

# 1

## ACCOUNTING AND THE FINANCIAL STATEMENTS

### DISCUSSION QUESTIONS

1. Accounting is a system for identifying, measuring, recording, and communicating financial information about an organization's activities to permit informed decisions by users of the information. Bookkeeping is the process—made up of mechanical “steps”—of recording transactions and maintaining accounting records. While bookkeeping is part of accounting, accounting is viewed as the complete information system that communicates the economic activities of a company to interested parties. Accounting is often referred to as the “language of business” because it communicates information about economic activities of a company that help people make decisions.
2. Accounting information is demanded or needed by decision-makers both inside and outside the business to provide information about business activities and finances so that informed decisions can be made. Five groups that create the demand for accounting information and their uses of accounting information are described below.
  - (1) Managers need accounting information to plan and make decisions about the business (e.g., predicting the consequences of their actions and deciding on which actions to take) and to control its operations (e.g., evaluating the effectiveness of their past decisions).
  - (2) Employees use accounting information about their employer to aid in planning their careers (e.g., judging the future prospects of the company).
  - (3) Investors (owners) need accounting information about a business to evaluate the future prospects of a business and to decide where to invest their money.
  - (4) Creditors (lenders) need accounting information to decide whether or not to lend money or extend credit to a business.
  - (5) Governments need accounting information about businesses to determine taxes owed by businesses, to implement a variety of regulatory objectives, and to make national economic policy decisions.
3. An accounting entity is a company that has an identity separate from that of its owners and managers and for which accounting records are kept. There are three main forms that accounting entities take: a sole proprietorship, a partnership, and a corporation.
4. A sole proprietorship is a business entity owned by one person. A partnership is a business entity owned jointly by two or more individuals. Proprietorships and partnerships are not legally separate from the personal affairs of the owners. That is, the owners are responsible for the debts of the business. A corporation is a separate legal entity formed by one or more persons called stockholder(s). A corporation is legally separate from the affairs of its owners, which limits the stockholders' legal responsibility for the debt of the business to the amount that the stockholders invested in the business. Corporate shareholders generally pay more taxes than owners of sole proprietorships or partnerships. Although the combined number of sole proprietorships and partnerships greatly outnumber the number of corporations, the majority of business in the United States is conducted by corporations.

5. The three main types of business activities are financing activities, investing activities, and operating activities. Financing activities involve obtaining the funds necessary to begin and operate a business. These funds come from either issuing stock or borrowing money. Investing activities involve buying and selling assets that enable a corporation to operate. Operating activities are the normal business activities that a company engages in as it conducts its business. These activities involve selling products or services, purchasing inventory, collecting amounts due from customers, and paying suppliers.
6. Assets are the economic resources or future economic benefits obtained or controlled by a business. Liabilities are the creditors' claims on the resources of a business. Stockholders' equity is the ownership claim on the resources of a business. Stockholders' equity is considered a residual interest in the assets of a business that remain after deducting the business's liabilities. All three items appear on the balance sheet, forming the following equation:  

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$
7. Revenues are the increases in assets (resources) that result from the sale of products or services. Expenses are the costs of assets (resources) used, or the liabilities created, in the operation of the business. If revenues are greater than expenses, a corporation has earned net income. If expenses are greater than revenues, a corporation has incurred a net loss.
8. The four primary financial statements are:
  - (1) Balance sheet: a presentation of information about a company's economic resources (assets) and the claims against those resources by creditors and owners (liabilities and stockholders' equity) at a specific point in time
  - (2) Income statement: a report on how well a company has performed its operations—the profitability of a company—over a period of time
  - (3) Retained earnings statement: a report on how much of the company's income was retained in the business and how much was distributed to owners over a period of time
  - (4) Statement of cash flows: a report on the changes in a company's cash during a period of time. The statement of cash flows provides information about the company's cash inflows (sources) and outflows (uses) from operating, investing, and financing activities.
9. There are many questions that can be answered based on each of the financial statements:
  - (1) Balance sheet:
    - a. What is the total amount of assets (economic resources) of a corporation? What is the total amount of liabilities (claims against the resources) for a corporation?
    - b. How much equity do the owners of the corporation have in its assets?
    - c. Is the corporation able to pay its debts as they become due?
  - (2) Income statement:
    - a. How much revenue was earned last month? Last quarter? Last year?
    - b. What was the total amount of expenses incurred to earn that revenue?
    - c. How much better off is the corporation at the end of the year than it was at the beginning of the year?
    - d. Was the corporation profitable, and what are the prospects for the corporation's future profitability?
    - e. What are the prospects for the future growth of the corporation?

- (3) Retained earnings statement:
- How much income was distributed in dividends by the corporation?
  - What amount of equity in the business has been generated internally?
- (4) Statement of cash flows:
- How much cash was taken in or paid out as a result of operations?
  - How much cash was invested in new equipment?
  - How much cash was used to pay off business debt?
- 10.** Point-in-time measurement means as of a particular date. The balance sheet is a point-in-time measurement. The period-of-time description applies to what has happened over a time interval. The income statement is a period-of-time measurement that explains the business activities between balance sheet dates. The statement of cash flows and the statement of retained earnings are also period-of-time measurements.
- 11.** The fundamental accounting equation is:
- $$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$
- The equation is significant because it means that the balance sheet must always balance. This implies that what a company owns (its resources) must always be equal to the claims of its creditors (liabilities) and investors (stockholders' equity).
- 12.** Each financial statement includes a heading that is comprised of (a) the name of the company, (b) the title of the financial statement, and (c) the time period covered—either a point-in-time measurement (an exact date) or a period-of-time description (e.g., a year ended in a specific date).
- 13.** Current assets are cash and other assets that are reasonably expected to be converted to cash within 1 year or the operating cycle, whichever is longer. Current liabilities are obligations that will be satisfied within 1 year or the operating cycle, whichever is longer.
- Since current assets are presented separately from other assets, statement users can see if the firm is likely to have enough resources available to meet its current liabilities as they come due. If current assets were presented among other assets, such a determination would be difficult.
- Current liabilities are separated from long-term liabilities because current liabilities will require asset outflows (or replacement with another liability) much sooner than will long-term liabilities. If all liabilities were presented together, financial statement users would have difficulty determining the assets (economic resources) required in the near future to satisfy the current liabilities.
- 14.** Current assets are generally listed on the balance sheet in order of liquidity or nearness to cash, whereas current liabilities are usually listed in the order in which they will be paid.
- 15.** The two main components of equity are contributed capital and retained earnings. Contributed capital is increased by investments of new capital in a company by its owners (the issue of common stock to stockholders). Retained earnings is the accumulated net income of a company that has not been distributed to owners. Retained earnings is increased by net income and decreased by net losses and dividends.
- 16.**  $\text{Net Income} = \text{Total Revenues} - \text{Total Expenses}$

17. The single-step income statement format takes into account only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a single step to arrive at net income. The multiple-step income statement format contains three important subtotals: gross margin (gross profit), income from operations, and net income. Gross margin is the difference between net sales and cost of sales (or cost of goods sold). Income from operations is the difference between gross margin and operating expenses. Net income is the difference between income from operations and any nonoperating revenues and expenses.
18. A retained earnings statement summarizes and explains the changes in retained earnings during an accounting period. Retained earnings is the income earned by the company but not paid to the owners in the form of dividends. The retained earnings statement starts with the balance in retained earnings at the beginning of the period. To this balance, add net income (or subtract the net loss) obtained from the income statement. Next, subtract any dividends the company declared during the period. The total is the retained earnings at the end of the period that is reported on the balance sheet.
19. The statement of cash flows classifies cash flows into three categories: (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities. Cash flows from operating activities are the cash flows related to the normal operations of the business in earning income, and include cash sales and collections of accounts receivable minus cash paid for goods, services, wages, salaries, and interest. Cash flows from investing activities are cash flows related to the acquisition or sale of investments and long-term assets, including cash received from the sales of property, plant, and equipment; investments; and other long-lived assets minus the cash spent to purchase long-term assets. The cash flows from investing activities by a healthy, growing business will usually represent an excess of expenditures over receipts. Cash flows from financing activities are the cash flows related to obtaining the capital of the company, including the cash contributed by owners and borrowed from creditors minus amounts paid as dividends and repayments of liabilities. A business can finance its growth either internally with cash generated by operations or externally with cash from owners and creditors.
20. The retained earnings statement describes the changes in retained earnings, a balance sheet account, that occur between two balance sheet dates. One of the major sources of change in retained earnings is the net income (or net loss) for the year, which is determined on the income statement. The other major source of change in retained earnings is dividends, which are not considered a part of income.
21. Other than the financial statements, users will find notes to the financial statements, management's discussion and analysis of the condition of the company, and the auditor's report in the annual report of a company. The notes to the financial statements are an integral part of the financial statements that clarify and expand upon the information in the financial statements. Management's discussion and analysis provides a discussion and explanation of various items reported in the financial statements. Additionally, management uses this opportunity to highlight favorable and unfavorable trends and significant risks facing the company. The auditor's report expresses the opinion of the auditor as to whether the financial statements fairly present the financial position and results of operations of the company.

- 22.** Examples of unethical behavior will differ from one student to another. One example is an accountant who gives in to personal pressure to prepare financial statements that overstate the income of the company by bending or violating generally accepted accounting principles. Overstated income may lead decision-makers to make the wrong choices. Decision-makers inside and outside the business must be able to rely on the financial information they receive to make proper decisions. Therefore, ethical behavior by accountants is necessary. Acting ethically is not always easy. However, because of the important role of accounting in society, accountants are expected to maintain the highest level of ethical behavior.

### MULTIPLE-CHOICE QUESTIONS

- 1-1. a
- 1-2. b
- 1-3. a (\$12,900 – \$6,300)
- 1-4. d
- 1-5. d
- 1-6. d
- 1-7. c (\$7,500 + \$3,900 + \$3,100)
- 1-8. b (\$6,000 + \$11,500)
- 1-9. a
- 1-10. b (\$182,300 – \$108,800 – \$48,600 – \$12,000)
- 1-11. c
- 1-12. c
- 1-13. b

## CORNERSTONE EXERCISES

## CE 1-14

Scenario 1:            **Assets = Liabilities + Equity**  
                               **X = \$42,000 + \$56,000**  
                               **(a) = \$98,000**

Scenario 2:            **\$115,000 = X + \$77,000**  
                               **(b) = \$38,000**

Scenario 3:            **\$54,000 = \$18,500 + X**  
                               **(c) = \$35,500**

## CE 1-15

*Note:* Be sure to treat situations b. through d. independently.

