Solutions for Financial Accounting 5th Edition by Rich

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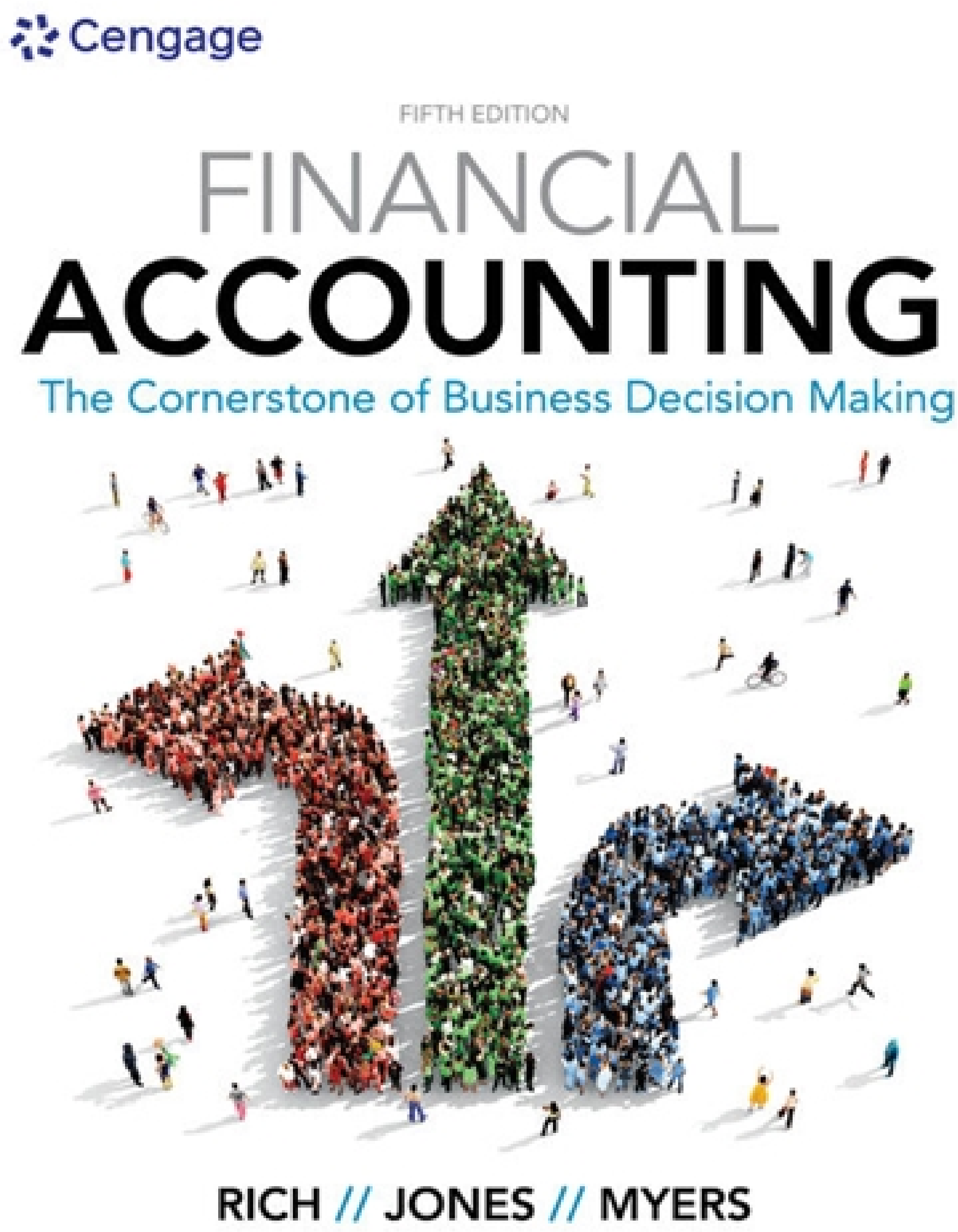

Solutions

1 ACCOUNTING AND THE FINANCIAL STATEMENTS

DISCUSSION QUESTIONS

1. Accounting is an information system that identifies, measures, records, and communicates financial information about a company's business activities to permit informed decisions by users of the information. Accounting is often referred to as the *language of business* because it communicates relevant and reliable information about economic activities of a company that helps people make better 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. Six groups that create the demand for accounting information and their uses of accounting information are described next:

(1) Managers use accounting information to help decide which actions to take, predict the consequences of their actions, and evaluate the effectiveness of their past decisions. They also use accounting information to control the operations of the company.

(2) Investors (owners) need accounting information about a business to evaluate the future prospects of a business and to decide where to invest their money.

(3) Creditors (lenders) need accounting information to decide whether or not to lend money (extend credit) to a business.

(4) 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.

(5) Labor unions use accounting information when negotiating wage increases for its members.

