

# CHAPTER 1

## Introduction to Financial Statements

### Learning Objectives

1. Describe the primary forms of business organization.
2. Identify the users and uses of accounting information.
3. Explain the three principal types of business activity.
4. Describe the content and purpose of each of the financial statements.
5. Explain the meaning of assets, liabilities, and stockholders' equity, and state the basic accounting equation.
6. Describe the components that supplement the financial statements in an annual report.

### Summary of Questions by Learning Objectives and Bloom's Taxonomy

Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT
<b>Questions</b>														
1.	1	K	6.	2	C	10.	4	C	14.	5	K	18.	6	K
2.	1	K	7.	3	C	11.	4	K	15.	5	K	19.	6	C
3.	1	K	8.	4	K	12.	4	C	16.	5	AP	20.	6	K
4.	2	C	9.	4	C	13.	4	AP	17.	5	C	21.	5	C
5.	2	C												
<b>Brief Exercises</b>														
1.	1	K	4.	4	C	6.	4, 5	K	8.	5	AP	10.	5	K
2.	2	K	5.	4, 5	AP	7.	4	K	9.	5	AP	11.	6	K
3.	3	K												
<b>Do It! Review Exercises</b>														
1.	1	C	2.	3	K	3.	4, 5	AP	4.	6	C			
<b>Exercises</b>														
1.	1, 2, 4, 6	K	5.	4	AP	9.	4, 5	AP	12.	5	AP	15.	5	AP
2.	3	C	6.	4	AP	10.	4, 5	AP	13.	5	AP	16.	5	AP
3.	3, 4	C	7.	4	AP	11.	4, 5	AP	14.	5	AP	17.	6	K
4.	4	AP	8.	4, 5	C									
<b>Problems: Set A</b>														
1.	1	C	2.	2, 4, 5	K	3.	4, 5	AP	4.	4, 5	AP	5.	4, 5	AP
<b>Problems: Set B</b>														
1.	1	C	2.	2, 4, 5	K	3.	4, 5	AP	4.	4, 5	AP	5.	4, 5	AP

## ASSIGNMENT CHARACTERISTICS TABLE

<b>Problem Number</b>	<b>Description</b>	<b>Difficulty Level</b>	<b>Time Allotted (min.)</b>
1A	Determine forms of business organization.	Simple	15–20
2A	Identify users and uses of financial statements.	Simple	15–20
3A	Prepare an income statement, retained earnings statement, and balance sheet; discuss results.	Moderate	40–50
4A	Determine items included in a statement of cash flows, prepare the statement, and comment.	Moderate	30–40
5A	Comment on proper accounting treatment and prepare a corrected balance sheet.	Moderate	40–50
1B	Determine forms of business organization.	Simple	15–20
2B	Identify users and uses of financial statements.	Simple	15–20
3B	Prepare an income statement, retained earnings statement, and balance sheet; discuss results.	Moderate	40–50
4B	Determine items included in a statement of cash flows, prepare the statement, and comment.	Moderate	30–40
5B	Comment on proper accounting treatment and prepare a corrected income statement.	Moderate	40–50

# ANSWERS TO QUESTIONS

1. The three basic forms of business organizations are (1) sole proprietorship, (2) partnership, and (3) corporation.
2. Advantages of a corporation are limited liability (stockholders not being personally liable for corporate debts), easy transferability of ownership, and ease of raising funds. Disadvantages of a corporation are increased taxation and government regulations.
3. Proprietorships and partnerships receive favorable tax treatment compared to corporations and are easier to form than corporations. They are also owner controlled. Disadvantages of proprietorships and partnerships are unlimited liability (proprietors/partners are personally liable for all debts) and difficulty in obtaining financing compared to corporations.
4. Yes. A person cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Accounting provides financial information to interested users through the preparation and distribution of financial statements.
5. Internal users are managers who plan, organize, and run a business. To assist management, accounting provides timely internal reports. Examples include financial comparisons of operating alternatives, projections of income from new sales campaigns, forecasts of cash needs for the next year, and financial statements.
6. External users are those outside the business who have either a present or potential direct financial interest (investors and creditors) or an indirect financial interest (taxing authorities, regulatory agencies, labor unions, customers, and economic planners).
7. The three types of business activities are financing activities, investing activities, and operating activities. Financing activities include borrowing money and selling shares of stock. Investing activities include the purchase and sale of property, plant, and equipment. Operating activities include selling goods, performing services, and purchasing inventory.
8. (a) Income statement. (d) Balance sheet.  
(b) Balance sheet. (e) Balance sheet.  
(c) Income statement. (f) Balance sheet.
9. When a company pays dividends, it reduces the amount of assets available to pay creditors. Therefore, banks and other creditors monitor dividend payments to ensure they do not put a company's ability to make debt payments at risk.
10. Yes. Net income does appear on the income statement—it is the result of subtracting expenses from revenues. In addition, net income appears in the retained earnings statement—it is shown as an addition to the beginning-of-period retained earnings. Indirectly, the net income of a company is also included in the balance sheet. It is included in the retained earnings account which appears in the stockholders' equity section of the balance sheet.
11. The primary purpose of the statement of cash flows is to provide financial information about the cash receipts and cash payments of a business for a specific period of time.

## Questions Chapter 1 (Continued)

12. The three categories of the statement of cash flows are operating activities, investing activities, and financing activities. The categories were chosen because they represent the three principal types of business activities.
13. Retained earnings is the net income retained in a corporation. Retained earnings is increased by net income and is decreased by dividends and a net loss.
14. The basic accounting equation is  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ .
15. (a) Assets are resources owned by a business. Liabilities are amounts owed to creditors. Put more simply, liabilities are existing debts and obligations. Stockholders' equity is the ownership claim on net assets.
- (b) The items that affect stockholders' equity are common stock, retained earnings, dividends, revenues, and expenses.
16. The liabilities are (b) Accounts payable and (g) Salaries and wages payable.
17. (a) Net income from the income statement is reported as an increase to retained earnings on the retained earnings statement.
- (b) The ending amount on the retained earnings statement is reported as the retained earnings amount on the balance sheet.
- (c) The ending amount on the statement of cash flows is reported as the cash amount on the balance sheet.
18. The purpose of the management discussion and analysis section is to provide management's views on its ability to pay short-term obligations, its ability to fund operations and expansion, and its results of operations. The MD&A section is a required part of the annual report.
19. An unqualified opinion shows that, in the opinion of an independent auditor, the financial statements have been presented fairly, in conformity with generally accepted accounting principles. This gives investors more confidence that they can rely on the figures reported in the financial statements.
20. Information included in the notes to the financial statements clarifies information presented in the financial statements and includes descriptions of accounting policies, explanations of uncertainties and contingencies, and statistics and details too voluminous to be reported in the financial statements.
21. Using dollar amounts, Tootsie Roll's accounting equation is:

$$\begin{array}{rclclcl} \text{Assets} & & & \text{Liabilities} & & \text{Stockholders' Equity} \\ \$857,856,000 & = & & \$191,921,000^* & + & \$665,935,000 \end{array}$$

$$*\$58,355,000 + \$133,566,000$$

# SOLUTIONS TO BRIEF EXERCISES

## BRIEF EXERCISE 1-1

- (a)   P   Shared control, tax advantages, increased skills and resources.
- (b)   SP   Simple to set up and maintains control with founder.
- (c)   C   Easier to transfer ownership and raise funds, no personal liability.