1.                        **Assets = Liabilities + Equity**  
                               **\$425,000 = \$260,000 + X**  
                               **X = \$165,000**

2.                        **Assets = Liabilities + Equity**  
                               **\$498,000\* = \$292,000\*\* + X**  
                               **X = \$206,000**

\* \$425,000 + \$73,000 = \$498,000

\*\* \$260,000 + \$32,000 = \$292,000

3.                        **Assets = Liabilities + Equity**  
                               **\$373,000\* = X + \$200,000\*\***  
                               **X = \$173,000**

\* \$425,000 – \$52,000 = \$373,000

\*\* \$165,000 (from part 1) + \$35,000 = \$200,000

4.                        **Assets = Liabilities + Equity**  
                               **X = \$345,000\* + \$92,000\*\***  
                               **X = \$437,000**

\* \$260,000 + \$85,000 = \$345,000

\*\* \$165,000 (from part 1) – \$73,000 = \$92,000

**CE 1-16**

- a. Balance sheet (B)
- b. Statement of cash flows (CF)
- c. Balance sheet (B)
- d. Income statement (I)
- e. Statement of cash flows (CF)
- f. Income statement (I)
- g. Balance sheet (B)
- h. Retained earnings statement (RE)

**CE 1-17**

- 1. d
- 2. b
- 3. a
- 4. f
- 5. e
- 6. a
- 7. c
- 8. g **(Note: While net income and dividends are reported on other financial statements, the definition of retained earnings is income that has not been distributed to stockholders. Therefore, by definition, this item is part of a company's retained earnings.)**
- 9. b
- 10. a

**CE 1-18**

Cavernous Homes Inc. Balance Sheet December 31, 2013		
<b>Assets</b>		
Cash.....	\$3,200	
Accounts receivable.....	4,500	
Supplies.....	<u>8,100</u>	
<b>Total assets.....</b>		<b><u>\$15,800</u></b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities:</b>		
Notes payable.....	<u>\$5,000</u>	
<b>Total liabilities.....</b>		<b>\$ 5,000</b>
<b>Stockholders' equity:</b>		
Common stock.....	\$7,000	
Retained earnings.....	<u>3,800</u>	
<b>Total stockholders' equity .....</b>		<b><u>10,800</u></b>
<b>Total liabilities and stockholders' equity.....</b>		<b><u>\$15,800</u></b>

**CE 1-19**

$$\begin{aligned}
 \text{Net Income} &= \text{Total Revenue} - \text{Total Expenses} \\
 \text{Net Income} &= \$78,000 - (\$33,200 + \$20,500) \\
 \text{Net Income} &= \underline{\underline{\$24,300}}
 \end{aligned}$$

**Note:** The dividends do not appear on the income statement in arriving at net income. Dividends do not affect the income statement. Dividends are a reduction of the balance in retained earnings.

**CE 1-20**

Beginning retained earnings .....	\$35,000
+ Net income (\$82,000 – \$55,000) .....	27,000
– Dividends .....	<u>(8,000)</u>
= Ending retained earnings.....	<b><u>\$54,000</u></b>

**BRIEF EXERCISES****BE 1-21**

- a. Government
- b. Manager
- c. Creditor
- d. Investor
- e. Employee

**BE 1-22**

- a. Corporation
- b. Sole Proprietorship, Partnership
- c. Partnership
- d. Corporation
- e. Corporation
- f. Sole Proprietorship
- g. Corporation

**BE 1-23**

- a. Financing
- b. Operating
- c. Investing
- d. Financing
- e. Operating
- f. Operating
- g. Financing

**BE 1-24**

- a. Total assets = \$202,000
- b. Total liabilities = \$32,500
- c. Increase in stockholders' equity = \$95,000

**BE 1-25**

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

**BE 1-26**

**Rutherford Company**  
**Income Statement**  
**For the year ended December 31, 2013**

<b>Revenues and gains:</b>		
Sales revenue	\$65,000	
Interest income	3,900	
Total revenues	\$68,900	\$68,900
<b>Expenses and losses:</b>		
Cost of goods sold	\$28,800	
Insurance expense	4,300	
Loss on disposal of property, plant, and equipment	1,200	
Total expenses and losses	34,300	34,300
Net income		\$34,600

**BE 1-27**

- a. I – Increases retained earnings
- b. D – Decreases retained earnings
- c. I – Increases retained earnings
- d. NE – No effect on retained earnings
- e. D – Decreases retained earnings
- f. D – Decreases retained earnings

**BE 1-28**

- a. O – Operating activities
- b. F – Financing activities
- c. F – Financing activities
- d. O – Operating activities
- e. I – Investing activities

**BE 1-29**

- (a) \$55,000 (\$30,000 + \$25,000 = a)
- (b) \$64,000 (b + \$30,000 = \$94,000)
- (c) \$20,000 (\$50,000 + c = \$70,000)

**BE 1-30**

- 1. (a) Notes to the financial statements
- 2. (c) Report of independent accountants
- 3. (b) Management’s discussion and analysis
- 4. (a) Notes to the financial statements

## EXERCISES

### E 1-31

1. **Bank (B)**
2. **Government (G)**
3. **Business managers (M)**
4. **Investor (I)**
5. **Labor union (U)**

### E 1-32

1. **Sole proprietorship: 1, 2, 4, 5**  
**Partnership: 2, 3, 4, 5, 7**  
**Corporation: 2, 3, 4, 5, 6, 8**
  
2. **There are many advantages and disadvantages to each particular type of business entity as listed below.**
  - a. **Sole Proprietorship**
    - **Advantages:**
      - (i) **The business is easily formed.**
      - (ii) **Control over the operations of the business is maintained by owner.**
      - (iii) **Sole proprietorships pay less taxes relative to corporations.**
    - **Disadvantages:**
      - (i) **The owner is personally liable for the debt of the business.**
      - (ii) **The life of the business is limited to the owner's life.**
  
  - b. **Partnership:**
    - **Advantages:**
      - (i) **Have increased access to the financial resources and individual skills of each of the partners.**
      - (ii) **Partnerships pay less taxes relative to corporations.**
    - **Disadvantages:**
      - (i) **Control over the operations of the business is shared among the partners.**
      - (ii) **The partners are personally liable for the debt of the business.**
      - (iii) **The life of the business is limited to life of the partners.**
  
  - c. **Corporation:**
    - **Advantages:**
      - (i) **Can more easily raise large amounts of money.**
      - (ii) **Ownership of the business can be easily transferred by selling stock.**
      - (iii) **The owners' liability is limited to the amount invested in the business.**
    - **Disadvantages:**
      - (i) **The formation and organization of the business is more complex.**
      - (ii) **Corporations generally pay higher taxes.**

**E 1-33**

- a. Investing (I)
- b. Financing (F)
- c. Operating (O)
- d. Investing (I)
- e. Operating (O)
- f. Financing (F)
- g. Financing (F)

**E 1-34**

- a. Financing (F)
- b. Investing (I)
- c. Investing (I)
- d. Operating (O)
- e. Operating (O)
- f. Financing (F)
- g. Operating (O)
- h. Operating (O)
- i. Investing (I)
- j. Financing (F)

**E 1-35**

- 1. c
- 2. e
- 3. b
- 4. g
- 5. d
- 6. f
- 7. a

**E 1-36**

	Assets	=	Liabilities	+	Equity
1.	\$116,200		(a) \$ 60,800*		\$55,400
2.	212,600		145,900		(b) 66,700**
3.	(c) 70,800***		22,500		48,300

\*  $\$116,200 - \$55,400 = \$60,800$

\*\*  $\$212,600 - \$145,900 = \$66,700$

\*\*\*  $\$22,500 + \$48,300 = \$70,800$

E 1-37

1.

<b>Higgins Company</b> <b>Balance Sheet</b> <b>Specific Point in Time</b>
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**Assets****Current assets:**

**Cash**  
**Accounts receivable**  
**Inventory**  
**Prepaid insurance**  
**Total current assets**

**Property, plant, and equipment:**

**Building**  
**Equipment**  
**Less: Accumulated depreciation**  
**Total property, plant, and equipment**

**Intangible assets:**

**Trademarks**

**Total assets****Liabilities and Stockholders' Equity****Liabilities:****Current liabilities:**

**Accounts payable**  
**Income taxes payable**  
**Wages payable**  
**Total current liabilities**

**Long-term liabilities:**

**Notes payable**  
**Bonds payable**  
**Total long-term liabilities**  
**Total liabilities**

**Stockholders' equity:**

**Common stock**  
**Retained earnings**  
**Total stockholders' equity**

**Total liabilities and stockholders' equity**

2. To assess liquidity, it would be helpful to have information on Higgins Company's current assets (cash, accounts receivable, inventory, and prepaid insurance) and current liabilities (accounts payable, income taxes payable, and wages payable). With this information, a user could compute a company's working capital (current assets – current liabilities) and current ratio (current assets ÷ current liabilities). These two measures are helpful in assessing a company's ability to pay its debts as they become due.

**E 1-38**

1. Since the operating cycle is 6 months, Dunn would use 1 year as the breakpoint between current and noncurrent items.
  - a. There are 17 months of prepaid rent (\$8,500 / \$500). Dunn should include \$6,000 (12 months × \$500 per month) as a current asset and \$2,500 (the remaining 5 months × \$500 per month) as a long-term asset.
  - b. The \$9,700 is a current liability.
  - c. Since all items are expected to be sold within 12 months, the entire \$46,230 is a current asset.
  - d. The \$700 portion of marketable securities is a current asset. The remaining \$1,200 is a long-term investment.
  - e. The \$1,050 of cash is a current asset.
  - f. The \$60,000 note due in March 2018 is a long-term liability. The \$3,750 interest related to 2013 is a current liability. The remaining interest of \$750 will not be recognized until 2014 and, therefore, is not on the 2013 balance sheet.
  - g. The entire \$2,850 is a current asset.
  - h. The store equipment and its accumulated depreciation are not current assets. Instead, they are classified as property, plant, and equipment.

