Chapter 1

The Financial Statements

Short Exercises

(5 min.) S 1-1

Computed amounts in boxes

	Total Assets	=	Total Liabilities	+	Stockholders' Equity
a.	$\boxed{\$340,000}$	=	$130,000	+	$210,000
b.	250,000	=	70,000	+	$\boxed{180,000}$
c.	190,000	=	$\boxed{110,000}$	+	80,000

(5 min.) S 1-2

Ethics is a factor that should be included in every business and accounting decision, beyond the potential economic and legal consequences. Ideally, for each decision, honesty and truthfulness should prevail, considering the rights of others. The decision guidelines at the end of the chapter spell out the considerations we should take when making decisions. Simply, we might ask ourselves three questions: (1) is the

action legal? (2) Who will be affected by the decision? (3) How will the decision make me feel afterward?

(10 min.) S 1-3

a. ***Corporation, Limited-liability partnership (LLP) and Limited-liability company (LLC).*** **If any of these businesses fails and cannot pay its liabilities, creditors cannot force the owners to pay the business's debts from the owners' personal assets.**

b. ***Proprietorship*. There is a single owner of the business, so the owner is answerable to no other owner.**

c. ***Partnership*. If the partnership fails and cannot pay its liabilities, creditors can force the partners to pay the business's debts from their personal assets. A partnership affords more protection for creditors than a proprietorship because there are two or more owners to share this liability.**

(5 min.) S 1-4

1. **The *entity assumption* applies.**
2. **Application of the entity assumption will separate Newman's personal assets from the assets of Quality Food Brands. This will help Newman, investors, and lenders know how much in assets the business controls, and this knowledge will help all parties evaluate the business realistically.**

(5-10 min.) S 1-5

a. Historical cost principle

b. Stable-monetary-unit assumption

c. Entity assumption

d. Historical cost principle

(5 min.) S 1-6

1. Owners' Equity = Assets − Liabilities

   This way of determining the amount of owners' equity applies to any company, your household, or a single Denny's restaurant.

2. Liabilities = Assets − Owners' Equity

(5 min.) S 1-7

1. ***Assets*** **are the *economic resources* of a business that are expected to produce a benefit in the future.**

   Owners' equity **represents the *insider claims* of a business, the owners' interest in its assets.**

   Assets and owners' equity *differ* in that assets are *resources* and owners' equity is a *claim to assets*.

   Assets must be at least as large as owners' equity, so equity can be smaller than assets.

2. **Both liabilities and owners' equity are *claims to assets*.**

   Liabilities are the *outsider* claims to the assets of a business; they are obligations to pay creditors.

   Owners' equity represents the *insider* claims to the assets of the business; they are the owners' interest in its assets.

(5-10 min.) S 1-8

a. Accounts payable L

b. Common stock S

c. Supplies A

d. Retained earnings S

e. Land A

f. Prepaid expenses A

g. Accounts receivable A

h. Long-term debt L

i. Merchandise inventory A

j. Notes payable L

k. Expenses payable L

l. Equipment A

(5 min.) S 1-9

1. *Revenues* and *expenses*
2. Net income (or net loss)

(5 min.) S 1-10

Call Anywhere Wireless, Inc.
Income Statement
Year Ended December 31, 2010

	Millions
Revenues……………………………………..	$ 94
Expenses…………………………………….	23
Net income…………………………………..	$ 71

(5 min.) S 1-11

Roam Corp.
Statement of Retained Earnings
Year Ended December 31, 2010

	Millions
Retained earnings:	
Balance, December 31, 2009………..	$210
Net income ($380 − $250)…………	130
Less: Dividends………………………..	(43)
Balance, December 31, 2010…………	$297

(10 min.) S 1-12

Tommer Products
Balance Sheet
December 31, 2010

ASSETS	
Current assets:	
Cash……	$ 12,000
Receivables……	5,000
Inventory……	42,000
Total current assets……	59,000
Equipment……	82,000
Total assets……	$141,000
LIABILITIES	
Current liabilities:	
Accounts payable……	$ 17,000
Total current liabilities……	17,000
Long-term liabilities:	
Long-term notes payable……	78,000
Total liabilities……	$95,000
STOCKHOLDERS' EQUITY	
Common stock……	14,800
Retained earnings……	31,200*
Total stockholders' equity……	46,000
Total liabilities and stockholders' equity……	$141,000

______

*Computation of retained earnings:
Total assets ($141,000) − current liabilities ($17,000) − long-term notes payable ($78,000) − common stock ($14,800) = $31,200

(10-15 min.) **S 1-13**

Lanos Medical, Inc.
Statement of Cash Flows
Year Ended December 31, 2010

Cash flows from operating activities:		
Net income………………………………………...		$ 95,000
Adjustments to reconcile net income to net cash provided by operating activities….		(20,000)
Net cash provided by operating activities..		75,000
Cash flows from investing activities:		
Purchases of equipment…………	$(35,000)	
Net cash used for investing activities……..		(35,000)
Cash flows from financing activities:		
Payment of dividends…………….	$(15,000)	
Net cash used for financing activities…….		(15,000)
Net increase in cash………………………………..		25,000
Cash balance, December 31, 2009……………….		25,000
Cash balance, December 31, 2010……………….		$ 50,000

(10 min.) S 1-14

a. Dividends SRE, SCF

b. Salary expense IS

c. Inventory BS

d. Sales revenue IS

e. Retained earnings SRE, BS

f. Net cash provided by operating activities SCF

g. Net income IS, SRE, SCF

h. Cash BS, SCF

i. Net cash used for financing activities SCF

j. Accounts payable BS

k. Common stock BS

l. Interest revenue IS

m. Long-term debt BS

n. Increase or decrease in cash SCF

(15-20 min.) S1-15

a. ***Paying large dividends*** **will cause retained earnings to be low.**

b. **Heavy *investing activity* and *paying off debts* can result in a cash shortage even if net income has been high.**

c. **The single best source of cash for a business is operating activities — *net income and the related cash receipts.* This source of cash is best because it results from the core operations of the business.**

d. ***Borrowing, issuing stock, and selling*** **land, buildings, and equipment can bring in cash even when the company has experienced losses. Reducing accounts receivable and inventory can also increase cash flow.**

Exercises

Group A

(10-15 min.) E 1-16A

Amounts in billions; computed amounts in boxes)

	Assets	=	Liabilities	+	Owners' Equity
Fresh Produce	$\boxed{\$26}$		$ 9		$17
Hudson Bank	29		$\boxed{14}$		15
Pet Lovers	21		10		$\boxed{11}$

Fresh Produce appears to have the strongest financial position because Fresh Produce's liabilities make up the smallest percentage of company assets ($9/$26 = .35). Stated differently, Fresh Produce's equity is the highest percentage of company assets ($17 / $26 = .65).

