# CHAPTER 1

## Introduction to Financial Statements

### Study 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 Study Objectives and Bloom's Taxonomy

| Item | SO | BT | Item | SO | BT | Item | SO | BT | Item | SO | BT | Item | SO | BT |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | **Questions** | | | | | | | |
| 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. | 5 | AP | 17. | 5 | C | 21. | 5 | C |
| 5. | 2 | C | | | | | | | | | | | | |
| | | | | | | | **Brief Exercises** | | | | | | | |
| 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, 4 | K | | | | | | | | | | | | |
| | | | | | | | **Do It! Review Exercises** | | | | | | | |
| 1. | 1 | C | 2. | 3 | K | 3. | 4 | AP | 4. | 6 | C | | | |
| | | | | | | | **Exercises** | | | | | | | |
| 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 | C | | | | | | | | | |
| | | | | | | | **Problems: Set A** | | | | | | | |
| 1. | 1 | C | 2. | 2, 4, 5 | K | 3. | 4, 5 | AP | 4. | 4, 5 | AP | 5. | 4, 5 | AP |
| | | | | | | | **Problems: Set B** | | | | | | | |
| 1. | 1 | C | 2. | 2, 4, 5 | K | 3. | 4, 5 | AP | 4. | 4, 5 | AP | 5. | 4, 5 | AP |

# ASSIGNMENT CHARACTERISTICS TABLE

| Problem Number | Description | Difficulty Level | Time Allotted (min.) |
|---|---|---|---|
| 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 easier to raise 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 activity 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.
   (b) Balance sheet.
   (c) Income statement.
   (d) Balance sheet.
   (e) Balance sheet.
   (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.

**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 activity.

**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 Assets = Liabilities + 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:

| Assets | | Liabilities | | Stockholders' Equity |
|---|---|---|---|---|
| $838,247,000 | = | $185,762,000* | + | $652,485,000 |

*$56,066,000 + $129,696,000

 

# 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

**WYOMING COMPANY**
**Balance Sheet**
**December 31, 2012**

**Assets**

| | |
|---|---|
| Cash | $22,000 |
| Accounts receivable | 71,000 |
| Total assets | $93,000 |

**Liabilities and Stockholders' Equity**

| | |
|---|---|
| **Liabilities** | |
| Accounts payable | $65,000 |
| **Stockholders' equity** | |
| Common stock | 28,000 |
| Total liabilities and stockholders' equity | $93,000 |

## BRIEF EXERCISE 1-6

| | | |
|---|---|---|
| IS | (a) | Income tax expense |
| BS | (b) | Inventories |
| BS | (c) | Accounts payable |
| BS | (d) | Retained earnings |
| BS | (e) | Property, plant, and equipment |
| IS | (f) | Net sales |
| IS | (g) | Cost of goods sold |
| BS | (h) | Common stock |
| BS | (i) | Receivables |
| IS | (j) | Interest expense |

## BRIEF EXERCISE 1-7

| | | |
|---|---|---|
| I | (a) | Revenue during the period. |
| B | (b) | Supplies on hand at the end of the year. |
| C | (c) | Cash received from issuing new bonds during the period. |
| B | (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

**GOULD CORPORATION**
**Income Statement**
**For the Year Ended December 31, 2012**

| | | |
|---|---|---|
| Revenues | | |
| Service revenue | | $25,000 |
| Expenses | | |
| Rent expense | $10,000 | |
| Advertising expense | 4,000 | |
| Supplies expense | 1,700 | |
| Total expenses | | 15,700 |
| Net income | | $ 9,300 |

## DO IT! 1-3 (Continued)

**GOULD CORPORATION**
**Retained Earnings Statement**
**For the Year Ended December 31, 2012**

| | | |
|---|---|---|
| Retained earnings, January 1 | | $ –0– |
| Add: Net income | | 9,300 |
| | | 9,300 |
| Less: Dividends | | 2,500 |
| Retained earnings, December 31 | | $6,800 |

**GOULD CORPORATION**
**Balance Sheet**
**December 31, 2012**

**Assets**

| | | |
|---|---|---|
| Cash | | $ 3,100 |
| Accounts receivable | | 2,000 |
| Supplies | | 1,900 |
| Equipment | | 26,800 |
| Total assets | | $33,800 |