## BRIEF EXERCISE 1-2

- (a)   4   Investors in common stock
- (b)   3   Marketing managers
- (c)   2   Creditors
- (d)   5   Chief Financial Officer
- (e)   1   Internal Revenue Service

## BRIEF EXERCISE 1-3

- O   (a) Cash received from customers.
- F   (b) Cash paid to stockholders (dividends).
- F   (c) Cash received from issuing new common stock.
- O   (d) Cash paid to suppliers.
- I   (e) Cash paid to purchase a new office building.

## BRIEF EXERCISE 1-4

- E   (a) Advertising expense
- R   (b) Service revenue
- E   (c) Insurance expense
- E   (d) Salaries and wages expense
- D   (e) Dividends
- R   (f) Rent revenue
- E   (g) Utilities expense
- NSE   (h) Cash purchase of equipment
- C   (i) Issued common stock for cash.

**BRIEF EXERCISE 1-5**

**BURNETT COMPANY**  
**Balance Sheet**  
**December 31, 2014**

<b>Assets</b>		
Cash.....		<b>\$22,000</b>
Accounts receivable.....		<u><b>71,000</b></u>
<b>Total assets .....</b>		<u><b>\$93,000</b></u>
 <b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Accounts payable .....		<b>\$65,000</b>
<b>Stockholders' equity</b>		
Common stock.....	<b>\$18,000</b>	
Retained earnings.....	<u><b>10,000</b></u>	<u><b>28,000</b></u>
<b>Total liabilities and stockholders' equity .....</b>		<u><b>\$93,000</b></u>

**BRIEF EXERCISE 1-6**

- IS (a) Income tax expense
- BS (b) Inventory
- BS (c) Accounts payable
- BS (d) Retained earnings
- BS (e) Equipment
- IS (f) Sales revenue
- IS (g) Cost of goods sold
- BS (h) Common stock
- BS (i) Accounts Receivable
- IS (j) Interest expense

**BRIEF EXERCISE 1-7**

- IS (a) Revenue during the period.
- BS (b) Supplies on hand at the end of the year.
- SCF (c) Cash received from issuing new bonds during the period.
- BS (d) Total debts outstanding at the end of the period.

### BRIEF EXERCISE 1-8

- (a)  $\$90,000 + \$230,000 = \$320,000$  (Total assets)
- (b)  $\$170,000 - \$80,000 = \$90,000$  (Total liabilities)
- (c)  $\$800,000 - 0.25(\$800,000) = \$600,000$  (Stockholders' equity)

### BRIEF EXERCISE 1-9

- (a)  $(\$800,000 + \$150,000) - (\$500,000 - \$80,000) = \$530,000$   
(Stockholders' equity)
- (b)  $(\$500,000 + \$100,000) + (\$800,000 - \$500,000 - \$70,000) = \$830,000$   
(Assets)
- (c)  $(\$800,000 - \$80,000) - (\$800,000 - \$500,000 + \$110,000) = \$310,000$   
(Liabilities)

### BRIEF EXERCISE 1-10

- A   (a) Accounts receivable
- L   (b) Salaries and wages payable
- A   (c) Equipment
- A   (d) Supplies
- SE  (e) Common stock
- L   (f) Notes payable

### BRIEF EXERCISE 1-11

- (d) All of these are required.

## SOLUTIONS TO DO IT! REVIEW EXERCISES

### DO IT! 1-1

- (a) Easier to transfer ownership: corporation
- (b) Easier to raise funds: corporation
- (c) More owner control: sole proprietorship
- (d) Tax advantages: sole proprietorship and partnership
- (e) No personal legal liability: corporation

### DO IT! 1-2

- (a) Issuance of ownership shares is classified as common stock.
- (b) Land purchased is classified as an asset.
- (c) Amounts owed to suppliers are classified as liabilities.
- (d) Bonds payable are classified as liabilities.
- (e) Amount earned from selling a product is classified as revenue.
- (f) Cost of advertising is classified as expense.

### DO IT! 1-3

**MARSH CORPORATION**  
**Income Statement**  
**For the Year Ended December 31, 2014**

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<b>Revenues</b>		
Service revenue.....		<b>\$25,000</b>
<b>Expenses</b>		
Rent expense.....	<b>\$10,000</b>	
Advertising expense.....	<b>4,000</b>	
Supplies expense.....	<u><b>1,700</b></u>	
Total expenses.....		<u><b>15,700</b></u>
<b>Net income .....</b>		<u><b>\$ 9,300</b></u>



**MARSH CORPORATION**  
**Retained Earnings Statement**  
**For the Year Ended December 31, 2014**

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Retained earnings, January 1 .....	\$ -0-
Add: Net income .....	<u>9,300</u>
	9,300
Less: Dividends.....	<u>2,500</u>
Retained earnings, December 31 .....	<u>\$6,800</u>

**MARSH CORPORATION**  
**Balance Sheet**  
**December 31, 2014**

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<u><b>Assets</b></u>	
Cash .....	\$ 3,100
Accounts receivable .....	2,000
Supplies .....	1,900
Equipment.....	<u>26,800</u>
Total assets .....	<u>\$33,800</u>

**Liabilities and Stockholders' Equity**

<b>Liabilities</b>			
Notes payable .....	\$ 7,000		
Account payable .....	<u>5,000</u>		
Total liabilities .....		\$12,000	
<b>Stockholder's equity</b>			
Common stock.....	15,000		
Retained earnings.....	<u>6,800</u>		
Total stockholders' equity.....		<u>21,800</u>	
<b>Total liabilities and stockholder's equity .....</b>			<u>\$33,800</u>

## **DO IT! 1-4**

- (1) Description of ability to pay near-term obligations: MD&A**
- (2) Unqualified opinion: auditor's report**
- (3) Details concerning liabilities, too voluminous to be included in the statements: notes**
- (4) Description of favorable and unfavorable trends: MD&A**
- (5) Certified Public Accountant (CPA): auditor's report**
- (6) Descriptions of significant accounting policies: notes**

# SOLUTIONS TO EXERCISES

## EXERCISE 1-1

- (a) 8. Auditor's opinion
- (b) 1. Corporation
- (c) 6. Common stock
- (d) 7. Accounts payable
- (e) 3. Accounts receivable
- (f) 2. Creditor
- (g) 5. Stockholder
- (h) 4. Partnership

## EXERCISE 1-2

- (a) Answers will vary.

	Financing	Investing	Operating
Abitibi Consolidated Inc.	Sale of stock	Purchase long-term investments	Sale of newsprint
Cal State—Northridge Std Union	Borrow money from a bank	Purchase office equipment	Payment of wages and benefits
Oracle Corporation	Sale of bonds	Purchase other companies	Payment of research expenses
Sportsco Investments	Payment of dividends to stockholders	Purchase hockey equipment	Payment for rink rentals
Grant Thornton LLP	Distribute earnings to partners	Purchase computers	Bill clients for professional services
Southwest Airlines	Sale of stock	Purchase airplanes	Payment for jet fuel

## EXERCISE 1-2 (Continued)

### (b) Financing

Sale of stock is common to all corporations. Borrowing from a bank is common to all businesses. Payment of dividends is common to all corporations. Sale of bonds is common to large corporations.

### Investing

Purchase and sale of property, plant, and equipment would be common to all businesses—the types of assets would vary according to the type of business and some types of businesses require a larger investment in long-lived assets. A new business or expanding business would be more apt to acquire property, plant, and equipment while a mature or declining business would be more apt to sell it.

### Operating

The general activities identified would be common to most businesses, although the service or product would differ.