(10-15 min.) E 1-17A

Req. 1

(Amounts in millions)

	Assets	=	Liabilities	+	Stockholders' Equity
	$290		$150		
	490		310		
	150				
Total	$930	=	$460	+	$470

Req. 2	Resources to work with	*Req. 3*	Amount owed to creditors	*Req. 4*	Actually owned by company stockholders

10-20 min.) E 1-18A

	Situation		
	1	2	3
	Millions		
Total stockholders' equity,			
January 31, 2010 ($31 − $9)…………	$22	$22	$22
Add: Issuances of stock………………..	11	-0-	55
Net income……………………….	0	18*	
Less: Dividends…………………………...	-0-	(11)	(32)
Net loss…………………………….	(4)*		(16)*
Total stockholders' equity,			
January 31, 2011 ($39 − $10)…………	$29	$29	$29

*Must solve for these amounts.

(10-15 min.) E 1-19A

1. Clay, Inc.

	Assets	=	Liabilities	+	Stockholders' Equity
Beginning amount	$130,000	=	$50,000	+	$80,000
Multiplier for increase	× 1.35				
Ending amount	$175,500				

2. EastWest Airlines, Inc.

	Assets	−	Liabilities	=	Stockholders' Equity
Beginning amount	$100,000	−	$7,000	=	$93,000
Net income					25,000
Ending amount					$118,000

(10-15 min.) E 1-20A

a. Balance sheet

b. Balance sheet

c. Statement of retained earnings, Statement of cash flows

d. Income statement

e. Balance sheet, Statement of retained earnings

f. Balance sheet

g. Balance sheet

h. Income statement

i. Statement of cash flows

j. Income statement

k. Statement of cash flows

l. Balance sheet, Statement of cash flows

m. Balance sheet

n. Income statement, Statement of retained earnings, Statement of cash flows

(10-20 min.) E 1-21A

Ellen Samuel Banking Company
Balance Sheet (*Amounts in millions*)
January 31, 2010

ASSETS		LIABILITIES	
Cash	$ 2.1	Current liabilities	$151.1
Receivables	0.9	Long-term liabilities	2.8
Investment assets	169.6	Total liabilities	153.9
Property and equipment, net	1.9		
Other assets	14.4	STOCKHOLDERS' EQUITY	
		Common stock	14.0
		Retained earnings	21.0*
		Total stockholders' equity	35.0
Total assets	$188.9	Total liabilities and stockholders' equity	$188.9

*Computation of retained earnings:
Total assets ($188.9) − Total liabilities ($153.9) − Common stock ($14.0) = $21.0

(15-25 min.) E 1-22A

Req. 1

Ellen Samuel Banking Company
Income Statement (*Amounts in millions*)
Year Ended January 31, 2010

Total revenue……………………………………….		**$37.8**
Expenses:		
Interest expense……………………………….	**$ 0.8**	
Salary and other employee expenses………	**17.7**	
Other expenses…………………………………	**6.9**	
Total expenses…………………………………		**25.4**
Net income……………………………………………		**$12.4**

Req. 2

The statement of retained earnings helps to compute dividends, as follows:

Statement of Retained Earnings (*Amounts in millions*)

Retained earnings, beginning of year…………………	**$8.6**
Add: Net income for the year (*Req. 1*)…………………	**12.4**
	21.0
Less: Dividends…………………………………………...	**0.0**
Retained earnings, end of year (from Exercise 1-21A)….	**$21.0**

(15-20 min.) E 1-23A

Lucky, Inc.
Statement of Cash Flows
Year Ended December 31, 2010

Cash flows from operating activities:		
Net income……………………………………..	**$410,000**	
Adjustments to reconcile net income to net cash provided by operating activities..	**70,000**	
Net cash provided by operating activities……..		**$480,000**
Cash flows from investing activities:		
Net cash used for investing activities…………..		**(420,000)**
Cash flows from financing activities:		
Net cash provided by financing activities……..		**72,000**
Net increase in cash………………………………………...		**132,000**
Beginning cash balance……………………………………		**87,000**
Ending cash balance………………………………………..		**$219,000**

Items given that do not appear on the statement of cash flows:

Total assets − Balance sheet
Total liabilities − Balance sheet

(15-20 min.) **E 1-24A**

EARL COPY CENTER, INC. INCOME STATEMENT MONTH ENDED JULY 31, 2010		
Revenue:		
Service revenue……………		$543,200
Expenses:		
Salary expense………………	$167,000	
Rent expense…………………	2,200	
Utilities expense…………….	10,000	
Total expenses………………		179,200
Net income………………………		$ 364,000

EARLCOPY CENTER, INC. STATEMENT OF RETAINED EARNINGS MONTH ENDED JULY 31, 2010	
Retained earnings, July 1, 2010……	$ -0-
Add: Net income for the month……….	364,000
	364,000
Less: Dividends………………………….	(4,800)
Retained earnings, July 31, 2010…….	$359,200

(15-20 min.) E 1-25A

EARL COPY CENTER, INC. BALANCE SHEET JULY 31, 2010			
Assets		**Liabilities**	
Cash…………	$ 10,900	Accounts payable………	$ 17,000
Office supplies	14,800		
Equipment……	420,000	**Stockholders' Equity**	
		Common stock……………	69,500
		Retained earnings………	359,200
		Total stockholders' equity	428,700
Total assets….	$445,700	Total liabilities and stockholders' equity……	$445,700

(15-20 min.) **E 1-26A**

EARL COPY CENTER, INC. STATEMENT OF CASH FLOWS MONTH ENDED JULY 31, 2010		
Cash flows from operating activities:		
Net income……………………………………….		$ 364,000
Adjustments to reconcile net income		
to net cash provided by operations…………		2,200
Net cash provided by operating activities		366,200
Cash flows from investing activities:		
Acquisition of equipment……………………	$(420,000)	
Net cash used for investing activities…		(420,000)
Cash flows from financing activities:		
Issuance (sale) of stock to owners……………	$ 69,500	
Payment of dividends…………………………….	(4,800)	
Net cash provided by financing activities.		64,700
Net increase in cash………………………………		$ 10,900
Cash balance, July 1, 2010…………………….		0
Cash balance, July 31, 2010…………………….		$ 10,900

(10-15 min.) E 1-27A

TO: Owner of Earl Copy Center, Inc.