**Liabilities and Stockholders' Equity**

| | | |
|---|---|---|
| Liabilities | | |
| Notes payable | $ 7,000 | |
| Account payable | 5,000 | |
| Total liabilities | | $12,000 |
| Stockholder's equity | | |
| Common stock | $15,000 | |
| Retained earnings | 6,800 | |
| Total stockholders' equity | | 21,800 |
| Total liabilities and stockholder's equity | | $33,800 |

**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—Stdt 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 of 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

**ALEXIS CO.**
**Income Statement**
**For the Year Ended December 31, 2012**

| | | |
|---|---|---|
| **Revenues** | | |
| Service revenue | | $58,000 |
| **Expenses** | | |
| Salaries and wages expense | $30,000 | |
| Rent expense | 10,400 | |
| Utilities expense | 2,400 | |
| Advertising expense | 1,800 | |
| Total expenses | | 44,600 |
| **Net income** | | $13,400 |

**ALEXIS CO.**
**Retained Earnings Statement**
**For the Year Ended December 31, 2012**

| | |
|---|---|
| Retained earnings, January 1 | $67,000 |
| Add: Net income | 13,400 |
| | 80,400 |
| Less: Dividends | 6,000 |
| Retained earnings, December 31 | $74,400 |

## EXERCISE 1-5

(a)

**MERCK AND CO.**
**Income Statement**
**For the Year Ended December 31, 2009**
**(in millions)**

| | | |
|---|---|---|
| Revenues | | |
| Sales revenue | $27,428.3 | |
| Other revenue | 11,147.7 | |
| Total revenue | | $38,576.0 |
| Expenses | | |
| Marketing and administrative expense | $ 8,543.2 | |
| Materials and production expense | 9,018.9 | |
| Research and development expense | 5,845.0 | |
| Tax expense | 2,267.6 | |
| Total expenses | | 25,674.7 |
| Net income | | $12,901.3 |

**MERCK AND CO.**
**Retained Earnings Statement**
**For the Year Ended December 31, 2009**
**(in millions)**

| | |
|---|---|
| Retained earnings, January 1 | $43,698.8 |
| Add: Net income | 12,901.3 |
| | 56,600.1 |
| Less: Dividends | 3,597.7 |
| Retained earnings, December 31 | $53,002.4 |

(b) The short-term implication would be a decrease in expenses of $2,922.5 ($5,845 X 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 ÷ $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 knowledgable investors reviewed Merck's financial statements and discovered the cause of the increase.**

## EXERCISE 1-6

**PACKEE INC.**
**Retained Earnings Statement**
**For the Year Ended December 31, 2012**

| | | |
|---|---|---|
| Retained earnings, January 1 | | $130,000 |
| Add: Net income | | 225,000* |
| | | 355,000 |
| Less: Dividends | | 65,000 |
| Retained earnings, December 31 | | $290,000 |
| | | |
| *Revenue from legal services | $400,000 | |
| Total expenses | 175,000 | |
| Net income | $225,000 | |

## EXERCISE 1-7

(a) Scott Corporation is distributing nearly all of this year's net income as dividends. This suggests that Scott is not pursuing rapid growth. Companies that have a lot of opportunities for growth pay low dividends.

(b) Silberman 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 | Income taxes payable |
| L | Accounts payable |
| R | Service revenue |
| E | Interest expense |

(b)

LINUS INC.
Income Statement
For the Year Ended December 31, 2012

| | | |
|---|---|---|
| Revenues | | |
| Sales revenue | $584,951 | |
| Service revenue | 4,806 | |
| Total revenues | | $589,757 |
| Expenses | | |
| Cost of goods sold | 438,458 | |
| Salaries and wages expense | 115,131 | |
| Interest expense | 1,882 | |
| Total expenses | | 555,471 |
| Net income | | $ 34,286 |

 

## 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 = $30,000**

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

**$12,000 + e – $5,000 = $27,000**
**$7,000 + e = $27,000**
**e = $20,000**

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

**Revenue – Cost of goods sold – Administrative expenses = Net income**

**$85,000 – c – $10,000 = $20,000**
**$75,000 – c = $20,000**
**c = $55,000**

## EXERCISE 1-10

(a)

| | | |
|---|---|---|
| Camping fee revenue | $132,000 | |
| General store revenue | 25,000 | |
| Total revenue | | $157,000 |
| Expenses | | 126,000 |
| Net income | | $ 31,000 |

(b)