## EXERCISE 1-3

	(a)	(b)
Accounts payable	L	O
Accounts receivable	A	O
Equipment	A	I
Sales revenue	R	O
Service revenue	R	O
Inventory	A	O
Mortgage payable	L	F
Supplies expense	E	O
Rent expense	E	O
Salaries and wages expense	E	O

**EXERCISE 1-4**

**MOLINA CO.**  
**Income Statement**  
**For the Year Ended December 31, 2014**

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<b>Revenues</b>		
Service revenue .....		<b>\$58,000</b>
<b>Expenses</b>		
Salaries and wages expense .....	<b>\$30,000</b>	
Rent expense .....	<b>10,400</b>	
Utilities expense .....	<b>2,400</b>	
Advertising expense .....	<b><u>1,800</u></b>	
Total expenses .....		<b><u>44,600</u></b>
<b>Net income .....</b>		<b><u>\$13,400</u></b>

**MOLINA CO.**  
**Retained Earnings Statement**  
**For the Year Ended December 31, 2014**

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Retained earnings, January 1 .....	<b>\$67,000</b>
Add: Net income .....	<b><u>13,400</u></b>
	<b>80,400</b>
Less: Dividends.....	<b><u>6,000</u></b>
Retained earnings, December 31 .....	<b><u>\$74,400</u></b>

**EXERCISE 1-5**

**(a)**

**MERCK AND CO.  
Income Statement  
For the Year Ended December 31, 2014  
(in millions)**

<hr/>		
<b>Revenues</b>		
Sales revenue .....		<b>\$38,576.0</b>
<b>Expenses</b>		
Cost of goods sold .....	<b>\$ 9,018.9</b>	
Selling and administrative expenses .....	<b>8,543.2</b>	
Research and development expense .....	<b>5,845.0</b>	
Income tax expense .....	<b><u>2,267.6</u></b>	
Total expenses .....		<b><u>25,674.7</u></b>
Net income .....		<b><u>\$12,901.3</u></b>

**MERCK AND CO.  
Retained Earnings Statement  
For the Year Ended December 31, 2014  
(in millions)**

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Retained earnings, January 1 .....		<b>\$43,698.8</b>
Add: Net income .....		<b><u>12,901.3</u></b>
		<b>56,600.1</b>
Less: Dividends .....		<b><u>3,597.7</u></b>
Retained earnings, December 31 .....		<b><u>\$53,002.4</u></b>

**(b)** The short-term implication would be a decrease in expenses of \$2,922.5 ( $\$5,845 \times 50\%$ ) resulting in a corresponding increase in income (ignoring income taxes). If all other revenues and expenses remain unchanged, decreasing research and development expenses would produce 22.7% more net income ( $\$2,922.5 \div \$12,901.3$ ).

## EXERCISE 1-5 (Continued)

The long-term implications would be more difficult to quantify but it is safe to predict that a reduction in research and development expenses would probably result in lower sales revenues in the future. Pharmaceutical companies are usually able to charge higher prices for newly developed products while lower cost generic versions usually replace older products. Decreasing research and development activities will probably mean fewer new products.

The stock market's initial reaction might be positive since Merck's net income would increase significantly. Such a reaction would probably be very short-lived as more knowledgeable investors reviewed Merck's financial statements and discovered the cause of the increase.

## EXERCISE 1-6

**DEVITO INC.**  
**Retained Earnings Statement**  
**For the Year Ended December 31, 2014**

Retained earnings, January 1 .....	\$130,000
Add: Net income .....	<u>225,000*</u>
	355,000
Less: Dividends.....	<u>65,000</u>
Retained earnings, December 31 .....	<u>\$290,000</u>
*Service revenue .....	\$400,000
Total expenses .....	<u>175,000</u>
Net income .....	<u>\$225,000</u>

**EXERCISE 1-7**

- (a) Grant Corporation is distributing nearly all of this year’s net income as dividends. This suggests that Grant is not pursuing rapid growth. Companies that have a lot of opportunities for growth pay low dividends.
- (b) Remington Corporation is not generating sufficient cash provided by operating activities to fund its investing activities. Instead it generates additional cash through financing activities. This is common for companies in their early years of existence.

**EXERCISE 1-8**

- (a)
 

A	Cash
SE	Retained earnings
E	Cost of goods sold
E	Salaries and wages expense
A	Prepaid insurance
A	Inventory
A	Accounts receivable
R	Sales revenue
L	Notes payable
L	Accounts payable
R	Service revenue
E	Interest expense

(b) **MOTTE INC.**  
**Income Statement**  
**For the Year Ended December 31, 2014**

<hr/>		
<b>Revenues</b>		
Sales revenue .....	\$584,951	
Service revenue .....	<u>4,806</u>	
Total revenues .....		\$589,757
<b>Expenses</b>		
Cost of goods sold .....	438,458	
Salaries and wages expense .....	115,131	
Interest expense.....	<u>1,882</u>	
Total expenses .....		<u>555,471</u>
Net income .....		<u>\$ 34,286</u>



## EXERCISE 1-9

First note that the retained earnings statement shows that (b) equals \$27,000.

Accounts payable + Common stock + Retained earnings = Total liabilities and stockholders' equity

$$\$5,000 + a + \$27,000 = \$62,000$$

$$a + \$32,000 = \$62,000$$

$$a = \underline{\$30,000}$$

Beginning retained earnings + Net income – Dividends = Ending retained earnings

$$\$12,000 + e - \$5,000 = \$27,000$$

$$\$7,000 + e = \$27,000$$

$$e = \underline{\$20,000}$$

From above, we know that net income (d) equals \$20,000.

Revenue – Cost of goods sold – Salaries and wages expense = Net income

$$\$85,000 - c - \$10,000 = \$20,000$$

$$\$75,000 - c = \$20,000$$

$$c = \underline{\$55,000}$$

## EXERCISE 1-10

(a) Service revenue .....	\$132,000	
Sales revenue .....	<u>25,000</u>	
Total revenue .....		\$157,000
Expenses .....		<u>126,000</u>
Net income .....		<u>\$ 31,000</u>

(b) **FLINT HILLS PARK**  
**Retained Earnings Statement**  
**For the Year Ended December 31, 2014**

Retained earnings, January 1 .....	\$ 5,000
Add: Net income .....	<u>31,000</u>
	36,000
Less: Dividends .....	<u>9,000</u>
Retained earnings, December 31 .....	<u>\$27,000</u>

**EXERCISE 1-10 (Continued)**

**FLINT HILLS PARK  
Balance Sheet  
December 31, 2014**

<b>Assets</b>		
Cash .....		\$ 8,500
Supplies .....		5,500
Equipment .....		<u>114,000</u>
<b>Total assets .....</b>		<b><u>\$128,000</u></b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Notes payable .....	\$50,000	
Accounts payable.....	<u>11,000</u>	
<b>Total liabilities.....</b>		<b>\$ 61,000</b>
<b>Stockholders' equity</b>		
Common stock .....	40,000	
Retained earnings .....	<u>27,000</u>	<u>67,000</u>
<b>Total liabilities and stockholders' equity.....</b>		<b><u>\$128,000</u></b>

(c) The income statement indicates that revenues from the general store were only about 16% ( $\$25,000 \div \$157,000$ ) of total revenue which tends to support Joe's opinion. In order to decide if the store is "more trouble than it is worth," I would need to know the amount of expenses attributable to the general store. The income statement reports all expenses in a single category rather than separating them into camping and general store expenses to correspond with revenues. A break down into two categories would help me decide if the general store is generating a profit or loss.