FROM: Student Name

SUBJECT: Opinion of net income, dividends, financial position, and cash flows

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Your first month of operations was successful. Revenues totaled $543,200 and net income was $364,000. These operating results look very strong.

The company was able to pay a $4,800 dividend, and this should make you happy with so quick a return on your investment.

Your financial position looks secure, with assets of $445,700 and liabilities of only $17,000. Your stockholders' equity is $428,700.

Operating activities generated cash of $366,200, which is respectable. You ended the month with cash of $10,900. Based on the above facts, I believe you should stay in business.

Student responses may vary.

Exercises

Group B

(10-15 min.) E 1-28B

Amounts in billions; computed amounts in boxes)

	Assets	=	Liabilities	+	Owners' Equity
DJ Video Rentals	$\boxed{\$26}$		$ 8		$18
Ernie's Bank	34		$\boxed{\$20}$		14
Hudson Gift & Cards	20		12		$\boxed{\$8}$

DJ Video Rentals appears to have the strongest financial position because DJ Video Rental's liabilities make up the smallest percentage of company assets ($8/$26 = .31). Stated differently, DJ Video Rental's equity is the highest percentage of company assets ($18 / $26 = .69).

(10-15 min.) E 1-29B

Req. 1

(Amounts in millions)

	Assets	=	Liabilities	+	Stockholders' Equity
	$270		$110		
	470		370		
	110				
Total	$850	=	$480	+	$370

Req. 2	Resources to work with	*Req. 3*	Amount owed to creditors	*Req. 4*	Actually owned by company stockholders

10-20 min.) E 1-30B

	Situation 1	Situation 2	Situation 3
	Millions		
Total stockholders' equity, January 31, 2010 ($24 − $1)………….	$23	$23	$23
Add: Issuances of stock………………..	15	-0-	90
Net income………………………….	0	15*	
Less: Dividends…………………………...	-0-	(11)	(35)
Net loss……………………………..	(11)*		(51)*
Total stockholders' equity, January 31, 2011 ($38 − $11)………….	$27	$27	$27

*Must solve for these amounts.

(10-15 min.) E 1-31B

1. Saphire, Inc.

	Assets	=	Liabilities	+	Stockholders' Equity
Beginning amount	$125,000	=	$90,000	+	$35,000
Multiplier for increase	× 1.30				
Ending amount	$162,500				

2. Southbound Airlines, Inc.

	Assets	−	Liabilities	=	Stockholders' Equity
Beginning amount	$95,000	−	$47,000	=	$48,000
Net income					26,000
Ending amount					$74,000

(10-15 min.) E 1-32B

a. Income statement

b. Income statement, Statement of retained earnings, Statement of cash flows

c. Balance sheet

d. Balance sheet

e. Balance sheet

f. Balance sheet, Statement of retained earnings

g. Income statement

h. Balance sheet, Statement of cash flows

i. Statement of retained earnings, Statement of cash flows

j. Balance sheet

k. Balance sheet

l. Income statement

m. Statement of cash flows

n. Statement of cash flows

(10-20 min.) E 1-33B

Eliza Bennet Banking Company
Balance Sheet (*Amounts in millions*)
May 31, 2010

ASSETS		LIABILITIES	
Cash	$ 2.7	Current liabilities	$155.1
Receivables	0.2	Long-term liabilities	2.3
Investment assets	169.8	Total liabilities	157.4
Property and equipment, net	1.6		
Other assets	14.9	**STOCKHOLDERS' EQUITY**	
		Common stock	14.9
		Retained earnings	16.9
		Total stockholders' equity	31.8
Total assets	$189.2	Total liabilities and stockholders' equity	$189.2

*Computation of retained earnings:
Total assets ($189.2) − Total liabilities ($157.4) − Common stock ($14.9) = $16.9

Req. 1

Eliza Bennet Banking Company
Income Statement (*Amounts in millions*)
Year Ended May 31, 2010

Total revenue……………………………………….		**$33.5**
Expenses:		
Interest expense………………………………..	**$ 0.4**	
Salary and other employee expenses………	**17.5**	
Other expenses…………………………………	**6.6**	
Total expenses…………………………………		**24.5**
Net income…………………………………………….		**$ 9.0**

Req. 2

The statement of retained earnings helps to compute dividends, as follows:

Statement of Retained Earnings (*Amounts in millions*)

Retained earnings, beginning of year…………………	**$8.6**
Add: Net income for the year (*Req. 1*)…………………	**9.0**
	17.6
Less: Dividends…………………………………………...	**0.7**
Retained earnings, end of year (from Exercise 1-33B)….	**$16.9**

(15-20 min.) E 1-35B

Fortune, Inc.
Statement of Cash Flows
Year Ended December 31, 2010

Cash flows from operating activities:		
Net income……………………………………..	$440,000	
Adjustments to reconcile net income to		
net cash provided by operating activities..	60,000	
Net cash provided by operating activities……..		$500,000
Cash flows from investing activities:		
Net cash used for investing activities…………..		(390,000)
Cash flows from financing activities:		
Net cash provided by financing activities……..		65,000
Net increase in cash………………………………………...		175,000
Beginning cash balance……………………………………		83,000
Ending cash balance………………………………………..		$258,000

Items given that do not appear on the statement of cash flows:

Total assets	− Balance sheet
Total liabilities	− Balance sheet

(15-20 min.) E 1-36B

CARSON COPY CENTER, INC. INCOME STATEMENT MONTH ENDED JULY 31, 2011		
Revenue:		
Service revenue……………		$542,200
Expenses:		
Salary expense………………	$162,000	
Rent expense…………………	2,900	
Utilities expense…………….	10,800	
Total expenses………………		175,700
Net income………………………		$ 366,500