**DEER TRACK PARK**
**Retained Earnings Statement**
**For the Year Ended December 31, 2012**

| | |
|---|---|
| Retained earnings, January 1 | $ 5,000 |
| Add: Net income | 31,000 |
| | 36,000 |
| Less: Dividends | 9,000 |
| Retained earnings, December 31 | $27,000 |

## EXERCISE 1-10 (Continued)

**DEER TRACK PARK**
**Balance Sheet**
**December 31, 2012**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $ 8,500 |
| Supplies | | 5,500 |
| Equipment | | 114,000 |
| Total assets | | $128,000 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Notes payable | $50,000 | |
| Accounts payable | 11,000 | |
| Total liabilities | | $ 61,000 |
| Stockholders' equity | | |
| Common stock | 40,000 | |
| Retained earnings | 27,000 | 67,000 |
| Total liabilities and stockholders' equity | | $128,000 |

(c) The income statement indicates that revenues from the general store were only about 16% ($25,000 ÷ $157,000) of total revenue which tends to support Ken'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 | Long-term debt |
| A | Inventories |
| R | Net sales |
| L | Accounts payable |
| SE | Common stock |
| E | Income tax expense |
| R | Other revenue |

(b)

**KELLOGG COMPANY**
**Income Statement**
**For the Year Ended December 31, 2009**
**(in millions)**

| | | |
|---|---|---|
| Revenues | | |
| Net sales | | $12,575 |
| Expenses | | |
| Cost of goods sold | $7,184 | |
| Selling and administrative expenses | 3,390 | |
| Income tax expense | 476 | |
| Interest expense | 295 | |
| Other expense | 22 | |
| Total expenses | | 11,367 |
| Net income | | $ 1,208 |

 

## EXERCISE 1-12

(a)

**O'BRIEN CORPORATION**
**Statement of Cash Flows**
**For the Year Ended December 31, 2012**

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

(b) As a creditor, I would feel reasonably confident that O'Brien has the ability to repay its lenders. During 2012, O'Brien generated $34,000 of cash from its operating activities. This amount more than covered its expenditures for new equipment but not dividends.

## EXERCISE 1-13

(a)

**SOUTHWEST AIRLINES**
**Statement of Cash Flows**
**For the Year Ended December 31, 2009**
**(in millions)**

| | | |
|---|---|---|
| **Cash flows from operating activities** | | |
| Cash received from customers | $9,823 | |
| Cash paid for goods and services | (6,978) | |
| Net cash provided by operating activities | | $2,845 |
| **Cash flows from investing activities** | | |
| Cash paid for property and equipment | (1,529) | |
| Net cash used by investing activities | | (1,529) |
| **Cash flows from financing activities** | | |
| 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 | (14) | |
| Net cash used by financing activities | | (493) |
| Net increase in cash | | 823 |
| Cash at beginning of period | | 1,390 |
| Cash at end of period | | $2,213 |

(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 2009.

## EXERCISE 1-14

**CHEYENNE COMPANY**
**Balance Sheet**
**December 31, 2012**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $18,000 |
| Accounts receivable | | 12,000 |
| Supplies | | 9,500 |
| Equipment | | 40,000 |
| Total assets | | $79,500 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Accounts payable | | $16,000 |
| Stockholders' equity | | |
| Common stock | $40,000 | |
| Retained earnings | 23,500* | 63,500 |
| Total liabilities and stockholders' equity | | $79,500 |

*$31,500 – $8,000

## EXERCISE 1-15

**All dollars are in millions.**

**(a) Assets**

| | |
|---|---|
| Cash | $ 2,291.1 |
| Accounts receivable | 2,883.9 |
| Inventories | 2,357.0 |
| Property, plant, and equipment | 1,957.7 |
| Other assets | 3,759.9 |
| Total assets | $13,249.6 |

**Liabilities**

| | |
|---|---|
| Notes payable | $ 342.9 |
| Accounts payable | 2,815.8 |
| Other liabilities | 1,311.5 |
| Income taxes payable | 86.3 |
| Total liabilities | $ 4,556.5 |

**Stockholders' Equity**

| | |
|---|---|
| Common stock | $ 2,874.2 |
| Retained earnings | 5,818.9 |
| Total stockholders' equity | $ 8,693.1 |

**(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 ÷ $13,249.6) compared to equity financing of 66% ($8,693.1 ÷ $13,249.6).