Even if the general store is operating at a loss, I might recommend retaining it if campers indicated that the convenience of having a general store on site was an important amenity in selecting a camp ground.

**EXERCISE 1-11**

- (a) SE Retained earnings  
E Cost of goods sold  
E Selling and administrative expenses  
A Cash  
L Notes payable  
E Interest expense  
L Bonds payable  
A Inventory  
R Sales revenue  
L Accounts payable  
SE Common stock  
E Income tax expense

(b) **KELLOGG COMPANY**  
**Income Statement**  
**For the Year Ended December 31, 2014**  
**(in millions)**

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<b>Revenues</b>		
Sales revenue.....		<b>\$12,575</b>
<b>Expenses</b>		
Cost of goods sold .....	<b>\$7,184</b>	
Selling and administrative expenses .....	<b>3,390</b>	
Income tax expense.....	<b>498</b>	
Interest expense .....	<b><u>295</u></b>	
Total expenses .....		<b><u>11,367</u></b>
<b>Net income .....</b>		<b><u>\$ 1,208</u></b>

**EXERCISE 1-12**

**(a)**

**DYCKMAN CORPORATION**  
**Statement of Cash Flows**  
**For the Year Ended December 31, 2014**

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<b>Cash flows from operating activities</b>		
Cash received from customers .....	<b>\$ 50,000</b>	
Cash paid to suppliers .....	<b><u>(16,000)</u></b>	
Net cash provided by operating activities .....		<b>\$ 34,000</b>
<b>Cash flows from investing activities</b>		
Cash paid for new equipment .....	<b><u>(28,000)</u></b>	
Net cash used by investing activities .....		<b>(28,000)</b>
<b>Cash flows from financing activities</b>		
Cash received from lenders .....	<b>20,000</b>	
Cash dividends paid.....	<b><u>(8,000)</u></b>	
Net cash provided by financing activities .....		<b><u>12,000</u></b>
Net increase in cash.....		<b>18,000</b>
Cash at beginning of period.....		<b><u>12,000</u></b>
Cash at end of period.....		<b><u>\$ 30,000</u></b>

**(b) As a creditor, I would feel reasonably confident that Dyckman has the ability to repay its lenders. During 2014, Dyckman generated \$34,000 of cash from its operating activities. This amount more than covered its expenditures for new equipment but not both equipment purchases and dividends.**

**EXERCISE 1-13**

(a)

**SOUTHWEST AIRLINES**  
**Statement of Cash Flows**  
**For the Year Ended December 31, 2014**  
**(in millions)**

<b>Cash flows from operating activities</b>		
Cash received from customers.....	\$9,823	
Cash paid for goods and services.....	<u>(6,978)</u>	
Net cash provided by operating activities .....		\$2,845
<b>Cash flows from investing activities</b>		
Cash paid for property and equipment.....	<u>(1,529)</u>	
Net cash used by investing activities .....		(1,529)
<b>Cash flows from financing activities</b>		
Cash received from issuance of long-term debt .....	500	
Cash received from issuance of common stock .....	144	
Cash paid for repurchase of common stock .....	(1,001)	
Cash paid for repayment of debt.....	(122)	
Cash paid for dividends .....	<u>(14)</u>	
Net cash used by financing activities .....		<u>(493)</u>
Net increase in cash .....		823
Cash at beginning of period .....		<u>1,390</u>
Cash at end of period .....		<u><u>\$2,213</u></u>

(b) Southwest reported \$2,845,000,000 cash from operating activities but spent \$1,529,000,000 to invest in new property and equipment. Its cash from operating activities was sufficient to finance its investing activities. Southwest supplemented the cash from operating activities by issuing long-term debt and additional shares of common stock. It used excess cash to repurchase stock, pay down debt, and pay dividends. In total, it generated more cash from operating activities than it paid for investing and financing activities resulting in a net increase in cash for 2014.

**EXERCISE 1-14**

**EDMINSON COMPANY**  
**Balance Sheet**  
**December 31, 2014**

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<b>Assets</b>		
Cash.....		<b>\$18,000</b>
Accounts receivable.....		<b>12,000</b>
Supplies.....		<b>9,500</b>
Equipment.....		<b><u>40,000</u></b>
<b>Total assets.....</b>		<b><u>\$79,500</u></b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Accounts payable.....		<b>\$16,000</b>
<b>Stockholders' equity</b>		
Common stock.....	<b>\$40,000</b>	
Retained earnings.....	<b><u>23,500*</u></b>	<b><u>63,500</u></b>
<b>Total liabilities and stockholders' equity.....</b>		<b><u>\$79,500</u></b>
<b>*\$31,500 – \$8,000</b>		

## EXERCISE 1-15

All dollars are in millions.

### (a) Assets

Cash.....	\$ 2,291.1
Accounts receivable.....	2,883.9
Inventory .....	2,357.0
Equipment .....	1,957.7
Buildings .....	<u>3,759.9</u>
Total assets.....	<u>\$13,249.6</u>

### Liabilities

Notes payable .....	\$ 342.9
Accounts payable.....	2,815.8
Mortgage payable .....	1,311.5
Income taxes payable .....	<u>86.3</u>
Total liabilities.....	<u>\$ 4,556.5</u>

### Stockholders' Equity

Common stock.....	\$ 2,874.2
Retained earnings .....	<u>5,818.9</u>
Total stockholders' equity .....	<u>\$ 8,693.1</u>

(b)            **Assets**            =            **Liabilities**            +            **Stockholders' Equity**  
                  \$13,249.6            =            \$4,556.5            +            \$8,693.1

- (c) Nike has relied more heavily on equity than debt to finance its assets. Debt (liabilities) financed 34% of its assets ( $\$4,556.5 \div \$13,249.6$ ) compared to equity financing of 66% ( $\$8,693.1 \div \$13,249.6$ ).

## EXERCISE 1-16

(a)	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>
	\$110,000	=	\$70,000	+	(a)
	(a)	=	\$40,000		

(b)	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>
	(b)	=	\$120,000	+	\$60,000
	(b)	=	\$180,000		

(c)	<b>Beginning</b>	+	<b>Revenues</b>	-	<b>Expenses</b>	-	<b>Dividends</b>	=	<b>Ending</b>
	<b>Stockholders'</b>								<b>Stockholders'</b>
	<b>Equity</b>								<b>Equity</b>
	\$40,000(a)	+	215,000	-	165,000	-	(c)	=	\$60,000
			\$ 90,000	-	(c)			=	\$60,000
					(c)			=	\$30,000

(d)	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>
	\$150,000	=	(d)	+	\$70,000
	(d)	=	\$80,000		

(e)	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>
	\$180,000	=	\$ 55,000	+	(e)
	(e)	=	\$125,000		

(f)	<b>Beginning</b>	+	<b>Revenues</b>	-	<b>Expenses</b>	-	<b>Dividends</b>	=	<b>Ending</b>
	<b>Stockholders'</b>								<b>Stockholders'</b>
	<b>Equity</b>								<b>Equity</b>
	\$70,000	+	(f)	-	80,000	-	5,000	=	\$125,000(e)
	(f)	=	\$140,000						

## EXERCISE 1-17

- (a) Financial statements
- (b) Auditor's opinion
- (c) Notes to the financial statements
- (d) Financial statements
- (e) Management discussion and analysis
- (f) Not disclosed