CARSON COPY CENTER, INC. STATEMENT OF RETAINED EARNINGS MONTH ENDED JULY 31, 2011	
Retained earnings, July 1, 2011……	$ -0-
Add: Net income for the month……….	366,500
	366,500
Less: Dividends………………………….	(4,100)
Retained earnings, July 31, 2011…….	$362,400

(15-20 min.) E 1-37B

CARSON COPY CENTER, INC. BALANCE SHEET JULY 31, 2011			
Assets		**Liabilities**	
Cash…………	$ 9,500	Accounts payable………	$ 17,900
Office supplies	15,000		
Equipment……	410,000	**Stockholders' Equity**	
		Common stock……………	54,200
		Retained earnings………	362,400
		Total stockholders' equity	416,600
Total assets….	$434,500	Total liabilities and stockholders' equity……	$434,500

(15-20 min.) E 1-38B

CARSON COPY CENTER, INC.
STATEMENT OF CASH FLOWS
MONTH ENDED JULY 31, 2011

Cash flows from operating activities:		
Net income……………………………………		**366,500**
Adjustments to reconcile net income to net cash provided by operations…………		**2,900**
Net cash provided by operating activities		**369,400**
Cash flows from investing activities:		
Acquisition of equipment……………………	**$(410,000)**	
Net cash used for investing activities…		**(410,000)**
Cash flows from financing activities:		
Issuance (sale) of stock to owners……………	**$ 54,200**	
Payment of dividends……………………………	**(4,100)**	
Net cash provided by financing activities.		**50,100**
Net increase in cash……………………………		**$ 9,500**
Cash balance, July 1, 2011…………………….		**0**
Cash balance, July 31, 2011…………………….		**$ 9,500**

(10-15 min.) E 1-39B

TO: Owner of Carson Copy Center, Inc.

FROM: Student Name

SUBJECT: Opinion of net income, dividends, financial position, and cash flows

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Your first month of operations was successful. Revenues totaled $542,200 and net income was $366,500. These operating results look very strong.

The company was able to pay a $4,100 dividend, and this should make you happy with so quick a return on your investment.

Your financial position looks secure, with assets of $434,500 and liabilities of only $17,900. Your stockholders' equity is $416,600.

Operating activities generated cash of $369,400, which is respectable. You ended the month with cash of $9,500. Based on the above facts, I believe you should stay in business.

Student responses may vary.

Quiz

Q1-40 a
Q1-41 c
Q1-42 a
Q1-43 a

Assets	=	Liabilities	+	Stockholders' Equity
+ $19,000	=	+ $6,000		$\boxed{\text{+ \$13,000}}$

Q1-44 b
Q1-45 b
Q1-46 c
Q1-47 b
Q1-48 a
Q1-49 c ($135,000 − $57,000 − $11,000 − $4,000 = $63,000)
Q1-50 c ($155,000 + $100,000 − $25,000 = $230,000)
Q1-51 d
Q1-52 b
Q1-53 d

	Assets	=	Liabilities	+	Stockholders' Equity
Begin.	$27,000	=	$12,000*	+	$15,000
Changes			+ 9,000		
End.	$41,000*	=	$21,000*	+	$20,000

*Must solve for these amounts.

Q1-54 a

	Total stockholders' equity	
Begin. bal.	$510,000 − $190,000 = $320,000	
+ Net income	X	= $185,000
− Dividends	− 55,000	
End. bal.	$740,000 − $290,000 = $450,000	

Problems

Group A

(15-30 min.) P 1-55A

Req. 1

A Division of Smith Corporation
Income Statement
Year Ended December 31, 2011

Service revenue……………………………..	$252,000	
Other revenue………………………………..	52,000	
Total revenue………………………………...		$304,000
Salary expense………………………………	$ 21,000	
Other expenses……………………………..	247,000	
Total operating expenses……………….		268,000
Income before income tax………………		36,000
Income tax expense ($36,000 × .35)…...		12,600
Net income…………………………………...		$ 23,400

Req. 2

a. Faithful representation. Report revenues at their actual sale value because that amount represents more faithfully what actually happened than what management believes the services are worth.

b. Historical cost principle. Account for expenses at their actual cost, not a hypothetical amount that the company might have incurred under other conditions.

c. Historical cost principle. Account for expenses at their actual cost.

d. Entity assumption. Each subdivision of the company is a separate entity, and the company as a whole constitutes an entity for accounting purposes.

e. Stable-monetary-unit assumption. Accounting in the United States ignores the effect of inflation.

f. Continuity (going-concern) assumption. There is no evidence that A Division of Smith Corporation is going out of business, so it seems safe to assume that the division is a going concern.

(30 min.) **P 1-56A**

Req. 1

Computed amounts in boxes

	Sapphire	Lance	Branch
		Millions	
Balance sheets:			
***Beginning*:**			
Assets………………………..	$ 83	$ 35	$ $\boxed{7}$
Liabilities……………………..	47	23	2
Common stock……………...	2	2	1
Retained earnings…………	$\boxed{34}$	10	4
***Ending*:**			
Assets………………………..	$ $\boxed{84}$	$ 54	$ 8
Liabilities……………………..	49	34	$\boxed{3}$
Common stock……………...	2	$\boxed{2}$	1
Retained earnings…………	33	$\boxed{18}$	$\boxed{4}$
***Income statement*:**			
Revenues……………………	$221	$ $\boxed{162}$	$18
Expenses……………………	213	152	$\boxed{15}$
Net income…………………..	$ $\boxed{8}$	$ $\boxed{10}$	$\boxed{3}$
Statement of retained earnings:			
Beginning RE………………..	$ 34	$ 10	$ 4
+ Net income…………………..	$\boxed{8}$	10	3
− Dividends……………………	(9)	(2)	(3)
= Ending RE……………………	$ 33	$ 18	$ 4

Req. 2

	Sapphire	Lance	Branch
		Millions	
Net income…………	$8	$10 *Highest*	$3
% of net income to revenues………	$\frac{\$8}{\$221}$ = 3.6%	$\frac{\$10}{\$162}$ = 6.2%	$\frac{\$3}{\$18}$ = 17% *Highest*

(20-25 min.) P 1-57A

Req. 1

Headlines, Inc.
Balance Sheet
June 30, 2010

ASSETS		LIABILITIES	
Cash	$ 8,000	Accounts payable	$ 5,000
Accounts receivable	2,600	Note payable	55,500
Notes receivable	13,000	Total liabilities	60,500
Office supplies	1,000	STOCKHOLDERS' EQUITY	
Equipment	39,500		
Land	77,000	Stockholders' equity	80,600*
Total assets	$141,100	Total liabilities and stockholders' equity	$141,100

***Total assets ($141,100) − Total liabilities ($60,500) = Stockholders' equity ($80,600).**

Req. 2

Headlines, Inc. is in *better* financial position than the erroneous balance sheet reports. Liabilities are less, and assets and equity are greater than reported originally.