(6) Financial analysts use accounting information when offering buy or sell recommendations to clients.

3. An accounting entity is a business 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. The owner of a sole proprietorship and the partners in a partnership 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 largely outnumbers 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.

7. Revenues are the increases in assets that result from the sale of products or services. Expenses are the costs of assets used, or the liabilities created, in the operation of the business. If revenues are greater than expenses, a business has earned net income. If expenses are greater than revenues, a business has incurred a net loss.

8. The four primary financial statements are as follows:

(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 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 sources (inflows) and uses (outflows) of cash.

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:
   a. How much income was distributed in dividends by the corporation?
   b. What amount of equity in the business has been generated internally?

(4) Statement of cash flows:
   a. How much cash was taken in or paid out as a result of operations?
   b. How much cash was invested in new equipment?
   c. 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:

Assets = Liabilities + 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 become 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. Net Income = Total Revenues – 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 organizes revenues and expenses into multiple categories. The resulting subtotals (gross margin [gross profit], income from operations, and net income) highlight important relationships between revenues and expenses that financial statement users find useful.

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 these 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 often reflect 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.

20. The retained earnings statement describes the changes in retained earnings, a balance sheet account, that occurs 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. 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. d

1-4. d

1-5. a ($12,900 – $6,300)

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

BRIEF EXERCISES

BE 1-13

a. Government
b. Manager
c. Creditor
d. Investor
e. Financial Analyst

BE 1-14

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

BE 1-15

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

BE 1-16

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

BE 1-16 (Continued)

	Assets	=	Liabilities	+	Equity
4.	X	=	$345,000*	+	$92,000**
	X	=	<u>$437,000</u>		

* $260,000 + $85,000 = $345,000
** $165,000 (from part 1) – $73,000 = $92,000

BE 1-17

	Assets	=	Liabilities	+	Equity
Scenario 1:	X	=	$42,000	+	$56,000
	(a)	=	<u>$98,000</u>		
Scenario 2:	$115,000	=	X	+	$77,000
	(b)	=	<u>$38,000</u>		
Scenario 3:	$54,000	=	$18,500	+	X
	(c)	=	<u>$35,500</u>		

BE 1-18

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

BE 1-19

Cavernous Homes Inc.
Balance Sheet
December 31

Assets

Cash	$3,200	
Accounts receivable	4,500	
Supplies	8,100	
Total assets		$15,800

Liabilities and Stockholders' Equity

Liabilities:		
Notes payable	$5,000	
Total liabilities		$5,000
Stockholders' equity:		
Common stock	$7,000	
Retained earnings	3,800	
Total stockholders' equity		10,800
Total liabilities and stockholders' equity		$15,800

BE 1-20

Rutherford Company
Income Statement
For the year ending December 31

Revenues and gains:		
Sales revenue	$65,000	
Interest income	3,900	
Total revenues		$68,900
Expenses and losses:		
Cost of goods sold	$28,800	
Salaries expense	22,500	
Insurance expense	4,300	
Loss on disposal of property, plant, and equipment	1,200	
Income taxes expense	2,400	
Total expenses and losses		(59,200)
Net income		$9,700

BE 1-21

Rutherford Company
Income Statement
For the year ending December 31

Sales revenue	$65,000	
Cost of goods sold	(28,800)	
Gross margin		$36,200
Operating expenses		
Salaries expense	$22,500	
Insurance expense	4,300	
Total operating expenses		(26,800)
Income from Operations		$9,400
Other income and expenses:		
Interest income	$ 3,900	
Loss on disposal of property, plant, and equipment	(1,200)	
Total other income and expenses		2,700
Income before income taxes		$ 12,100
Income taxes expense		(2,400)
Net income		$ 9,700

BE 1-22

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

BE 1-23

	Beginning retained earnings	$35,000
+	Net income ($82,000 – $55,000)	27,000
–	Dividends	(8,000)
=	Ending retained earnings	$54,000

BE 1-24

a. Operating activities (O)
b. Financing activities (F)
c. Financing activities (F)
d. Operating activities (O)
e. Investing activities (I)

BE 1-25

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

EXERCISES

E 1-26

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

E 1-27

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 the 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.
   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 are more complex.
        (ii) Corporations generally pay higher taxes.

E 1-28

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

E 1-29

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 1-30

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

E 1-31

	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 1-32

1.

Higgins Company
Balance Sheet
Specific point in time

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 the 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 1-33

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 5 years is a long-term liability. The $3,750 interest related to the current year is a current liability. The remaining interest of $750 will not be recognized until the following year and, therefore, is not on the current year 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, 2020

Current assets:		
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
Current liabilities:		
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

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 1-34

1.