**Dunn Sporting Goods  
Partial Balance Sheet  
December 31, 2013**

<b>Current assets:</b>		
Cash.....	\$ 1,050	
Short-term investment in marketable securities.....	700	
Accounts receivable.....	2,850	
Inventory.....	46,230	
Prepaid rent.....	6,000	
Total current assets.....		\$56,830
<b>Current liabilities:</b>		
Accounts payable.....	\$ 9,700	
Interest payable on equipment loan (see f above).....	3,750	
Total current liabilities.....		\$13,450

2. Working Capital = Current Assets – Current Liabilities
  - = \$56,830 – \$13,450
  - = \$43,380
  
- Current Ratio = Current Assets / Current Liabilities
  - = \$56,830 / \$13,450
  - = 4.23

**E 1-38 (Continued)**

3. These ratios give users insights into a company's liquidity—that is a company's ability to pay obligations as they become due. These ratios show that Dunn Sporting Goods has adequate current assets to cover all of the current liabilities that will become due in the near future. Comparing these ratios to other companies in the same industry and examining the trend in these measures over time will yield additional insights.

**E 1-39**

1.

<b>Hanson Construction Partial Balance Sheet December 31, 2013</b>
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**Current assets:**

Cash.....	\$1,380	
Accounts receivable.....	7,000	
Notes receivable.....	1,500	
Supplies.....	<u>6,200</u>	
<b>Total current assets.....</b>		<b>\$16,080</b>

**Current liabilities:**

Accounts payable.....	\$2,100	
Notes payable .....	<u>6,800</u>	
<b>Total current liabilities.....</b>		<b>\$ 8,900</b>

The accounts receivable of \$5,000 due in 18 months will be classified as a long-term asset. The construction equipment and related accumulated depreciation are classified as property, plant, and equipment (a noncurrent asset).

2. Hanson Construction's liquidity may be evaluated by examining its current ratio and working capital. Its current ratio is 1.81 ( $\$16,080 / \$8,900$ ) and its working capital is \$7,180 ( $\$16,080 - \$8,900$ ). Because current assets well exceed the current liabilities, Hanson appears to be able to pay its debts that become due within the next year.

**E 1-40**

The balance sheet at December 31, 2013, will show equipment at its historical cost of \$425,000 reduced by accumulated depreciation (a contra-asset) of \$40,000. Therefore, the net book value (or carrying value) of the equipment is \$385,000. (Note: The concepts of book value and carrying value will be covered in more detail in later chapters.) The equipment and accumulated depreciation will be reported under the caption “Property, plant, and equipment” in the asset section of the balance sheet.

The 2013 income statement will show depreciation expense of \$40,000. In a multiple-step income statement, depreciation expense will be reported as an operating expense.

**E 1-41**

<b>Mulcahy Manufacturing Inc.</b>		
<b>Partial Balance Sheet</b>		
<b>December 31, 2013</b>		

<b>Stockholders' equity:</b>		
Common stock.....	\$150,000	
Retained earnings.....	37,500	
<b>Total stockholders' equity.....</b>		<b>\$187,500</b>

**Note:** Transactions among stockholders do not change stockholders' equity balances.

**E 1-42**

1.

<b>College Spirit</b>		
<b>Balance Sheet</b>		
<b>December 31, 2013</b>		

**Assets**

<b>Current assets:</b>		
Cash.....	\$ 13,300	
Accounts receivable.....	6,700	
Inventory .....	481,400	
Prepaid rent .....	54,000	
<b>Total current assets.....</b>		<b>\$555,400</b>
<b>Long-term investments:</b>		
Investment .....		110,900
<b>Property, plant, and equipment:</b>		
Furniture .....	\$ 88,000	
Less: Accumulated depreciation.....	(23,700)	64,300
<b>Total assets .....</b>		<b><u>\$730,600</u></b>

## E 1-42 (Continued)

<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable.....	<b>\$104,700</b>	
Notes payable .....	<b>50,000</b>	
Income taxes payable .....	<b>11,400</b>	
Total current liabilities.....		<b>\$166,100</b>
<b>Long-term liabilities:</b>		
Bonds payable.....		<b>180,000</b>
Total liabilities.....		<b>\$346,100</b>
<b>Stockholders' equity:</b>		
Common stock.....	<b>\$300,000</b>	
Retained earnings.....	<b>84,500</b>	
Total stockholders' equity.....		<b>384,500</b>
Total liabilities and stockholders' equity.....		<b>\$730,600</b>

2. College Spirit has working capital of \$389,300 ( $\$555,400 - \$166,100$ ) and a current ratio of 3.34 ( $\$555,400 / \$166,100$ ).
  
3. The working capital and current ratios show that College Spirit has adequate current assets to cover all of the current liabilities that will become due in the near future. Therefore, College Spirit's liquidity should not be a major concern. Comparing these items to those of other companies in the same industry and examining the trends in these measures over time will yield additional insights.

E 1-43

1.

**Jerrison Company  
Balance Sheet  
December 31, 2013**

<b>Assets</b>		
<b>Current assets:</b>		
Cash .....	\$ 11,400	
Investments (short-term) .....	21,000	
Accounts receivable.....	95,500	
Prepaid insurance.....	5,700	
Inventory .....	<u>187,900</u>	
Total current assets.....		<b>\$321,500</b>
<b>Long-term investments:</b>		
Investment .....		32,700
<b>Property, plant, and equipment:</b>		
Land.....	\$ 41,000	
Building .....	\$ 419,900	
Less: Accumulated depreciation.....	<u>(216,800)</u>	203,100
Trucks .....	\$ 106,100	
Less: Accumulated depreciation.....	<u>(31,200)</u>	74,900
Equipment (data processing).....	\$ 309,000	
Less: Accumulated depreciation.....	<u>(172,400)</u>	<u>136,600</u>
Total property, plant, & equipment ...		<b>455,600</b>
<b>Total assets.....</b>		<b><u><u>\$809,800</u></u></b>

## E 1-43 (Continued)

<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable.....	\$ 65,100	
Notes payable (due June 1, 2014).....	150,000	
Salaries payable.....	14,400	
Interest payable.....	12,600	
Income taxes payable.....	<u>21,600</u>	
Total current liabilities.....		\$263,700
<b>Long-term liabilities:</b>		
Bonds payable (due 2017).....		<u>200,000</u>
Total liabilities.....		<u>\$463,700</u>
<b>Stockholders' equity:</b>		
Common stock.....	\$150,000	
Retained earnings*.....	<u>196,100</u>	
Total stockholders' equity.....		<u>346,100</u>
Total liabilities and stockholders' equity.....		<u><u>\$809,800</u></u>

\* *Note:* Retained earnings is computed using the concepts implied by the fundamental accounting equation. Because assets must equal liabilities plus stockholders' equity, retained earnings is computed by determining the amount that causes both sides of the accounting equation to remain equal. This amount is computed as:

First, compute stockholders' equity as:

$$\begin{aligned}
 \text{Total Assets} &= \text{Total Liabilities} + \text{Total Stockholders' Equity} \\
 \$809,800 &= \$463,700 + X \\
 X &= \underline{\underline{\$346,100}}
 \end{aligned}$$

Next, compute retained earnings:

$$\begin{aligned}
 \text{Total Stockholders' Equity} &= \text{Common Stock} + \text{Retained Earnings} \\
 \$346,100 &= \$150,000 + Y \\
 Y &= \underline{\underline{\$196,100}}
 \end{aligned}$$

2. Jerrison has working capital of \$57,800 (\$321,500 – \$263,700) and a current ratio of 1.22 (\$321,500 / \$263,700).
3. While Jerrison appears to be liquid, inventory is its largest current asset at \$187,900. If a large portion of inventory cannot be sold, Jerrison will most likely not generate sufficient cash flow to pay its obligations as they become due.

**E 1-44**

- a. **Current assets:**  $(a) + \$19,200 + \$85,700 + \$10,400 = \$142,200$   
 $(a) = \$26,900$
- b. **Long-term liabilities:**  $\$14,500 + (b) = \$50,300$   
 $(b) = \$35,800$
- c. **Total liabilities and stockholders' equity:**  $(e) = \text{Total assets}$   
 $(e) = \$142,200$
- d. **Total stockholders' equity:**  $\$142,200 (e) = \$50,300 + (d)$   
 $(d) = \$91,900$
- e. **Contributed capital:**  $(c) + \$56,900 = \$91,900 (d)$   
 $(c) = \$35,000$
- f. **Total assets:**  $(g) = \text{Total liabilities and stockholders' equity}$   
 $(g) = \$149,200$
- g. **Long-term investments:**  $\$25,000 + (f) + \$92,800 + \$9,200 = \$149,200 (g)$   
 $(f) = \$22,200$
- h. **Total liabilities:**  $\$12,300 + \$34,900 = (h)$   
 $(h) = \$47,200$
- j. **Total stockholders' equity:**  $\$47,200 (h) + (j) = \$149,200$   
 $(j) = \$102,000$
- i. **Contributed capital:**  $(i) + \$67,000 = \$102,000 (j)$   
 $(i) = \$35,000$

E 1-45

1.

**Butler Company**  
**Income Statement**  
**For a Period of Time**

**Revenues:**

Sales revenue

**Expenses:**

Cost of goods sold

Advertising expense

Salaries expense

Utilities expense

Depreciation expense

Interest expense

Income taxes expense

**Net income**

2. Information contained on the income statement can be used to predict a company's ability to generate future income. Specifically, by examining a company's net profit margin (Net Income / Sales Revenue), a financial statement user can gain insights into management's ability to control expenses, a critical factor to achieve future profitability.

E 1-46

ERS Inc. Income Statement For the year ended December 31, 2013		
<b>Revenues:</b>		
Service revenue.....		<b>\$933,800</b>
<b>Expenses:</b>		
Wages expense .....	<b>\$448,300</b>	
Salaries expense .....	<b>195,600</b>	
Supplies expense .....	<b>66,400</b>	
Rent expense .....	<b>58,400</b>	
Utilities expense .....	<b>26,100</b>	
Advertising expense.....	<b>24,200</b>	
Depreciation expense .....	<b>16,250</b>	
Insurance expense .....	<b>11,900</b>	
Interest expense.....	<b>10,100</b>	
Income taxes expense .....	<b>15,150</b>	
Total expenses.....		<u><b>872,400</b></u>
Net income.....		<u><u><b>\$ 61,400</b></u></u>

2. Net profit margin is 6.58% ( $\$61,400 \text{ net income} / \$933,800 \text{ service revenue}$ ). This indicates that \$0.066 of each sales dollar is profit. If ERS were to increase revenues by \$100,000, an additional \$6,600 of profit would be recognized. If ERS wanted to achieve larger profits, it should focus on controlling its expenses.
  