Req. 3

The following accounts are not reported on the balance sheet because they are expenses. Expenses are reported on the *income statement*.

Utilities expense
Advertising expense
Salary expense
Interest expense

(20-25 min.) P 1-58A

Req. 1

Sandy Healey, Realtor, Inc.
Balance Sheet
April 30, 2011

ASSETS		LIABILITIES	
Cash	$ 71,000	Accounts payable	$ 33,000
Office supplies	11,000	Note payable	36,000
Franchise	24,000	Total liabilities	69,000
Furniture	41,000	STOCKHOLDERS' EQUITY	
Land	110,000		
		Common stock	95,000
		Retained earnings	93,000*
		Total stockholders' equity	188,000
Total assets	$257,000	Total liabilities and stockholders' equity	$257,000

*Total assets ($257,000) − Total liabilities ($69,000) − Common stock ($95,000) = Retained earnings ($93,000).

Req. 2

It appears that Sandy Healy's business can pay its debts. Total assets far exceed total liabilities.

Req. 3

Personal items not reported on the *balance sheet* of the business:

a. Personal cash ($16,000)
e. Personal residence ($340,000) and mortgage payable ($65,000)
f. Personal account payable ($1,000)

(30-45 min.) P 1-59A

Req. 1

Post Maple, Inc.
Income Statement
Year Ended December 31, 2010

Revenue		
Service revenue………………..		$145,000
Expenses		
Salary expense………………...	$34,000	
Rent expense…………………..	14,000	
Interest expense……………….	4,200	
Utilities expense……………….	3,000	
Property tax expense…………	1,900	
Total expenses…………………		57,100
Net income………………………...		$ 87,900

Req. 2

Post Maple, Inc.
Statement of Retained Earnings
Year Ended December 31, 2010

Retained earnings, December 31, 2009…		$117,000
Add:	Net income for the year…………..	87,900
		204,900
Less:	Dividends…………………………...	(38,000)
Retained earnings, December 31, 2010…		$166,900

Req. 3

Post Maple, Inc.
Balance Sheet
December 31, 2010

ASSETS		LIABILITIES	
Cash	$ 15,000	Accounts payable	$ 11,000
Accounts receivable	24,000	Interest payable	1,200
Supplies	2,200	Note payable	28,000
Equipment	33,000	Total liabilities	40,200
Building	126,000	STOCKHOLDERS' EQUITY	
Land	8,200		
		Common stock	1,300
		Retained earnings	166,900
		Total stockholders' equity	168,200
Total assets	$208,400	Total liabilities and stockholders' equity	$208,400

Req. 4

a. **Post Oak was profitable; net income was $87,900.**

b. **Retained earnings increased by $49,900 — from $117,000 to $166,900.**

c. **Total equity ($168,200) exceeds total liabilities ($40,200).**

Therefore, the stockholders own more of the company's assets than do the creditors.

(20 min.) P 1-60A

Req. 1

The Water Sport Company
Statement of Cash Flows
Year Ended May 31, 2011

		Millions
Cash flows from operating activities:		
Net income……………………………………		$ 3,030
Adjustments to reconcile net income to cash provided by operations…………….		2,370
Net cash provided by operating activities..		5,400
Cash flows from investing activities:		
Purchases of property, plant, and equipment.	$(3,515)	
Sales of property, plant, and equipment……..	30	
Other investing cash payments………………..	(180)	
Net cash used for investing activities……..		(3,665)
Cash flows from financing activities:		
Issuance of common stock……………………..	$ 170	
Payment of dividends…………………………..	(290)	
Net cash used for financing activities……..		(120)
Net increase in cash………………………………		1,615
Cash, beginning……………………………………		275
Cash, ending………………………………………		$ 1,890

Req. 2

Operating activities provided the bulk of The Water Sport Company's cash. This is a sign of strength because operations should be the main source of cash.

(40-50 min.) P 1-61A

		2010	2009	
		(Thousands)		
INCOME STATEMENT				
Income revenues	13,830 =	$ k	$15,750	
Cost of goods sold		(11,030)	(a)	= (12,750)
Other expenses		(1,220)	(1,170)	
Income before income taxes		1,580	1,830	
Income taxes (35% tax rate)	553 =	(f)	641	
Net income	1,027 =	$ m	$ b	= 1,189
STATEMENT OF RETAINED EARNINGS				
Beginning balance	3,729 =	$ n	$ 2,660	
Net income	1,027 =	o	c	= 1,189
Dividends		(98)	(120)	
Ending balance	4,658 =	$ p	$ d	= 3,729
BALANCE SHEET				
Assets:				
Cash	1,240 =	$ q	$ e	= 1,330
Property, plant and equipment		1,600	1,725	
Other assets	11,558 =	r	10,184	
Total assets	14,398 =	$ s	$13,239	
Liabilities:				
Current liabilities	4,950 =	$ t	$ 5,650	
Notes payable and long-term debt		4,350	3,380	
Other liabilities		50	70	
Total liabilities		9,350	f	= 9,100
Shareholders' Equity:				
Common stock		$ 250	$ 250	
Retained earnings	4,658 =	u	g	= 3,729
Other shareholders' equity		140	160	
Total shareholders' equity	5,048 =	v	4,139	
Total liabilities and shareholders' equity	14,398 =	$ w	$ h	= 13,239
STATEMENT OF CASH FLOWS				
Net cash provided by operating activities	700 =	$ x	$ 950	
Net cash provided by investing activities		(230)	(300)	
Net cash used for financing activities		(560)	(540)	
Increase (decrease) in cash		(90)	(i)	= 110
Cash at beginning of year	1,330 =	y	1,195	
Cash at end of year	1,240 =	$ z	$ j	= 1,330