# SOLUTIONS TO PROBLEMS

## PROBLEM 1-1A

- (a) The concern over legal liability would make the corporate form a better choice over a partnership. Also, the corporate form will allow the business to raise cash more easily, which may be of importance in a rapidly growing industry.**
- (b) Al should run his business as a sole proprietor. He has no real need to raise funds, and he doesn't need the expertise provided by other partners. The sole proprietorship form would provide the easiest form. One should avoid a more complicated form of business unless the characteristics of that form are needed.**
- (c) The fact that the combined business expects that it will need to raise significant funds in the near future makes the corporate form more desirable in this case.**
- (d) It is likely that this business would form as a partnership. Its needs for additional funds would probably be minimal in the foreseeable future. Also, the three know each other well and would appear to be contributing equally to the firm. Service firms, like consulting businesses, are frequently formed as partnerships.**
- (e) One way to ensure control would be for Jack to form a sole proprietorship. However, in order for this business to thrive it will need a substantial investment of funds early. This would suggest the corporate form of business. In order for Jack to maintain control over the business he would need to own more than 50 percent of the voting shares of common stock. In order for the business to grow, he may have to be willing to give up some control.**

**PROBLEM 1-2A**

- (a) In deciding whether to extend credit for 30 days, The North Face would be most interested in the balance sheet because the balance sheet shows the assets on hand that would be available for settlement of the debt in the near-term.**
- (b) In purchasing an investment that will be held for an extended period, the investor must try to predict the future performance of Amazon.com. The income statement provides the most useful information for predicting future performance.**
- (c) In extending a loan for a relatively long period of time, the lender is most interested in the probability that the company will generate sufficient income to meet its interest payments and repay its principal. The lender would therefore be interested in predicting future net income using the income statement. It should be noted, however, that the lender would also be very interested in both the balance sheet and statement of cash flows—the balance sheet because it would show the amount of debt the company had already incurred, as well as assets that could be liquidated to repay the loan. And the company would be interested in the statement of cash flows because it would provide useful information for predicting the company’s ability to generate cash to repay its obligations.**
- (d) The president would probably be most interested in the statement of cash flows since it shows how much cash the company generates and how that cash is used. The statement of cash flows can be used to predict the company’s future cash-generating ability.**

<b>PROBLEM 1-3A</b>
---------------------

(a)

**HIGHTOWER SERVICE CO.  
Income Statement  
For the Month Ended June 30, 2014**

<hr/>		
<b>Revenues</b>		
Service revenue .....		<b>\$7,500</b>
<b>Expenses</b>		
Salaries and wages expense .....	<b>\$1,400</b>	
Supplies expense .....	<b>1,000</b>	
Maintenance and repairs expense .....	<b>600</b>	
Advertising expense .....	<b>400</b>	
Utilities expense .....	<b>300</b>	
Total expenses .....		<u><b>3,700</b></u>
<b>Net income</b> .....		<u><b>\$3,800</b></u>

**HIGHTOWER SERVICE CO.  
Retained Earnings Statement  
For the Month Ended June 30, 2014**

<hr/>	
Retained earnings, June 1 .....	<b>\$ 0</b>
Add: Net income .....	<u><b>3,800</b></u>
	<b>3,800</b>
Less: Dividends .....	<u><b>1,400</b></u>
Retained earnings, June 30 .....	<u><b>\$2,400</b></u>

**PROBLEM 1-3A (Continued)**

**HIGHTOWER SERVICE CO.  
Balance Sheet  
June 30, 2014**

Assets		
Cash .....		\$ 4,600
Accounts receivable .....		4,000
Supplies .....		2,400
Equipment .....		<u>26,000</u>
<b>Total assets .....</b>		<b><u>\$37,000</u></b>
Liabilities and Stockholders' Equity		
<b>Liabilities</b>		
Notes payable .....	\$12,000	
Accounts payable .....	<u>500</u>	
<b>Total liabilities .....</b>		<b>\$12,500</b>
<b>Stockholders' equity</b>		
Common stock .....	22,100	
Retained earnings .....	<u>2,400</u>	<u>24,500</u>
<b>Total liabilities and stockholders' equity .....</b>		<b><u>\$37,000</u></b>

- (b) Hightower had a very successful first month, earning \$3,800 or 51% of service revenues ( $\$3,800 \div \$7,500$ ). Its net income represents a 17% return on the initial investment ( $\$3,800 \div \$22,100$ ).
- (c) Distributing a dividend after only one month of operations is probably unusual. Most new businesses choose to build up a cash balance to provide for future operating and investing activities or pay down debt. Hightower distributed 37% ( $\$1,400 \div \$3,800$ ) of its first month's income but it had adequate cash to do so and still showed a significant increase in retained earnings.

<b>PROBLEM 1-4A</b>
---------------------

- (a) Wenger Corporation should include the following items in its statement of cash flows:

Cash paid to suppliers  
 Cash dividends paid  
 Cash paid to purchase equipment  
 Cash received from customers  
 Cash received from issuing common stock

**WENGER CORPORATION**  
**Statement of Cash Flows**  
**For the Year Ended December 31, 2014**

<hr/>		
<b>Cash flows from operating activities</b>		
Cash received from customers.....	\$132,000	
Cash paid to suppliers.....	<u>(104,000)</u>	
Net cash provided by operating activities .....		\$28,000
<b>Cash flows from investing activities</b>		
Cash paid to purchase equipment .....	<u>(12,000)</u>	
Net cash used by investing activities .....		(12,000)
<b>Cash flows from financing activities</b>		
Cash received from issuing common stock....	22,000	
Cash dividends paid .....	<u>(7,000)</u>	
Net cash provided by financing activities .....		<u>15,000</u>
Net increase in cash.....		31,000
Cash at beginning of period .....		<u>9,000</u>
Cash at end of period.....		<u><u>\$40,000</u></u>

- (b) Wenger Corporation's operating activities provided \$28,000 cash which was adequate to fund its investing activities (\$12,000) and make (\$7,000) of dividend payments.

<b>PROBLEM 1-5A</b>
---------------------

- (a)
1. Since the boat actually belongs to Bill Jensen—not to Merando Corporation—it should not be reported on the corporation’s balance sheet. Likewise, the boat loan is a personal loan of Bill’s—not a liability of Merando Corporation.
  2. The inventory should be reported at \$25,000, the amount paid when it was purchased. Merando Corporation will record \$36,000 as revenues when the inventory is sold.
  3. The \$10,000 receivable is not an asset of Merando Corporation—it is a personal asset of Bill Jensen.

(b)

**MERANDO CORPORATION**  
**Balance Sheet**  
**December 31, 2014**

<b>Assets</b>		
Cash .....		\$20,000
Accounts receivable .....		40,000*
Inventory .....		<u>25,000</u>
<b>Total assets .....</b>		<b><u>\$85,000</u></b>
<b>Liabilities and Stockholders’ Equity</b>		
<b>Liabilities</b>		
Notes payable .....	\$15,000	
Accounts payable.....	<u>30,000</u>	
<b>Total liabilities .....</b>		<b>\$45,000</b>
<b>Stockholders’ equity.....</b>		<b><u>40,000**</u></b>
<b>Total liabilities and stockholders’ equity.....</b>		<b><u>\$85,000</u></b>

\*\$50,000 – \$10,000  
\*\*\$85,000 – \$45,000 (Total assets minus total liabilities)