3. A declining profit margin implies that ERS is having difficulty maintaining control over its expenses. While further investigation is warranted to determine the cause of the growing expenses (e.g., is it due to increasing costs that are within management control or are the cost increases due to economic factors beyond ERS's short-term control), the declining profit margin signals that ERS may have difficulty generating future profits that are comparable with its past performance.

E 1-47

<b>Bergin Pastry Shop</b> <b>Income Statement</b> <b>For the year ended December 31</b>	
Net sales .....	\$85,300
Cost of goods sold* .....	50,600
Gross margin .....	<u>\$34,700</u>
Operating expenses** .....	25,500
Income from operations .....	<u>\$ 9,200</u>
<b>Other expenses and losses:</b>	
Interest expense.....	1,800
Income before taxes.....	<u>\$ 7,400</u>
Income taxes expense*** .....	1,110
Net income.....	<u><u>\$ 6,290</u></u>

\* Cost of goods sold is computed as net sales (\$85,300) minus gross margin (\$34,700).

\*\* Operating expenses are computed as gross margin (\$34,700) minus income from operations (\$9,200).

\*\*\*  $15\% \times \$7,400 = \$1,110$

E 1-48

1. **Wright Auto Supply  
Income Statement  
For the year ended December 31, 2013**

<b>Revenues:</b>		
Sales revenue.....		\$585,600
<b>Expenses:</b>		
Cost of goods sold.....	\$292,000	
Wages expense .....	96,750	
Salaries expense .....	33,800	
Depreciation expense .....	31,250	
Rent expense .....	21,000	
Interest expense.....	2,400	
Income taxes expense.....	<u>32,520</u>	
Total expenses.....		<u>509,720</u>
Net income.....		<u><u>\$ 75,880</u></u>

2. **Wright Auto Supply  
Income Statement  
For the year ended December 31, 2013**

Sales revenue.....		\$585,600
Cost of goods sold.....		<u>292,000</u>
Gross margin.....		\$293,600
<b>Operating expenses:</b>		
Wages expense .....	\$96,750	
Salaries expense .....	33,800	
Depreciation expense .....	31,250	
Rent expense .....	<u>21,000</u>	<u>182,800</u>
Income from operations.....		\$110,800
<b>Other expenses and losses:</b>		
Interest expense.....		<u>2,400</u>
Income before taxes.....		\$108,400
Income taxes expense .....		<u>32,520</u>
Net income .....		<u><u>\$ 75,880</u></u>

3. Both a single-step income statement and a multiple-step income statement report the same amount for net income. However, a single-step income statement only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step income statement provides three important classifications that financial statement users find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

**E 1-49**

- |  |                 |                  |
|--|-----------------|------------------|
| 1. Beginning retained earnings.....        | \$ 18,240       |                  |
| + Net income (\$837,400 – \$792,100) ..... | 45,300          |                  |
| – Dividends.....                           | <u>(38,650)</u> |                  |
| = Ending retained earnings.....            |                 | <u>\$ 24,890</u> |
2. Sherwood is paying 85% ( $\$38,650 / \$45,300$ ) of its income to its shareholders in the form of dividends. This large dividend payout will result in investors receiving relatively more of the company’s earnings in the form of cash during the year rather than in share appreciation. Financial statement users should examine the dividend payout ratio in relation to the firm’s current ratio and working capital to ensure that Sherwood is not paying too much in dividends so that it will be able to repay its debts when they become due.

**E 1-50**

- |  |                 |           |
|--|-----------------|-----------|
| 1. Cash flow from operating activities:          |                 |           |
| Cash received from customers.....                | \$ 139,800      |           |
| Cash paid for advertising.....                   | (34,200)        |           |
| Cash paid to employees for salaries.....         | (46,400)        |           |
| Cash paid for supplies.....                      | <u>(28,700)</u> |           |
| Net cash provided by operating activities.....   |                 | \$ 30,500 |
| Cash flow from investing activities:             |                 |           |
| Cash paid for purchase of land and building..... | \$(128,700)     |           |
| Cash paid to purchase machine.....               | <u>(32,000)</u> |           |
| Net cash used by investing activities.....       |                 | (160,700) |
| Cash flow from financing activities:             |                 |           |
| Cash received from owners.....                   | \$ 201,500      |           |
| Cash paid for dividends to stockholders.....     | <u>(37,500)</u> |           |
| Net cash provided by financing activities .....  |                 | 164,000   |
2. Walters has positive cash flow, especially from operations, showing the company is in a good financial position to pay its debts as they come due. The negative cash flow (cash outflow) in investing is a sign of a growing company that is investing in revenue-producing assets. In addition, from the large amount of cash received from financing activities, it appears that Walters is able to raise large amounts of capital to finance its operations.

**E 1-51**

**Cash at the end of the year:**

Cash flow from operating activities.....	\$ 892,250
Cash outflow for investing activities.....	(990,300)
Cash flow from financing activities.....	108,400
Change in cash.....	<u>\$ 10,350</u>
Add: Cash at 12/31/12.....	<u>20,400</u>
Cash at 12/31/13.....	<u><u>\$ 30,750</u></u>

**Retained earnings at end of 2013:**

Retained earnings at 12/31/12.....	\$ 105,600
Add: 2013 net income (\$650,100 – \$578,600).....	71,500
Less: 2013 dividends.....	<u>(30,000)</u>
Retained earnings at 12/31/13.....	<u><u>\$ 147,100</u></u>

**E 1-52**

From the information given in the problem and the fundamental accounting equation:

	Assets	=	Liabilities	+	Equity
12/31/2012	\$82,400	=	\$9,200	+	(\$50,000 + Retained Earnings)
12/31/2013	\$88,500	=	\$11,300	+	(\$50,000 + Retained Earnings)

For each year, solve for retained earnings:

12/31/2012	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	\$82,400 – \$9,200 – \$50,000
		=	\$23,200
12/31/2013	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	\$88,500 – \$11,300 – \$50,000
		=	\$27,200

Using the computed amounts for retained earnings, dividends can be determined using the relationships found in the retained earnings statement.

Beginning retained earnings.....	\$23,200
+ Net income.....	19,500
– Dividends.....	<u>?</u>
= Ending retained earnings.....	<u><u>\$27,200</u></u>

**Dividends = \$15,500**

**E 1-53**

From the information given in the problem and the fundamental accounting equation:

	Assets	=	Liabilities	+	Equity
12/31/2012	\$152,200	=	\$56,600	+	(\$60,000 + Retained Earnings)
12/31/2013	\$171,800	=	\$63,750	+	(\$60,000 + Retained Earnings)

For each year, solve for retained earnings:

12/31/2012	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	\$152,200 – \$56,600 – \$60,000
		=	\$35,600
12/31/2013	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	\$171,800 – \$63,750 – \$60,000
		=	\$48,050

Using the computed amounts for retained earnings, net income can be determined using the relationships found in the retained earnings statement.

Beginning retained earnings.....	\$ 35,600
+ Net income.....	?
– Dividends.....	(20,000)
= Ending retained earnings.....	<u>\$ 48,050</u>

Net income = \$32,450

**E 1-54**

- a. Management’s discussion and analysis
- b. Notes to the financial statements
- c. Notes to the financial statements
- d. Financial statements (balance sheet)
- e. Management’s discussion and analysis
- f. Financial statements (retained earnings statement)
- g. Report of independent accountants
- h. Financial statements (income statement)

**E 1-55**

- a. Unethical (U)
- b. Ethical (E)
- c. Unethical (U)
- d. Ethical (E)
- e. Ethical (E)
- f. Unethical, and probably illegal (U)
- g. Ethical (E)
- h. Unethical (U)

## PROBLEM SET A

### P 1-56A

The fundamental accounting equation requires that there be an equality between assets and liabilities plus stockholders' equity. Therefore, the amount of liabilities that Huffer must have at the end of 2013 can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

The amount of Huffer's assets at 12/31/13 is \$285,500. Huffer's stockholders' equity at the end of 2013 is the amount of stockholders' equity at the beginning of the year plus (minus) net income (loss) minus dividends plus the sale of common stock.

	Common Stock	+	Retained Earnings	=	Stockholders' Equity
Equity, 1/1/13	\$50,000	+	\$ 88,200	=	\$138,200
Net income			51,750		
Dividends			(10,000)		
Common stock issued	15,000				
Equity, 12/31/13	\$65,000	+	\$129,950	=	\$194,950

The amount of liabilities that Huffer must have at the end of 2013 is determined by using the balance sheet equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/13	\$285,500	=	?	+	\$194,950

**Liabilities = \$285,500 – \$194,950 = \$90,550**



**P 1-59A**

<b>Floyd:</b>	<b>Revenues</b>	<b>- Expenses</b>	<b>= Net Income</b>
	<b>\$125</b>	<b>- \$92</b>	<b>= <u>\$33 (a)</u></b>
	<b>Assets</b>	<b>= Liabilities</b>	<b>+ Stockholders' Equity</b>
	<b>\$905</b>	<b>= \$412</b>	<b>+ <u>\$493 (b)</u></b>
<b>Slater:</b>	<b>Revenues</b>	<b>- Expenses</b>	<b>= Net Income</b>
	<b>\$715</b>	<b>- <u>\$531 (c)</u></b>	<b>= \$184</b>
	<b>Assets</b>	<b>= Liabilities</b>	<b>+ Stockholders' Equity</b>
	<b>\$1,988</b>	<b>= <u>\$1,165 (d)</u></b>	<b>+ \$823</b>
<b>Wooderson:</b>	<b>Revenues</b>	<b>- Expenses</b>	<b>= Net Income</b>
	<b><u>\$72 (e)</u></b>	<b>- \$54</b>	<b>= \$18</b>
	<b>Assets</b>	<b>= Liabilities</b>	<b>+ Stockholders' Equity</b>
	<b><u>\$197 (f)</u></b>	<b>= \$117</b>	<b>+ \$80</b>
<b>O'Bannion:</b>	<b>Revenues</b>	<b>- Expenses</b>	<b>= Net Income (Loss)</b>
	<b>\$2,475</b>	<b>- <u>\$3,075 (g)</u></b>	<b>= \$(600)</b>
	<b>Assets</b>	<b>= Liabilities</b>	<b>+ Stockholders' Equity</b>
	<b>\$8,140</b>	<b>= \$2,280</b>	<b>+ <u>\$5,860 (h)</u></b>

