. The revenues minus the expenses would indicate whether the business generated net income (profit) or a net loss for the period. Using only the difference between the two bank account balances ignores such factors as amounts due from customers (receivables), liabilities (accounts pay-able) that need to be paid for wages or other operating expenses, additional investments that Dr. Tempkin may have made in the business during the period, or dividends paid during the period.

Some businesses that have few, if any, receivables or payables may use a “cash” basis of accounting. The cash basis of accounting ignores receivables and pay-ables because they are assumed to be insignificant in amount. However, even with the cash basis of accounting, additional investments during the period and any dividends during the period have to be considered in determining the net  
income (profit) or net loss for the period.

Case 1–5

#### Note to Instructors: The purpose of this activity is to show students that the accounting equation has real world impact. By illustrating how the accounting equation applies to well-known companies, the importance of accounting and the concepts discussed in this chapter are emphasized to students.

Case 1–6

As can be seen from the balance sheet data in the case, Enron was financed largely by debt as compared to equity. Specifically, Enron’s stockholders’ equity represented only 17.5% ($11,470 ÷ $65,503) of Enron’s total assets. The remainder of Enron’s total assets, 82.5%, was financed by debt. When a company is financed largely by debt, it is said to be highly leveraged.

In late 2001 and early 2002, allegations arose as to possible misstatements of  
Enron’s financial statements. These allegations revolved around the use of “special purpose entities” (partnerships) and related party transactions. The use of special purpose entities allowed Enron to hide a significant amount of additional debt off its balance sheet. The result was that Enron’s total assets were even more financed by debt than the balance sheet indicated.

After the allegations of misstatements became public, Enron’s stock rapidly declined and the company filed for bankruptcy. Subsequently, numerous lawsuits were filed against the company and its management. In addition, the Securities and Exchange Commission, the Justice Department, and Congress launched investigations into Enron. As a result, several of Enron’s top executives were criminally prosecuted and were sentenced to prison.

*Note to Instructors:* The role of the auditors and board of directors of Enron also might be discussed. These topics are not covered in Chapter 1 but will be covered in later chapters.