Problems

Group B

(15-20 min.) P 1-62B

Req. 1

Perez Corporation
Income Statement
Year Ended December 31, 2011

		Thousands
Sales revenue………………………..	$ 263	
Other revenue………………………..	55	
Total revenue………………………...		$ 318
Salaries………………………………..	24	
Other expenses……………………...	235	
Total expenses………………………		259
Income before income tax…………		59
Income tax expense ($59 × .33)…...		19
Net income……………………………		$ 40

Req. 2

a. Faithful representation principle. Report revenues at their actual sale value because that represents more faithfully what happened than what management believes the goods are worth.

b. Historical cost principle. Account for expenses at their actual cost, not a hypothetical amount that the company might have incurred if the products were purchased outside.

c. Historical cost principle. Account for expenses at their actual cost.

d. Entity assumption. Each division of the company is a separate entity, and the company as a whole constitutes an entity for accounting purposes.

e. Stable-monetary-unit assumption. Accounting in the United States ignores the effect of inflation.

f. Continuity (going concern) assumption. There is no evidence that ABM is going out of business, so it seems safe to assume that the company is a going concern.

(30 min.) **P 1-63B**

Req. 1

Computed amounts in boxes.

	Diamond	Lally	Bryant
		Millions	
Balance sheets:			
***Beginning*:**			
Assets………………………...	$82	$ 25	$ $\boxed{8}$
Liabilities…………………….	48	21	5
Common stock……………...	3	2	1
Retained earnings…………	$\boxed{31}$	2	2
***Ending*:**			
Assets………………………...	$ $\boxed{83}$	$ 43	$ 10
Liabilities…………………….	50	34	$\boxed{6}$
Common stock……………...	3	$\boxed{2}$	1
Retained earnings…………	30	$\boxed{7}$	$\boxed{3}$
***Income statement*:**			
Revenues…………………….	$223	$ $\boxed{166}$	$ 26
Expenses…………………….	215	159	$\boxed{22}$
Net income…………………..	$ $\boxed{8}$	$ $\boxed{7}$	$\boxed{4}$
Statement of retained earnings:			
Beginning RE………………	$ 31	$ 2	$ 2
+ Net income…………………..	$\boxed{8}$	7	4
− Dividends…………………….	(9)	(2)	$\boxed{(3)}$
= Ending RE……………………	$30	$ 7	$ 3

((20-25 min.) **P 1-64B**

Req. 1

News Maker, Inc.
Balance Sheet
November 30, 2010

ASSETS		LIABILITIES	
Cash	$7,500	Accounts payable	$ 4,000
Accounts receivable	3,400	Note payable	55,000
Notes receivable	14,500	Total liabilities	59,000
Office supplies	900	STOCKHOLDERS' EQUITY	
Equipment	39,000		
Land	82,000	Stockholders' equity	88,300*
		Total liabilities and	
Total assets	$147,300	stockholders' equity	$147,300

***Total assets ($147,300) − Total liabilities ($59,000) = Stockholders' equity ($88,300).**

Req. 2

News Maker, Inc. is in *better* financial position than the erroneous balance sheet reports. Assets are higher than reported, but liabilities are somewhat lower, and owners' equity is higher than reported originally. Overall, News Maker has less debt and more equity than first reported.

Req. 3

The following accounts are not reported on the balance sheet because they are revenues or expenses. These accounts are reported on the *income statement*.

Advertising expense
Utilities expense
Salary expense
Interest expense

(20-25 min.) P 1-65B

Req. 1

Jeana Hart, Realtor, Inc.
Balance Sheet
September 30, 2011

ASSETS		LIABILITIES	
Cash	$ 70,000	Accounts payable	$ 31,000
Office supplies	7,000	Note payable	36,000
Franchise	29,000	Total liabilities	67,000
Furniture	45,000	STOCKHOLDERS'	
Land	116,000	EQUITY	
		Common stock	95,000
		Retained earnings	105,000*
		Total stockholders' equity	200,000
		Total liabilities and	
Total assets	$267,000	stockholders' equity	$267,000

*Total assets ($267,000) − Total liabilities ($67,000) − Common stock ($95,000) = $105,000.

Req. 2

It appears that the business can pay its debts. Total assets far exceed total liabilities.

Req. 3

Personal items not reported on the *balance sheet* of the business:
a. Personal cash ($15,000)
b. Personal account payable ($2,000)
g. Personal residence ($360,000) and mortgage payable ($140,000)

(30-45 min.) P 1-66B

Req. 1

Post Shrub
Income Statement
Year Ended December 31, 2011

Revenue		
Service revenue…………………		**$144,000**
Expenses		
Salary expense…………………	**$38,000**	
Rent expense……………………	**13,500**	
Utilities expense……………..…	**3,200**	
Interest expense………………...	**4,950**	
Property tax expense…………..	**1,900**	
Total expenses…………………..		**61,550**
Net income…………………………		**$ 82,450**

Req. 2

Post Shrub
Statement of Retained Earnings
Year Ended December 31, 2011

Retained earnings, December 31, 2010……..	**112,000**
Add: Net income for the year……………	**82,450**
	194,450
Less: Dividends…………………………….	**(42,000)**
Retained earnings, December 31, 2011…	**$ 152,450**

Req. 3

Post Shrub Corporation
Balance Sheet
December 31, 2011

ASSETS		LIABILITIES	
Cash	$ 15,000	Accounts payable	$ 14,000
Accounts receivable	26,000	Note payable	33,000
Supplies	2,000	Interest payable	1,100
Equipment	36,000	Total liabilities	48,100
Building	129,000	STOCKHOLDERS' EQUITY	
Land	9,000		
		Common stock	16,450
		Retained earnings	152,450
		Total stockholders' equity	168,900
Total assets	$217,000	Total liabilities and stockholders' equity	$217,000

Req. 4

a. Post Shrub was profitable; net income was $82,450.

b. Retained earnings increased by $40,450 — from $112,000 to $152,450.

c. Stockholders' equity ($168,900) exceeds liabilities ($48,100).