## PROBLEM 1-1B

- (a) Randy should run his business as a sole proprietor. He has no real need to raise funds, and he doesn't need the expertise provided by other partners. The sole proprietorship form would provide the easiest form. One should avoid a more complicated form of business unless the characteristics of that form are needed.**
- (b) The fact that the combined business expects that it will need to raise significant funds in the near future makes the corporate form more desirable in this case.**
- (c) The concern over legal liability would make the corporate form a better choice over a partnership. Also, the corporate form will allow the business to raise cash more easily, which may be of importance in a rapidly growing industry.**
- (d) One way to ensure control would be for Marty to form a sole proprietorship. However, in order for this business to thrive it will need a substantial investment of funds early. This would suggest the corporate form of business. In order for Marty to maintain control over the business she would need to own more than 50 percent of the voting shares of common stock. In order for the business to grow, she may have to be willing to give up some control.**
- (e) It is likely that this business would form as a partnership. Its needs for additional funds would probably be minimal in the foreseeable future. Also, the two know each other well and would appear to be contributing equally to the firm. Service firms, like consulting businesses, are frequently formed as partnerships.**

**PROBLEM 1-2B**

- (a) In purchasing an investment that will be held for an extended period, the investor must try to predict the future performance of 24/7 Fitness. The income statement provides the most useful information for predicting future performance.**
- (b) In deciding whether to extend credit for 60 days Xerox would be most interested in the balance sheet because the balance sheet shows the assets on hand that would be available for settlement of the debt in the near-term.**
- (c) The president would probably be most interested in the statement of cash flows since it shows how much cash the company generates and how that cash is used. The statement of cash flows can be used to predict the company's future cash-generating ability.**
- (d) In extending a loan for a relatively long period of time the lender is most interested in the probability that the company will generate sufficient income to meet its interest payments and repay its principal. The lender would therefore be interested in predicting future income using the income statement. It should be noted, however, that the lender would also be very interested in both the balance sheet and the statement of cash flows—the balance sheet because it would show the amount of debt the company had already incurred, as well as assets that could be liquidated to repay the loan. And the company would be interested in the statement of cash flows because it would provide useful information for predicting the company's ability to generate cash to repay its obligations.**



<b>PROBLEM 1-3B</b>
---------------------

(a)

**SHAW'S GARDEN**  
**Income Statement**  
For the Month Ended May 31, 2014

<hr/>		
<b>Revenues</b>		
Service revenue .....		\$10,400
<b>Expenses</b>		
Maintenance and repairs expense ....	\$2,100	
Salaries and wages expense .....	1,900	
Advertising expense .....	1,800	
Insurance expense .....	<u>400</u>	
Total expenses .....		<u>6,200</u>
<b>Net income</b> .....		<u><u>\$ 4,200</u></u>

**SHAW'S GARDEN**  
**Retained Earnings Statement**  
For the Month Ended May 31, 2014

<hr/>	
<b>Retained earnings, May 1</b> .....	\$ 0
<b>Add: Net income</b> .....	<u>4,200</u>
	4,200
<b>Less: Dividends</b> .....	<u>1,600</u>
<b>Retained earnings, May 31</b> .....	<u><u>\$2,600</u></u>

**PROBLEM 1-3B (Continued)**

**SHAW'S GARDEN  
Balance Sheet  
May 31, 2014**

Assets		
Cash.....		\$10,800
Accounts receivable.....		8,400
Equipment.....		<u>58,800</u>
<b>Total assets.....</b>		<b><u>\$78,000</u></b>
Liabilities and Stockholders' Equity		
<b>Liabilities</b>		
Notes payable.....	\$26,000	
Accounts payable.....	<u>4,400</u>	
<b>Total liabilities.....</b>		<b>\$30,400</b>
<b>Stockholders' equity</b>		
Common stock.....	45,000	
Retained earnings.....	<u>2,600</u>	<u>47,600</u>
<b>Total liabilities and stockholders' equity.....</b>		<b><u>\$78,000</u></b>

- (b) Shaw's Garden was very profitable during its first month of operations. Net income of \$4,200 represents a 9.3% return on the \$45,000 investment as well as 40.4% of service revenues ( $\$4,200 \div \$10,400$ ).
- (c) Many companies choose to "reinvest" in themselves by building up a larger balance in retained earnings rather than distributing dividends as soon as income is earned so Shaw's Garden decision might be seen as risky. Lenders might view such an action negatively since Shaw's Garden owes \$26,000 in notes payable. On the other hand, the company still "retained" more than 62% of its earnings (\$4,200) and it had adequate cash to cover the \$1,600 dividend.

<b>PROBLEM 1-4B</b>
---------------------

- (a) Preacher Corporation should include the following items in its statement of cash flows:

Cash paid to suppliers  
 Cash dividends paid  
 Cash paid to purchase equipment  
 Cash received from customers  
 Cash received from issuing bonds payable

**PREACHER CORPORATION**  
**Statement of Cash Flows**  
**For the Year Ended December 31, 2014**

<hr/>		
<b>Cash flows from operating activities</b>		
Cash received from customers .....	\$162,000	
Cash paid to suppliers .....	<u>(154,000)</u>	
Net cash provided by operating activities .....		\$8,000
<b>Cash flows from investing activities</b>		
Cash paid to purchase equipment .....	<u>(20,000)</u>	
Net cash used by investing activities .....		(20,000)
<b>Cash flows from financing activities</b>		
Cash received from issuing bonds payable ...	40,000	
Cash dividends paid .....	<u>(2,000)</u>	
Net cash provided by financing activities .....		<u>38,000</u>
Net increase in cash .....		26,000
Cash at beginning of period .....		<u>11,000</u>
Cash at end of period .....		<u><u>\$37,000</u></u>

- (b) Operating activities provided \$8,000 cash, which was not adequate to cover \$20,000 needed for investing activities and \$2,000 of dividend payments. Preacher issued \$40,000 of bonds payable to fund these cash payments and increase its year-end cash balance.

<b>PROBLEM 1-5B</b>
---------------------

- (a)
1. The \$3,000 of revenue that the company earned in 2013 should not be included in the 2014 revenues. Instead, the \$3,000 should be added to the beginning balance of retained earnings to correct for the omission in 2013.
  2. Since the corporation did not incur or pay the \$10,000 of rent expense, it should not be included in the income statement. Including the \$10,000 as an expense misstates the corporation's net income and presents misleading results.
  3. Including the \$6,000 as vacation expense misstates the corporation's net income.

(b)

**WALTERS CORPORATION**  
**Income Statement**  
**For the Year Ended December 31, 2014**

Revenue (\$40,000 – \$3,000)* .....	\$37,000
<b>Expenses</b>	
Insurance expense .....	<u>7,000</u>
Net income.....	<u><u>\$30,000</u></u>

\*John incorrectly included revenue of \$3,000 in 2014. This revenue should have been reported in 2013.

- (a) Natalie has a choice between a sole proprietorship and a corporation. A partnership is not an option since she is the sole owner of the business.

A proprietorship is easier to create and operate because there are no formal procedures involved in creating the proprietorship. However, if she operates the business as a proprietorship she will personally have unlimited liability for the debts of the business. Operating the business as a corporation would limit her liability to her investment in the business. Natalie will in all likelihood require the services of a lawyer to incorporate. Costs to incorporate as well as additional ongoing costs to administrate and operate the business as a corporation may be costly. Also, her taxes would be higher if she incorporates.

- (b) Yes, Natalie will need accounting information to help her operate her business. She will need information concerning her cash balance on a daily or weekly basis to help her determine if she can pay her bills. She will need to know the cost of her services so she can establish her prices. She will need to know revenue and expenses so she can report her net income for personal income tax purposes, on an annual basis. If she borrows money, she will need financial statements so lenders can assess the liquidity, solvency, and profitability of the business. Natalie would also find financial statements useful to better understand her business and identify any financial issues as early as possible. Monthly financial statements would be best because they are more timely, but they are also more work to prepare.