## EXERCISE 1-16

(a)

| | Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| | $110,000 | = | $70,000 | + | (a) |
| | (a) | = | | | $40,000 |

(b)

| | Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| | (b) | = | $120,000 | + | $60,000 |
| | (b) | = | $180,000 | | |

(c)

| Beginning Stockholders' Equity | + | Revenues | – | Expenses | – | Dividends | = | Ending Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|
| $40,000(a) | + | 215,000 | – | 165,000 | – | (c) | = | $60,000 |
| | | $ 90,000 | – | (c) | | | = | $60,000 |
| | | | | (c) | | | = | $30,000 |

(d)

| | Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| | $150,000 | = | (d) | + | $70,000 |
| | (d) | = | $80,000 | | |

(e)

| | Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| | $180,000 | = | $ 55,000 | + | (e) |
| | (e) | = | $125,000 | | |

(f)

| Beginning Stockholders' Equity | + | Revenues | – | Expenses | – | Dividends | = | Ending Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|
| $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) Ed 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 Mark 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 Mark 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, Inc. 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.

  

## PROBLEM 1-3A

(a)

**BEARDSLEY SERVICE CO.**
**Income Statement**
**For the Month Ended June 30, 2012**

| | | |
|---|---|---|
| **Revenues** | | |
| Service revenue | | $7,500 |
| **Expenses** | | |
| Salaries and wages expense | $1,400 | |
| Supplies expense | 1,000 | |
| Maintenance and repairs expense | 600 | |
| Advertising expense | 400 | |
| Utilities expense | 300 | |
| Total expenses | | 3,700 |
| **Net income** | | $3,800 |

**BEARDSLEY SERVICE CO.**
**Retained Earnings Statement**
**For the Month Ended June 30, 2012**

| | |
|---|---|
| Retained earnings, June 1 | $ 0 |
| Add: Net income | 3,800 |
| | 3,800 |
| Less: Dividends | 1,400 |
| Retained earnings, June 30 | $2,400 |

 

**BEARDSLEY SERVICE CO.**
**Balance Sheet**
**June 30, 2012**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $ 4,600 |
| Accounts receivable | | 4,000 |
| Supplies | | 2,400 |
| Equipment | | 26,000 |
| Total assets | | $37,000 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Notes payable | $12,000 | |
| Accounts payable | 500 | |
| Total liabilities | | $12,500 |
| Stockholders' equity | | |
| Common stock | 22,100 | |
| Retained earnings | 2,400 | 24,500 |
| Total liabilities and stockholders' equity | | $37,000 |

(b) Beardsley had a very successful first month, earning $3,800 or 51% of service revenues ($3,800 ÷ $7,500). Its net income represents a 17% return on the initial investment ($3,800 ÷ $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. Beardsley distributed 37% ($1,400 ÷ $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.

  

## PROBLEM 1-4A

(a) Yvonne 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

### YVONNE CORPORATION
### Statement of Cash Flows
### For the Year Ended December 31, 2012

| | | |
|---|---|---|
| Cash flows from operating activities | | |
| Cash received from customers | $132,000 | |
| Cash paid to suppliers | (104,000) | |
| Net cash provided by operating activities | | $28,000 |
| Cash flows from investing activities | | |
| Cash paid to purchase equipment | (12,000) | |
| Net cash used by investing activities | | (12,000) |
| Cash flows from financing activities | | |
| Cash received from issuing common stock | 22,000 | |
| Cash dividends paid | (7,000) | |
| Net cash provided by financing activities | | 15,000 |
| Net increase in cash | | $31,000 |

(b) Yvonne 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.

## PROBLEM 1-5A

(a) 1. Since the boat actually belongs to John Paulus—not to Gabelli Corporation—it should not be reported on the corporation's balance sheet. Likewise, the boat loan is a personal loan of John's—not a liability of Gabelli Corporation.

2. The inventory should be reported at $25,000, the amount paid when it was purchased. Gabelli Corporation will record $36,000 as revenues when the inventory is sold.

3. The $10,000 receivable is not an asset of Gabelli Corporation—it is a personal asset of John Paulus.

(b)

**GABELLI CORPORATION**
**Balance Sheet**
**December 31, 2012**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $20,000 |
| Accounts receivable | | 40,000* |
| Inventory | | 25,000 |
| Total assets | | $85,000 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Notes payable | $15,000 | |
| Accounts payable | 30,000 | |
| Total liabilities | | $45,000 |
| Stockholders' equity | | 40,000** |
| Total liabilities and stockholders' equity | | $85,000 |

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

 

## PROBLEM 1-1B

(a) Rachel should run her business as a sole proprietor. She has no real need to raise funds, and she 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 Brittany 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 Brittany 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 Bally Total Fitness. The income statement provides the most useful information for predicting future performance.