P 1-60A

**Rogers Enterprises**  
**Income Statement**  
**For the year ended December 31, 2013**

<b>Revenues:</b>		
Service revenue.....		\$463,500
<b>Expenses:</b>		
Salaries expense.....	\$235,200	
Rent expense.....	135,000	
Supplies expense.....	34,400	
Interest expense.....	16,000	
Income taxes expense.....	12,800	433,400
Income taxes expense.....	<u>12,800</u>	<u>433,400</u>
Net income.....		<u><u>\$ 30,100</u></u>

**Rogers Enterprises**  
**Balance Sheet**  
**December 31, 2013**

**Assets**

<b>Current assets:</b>		
Cash.....	\$ 13,240	
Accounts receivable.....	72,920	
Supplies.....	42,000	
Prepaid rent.....	31,500	
Prepaid rent.....	<u>31,500</u>	
Total current assets.....		\$159,660
Property, plant, and equipment.....		<u>90,000</u>
Total assets.....		<u><u>\$249,660</u></u>

**Liabilities and Stockholders' Equity**

<b>Current liabilities:</b>		
Salaries payable.....	\$ 14,800	
Income taxes payable.....	4,150	
Income taxes payable.....	<u>4,150</u>	
Total current liabilities.....		\$ 18,950
<b>Long-term liabilities:</b>		
Notes payable (due in 10 years).....		<u>25,000</u>
Total liabilities.....		\$ 43,950
<b>Stockholders' equity:</b>		
Common stock (10,000 shares).....	\$ 70,000	
Retained earnings*.....	135,710	
Retained earnings*.....	<u>135,710</u>	
Total stockholders' equity.....		<u>205,710</u>
Total liabilities and stockholders' equity.....		<u><u>\$249,660</u></u>

\* Retained earnings is computed as the amount needed to make the fundamental accounting equation balance.

**P 1-61A**

**Dittman Expositions  
Retained Earnings Statement  
For the years ended December 31, 2013, and December 31, 2014**

	2013	2014
Retained earnings, beginning of year*	\$ 20,900	\$ 36,050
Add: Net income**	25,400	33,000
Less: Dividends	(10,250)	(12,920)
Retained earnings, end of year	\$ 36,050	\$ 56,130

\* The ending retained earnings balance for 2013 becomes the beginning retained earnings balance for 2014.

	2013	2014
** Net income computed as follows:		
Revenue	\$ 407,500	\$ 451,600
Less: Expenses	(382,100)	(418,600)
Net income	\$ 25,400	\$ 33,000

**P 1-62A**

(a)  $\$30,700 - \text{Dividends (a)} = \$27,200$   
 $\text{Dividends (a)} = \$3,500$

(b)  $\text{Retained Earnings, Beginning (2013)} = \text{Retained Earnings, Ending (2012)}$   
 $= \$27,200$

(c)  $\text{Retained Earnings, Beginning (b)} + \text{Net Income} = (c)$   
 $\$27,200 + \$10,100 = \$37,300$

You must solve for (e) prior to solving for (d):

(e)  $\text{Retained Earnings, Ending (2013)} = \text{Retained Earnings, Beginning (2014)}$   
 $= \$33,600$

(d)  $\text{Retained Earnings, Ending (e)} = (c) - \text{Dividends (d)}$   
 $\$33,600 = \$37,300 - \text{Dividends (d)}$   
 $\text{Dividends (d)} = \$3,700$

You must solve for (g) prior to solving for (f):

(g)  $\text{Retained Earnings, Ending} = (g) - \text{Dividends}$   
 $\$41,200 = (g) - \$3,900$   
 $(g) = \$45,100$

(f)  $\text{Retained Earnings, Beginning} + \text{Net Income (f)} = (g)$   
 $\$33,600 + \text{Net Income (f)} = \$45,100$   
 $\text{Net Income (f)} = \$11,500$

P 1-63A

1.

<b>Ashton Appliances</b> <b>Income Statement</b> <b>For the year ended December 31, 2013</b>
--

<b>Revenues:</b>		
Sales revenue.....		<b>\$948,670</b>
<b>Expenses:</b>		
Cost of goods sold.....	<b>\$511,350</b>	
Wages expense .....	<b>127,710</b>	
Salaries expense.....	<b>101,000</b>	
Rent expense.....	<b>80,800</b>	
Insurance expense.....	<b>36,610</b>	
Interest expense.....	<b>15,500</b>	
Depreciation expense (furniture).....	<b>12,000</b>	
Depreciation expense (building).....	<b>11,050</b>	
Income taxes expense.....	<b>16,650</b>	
Total expenses.....	<b>912,670</b>	
Net income.....		<b>\$ 36,000</b>

<b>Ashton Appliances</b> <b>Retained Earnings Statement</b> <b>For the year ended December 31, 2013</b>
---

Beginning retained earnings, January 1, 2013.....		<b>\$ 54,000</b>
Add: Net income*.....		<b>36,000</b>
Ending retained earnings, December 31, 2013.....		<b>\$ 90,000</b>

\* From the income statement

**P 1-63A (Continued)**

<b>Ashton Appliances</b>			
<b>Balance Sheet</b>			
<b>December 31, 2013</b>			
<b>Assets</b>			
<b>Current assets:</b>			
Cash.....		\$ 41,450	
Accounts receivable.....		69,900	
Inventory.....		59,850	
<b>Total current assets.....</b>			<b>\$171,200</b>
<b>Property, plant, and equipment:</b>			
Building.....	\$ 300,000		
Less: Accumulated depreciation.....	(104,800)	\$195,200	
Furniture.....	\$ 130,000		
Less: Accumulated depreciation.....	(27,600)	102,400	
<b>Total property, plant, and equipment .....</b>			<b>297,600</b>
Other assets.....			92,800
<b>Total assets.....</b>			<b>\$561,600</b>
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities:</b>			
Accounts payable.....		\$ 16,800	
Income taxes payable.....		12,000	
Salaries payable.....		7,190	
<b>Total current liabilities.....</b>		<b>\$ 35,990</b>	
<b>Long-term liabilities:</b>			
Bonds payable.....		192,000	
<b>Total liabilities .....</b>			<b>\$227,990</b>
<b>Stockholders' equity:</b>			
Common stock.....		\$243,610	
Retained earnings*.....		90,000	
<b>Total stockholders' equity.....</b>			<b>333,610</b>
<b>Total liabilities and stockholders' equity.....</b>			<b>\$561,600</b>

\* From the retained earnings statement

- Both a single-step income statement and a multiple-step income statement report the same amount for net income. However, a single-step income statement only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step income statement provides three important classifications that financial statement users find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

**P 1-64A****Berko Company:**

- (a) \$62,100      (\$50,000 + \$12,100)  
 (b) \$17,100      (\$12,100 + \$7,000 – \$2,000)  
 (c) \$67,100      (\$17,100 + \$50,000)  
 (d) \$25,400      (\$92,500 – \$67,100)

**Manning Company:**

- (e) \$9,300      (\$44,300 – \$35,000)  
 (f) \$7,500      (\$9,300 – \$1,800)  
 (g) \$42,500      (\$35,000 + \$7,500)  
 (h) \$57,300      (\$42,500 + \$14,800)

**Lucas Company:**

- (i) \$40,000      (\$66,400 – \$26,400)

**Must solve for (k) before (j):**

- (k) \$29,500      (\$84,500 – \$55,000)  
 (j) \$2,900      (\$26,400 + \$6,000 – \$29,500)  
 (l) \$14,700      (\$99,200 – \$84,500)

**Corey Company:**

- (m) \$7,100      (\$27,600 – \$21,900 + \$1,400)  
 (n) \$42,600      (\$15,000 + \$27,600)  
 (o) \$53,300      (\$10,700 + \$42,600)

**P 1-65A**

First, use the fundamental accounting equation to determine stockholders' equity:

	<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Stockholders' Equity</b>
<b>Beginning</b>	<b>\$385,500</b>	<b>=</b>	<b>\$152,800</b>	<b>+</b>	<b>\$232,700 *</b>
<b>End</b>	<b>\$420,250</b>	<b>=</b>	<b>\$156,600</b>	<b>+</b>	<b>\$263,650 **</b>

$$* \$385,500 - \$152,800 = \$232,700$$

$$** \$420,250 - \$156,600 = \$263,650$$

Next, use these fundamental relationships to solve for each situation:

$$\text{Stockholders' Equity} = \text{Common Stock} + \text{Retained Earnings}$$

$$\text{Change in Stockholders' Equity} = \text{Change in Common Stock} \\ + \text{Change in Retained Earnings}$$

$$\text{Change in Retained Earnings} = \text{Net Income} - \text{Dividends}$$

Therefore,

$$\text{Change in Stockholders' Equity} = \text{Change in Common Stock} + \text{Net Income} \\ - \text{Dividends}$$

1.  $(\$263,650 - \$232,700) = \$0 + \text{Net Income} - \$0$   
Net Income = \$30,950
2.  $(\$263,650 - \$232,700) = \$40,000 + \text{Net Income} - \$0$   
Net Loss = (\$9,050)
3.  $(\$263,650 - \$232,700) = \$0 + \text{Net Income} - \$15,000$   
Net Income = \$45,950
4.  $(\$263,650 - \$232,700) = \$35,000 + \text{Net Income} - \$20,000$   
Net Income = \$15,950

**PROBLEM SET B****P 1-56B**

The fundamental accounting equation requires that there be an equality between assets and liabilities plus stockholders' equity. Therefore, the amount of liabilities that KJ Corporation must have at the end of 2013 can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

The amount of KJ's assets at 12/31/13 is \$710,100. KJ's stockholders' equity at the end of 2013 is the amount of stockholders' equity at the beginning of the year plus (minus) net income (loss) minus dividends plus the sale of common stock.

	<u>Common Stock</u>	+	<u>Retained Earnings</u>	=	<u>Stockholders' Equity</u>
Equity, 1/1/13	\$100,000	+	\$134,900	=	\$234,900
Net income			205,500		
Dividends			(70,000)		
Common stock issued	<u>75,000</u>				
Equity, 12/31/13	\$175,000	+	<u>\$270,400</u>	=	<u>\$445,400</u>

The amount of liabilities that KJ must have at the end of 2013 is determined by using the balance sheet equation and solving for the missing amount.

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
At 12/31/13	\$710,100	=	?	+	\$445,400

$$\text{Liabilities} = \$710,100 - \$445,400 = \$264,700$$

**P 1-57B**

It is necessary to answer these questions out of order because of the way the relationships between the accounts work.