The stockholders own more of Post Shrub's assets than do the company's creditors.

(20 min.) **P 1-67B**

Req. 1

High Tide Company
Statement of Cash Flows
Year Ended May 31, 2011

		Millions
Cash flows from operating activities:		
Net income……………………………………		$ 3,030
Adjustments to reconcile net income		
to cash provided by operations…………….		2,390
Net cash provided by operating activities..		5,420
Cash flows from investing activities:		
Purchases of property, plant, and equipment.	$(3,480)	
Sales of property, plant, and equipment……..	25	
Other investing cash payments………………..	(170)	
Net cash used for investing activities……..		(3,625)
Cash flows from financing activities:		
Issuance of common stock……………………..	$ 190	
Payment of dividends……………………………	(285)	
Net cash provided by financing activities…		(95)
Net increase in cash…………………………………		$ 1,700
Cash, beginning………………………………………		200
Cash, ending…………………………………………		$ 1,900

Req. 2

Operating activities provided the largest amount of cash. This signals financial strength because operations should be the main source of cash.

(40-50 min.) P 1-68B

			2011	2010		
INCOME STATEMENT						
Revenues	$13,830	=	$ k	$15,250		
Cost of goods sold			(11,070)	(a)	=	(12,190)
Other expenses			(1,260)	(1,230)		
Income before income taxes			1,500	1,830		
Income taxes (35% tax rate	525	=	(l)	(641)		
Net income	975	=	$ m	$ b	=	1,189
STATEMENT OF RETAINED EARNINGS						
Beginning balance	3,769	=	$ n	$ 2,720		
Net income	975	=	o	c	=	1,189
Dividends			(84)	(140)		
Ending balance	4,660	=	$ p	$ d	=	3,769
BALANCE SHEET						
Assets:						
Cash	1,175	=	$ q	$ e	=	1,265
Property, plant and equipment			2,100	1,750		
Other assets	11,095	=	r	10,404		
Total assets	14,370	=	$ s	$13,419		
Liabilities:						
Current liabilities	4,890	=	$ t	$ 5,690		
Long-term debt and other liabilities			4,360	3,420		
Total liabilities			9,250	f	=	9,110
Shareholders' Equity:						
Common stock			$ 350	$ 350		
Retained earnings	4,660	=	u	g	=	3,769
Other shareholders' equity			110	190		
Total shareholders' equity	5,120	=	v	4,309		
Total liabilities and shareholders' equity	14,370	=	$ w	$ h	=	13,419
STATEMENT OF CASH FLOWS						
Net cash provided by operating activities	710	=	$ x	$ 850		
Net cash used for investing activities			(240)	(325)		
Net cash provided by financing activities			(560)	(490)		
Increase (decrease) in cash			(90)	i	=	35
Cash at beginning of year	1,265	=	y	1,230		
Cash at end of year	1,175	=	$ z	$ j	=	1,265

Decision Cases

(30-40 min.) Decision Case 1

Based solely on these balance sheets, Open Road appears to be the better credit risk because:

1. **Blue Skies has more assets ($150,000) than Open Road ($65,000), but Blue Skies owes much more in liabilities ($130,000 versus $15,000 for Open Road). Blue Sky's stockholders' equity is far greater than that of Open Skies ($50,000 compared to $20,000). Open Road is not heavily in debt, but Blue Skies is.**

2. **You would be better off granting the loan to Open Road. You should consider what will happen if the borrower cannot pay you back as planned. Blue Skies has far more liabilities to pay, and it may be hard for Blue Skies to come up with the money to pay you. On the other hand, Open Road has little debt to pay to others before paying you.**

(20-30 min.) Decision Case 2

Req. 1

GrandPrize Unlimited, Inc. Income Statement Year Ended Dec. 31, 2011		GrandPrize Unlimited, Inc. Balance Sheet Dec. 31, 2011			
Revenues………..	$140,000[1]	Cash……………	$ 6,000	Liabilities………	$70,000[4]
Expenses………..	130,000[2]	Other assets….	90,000[3]	Equity…………..	26,000[5]
				Total liabilities	
Net income………	$ 10,000	Total assets…...	$96,000	and equity……..	$96,000

[1] $100,000 + $40,000 = $140,000

[2] $80,000 + $50,000 = $130,000

[3] $100,000 − $50,000 + $40,000 = $90,000

[4] $60,000 + $10,000 = $70,000

[5] $96,000 − $70,000 = $26,000

Req. 3

The company's *financial position* is much *weaker* than originally reported. Assets and equity are lower and liabilities are higher. *Results of operations* are *worse* than reported. The company did not earn as much profit as reported.

Req. 4

Based on the actual figures, I would *not* invest in GrandPrize Unlimited for reasons given in *Req. 2*.

Ethical Issue

Note to instructor: student responses will vary on this problem. Keep the discussion pointed toward use of the multiple-criteria model for making good ethical decisions, pointing out elements of students' reasoning that may be faulty or incomplete. It might be useful to have a debate or role play, assigning students to different sides of the issue (for or against accepting a copy of the exam).

Req. 1

The fundamental ethical issue in this situation is whether you should accept a copy of the old exam from your friend.

Req. 2

The stakeholders are:

- **a. You**
- **b. Your friend**
- **c. The remainder of the students in the class**
- **d. The professor**
- **e. The University**
- **f. Your family**

(This may not be a complete list; you may think of more.)

Consequences are discussed in requirement 3.