(b) In deciding whether to extend credit for 60 days Boeing 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.

 

## PROBLEM 1-3B

(a)

**SPECIAL DELIVERY**
**Income Statement**
**For the Month Ended May 31, 2012**

| | | |
|---|---|---|
| Revenues | | |
| Service revenue | | $10,400 |
| Expenses | | |
| Maintenance and repairs expense | $2,900 | |
| Salaries and wages expense | 2,000 | |
| Advertising expense | 800 | |
| Insurance expense | 400 | |
| Total expenses | | 6,100 |
| Net income | | $ 4,300 |

**SPECIAL DELIVERY**
**Retained Earnings Statement**
**For the Month Ended May 31, 2012**

| | |
|---|---|
| Retained earnings, May 1 | $ 0 |
| Add: Net income | 4,300 |
| | 4,300 |
| Less: Dividends | 1,700 |
| Retained earnings, May 31 | $2,600 |

**SPECIAL DELIVERY**
**Balance Sheet**
**May 31, 2012**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $15,800 |
| Accounts receivable | | 6,200 |
| Equipment | | 56,000 |
| Total assets | | $78,000 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Notes payable | $28,000 | |
| Accounts payable | 2,400 | |
| Total liabilities | | $30,400 |
| Stockholders' equity | | |
| Common stock | 45,000 | |
| Retained earnings | 2,600 | 47,600 |
| Total liabilities and stockholders' equity | | $78,000 |

(b) Special delivery was very profitable during its first month of operations. Net income of $4,300 represents an 9.6% return on the $45,000 investment as well as 41% of service revenues ($4,300 ÷ $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 Special Delivery's decision might be seen as risky. Lenders might view such an action negatively since Special Delivery owes $28,000 in notes payable. On the other hand, the company still "retained" more than 60% of its earnings ($2,600 ÷ $4,300) and it had adequate cash to cover the $1,700 dividend.

  

## PROBLEM 1-4B

(a) Rowe 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

**ROWE CORPORATION**
**Statement of Cash Flows**
**For the Year Ended December 31, 2012**

| | | |
|---|---|---|
| Cash flows from operating activities | | |
| Cash received from customers | $172,000 | |
| Cash paid to suppliers | (154,000) | |
| Net cash provided by operating activities | | $18,000 |
| Cash flows from investing activities | | |
| Cash paid to purchase equipment | (30,000) | |
| Net cash used by investing activities | | (30,000) |
| Cash flows from financing activities | | |
| Cash received from issuing bonds payable | 40,000 | |
| Cash dividends paid | (6,000) | |
| Net cash provided by financing activities | | 34,000 |
| Net increase in cash | | $22,000 |

(b) Operating activities provided $18,000 cash which was not adequate to cover $30,000 needed for investing activities and $6,000 of dividend payments. Rowe issued $40,000 of bonds payable to fund these cash payments and increase its year-end cash balance.

## PROBLEM 1-5B

(a) 1. The $3,000 of revenue that the company earned in 2011 should <u>not</u> be included in the 2012 revenues. Instead, the $3,000 should be added to the beginning balance of retained earnings to correct for the omission in 2011.

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 $4,000 as vacation expense misstates the corporation's net income.

(b)

**AUSTIN CORPORATION**
**Income Statement**
**For the Year Ended December 31, 2012**

| | |
|---|---|
| Revenue ($47,000 – $3,000)* | $44,000 |
| Expenses | |
| Insurance expense | 7,000 |
| Net income | $37,000 |

*Joanna incorrectly included revenue of $3,000 in 2012. This revenue should have been reported in 2011.

  

## BYP 1-1 FINANCIAL REPORTING PROBLEM

(a) Tootsie Roll's total assets at December 31, 2009 were $838,247,000 and at December 31, 2008 were $813,525,000.

(b) Tootsie Roll had $90,990,000 of cash at December 31, 2009.

(c) Tootsie Roll had accounts payable totaling $9,140,000 on December 31, 2009 and $13,885,000 on December 31, 2008.

(d) Tootsie Roll reported total revenues in 2009 of $499,331,000 and in 2008 of $496,016,000.

(e) Tootsie Roll's net income increased by $14,698,000 from 2008 to 2009, from $38,777,000 to $53,475,000.