(a) Assets	=	Liabilities	+	Stockholders' Equity
				(all at the beginning of the year)
	=	\$368,200	+	\$272,900
	=	\$641,100		

Note: Item (d) is found prior to finding items (b) and (c).

(d) Net Income	=	Revenues	-	Expenses
	=	\$929,440	-	\$835,320
	=	\$94,120		

Note: Item (c) is found prior to finding item (b).

(c) Beginning Stockholders' Equity	+	Net Income	-	Dividends	=	Ending Stockholders' Equity
\$272,900	+	\$94,120	-	\$35,500	=	Ending Stockholders' Equity
Ending Stockholders' Equity			=	\$331,520		

(b) Assets	=	Liabilities	+	Stockholders' Equity
				(all at end of year)
\$758,150	=	Liabilities	+	\$331,520
Liabilities	=	\$426,630		

## P 1-58B

<b>Parker Renovation Inc.</b>		
<b>Income Statement</b>		
<b>For the year ended December 31, 2013</b>		
<b>Revenues:</b>		
Service revenue.....	<b>\$763,400</b>	
Interest income.....	<b>5,475</b>	
<b>Total revenues.....</b>		<b>\$768,875</b>
<b>Expenses:</b>		
Wages expense.....	<b>\$222,900</b>	
Depreciation expense.....	<b>135,000</b>	
Utilities expense.....	<b>109,300</b>	
Insurance expense.....	<b>65,850</b>	
Miscellaneous expense.....	<b>31,000</b>	
Income taxes expense.....	<b>61,400</b>	
<b>Total expenses.....</b>		<b>625,450</b>
<b>Net income.....</b>		<b><u>\$143,425</u></b>

**P 1-59B**

<b>Crick:</b>	<b>Net Income</b> <u><b>\$81 (a)</b></u>	<b>= Revenues</b> <b>= \$925</b>	<b>- Expenses</b> <b>- \$844</b>
	<b>Assets</b> <b>\$709</b>	<b>= Liabilities</b> <b>= \$332</b>	<b>+ Stockholders' Equity</b> <b>+ <u>\$377 (b)</u></b>
<b>Pascal:</b>	<b>Net Income</b> <b>\$289</b>	<b>= Revenues</b> <b>= \$533</b>	<b>- Expenses</b> <b>- <u>\$244 (c)</u></b>
	<b>Assets</b> <b>\$1,810</b>	<b>= Liabilities</b> <b>= <u>\$860 (d)</u></b>	<b>+ Stockholders' Equity</b> <b>+ \$950</b>
<b>Eiffel:</b>	<b>Net Income</b> <b>\$126</b>	<b>= Revenues</b> <b>= <u>\$503 (e)</u></b>	<b>- Expenses</b> <b>- \$377</b>
	<b>Assets</b> <b><u>\$552 (f)</u></b>	<b>= Liabilities</b> <b>= \$454</b>	<b>+ Stockholders' Equity</b> <b>+ \$98</b>
<b>Hilbert:</b>	<b>Net Income (Loss)</b> <b>(\$340)</b>	<b>= Revenues</b> <b>= \$1,125</b>	<b>- Expenses</b> <b>- <u>\$1,465 (g)</u></b>
	<b>Assets</b> <b>\$3,150</b>	<b>= Liabilities</b> <b>= \$2,267</b>	<b>+ Stockholders' Equity</b> <b>+ <u>\$883 (h)</u></b>

**P 1-60B**

<b>Ross Airport Auto Service</b> <b>Income Statement</b> <b>For the year ended December 31, 2013</b>
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<b>Revenues:</b>		
Service revenue (parking).....	\$232,600	
Service revenue (repair).....	198,500	
Interest income.....	<u>4,100</u>	
<b>Total revenues.....</b>		<b>\$435,200</b>
<b>Expenses:</b>		
Wages expense.....	\$246,100	
Rent expense.....	103,500	
Supplies expense.....	36,900	
Interest expense.....	21,300	
Depreciation expense.....	12,450	
Income taxes expense.....	<u>2,700</u>	
<b>Total expenses.....</b>		<b><u>422,950</u></b>
<b>Net income.....</b>		<b><u>\$ 12,250</u></b>

## P 1-60B (Continued)

<b>Ross Airport Auto Service</b>		
<b>Balance Sheet</b>		
<b>December 31, 2013</b>		
<b>Assets</b>		
<b>Current assets:</b>		
Cash.....	\$ 7,700	
Accounts receivable.....	39,200	
Inventory.....	6,100	
Prepaid rent.....	27,300	
<b>Total current assets.....</b>		<b>\$ 80,300</b>
<b>Long-term investments:</b>		
Investments.....		35,000
<b>Property, plant, and equipment:</b>		
Equipment.....	\$270,800	
Less: Accumulated depreciation.....	(42,300)	228,500
<b>Total assets.....</b>		<b>\$343,800</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable.....	\$ 17,200	
Wages payable.....	12,500	
Income taxes payable.....	1,100	
Interest payable.....	4,800	
<b>Total current liabilities.....</b>		<b>\$ 35,600</b>
<b>Long-term liabilities:</b>		
Notes payable.....		160,000
<b>Total liabilities .....</b>		<b>\$195,600</b>
<b>Stockholders' equity:</b>		
Common stock.....	\$100,000	
Retained earnings.....	48,200	
<b>Total stockholders' equity.....</b>		<b>148,200</b>
<b>Total liabilities and stockholders' equity.....</b>		<b>\$343,800</b>

**Note:** Dividends do not appear on the income statement or the balance sheet. Instead, dividends are reported on the retained earnings statement.

**P 1-61B**

**Magical Experiences Vacation Company  
Retained Earnings Statement  
For the years ended December 31, 2013, and December 31, 2014**

	2013	2014
Retained earnings, beginning of year*	\$ 55,300	\$ 74,700
Add: Net income**	33,400	74,600
Less: Dividends	(14,000)	(16,000)
Retained earnings, end of year	\$ 74,700	\$133,300

\* The ending retained earnings balance for 2013 becomes the beginning retained earnings balance for 2014.

	2013	2014
** Net income computed as follows:		
Revenue	\$ 221,900	\$ 325,400
Less: Expenses	(188,500)	(250,800)
Net income	\$ 33,400	\$ 74,600

**P 1-62B**

(a)  $\$26,900 - \$11,100 = \$15,800$

(b) Retained Earnings, Ending (2012) = Retained Earnings, Beginning (2013)  
= \$19,500

You must solve for (e) prior to solving for (c) or (d):

(e) Retained Earnings, Ending (2013) = Retained Earnings, Beginning (2014)  
= \$26,700

You must solve for (d) prior to solving for (c):

(d) = Retained Earnings, Ending, 2013 (e) + Dividends  
=  $\$26,700 + \$5,200$   
=  $\$31,900$

(c) Net Income = (d) – Retained Earnings, Beginning (2013)  
=  $\$31,900 - \$19,500$   
=  $\$12,400$

(f) = Retained Earnings, Beginning (2014) + Net Income  
=  $\$26,700 + \$9,500$   
=  $\$36,200$

(g) Dividends = (f) – Retained Earnings, Ending (2014)  
=  $\$36,200 - \$34,100$   
=  $\$2,100$

## P 1-63B

**McDonald Marina**  
**Income Statement**  
**For the year ended December 31, 2013**

<b>Revenues:</b>		
Service revenue (docking).....	\$1,460,000	
Service revenue (cleaning).....	<u>472,300</u>	
<b>Total service revenues.....</b>		<b>\$1,932,300</b>
<b>Expenses:</b>		
Wages expense.....	\$ 987,200	
Depreciation expense (equipment).....	246,300	
Utilities expense .....	239,400	
Interest expense.....	236,000	
Supplies expense.....	89,100	
Depreciation expense (building).....	21,500	
Rent expense.....	14,600	
Income taxes expense.....	<u>21,700</u>	
<b>Total expenses.....</b>		<b><u>1,855,800</u></b>
<b>Net income.....</b>		<b><u><u>\$ 76,500</u></u></b>

**McDonald Marina**  
**Retained Earnings Statement**  
**For the year ended December 31, 2013**

Retained earnings, January 1, 2013.....	\$ 128,600
Add: Net income for 2013.....	76,500
Less: Dividends.....	<u>(25,300)</u>
Retained earnings, December 31, 2013.....	<b><u><u>\$ 179,800</u></u></b>

**P 1-63B (Continued)**

<b>McDonald Marina</b>			
<b>Balance Sheet</b>			
<b>December 31, 2013</b>			
<b>Assets</b>			
<b>Current assets:</b>			
Cash.....		\$ 22,300	
Accounts receivable.....		268,700	
Supplies.....		9,800	
<b>Total current assets.....</b>		<u>300,800</u>	<b>\$ 300,800</b>
<b>Property, plant, and equipment:</b>			
Land.....		\$ 875,000	
Building.....	\$ 197,300		
Less: Accumulated depreciation.....	<u>(64,500)</u>	132,800	
Equipment.....	\$2,490,000		
Less: Accumulated depreciation.....	<u>(950,400)</u>	<u>1,539,600</u>	
<b>Total property, plant, and equipment..</b>			<u><b>2,547,400</b></u>
<b>Total assets.....</b>			<u><u><b>\$2,848,200</b></u></u>
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities:</b>			
Accounts payable.....		\$ 26,400	
Wages payable.....		21,600	
Interest payable.....		18,000	
Rent payable.....		2,400	
<b>Total current liabilities.....</b>			<u><b>\$ 68,400</b></u>
<b>Long-term liabilities:</b>			
Bonds payable.....			<u><b>2,000,000</b></u>
<b>Total liabilities.....</b>			<u><b>\$2,068,400</b></u>
<b>Stockholders' equity:</b>			
Common stock.....		\$ 600,000	
Retained earnings.....		179,800	
<b>Total stockholders' equity.....</b>			<u><b>779,800</b></u>
<b>Total liabilities and stockholders' equity.....</b>			<u><u><b>\$2,848,200</b></u></u>

2. Both a single-step income statement and a multiple-step income statement report the same amount for net income. However, a single-step income statement only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step income statement provides three important classifications that financial statement users find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

**P 1-64B****Stackhouse Company:**

- (a) \$5,000 ( $\$21,700 - \$18,800 + \$2,100$ )
- (b) \$66,700 ( $\$45,000 + \$21,700$ )
- (c) \$81,100 ( $\$14,400 + \$66,700$ )

**Compton Company:**

- (d) \$54,300 ( $\$39,000 + \$15,300$ )
- (e) \$21,600 ( $\$15,300 + \$7,100 - \$800$ )
- (f) \$60,600 ( $\$21,600 + \$39,000$ )
- (g) \$27,600 ( $\$88,200 - \$60,600$ )

**Bellefleur Company:**

Must solve for (i) first.