- (c) **Assets: Cash, Accounts Receivable, Supplies, Equipment, Prepaid Insurance**

**Liabilities: Accounts Payable, Unearned Service Revenue, Notes Payable**

**Revenue: Service Revenue**

**Expenses: Advertising Expense, Supplies Expense, Rent Expense, Utilities Expense, Insurance Expense**

## **CONTINUING COOKIE CHRONICLE (Continued)**

- (d) Natalie should have a separate bank account. This will make it easier to prepare financial statements for her business. The business is a separate entity from Natalie and must be accounted for separately.**
- (e) I recommend that Natalie keep the car as a personal asset and pay for all costs personally. She should keep track of how many miles she drives for business purposes versus personal use and determine the percentage of business use versus personal use. She should keep track of all costs of owning and operating her car including such things as fuel, insurance, registration, and repairs and maintenance. Then she can multiply the percentage of business use by the total cost of owning and operating her car to calculate the amount of expense the business can record for travel.**

**The business will record this as an expense. Natalie can either reimburse herself for these business expenses by taking cash out of the business to pay for these costs or she can treat it as an investment in the business.**

**[Note to instructors: This last question is fairly complex and there are income tax considerations. This suggested solution does not cover all of the issues that should be considered. The intent is just to ensure students begin to think about how to deal with a fairly common issue for self-employed people.]**

- (a) Tootsie Roll's total assets at December 31, 2011 were \$857,856,000 and at December 31, 2010 were \$857,959,000.
- (b) Tootsie Roll had \$78,612,000 of cash at December 31, 2011.
- (c) Tootsie Roll had accounts payable totaling \$10,683,000 on December 31, 2011 and \$9,791,000 on December 31, 2010.
- (d) Tootsie Roll reported total revenues in 2011 of \$532,505,000 and in 2010 of \$521,448,000.
- (e) Tootsie Roll's net income decreased by \$9,125,000 from 2010 to 2011, from \$53,063,000 to \$43,938,000.

(a) <u>(amounts in thousands)</u>	<u>Tootsie Roll Industries, Inc.</u>	<u>The Hershey Company</u>
1. Total assets	\$857,856	\$4,412,199
2. Net property, plant and equipment	\$212,162	\$1,559,717
3. Total revenue	\$532,505	\$6,080,788
4. Net income	\$ 43,938	\$ 628,962

- (b) Both companies are profitable. Hershey's total assets and total revenues suggest that it is a substantially bigger company than Tootsie Roll. Hershey's total assets are more than five times as big as those of Tootsie Roll and its total revenues are more than 11 times as big as those of Tootsie Roll.



- (a) The ideas that the Public Company Accounting Oversight Board proposed for expanding the role of auditors in “passing judgement on more of what a company does and says” include weighing in on the quality of a company’s disclosures in its earnings releases and commenting on what the company says in its Management’s Discussion and Analysis section of its annual report.
- (b) Many people were surprised by the fact that many of the financial institutions that failed or required government support received “clean” audit opinions shortly before they announced their troubles. This caused some people to think that auditors should reveal more specific information.
- (c) The proposed Auditor’s Discussion and Analysis report would include information about the auditor’s views on the company’s use of judgments, estimates and accounting policies. The auditor would also discuss whether it believes the company’s financial reporting practices are aggressive.
- (d) It is likely that auditors would have mixed opinions of these proposals. On-the-one-hand, the expansion of the auditor’s role would create new revenue opportunities for auditors. However, the expansion of duties could very well create additional tension between the auditor and the client. Since the company is actually the one that hires the auditor, auditors might be reluctant to reveal too much. Also, many of these new duties appear to be less clearly defined than expressing an opinion on whether statements are presented in accordance with GAAP. This lack of clearly defined criteria could increase the auditor’s legal exposure.

- (a) Creditors lend money to companies with the expectation that they will be repaid at a specified point in time in the future. If a company is generating cash from operations in excess of its investing needs, it is more likely that it will be able to repay its creditors. Not only did Xerox actually have negative cash from operations, but all of the cash it received in order to meet its cash deficiency was from issuing new debt. Both of these facts would be of concern to the company's creditors, since it would suggest it will be less likely to be able to repay its debts.
- (b) As a stockholder you are interested in the long-term performance of a company and how that translates into its stock price. Often during the early years of a company's life its cash provided by operations is not sufficient to meet its investment needs, so the company will have to get cash from outside sources. However, in the case of Xerox, the company has operated for many years and has a well-established name brand. The negative cash from operations might suggest operating deficiencies.
- (c) The statement of cash flows reports information on a cash basis. An investor cannot get the complete story on the company's performance and financial position without looking at the income statement and balance sheet. Also, investors would want to look at more than one year's worth of data. The current year might not be representative of past or future years.
- (d) Xerox is a well known company. It has a past record of paying dividends. Its management probably decided to continue to pay a dividend to demonstrate confidence in the company's future. They may have felt that by not paying the dividend for the year they would send a negative message to investors. However, by choosing to pay a cash dividend the company obviously weakened its cash position, and decreased its ability to repay its debts.

Answers to this question will differ depending on the companies chosen by the student, and the year. We provide the following solution for Tootsie Roll for the year ended December 31, 2011.

- (a) During the year ended December 31, 2011, Tootsie Roll reported net income of \$43.9 million.
- (b) During the year ended December 31, 2011, Tootsie Roll reported sales of \$532.5 million.
- (c) The “Industry” label on the left side of the Profile site tells us that Tootsie Roll is in the Confectioners industry.
- (d) Companies also in this industry would include The Hershey Company, Cosan Ltd., Paradise Inc., Imperial Sugar Co., and Rocky Mountain Chocolate Factory Inc.
- (e) We chose Imperial Sugar Co. During the year ended September 30, 2011, Imperial reported sales of \$848.0 million and net loss of \$53.4 million.

- (a) The Report of Independent Accountants indicates that PriceWaterhouse Coopers LLP performed the audit of Tootsie Roll's financial statements.
- (b) The Consolidated Statement of Earnings, Comprehensive Earnings and Retained Earnings states that its earnings per share were \$0.76 in 2011.
- (c) Note 9 indicates that net sales in foreign countries were \$41,184,000 in 2011.
- (d) Earnings from operations were \$57,966 in 2011 compared to \$64,710 in 2010, a decrease of \$6,744. Earnings from operations includes \$29 and \$3,364 in certain deferred compensation expenses in 2011 and 2010, respectively. As discussed above, these deferred compensation expenses relate to changes in deferred compensation liabilities resulting from corresponding changes in the market value of trading securities and related investment income that hedge these liabilities. Adjusting for these deferred compensation expenses, operating earnings were \$57,995 and \$68,074 in 2011 and 2010, respectively, a decrease of \$10,079 or 14.8%. This decrease in earnings from operations principally reflects significantly higher ingredient costs and resulting lower gross profit margins, as well as higher freight and delivery expenses.

Management believes this comparison after adjusting for changes in deferred compensation is more reflective of the underlying operations of the company.

- (e) Per the Five Year Summary of Earnings and Financial Highlights, Net Sales in 2007 were \$492,742,000.
- (f) The Shareholders' Equity section of the Consolidated Statement of Financial Position states that 40,000,000 shares were authorized.
- (g) Per the Consolidated Statement of Cash Flows, \$16,351,000 was spent on capital expenditures.
- (h) Note 1 states that depreciation is based on "useful lives of 20 to 35 years for buildings."
- (i) Per the Consolidated Statement of Financial Position, raw materials and supplies were \$21,236,000 in 2010.