## BYP 1-2 COMPARATIVE ANALYSIS PROBLEM

(a)

| (amounts in thousands) | Tootsie Roll Industries, Inc. | Hershey Foods Corporation |
|---|---|---|
| 1. Total assets | $838,247 | $3,675,031 |
| 2. Net property, plant and equipment | $220,721 | $1,404,767 |
| 3. Total revenues | $499,331 | $5,298,668 |
| 4. Net income | $ 53,475 | $ 435,994 |

(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 four times as big as those of Tootsie Roll and its total revenues are more than 10 times as big as those of Tootsie Roll.

## BYP 1-3 RESEARCH CASE

**(a) The 2009 rankings of each of the "Big Four" accounting firms were:**
**Deloitte and Touche (1)**
**Ernst and Young (2)**
**PricewaterhouseCoopers (3)**
**KPMG (4)**

**(b) The article suggest that the accounting firms success in the survey was due to rich benefits, extensive training programs, and a massive combined recruiting effort that results in more than 10,000 new hires a year.**

**(c) The starting salary for a new employee at Deloitte and Touche was $55,000 to $60,000.**

**(d) Deloitte's hiring decline by 1.1% relative to 2008, which was the smallest decline of the Big Four. According to information posted as of July 2010, KPMG's hiring declined by 29.7%, which was the largest decline of the accounting firms.**

## BYP 1-4 INTERPRETING FINANCIAL STATEMENTS

(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.

  

## BYP 1-5 FINANCIAL ANALYSIS ON THE WEB

**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, 2009.**

**(a) You must read the description of "ttm" to see the period that net income and sales were measured over. During the year ended December 31, 2009, Tootsie Roll reported net income of $53.5 million.**

**(b) During the year ended December 31, 2009, Tootsie Roll reported sales of $499.3 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 Hershey Foods Corp., 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, 2009, Imperial reported sales of $522.6 million and net loss of $23.2 million.**

 

## BYP 1-6 DECISION-MAKING ACROSS THE ORGANIZATION

(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 $0.95 in 2009.

(c) Note 9 indicates that net sales in foreign countries were $40,075,000 in 2009.

(d) Management's Discussion and Analysis of Financial Condition and Results of Operations states that the decrease resulted from increases in deferred compensation charges of $11,858 and a nonrecurring $14,000 non-cash impairment charge. Without these unusual charges, "operating earnings were $80,603 and $59,193 in 2009 and 2008, respectively, an increase of $21,410 or 36.2%. Management believes this comparison is more reflective of the underlying operations of the Company."

(e) Per the Five Year Summary of Earnings and Financial Highlights, Net Sales in 2005 were $487,739,000.

(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, $20,831,000 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 $20,722,000 in 2008.

  

## BYP 1-7 COMMUNICATION ACTIVITY

**To:** Jane Noonan

**From:** Student

I have received the balance sheet of Wilson Company, Inc. as of December 31, 2012. 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, 2012."

(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. The note payable is also a liability and should be reported in the liability section.

(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 Retained earnings to arrive at the ending balance.

A correct balance sheet is as follows:

**WILSON COMPANY, INC.**
**Balance Sheet**
**December 31, 2012**

**Assets**

| | | |
|---|---|---|
| Cash | | $ 9,000 |
| Accounts receivable | | 6,000 |
| Supplies | | 1,000 |
| Equipment | | 18,000 |
| Total assets | | $34,000 |

**Liabilities and Stockholders' Equity**

| | | |
|---|---|---|
| Liabilities | | |
| Notes payable | $10,000 | |
| Accounts payable | 4,000 | |
| Total liabilities | | $14,000 |
| Stockholders' equity | | |
| Common stock | 12,000 | |
| Retained earnings | 8,000* | 20,000 |
| Total liabilities and stockholders' equity | | $34,000 |

| | |
|---|---|
| *Retained earnings | $10,000 |
| Less: Dividends | 2,000 |
| Ending retained earnings | $ 8,000 |

  

## BYP 1-8 ETHICS CASE

(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.

## BYP 1-9 ALL ABOUT YOU: THE ETHICS OF FINANCIAL AID

(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 can not 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.

  

## IFRS CONCEPTS AND APPLICATION

### 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 a 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.**

## IFRS1-5 INTERNATIONAL FINANCIAL REPORTING PROBLEM

(a) Grant Thornton UK LLP
(b) Note (k) 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 L75,093 and Natural and Premium Snacks which had sales of L43,509.

  