- (i) \$15,300 ( $\$95,300 - \$80,000$ )
- (h) \$1,300 ( $\$6,900 + \$9,700 - \$15,300$ )
- (j) \$18,100 ( $\$113,400 - \$95,300$ )

**Merlotte Company:**

- (k) \$13,900 ( $\$38,900 - \$25,000$ )
- (l) \$9,400 ( $\$13,900 - \$4,500 - \$0$ )
- (m) \$34,400 ( $\$25,000 + \$9,400$ )
- (n) \$50,100 ( $\$15,700 + \$34,400$ )

**P 1-65B**

First, use the fundamental accounting equation to determine stockholders' equity:

	<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Stockholders' Equity</b>
<b>Beginning</b>	<b>\$256,500</b>	<b>=</b>	<b>\$92,650</b>	<b>+</b>	<b>\$163,850 *</b>
<b>End</b>	<b>\$358,200</b>	<b>=</b>	<b>\$121,900</b>	<b>+</b>	<b>\$236,300 **</b>

$$* \$256,500 - \$92,650 = \$163,850$$

$$** \$358,200 - \$121,900 = \$236,300$$

Next, use these fundamental relationships to solve for each situation:

$$\begin{aligned} \text{Stockholders' Equity} &= \text{Common Stock} + \text{Retained Earnings} \\ \text{Change in Stockholders' Equity} &= \text{Change in Common Stock} \\ &\quad + \text{Change in Retained Earnings} \\ \text{Change in Retained Earnings} &= \text{Net Income} - \text{Dividends} \end{aligned}$$

Therefore,

$$\text{Change in Stockholders' Equity} = \text{Change in Common Stock} + \text{Net Income} - \text{Dividends}$$

1.  $(\$236,300 - \$163,850) = \$0 + \text{Net Income} - \$0$   
Net Income = \$72,450
2.  $(\$236,300 - \$163,850) = \$15,000 + \text{Net Income} - \$0$   
Net Income = \$57,450
3.  $(\$236,300 - \$163,850) = \$0 + \text{Net Income} - \$10,000$   
Net Income = \$82,450
4.  $(\$236,300 - \$163,850) = \$20,000 + \text{Net Income} - \$12,000$   
Net Income = \$64,450

## CASES

### Case 1-66

Answers to this question may vary; however, many students will focus on income. If Jim had kept track of his revenues (e.g., his earnings from the summer job, the small scholarship, and the fixed amount from his parents) and his expenses (e.g., tuition, books, apartment, and entertainment) during earlier semesters, he might have been able to budget for the spring term. Many of his expenses will be the same or very similar from term to term. Jim could use the information from the fall term to predict what his revenues and expenses would be for the spring term. He would then have a better idea of how much he could spend on entertainment without “maxing out” his credit card. In addition, Jim could keep track of his assets and liabilities. He could track which assets were current (e.g., cash in his bank account) and which liabilities would be coming due in the near term (e.g., spring tuition, living expenses). He could then know prior to the spring term which bills would be coming due and if he had enough liquid assets to pay these bills. Keeping better track of his revenues, expenses, income, assets, and liabilities may have allowed Jim to avoid overspending his resources.

### Case 1-67

1. The following examples are illustrative and student answers may vary:
  - a. Nonbusiness entities (including governments and educational institutions):
    - The Accounting Review* (university and college educators), American Accounting Association
    - Issues in Accounting Education* (university and college educators), American Accounting Association
    - The GAO Journal* (governmental accountants), U.S. General Accounting Office
  - b. Business entities:
    - Strategic Finance* (management accountants and finance professionals), Institute of Management Accountants
    - Financial Executive* (controllers, treasurers, and senior financial executives), Financial Executives Institute
    - Internal Auditor* (internal auditors), Institute of Internal Auditors

**Case 1-67 (Continued)**

**c. Public practice:**

*Journal of Accountancy* (certified public accountants), American Institute of Certified Public Accountants

*The CPA Journal* (certified public accountants), New York State Society of CPAs

2. Activities and events in one segment of the accounting profession affect activities and events in other segments of the profession. Education affects preparedness for public practice. New business activities require new auditing procedures. Accounting research affects the practice of accounting, and accounting practice influences the form of accounting research. Information about developments outside one's own segment of accounting can help one better understand and, perhaps, shape developments inside one's own segment.

**Case 1-68**

Student responses to this assignment will vary widely, but it is a good basis for classroom discussion. Some students will have interests in various accounting careers; others will have interests in other business careers or perhaps graduate professional degrees. Of those with plans for graduate education, some intend to work for several years before returning for additional education; others will plan to go directly into graduate school. Some will plan to start their careers in one field and then move into another after several years. Some may have plans to start their own business. The steps necessary to implement these plans can be an interesting basis for discussion.

**Case 1-69**

1. 

Current assets (1/31/13)	= \$5,210 + \$28,100 + \$7,152 = \$40,462
Current liabilities (1/31/13)	= \$19,655
Current assets (1/31/12)	= \$4,125 + \$32,891 + \$7,853 = \$44,869
Current liabilities (1/31/12)	= \$35,483

Agency Rent-A-Car reported a current ratio of 2.06 ( $\$40,462 / \$19,655$ ) in 2013 and a current ratio of 1.26 ( $\$44,869 / \$35,483$ ) in 2012. Its working capital is \$20,807 ( $\$40,462 - \$19,655$ ) in 2013 and \$9,386 ( $\$44,869 - \$35,483$ ) in 2012. These ratios show that the company has adequate current assets to cover the current liabilities in both years. In addition, its liquidity is improving between 2012 and 2013.

2. **Net Income = Stockholders' Equity (1/31/2013) – Stockholders' Equity (1/31/2012) + Dividends\***

$$\$172,529 - \$135,819 + \$21,000 = \$57,710$$

\* Beg. Stockholders' Equity \$135,819 + Net Income – Dividends \$21,000  
= End. Stockholders' Equity \$172,529

**Case 1-70****1. Trends:**

- (a) Revenues decreased dramatically from 2011 to 2012.
  - (b) Operating income (loss) has fluctuated dramatically in the 5-year period, but shows some improvement (less of a loss) in 2013.
  - (c) Net income (loss) was down dramatically from 2012 and seems to be slowly recovering in 2013 with a much smaller loss.
2. In 2009 and 2010, Wright Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in 2011, 2012, and 2013, causing current liabilities to be much larger than current assets. It seems as though Wright Brothers used its assets to pay down its long-term debt in 2011.
  3. Yes, the company has shown a considerable decrease throughout the 5-year period in net income and also shows that it may have difficulty in paying current liabilities with the small amount of current assets it has.

**Case 1-71**

Ethical behavior by accountants is important to society because capital markets and businesses cannot operate efficiently or effectively without reliable financial information. Financial information determines the way in which resources are deployed and distributed. Thus, individuals who stand to benefit from changes in resource deployment or distribution have an incentive to misrepresent financial information or to pressure accountants to do so. Such individuals may even create financial incentives for accountants to bias or misrepresent the facts. Unethical behavior by an accountant, once revealed, usually brings loss of employment and frequently loss of professional credentials (e.g., professional license) as well. In addition, individuals may face criminal or civil prosecution.

**Case 1-72**

**There are many ethical implications involved with the discussion between Lola and Frank. It is not ethical to change items in the financial statements simply to appear better to the public. This can be very misleading to both creditors and investors and could potentially cause harm to these parties who based their expectations of future performance on the past numbers that have been changed. If the company doesn't perform as well as expected, these creditors and investors will likely blame the accounting numbers that have been misrepresented. If management intends to pay off accounts within a year, they need to be classified as current liabilities. Also, investments that have been purchased with the intent to hold them for a long period of time should be considered long-term investments. Management should not reclassify these unless their intent changes and they plan to sell the investments within the next year. In addition, the company should follow generally accepted accounting principles and record its assets at historical cost. Management cannot pick and choose which assets to present at their market value. Management should not use the excuse of "judgment" to alter numbers in order to make the company appear better on paper.**

**Case 1-73**

1. **Apple's fiscal year ended on September 24, 2011. This year-end is different than from previous years for the simple reason that Apple has a floating year-end. Apple's year-end always falls on the last Saturday of the month of September, so the actual date changes from year to year.**
2. **Apple presents 2 years of balance sheet information and 3 years of income statement information.**
3. **Balance sheet information:**
  - a. **For 2011, Apple reported total assets of \$116,371,000,000, total liabilities of \$39,756,000,000, and total stockholders' equity of \$76,615,000,000.**
  - b. **The dollar amounts for all three categories have changed in the past year. For 2010, Apple reported total assets of \$75,183,000,000, total liabilities of \$27,392,000,000, and total stockholders' equity of \$47,791,000,000. This represented an increase in total assets of \$41,188,000,000 ( $\$116,371,000,000 - \$75,183,000,000$ ), an increase in total liabilities of \$12,364,000,000 ( $\$39,756,000,000 - \$27,392,000,000$ ), and an increase in total stockholders' equity of \$28,824,000,000 ( $\$76,615,000,000 - \$47,791,000,000$ ). Apple experienced significant growth in its resources and claims against those resources during 2011.**
  - c. **For 2011, Apple reported current assets of \$44,988,000,000 and current liabilities of \$27,970,000,000. For 2010, Apple reported current assets of \$41,678,000,000 and current liabilities of \$20,722,000,000.**
  - d. **Apple reported working capital of \$17,018,000,000 ( $\$44,988,000,000 - \$27,970,000,000$ ) for 2011 and working capital of \$20,956,000,000 ( $\$41,678,000,000 - \$20,722,000,000$ ) for 2010. Apple's current ratio was 1.61 ( $\$44,988,000,000 / \$27,970,000,000$ ) for 2011 and 2.01 ( $\$41,678,000,000 / \$20,722,000,000$ ) for 2010. Apple's current assets are greater than its current liabilities for both years, which indicates that Apple should be able to pay the liabilities that become due within the next year. While Apple's working capital and current ratio have decreased during 2011 when compared to 2010, Apple still appears to have sufficient liquidity.**

**Case 1-73 (Continued)**

**4. Income statement information:**

- a. For 2011, Apple reported revenues (net sales) of \$108,249,000,000 and expenses of \$82,327,000,000 (\$64,431,000,000 + \$10,028,000,000 + \$8,283,000,000 – \$415,000,000). *Note:* The \$415,000,000 is a combination of other income and expenses and was subtracted from expenses. Apple's net income was \$25,922,000,000.
- b. Sales have been increasing throughout the 3-year period, with a dramatic jump in 2011, as shown in the comparative income statements. As noted in the Management Discussion & Analysis, the large increase in sales in 2011 is due primarily to increased iPhone-related sales (87% increase compared to 2010) and increases in the sales of iPad-related sales (311% increase compared to 2010). This has caused cost of sales (an expense) to increase as well. However, the sales increases have been slightly larger than the cost of sales increases, which have led to the observed increases in gross margin and net income.