Req. 3

Analysis of the problem:

a. Economic perspective: If use of the old exam turns out to help you (it may not) you might improve your grade and allow you to retain your scholarship. This might help you and your family financially. If you use the exam to your unfair advantage, and you are reported, you and possibly your friend might receive grades of F in the class although you might otherwise have passed. This could cause adverse economic consequences to you, your friend and your families.

b. Legal perspective: Although it may not violate local or federal law, giving or accepting copies of old exams may violate the university's honor code, which serves the same purpose of a legal code in this case. If you use the old exam and it turns out that you violated he University's honor code, both you and your friend could be in trouble. Your family and your friend's family could also be impacted by any adverse consequences to you or her. Academic institutions establish policies against academic dishonesty because cheating hurts everyone—the student who commits the act, the other students in the class whose rights to fair treatment are violated by cheating, the professor, who must endure hours of investigating, reporting, and perhaps testifying.

c. **Ethical perspective. Receiving questionable help from others in the face of policies that prohibit it is, at best, risky, and at worst, downright wrong. Cheating is similar to stealing, since it is stealing the work of another without their permission. It is usually accompanied by lying to cover it up, or at least, not concealing the truth. Cheating violates other students' rights to fair and equal treatment. It violates the instructor's rights to run a course as a "fair game" for all participants. Because the students and faculty are hurt by cheating, the university is hurt too. If cheating goes unpunished, grades are inflated, ultimately damaging the academic reputation of the institution and eroding the value of its degrees. Parents of students who are caught cheating have to endure the agony of working through the problem with their son or daughter, and perhaps the social stigma that comes from adverse publicity.**

These are just some of the arguments against cheating. Of course, there is a question in this case as to whether taking the test actually violates the professor's or the university's policies.

Req. 4

It would be helpful to find out what the professor's policies are with respect to use of fraternity and sorority test files. The university might have a blanket policy on this. (Some students might spend a little time researching this by reading the university's honor code on their web site; just reading the honor code will be an eye-opening experience for most students). Advise your students to research the use of fraternity and sorority test files on the university web site, or to discuss the issue with the head of the department or the chair of the university honor council.

Unfortunately, in this case, there is not much time. Researching the issue in the university's honor code takes valuable time away from studying for the exam, which, if you do, could help you raise your grade and solve the whole problem!

Probably the best solution to this problem is "when in doubt, don't." You may not do well on the test, but at least you won't have to live with the terrible consequences of being accused as a cheater. It should make you feel better in the long run that, although you may not make the highest grades in the class, at least you are not a cheater.

Req. 5

Cheating is very closely related to stealing, which is a form of fraud. When employees steal from their companies, they steal property that belongs to others. There are economic, legal, and ethical consequences to the company, the employee and their families, and customers (who ultimately have to pay for fraud through higher prices). We will study fraud in depth in Chapter 4.

Focus on Financials: Amazon.com, Inc.

(30 min.)

1. ***Net income*, because it shows the overall result of all the revenues minus all the expenses for a period. In effect, net income gives the results of operations in a single figure.**

   During 2008, net income rose from $476 million to $645 million. This is good news because the company's profit increased during the year.

2. **Amazon.com's largest expense is cost of sales. This is Amazon's cost of the products the company sells. Another title of this expense is *cost of goods sold*.**

3. **Total resources (total assets) at the end of 2008………………………………………………... $8,314 million**
   Amount owed (total liabilities) at the end of the year($4,746 + $409 + $487)…………..……… $5,642 million
   Portion of the company's assets owned by the company's stockholders (this is shareholders' equity)…………………………... $2,672 million

Amazon.com, Inc.'s accounting equation *(in millions):*

Assets	**=**	**Liabilities**	**+**	**Stockholders' equity**
$8,314	**=**	**$5,642**	**+**	**$2,672**

4. At the beginning of 2008, Amazon.com, Inc. had $2,539 million of cash. At the end of the year, Amazon.com, Inc. had $2,769 million of cash.

Focus on Analysis: Foot Locker, Inc.

(30 min.)

1. ***(Amounts in millions)***

$$\begin{array}{cccccc} \textbf{Assets} & = & \textbf{Liabilities} & + & \textbf{Shareholders' equity} \\ \$3{,}248 & = & \underbrace{(\$501 + \$221 + \$255)}_{\$977} & + & \$2{,}271 \end{array}$$

Foot Locker, Inc. appears to be in *strong* financial condition. Total assets are over 3 times total liabilities. That suggests that the company will have no difficulty paying its debts and will have money to expand.

2. Refer to the company's Consolidated Statements of Operations. The end result of operations for 2007 was a *net income* of $51 million. There is good news and bad news in this result. The *good news* is revenue exceeds expenses for fiscal 2007, which is better than the opposite. However, the *bad news* is the disturbingly steep downward trend in earnings over the past two years ($264 million, $251 million, and $51 million in fiscal 2005, 2006, and 2007, respectively). The company needs to make strategic decisions to both increase revenue and decrease expenses going forward, in order to reverse the downward spiral in earnings.

3. In Foot Locker, Inc.'s Consolidated Balance Sheets, shareholders' equity is shown as a single number ($2,271 million as of the end of fiscal 2007). Since retained earnings is a component of shareholders' equity, we have to look at the Consolidated Statement of Shareholders' Equity to analyze the account. Of the total $2,271 million of shareholders' equity at February 2, 2008, retained earnings comprised $1,760 million. The balance of retained earnings as of the beginning of the 2007 was $1,785 million. Therefore, the balance in the retained earnings account decreased by $25 million in 2007, even though the company was profitable. How did this happen? As shown in the Retained Earnings portion of the Consolidated Statements of Shareholders' Equity, the company had a small positive adjustment to retained earnings of $1 million. Next, its net income of $51 million carried forward to retained earnings from the Consolidated Statements of Operations. Surprisingly, the company paid a hefty dividend of $77 million, a sizeable increase in dividends over 2006 and 2005, and exceeding net income. This unusual decision on the part of the company's management caused retained earnings to decrease by $25 million. The fact that retained earnings decreased, while not the best of outcomes, is not a sign of a weak company in the long run. In fact, paying dividends, especially in a weakening economy, is the sign of a strong

company headed by a management team that is confident of the company's long run earning power and cash position. It remains to be seen as to whether the generous dividend in 2007 will actually be seen as a good or bad decision in 2008 and beyond. Once paid to shareholders, a dividend cannot be retrieved. Given the recessionary economy of 2008 and 2009, it is possible that Foot Locker's 2007 dividend will be viewed as overly generous, leaving the company short of the cash it needs to operate without borrowing.

4. **The *Consolidated Balance Sheets* report cash as part of financial position. The *Consolidated Statements of Cash Flows* tell why cash increased or decreased.**

   Sales of short-term investments ($1,620 million) caused cash to increase the most during fiscal 2007. Purchases of short-term investments ($1,378 million) caused cash to decrease the most.

Group Projects

Student responses will vary.