**To: Lori Milner**

**From: Student**

I have received the balance sheet of Philco Company, Inc. as of December 31, 2014. The purpose of a balance sheet is to report a company's financial position at a point in time. It reports what the company owns (assets) and what it owes (liabilities) and the net amount attributed to owners (equity). A number of items in this balance sheet are not properly reported. They are:

- (1) The balance sheet should be dated as of a specific date, not for a period of time. Therefore, it should be stated "December 31, 2014."**
- (2) Equipment should be below Supplies on the balance sheet.**
- (3) Accounts receivable should be shown as an asset and reported between Cash and Supplies on the balance sheet.**
- (4) Accounts payable should be shown as a liability, not an asset. Therefore, it should be reported in the liability section, after note payable.**
- (5) Liabilities and stockholders' equity should be shown separately on the balance sheet. Common stock, Retained earnings, and Dividends are not liabilities.**
- (6) Common stock, Retained earnings, and Dividends are part of stockholders' equity. The Dividends account is not reported on the balance sheet but is subtracted from beginning retained earnings to arrive at the ending balance.**

**A correct balance sheet is as follows:**

**PHILCO COMPANY, INC.**  
**Balance Sheet**  
**December 31, 2014**

<b>Assets</b>		
Cash.....		\$ 9,000
Accounts receivable.....		6,000
Supplies.....		1,000
Equipment .....		<u>18,000</u>
<b>Total assets .....</b>		<b><u>\$34,000</u></b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Notes payable.....	\$10,000	
Accounts payable .....	<u>4,000</u>	
<b>Total liabilities .....</b>		<b>\$14,000</b>
<b>Stockholders' equity</b>		
Common stock .....	12,000	
Retained earnings.....	<u>8,000*</u>	<u>20,000</u>
<b>Total liabilities and stockholders' equity .....</b>		<b><u>\$34,000</u></b>
*Retained earnings .....	\$10,000	
Less: Dividends.....	<u>2,000</u>	
<b>Ending retained earnings .....</b>	<b><u>\$ 8,000</u></b>	

- (a) Investors rely on auditors to perform an independent assessment of a company. If the auditor owns stock in that company, he or she might not be able to act in an independent and impartial manner.
- (b) There are pros and cons to this argument. On the positive side, it could be argued that as long as a person has no direct relationship with a client company, that person will not influence the findings of the work. However, a counter argument is that an influential partner within a firm, who had a investment in a client that he or she didn't work on, might be tempted to try to influence the findings of the audit if he or she feared that the findings were going to negatively affect the value of his or her investment.
- (c) The fact that four firms have become so big means that prohibiting employees of those accounting firms from buying stock in clients of the firm would bar those employees from investing in roughly 25% of publicly traded firms. Some have argued that such restrictive rules would create undue hardship, and unfairly restrict the investment options of these people. They also argue that in such a large organization it is increasingly unlikely that an individual who does not work on a particular audit will be able to influence the outcome of that audit. As a consequence, rules that focus on restricting investments by those employees actually involved in the audit of a client may be most reasonable and most effective.
- (d) Answers to this question will vary. This is a particularly difficult issue since the rule effectively eliminates the individual's control over their investment portfolio. They did nothing wrong when they bought the shares, but now they are being forced to sell when it is not advantageous.
- (e) The management of PricewaterhouseCoopers noted that auditor independence is vitally important to the audit function. If investors don't think the auditor is independent of the client they will lose faith in auditing, which would have dire consequences for securities markets. Therefore, it was important that the firm make a bold, unambiguous response to address this problem.

- (a) Answers to the following will vary depending on students' opinions.
- (i) This does not represent the hiding of assets, but rather a choice as to the order of use of assets. This would seem to be ethical.
  - (ii) This does not represent the hiding of assets, but rather is a change in the nature of assets. Since the expenditure was necessary, although perhaps accelerated, it would seem to be ethical.
  - (iii) This represents an intentional attempt to deceive the financial aid office. It would therefore appear to be both unethical and potentially illegal.
  - (iv) This is a difficult issue. By taking the leave, actual net income would be reduced. The form asks the applicant to report actual net income. However, it is potentially deceptive since you do not intend on taking unpaid absences in the future, thus future income would be higher than reported income.
- (b) Companies might want to overstate net income in order to potentially increase the stock price by improving investors' perceptions of the company. Also, a higher net income would make it easier to receive debt financing. Finally, managers would want a higher net income to increase the size of their bonuses.
- (c) Sometimes companies want to report a lower income if they are negotiating with employees. For example, professional sports teams frequently argue that they cannot increase salaries because they aren't making enough money. This also occurs in negotiations with unions. For tax accounting (as opposed to the financial accounting in this course) companies frequently try to minimize the amount of reported taxable income.
- (d) Unfortunately many times people who are otherwise very ethical will make unethical decisions regarding financial reporting. They might be driven to do this because of greed. Frequently it is because their superiors have put pressure on them to take an unethical action, and they are afraid to not follow directions because they might lose their job. Also, in some instances top managers will tell subordinates that they should be a team player, and do the action because it would help the company, and therefore would help fellow employees.



- (a) The 5 aspirations relate to the company's goals related to sustaining its business, its brands, its people, its community and the planet.
- (b) The annual reports discussed in the chapter report on a company's financial results and financial position. Financial annual reports have a format and content that follows requirements specified by accounting regulators. The primary contents of a financial annual report is the company's financial statements, which are audited by independent accountants. The Clif Bar & Company Annual Report describes the company's goals and results related to its 5 aspirations. The report does not follow a prescribed format, but instead can take whatever form, and include any content that the company chooses. The report is not audited by an outside body.
- (c)
- i. Support sustainable food and agriculture: Purchased 170 million pounds of organic ingredients since the company's inception.
  - ii. Embrace zero waste business practices: Caddies are 100% shrink-wrap free and made from 100% recycled paperboard.
  - iii. Promote climate action and renewable energy: Installed largest "smart" solar array in North America that provides nearly all of its electrical needs.
  - iv. Conserve natural resources, protect wild places: Planted 40,000 trees in partnership with American Forests.

### IFRS1-1

The International Accounting Standards Board, IASB, and the Financial Accounting Standards Board, FASB, are two key players in developing international accounting standards. The IASB releases international standards known as International Financial Reporting Standards (IFRS). The FASB releases US standards, referred to as Generally Accepted Accounting Standards or GAAP.

### IFRS1-2

Accounting standards have developed in different ways because the standard setters have responded to different user needs. In some countries, the primary users of financial statements are private investors; in others the primary users are taxing authorities or central government planners.

### IFRS1-3

A single set of high-quality accounting standards is needed because of increases in multinational corporations, mergers and acquisitions, use of information technology, and international financial markets.

### IFRS1-4

Currently the internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. If such standards were adopted by non-U.S. companies, users of statements would benefit from more uniform regulation and U.S. companies would be competing on a more “even” playing field. The disadvantage of adopting SOX would be the additional cost associated with its required internal control measures.

- (a) Grant Thornton UK LLP**
- (b) Note 3.10 states that straight line depreciation is used for freehold buildings at a rate of 2% per period. A 2% rate indicates a 50 year life.**
- (c) 1000 Highgate Studios, 53-79 Highgate Road, London, NW5 1TL**
- (d) The company reports in sterling (pounds).**
- (e) The company operates in Confectionary which had sales of L85,861 and Natural Snacks which had sales of L49,137.**