**5. Statement of cash flows information:**

- a. For 2011, Apple reported a net cash inflow from operating activities of \$37,529,000,000, a net cash outflow from investing activities of \$40,419,000,000, and a net cash inflow from financing activities of \$1,444,000,000).
- b. In 2011, Apple paid \$4,260,000,000 for the acquisition of property, plant, and equipment.

**6. Management's discussion and analysis information:**

- a. Apple's management considers several accounting policies critical, including: following generally accepted accounting principles, revenue recognition, allowance for doubtful accounts, inventory valuation, warranty costs, valuation of marketable securities, income taxes, and contingencies policy. This information was found in the management's discussion and analysis section of the annual report. More detail on significant accounting policies can also be found in the notes to the financial statements (Note 1).
- b. The company does believe that it has performed well during the current year. Its analysis can be found in the management's discussion and analysis section (Item 7 of the 10-K). Management lays out its beliefs on current operations as well as future prospects in this part of the financial statements.

**7. The financial statements are audited by Ernst & Young.**

**Case 1-74**

1. Under Armour's principal business activities are the development, marketing and distribution of branded performance apparel, footwear, and accessories. Its apparel consists of a variety of styles and is marketed under the trademarks "HEATGEAR," "COLDGEAR," and "ALLSEASONGEAR." Its footwear includes cleats, slides, performance training footwear, running footwear, basketball footwear, and hunting boots. Accessories include hats, bags, gloves (baseball batting, football, golf, and running), and other items.

VF is a global apparel and footwear company that sells a variety of products. A review of its product offerings (from an Internet search) indicates that VF's brands include "The North Face," "Vans," "Timberland," "JanSport," "Eastpak," "Wrangler," "Lee," "Nautica," and "7 For All Mankind."

2. a. The fiscal year-end for Under Armour is December 31, and the fiscal year-end for VF is December 31. We would expect these year-ends to be the same or similar because they are in the same industry and follow the same major trends in sales.
- b. As explained in footnote 1 of VF's financial statements, its fiscal year ends on the Saturday closest to December 31 of each year. This typically results in a 52-week year, but a fiscal year may occasionally contain an additional week, resulting in a 53-week year. This practice is quite common. Note that VF's last 3 fiscal years ended on December 31, 2011, January 1, 2011, and January 2, 2010. It refers to each of these fiscal years as "2011," "2010," "2009," respectively.

3. Balance sheet information:

- a. Under Armour (at December 31, 2011):

Assets = \$919,210,000

Liabilities = \$282,778,000 (\$183,607,000 + \$70,842,000 + \$28,329,000)

Stockholders' equity = \$636,432,000

- VF (at December 31, 2011):

Assets = \$9,313,126,000

Liabilities = \$4,787,951,000 (\$1,666,032,000 + \$1,831,781,000 + \$1,290,138,000)

Stockholders' equity = \$4,525,175,000

- b. Under Armour (at December 31, 2011):

Current assets = \$689,663,000

Current liabilities = \$183,607,000

- VF (at December 31, 2011):

Current assets = \$3,187,944,000

Current liabilities = \$1,666,032,000

**Case 1-74 (Continued)**

- c. Under Armour’s current assets are almost four times that of its current liabilities. Under Armour reported working capital of \$506,056,000 (\$689,663,000 – \$183,607,000) and a current ratio of 3.76 (\$689,663,000/\$183,607,000). This indicates that Under Armour should be able to pay off liabilities that come due in the next year. The liquidity picture of VF is similar. VF reports working capital of \$1,521,912,000 (\$3,187,944,000 – \$1,666,032,000) and a current ratio of 1.91 (\$3,187,944,000 / \$1,666,032,000). Both companies appear to be able to pay off their debts as they become due.
- d. VF’s financial statements show a much larger amount of assets, but also a much larger amount of liabilities than Under Armour. Thus, VF is a larger company. Another difference you can notice from these figures is that Under Armour is financed relatively more by stockholders’ equity, whereas a relatively larger portion of VF’s financing has been done by liabilities. Another trend to notice is that both companies have large amounts of current assets relative to current liabilities, showing relatively good liquidity for both of the companies.

**4. Income statement information:**

**a. Under Armour (for the fiscal year ending December 31, 2011):**

Revenues.....	\$1,472,684,000
Expenses.....	1,375,765,000*
Net income.....	<u>\$ 96,919,000</u>

**VF (for the fiscal year ending December 31, 2011):**

Revenues.....	\$9,464,010,000**
Expenses.....	8,575,921,000***
Net income.....	<u>\$ 888,089,000</u>

\* \$759,848,000+ \$550,069,000 + \$3,841,000 + \$2,064,000 + \$59,943,000

\*\* \$9,365,477,000 + \$93,755,000 + \$4,778,000

\*\*\* \$5,128,602,000 + \$3,085,839,000 + \$77,578,000 + \$7,248,000 + \$274,350,000 + \$2,304,000

- b. For both companies, revenues show an increasing trend through the 3 years presented. With that, the cost of sales and other expenses have also continued to increase throughout the period shown. Also, as you can see from the earnings per share information, both companies have continually increased the returns they are providing for their investors.

**Case 1-74 (Continued)****5. Obtained from the statements of cash flows for each of the companies:**

**Under Armour:** In addition to operating activities, its major sources of cash include borrowings from revolving credit facilities, proceeds from a term loan, and inflows related to its common stock. Major uses of cash include capital expenditures (purchases of property, plant, and equipment), purchase of a corporate headquarters, and repayment of borrowings.

**VF:** Its major sources of cash arise from its operations as well as proceeds from short and long-term borrowings. Major uses of cash include capital expenditures, business acquisitions, and cash dividends.

**6. You can find this information in the management's discussion and analysis in each of the companies' annual reports. Under Armour management feels the results for the current year are good and sees good prospects for future earnings. Specifically, Under Armour sees a growth in the demand for performance products and feels that they have a strong brand that will benefit from this growth. Similarly, VF management also believes future prospects for the company are good. Specifically, VF owns a diverse portfolio of brands with strong market positions in many categories. Because of its broad customer base and distribution through leading specialty stores as well as upscale stores and national chains, VF believes it is well-positioned to take advantage of opportunities in the highly competitive apparel industry.**

**Case 1-75**

- 1. The first concern for Front Row Entertainment is to obtain financing for the business. Normally, a concert promoter must pay a significant amount of up-front cash to secure the venue and advertise the tour. Therefore, it is critical that Front Row Entertainment raise a large amount of cash if the business is to succeed. This cash may be raised by issuing debt (e.g., notes payable, bonds payable), shares of stock (e.g., common stock), or a combination of both. Next, Front Row Entertainment must purchase the assets necessary to operate. Because a concert promoter provides a service, the initial investment in property, plant, and equipment is likely to be relatively small and involve typical office equipment (e.g., desks, telephones, computers). These assets are normally combined and reported as equipment on the balance sheet. The business can now begin to operate. Revenues (e.g., sales revenue, service revenue) will be generated as Front Row Entertainment fulfills its contractual duties (e.g., sells tickets). One of the major expenses for a concert promoter would be the fees paid to the musical artist upon completion of the event (reported as cost of sales). In addition, Front Row Entertainment will likely incur large expenses initially as it books the venue and advertises the concert. Typical expenses may include rent expense (for office space of the business as well as a rental fee on the venue), utilities expense, salaries expense (for Cam and Anna's salaries), advertising expense, and insurance expense. Some of these expenses may be prepaid (resulting in accounts such as prepaid advertising or prepaid rent) while payment for others may be delayed (resulting in accounts such as accounts payable, salaries payable, and rent payable).**
- 2. Cam and Anna can choose to organize Front Row Entertainment as either a partnership or a corporation. Relative to the corporate form of organization, partnerships are easier to organize. In addition, the control of the partnership would be shared by Cam and Anna, and the business would have access to the financial resources and skills of each partner. Finally, a partnership would also pay less taxes than a corporation. This is because the corporate tax rate is higher than the individual tax rate and the corporation's income is taxed twice—once at the corporate level and again at the stockholder level as earnings are distributed. However, the corporate form also has advantages. First, it can raise larger amounts of resources through the issuance of stock. Second, the corporate form limits the liability of its stockholders to the amount they have invested in the business. If the business were to fail, shareholders would only lose their investment. On the other hand, creditors could attempt to recover their losses from the personal assets of the partners. Finally, corporations have an unlimited life, with**

**Case 1-75 (Continued)**

ownership easily transferred by the sale of stock. However, partnerships are dissolved when any partner leaves the partnership. Cam and Anna need to carefully weigh the advantages and disadvantages of each form of business organization and select the form that best fits their needs.

3. Cam and Anna will need to prepare four basic financial statements: a balance sheet, an income statement, a retained earnings statement, and a statement of cash flows. A balance sheet reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time. By providing information about the structure of assets, liabilities, and stockholders' equity, a balance sheet provides users insights into whether a company can pay its obligations as they become due (liquidity). An income statement reports how well a company has performed its operations (revenues, expenses, and income) over a period of time. By providing information about a company's current profitability, users are better able to judge a company's ability to generate future income and growth potential. Such information impacts the decision of whether to make a loan to the company or invest in the company. A retained earnings statement reports how much of a company's income was retained in the business and how much was distributed to owners over a period of time. Insights into a company's dividend policy assist investors in determining a company's ability to pursue future growth opportunities. Finally, a statement of cash flows reports the sources and uses of a company's cash over a period of time. This information allows investors and creditors to judge the ability of a company to generate cash in the future, as well as to assess the creditworthiness of a company and its ability to pay future dividends.