Hanson Construction
Partial Balance Sheet
December 31

Current assets:		
Cash	$1,380	
Accounts receivable	7,000	
Notes receivable	1,500	
Supplies	6,200	
Total current assets		$16,080
Current liabilities:		
Accounts payable	$2,100	
Notes payable	6,800	
Total current liabilities		$ 8,900

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 1-35

The balance sheet at December 31 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 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 1-36

Mulcahy Manufacturing Inc.
Partial Balance Sheet
December 31

Stockholders' equity:	
Common stock	$150,000
Retained earnings	37,500
Total stockholders' equity	$187,500

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

E 1-37

1.

College Spirit
Balance Sheet
December 31

Assets

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

Liabilities and Stockholders' Equity

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

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 1-38

1.

Jerrison Company
Balance Sheet
December 31

Assets

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

E 1-38 (Continued)

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 65,100	
Notes payable	150,000	
Salaries payable	14,400	
Interest payable	12,600	
Income taxes payable	21,600	
Total current liabilities		$263,700
Long-term liabilities:		
Bonds payable		200,000
Total liabilities		$463,700
Stockholders' equity:		
Common stock	$150,000	
Retained earnings*	196,100	
Total stockholders' equity		346,100
Total liabilities and stockholders' equity		$809,800

******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 follows:**

First, compute stockholders' equity:

Total Assets	=	Total Liabilities + Total Stockholders' Equity
$809,800	=	$463,700 + X
X	=	$346,100

Next, compute retained earnings:

Total Stockholders' Equity	=	Common Stock + Retained Earnings
$346,100	=	$150,000 + Y
Y	=	$196,100

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 1-39

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) = 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) = 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

i. **Contributed capital: (i) + $67,000 = $102,000 (j)**
(i) = $35,000

j. **Total stockholders' equity: $47,200 (h) + (j) = $149,200**
(j) = $102,000

E 1-40

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 1-41

1.

ERS Inc.
Income Statement
For the year ending December 31

Revenues:		
Service revenue		$933,800
Expenses:		
Wages expense	$448,300	
Salaries expense	195,600	
Supplies expense	66,400	
Rent expense	58,400	
Utilities expense	26,100	
Advertising expense	24,200	
Depreciation expense	16,250	
Insurance expense	11,900	
Interest expense	10,100	
Income taxes expense	15,150	
Total expenses		(872,400)
Net income		$ 61,400

2. **Net profit margin is 6.58% ($61,400 net income / $933,800 service revenue). This indicates that $0.0658 of each sales dollar is profit. If ERS were to increase revenues by $100,000, an additional $6,580 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 1-42

Bergin Pastry Shop
Income Statement
For the year ending December 31

Net sales	$85,300
Cost of goods sold*	(50,600)
Gross margin	$34,700
Operating expenses**	(25,500)
Income from operations	$ 9,200
Other expenses and losses:	
Interest expense	(1,800)
Income before taxes	$ 7,400
Income taxes expense***	(1,110)
Net income	$ 6,290

* 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% × $7,400 = $1,110

E 1-43

1.

Wright Auto Supply
Income Statement
For the year ending December 31

Revenues:		
Sales revenue		$ 585,600
Expenses:		
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	32,520	
Total expenses		(509,720)
Net income		$ 75,880

E 1-43 (Continued)

2.

Wright Auto Supply
Income Statement
For the year ending December 31

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

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 1-44

1.

Beginning retained earnings	$ 18,240
+ Net income ($837,400 – $792,100)	45,300
– Dividends	(38,650)
= Ending retained earnings	$ 24,890

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 1-45

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	(28,700)	
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	(32,000)	
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	(37,500)	
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 become 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 1-46

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	$ 10,350
Add: Cash as on January 1	20,400
Cash at December 31	$ 30,750
Retained earnings at the end of the year:	
Retained earnings as on January 1	$ 105,600
Add: Net income ($650,100 – $578,600)	71,500
Less: Dividends declared	(30,000)
Retained earnings as on December 31	$ 147,100

E 1-47

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

	Assets	=	Liabilities	+	Equity
January 1	$82,400	=	$9,200	+	($50,000 + Retained Earnings)
December 31	$88,500	=	$11,300	+	($50,000 + Retained Earnings)

Solve for retained earnings as on January 1 and December 31:

January 1	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$82,400 – $9,200 – $50,000
		=	$23,200
December 31	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$88,500 – $11,300 – $50,000
		=	$27,200

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

Beginning retained earnings	$23,200
+ Net income	19,500
– Dividends declared	?
= Ending retained earnings	$27,200

Dividends = $15,500

E 1-48

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

	Assets	=	Liabilities	+	Equity
January 1	$152,200	=	$56,600	+	($60,000 + Retained Earnings)
December 31	$171,800	=	$63,750	+	($60,000 + Retained Earnings)

For each year, solve for retained earnings:

January 1	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$152,200 – $56,600 – $60,000
		=	$35,600
December 31	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 declared	(20,000)
= Ending retained earnings	$ 48,050

Net income = $32,450

E 1-49

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 1-50A

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 the year can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

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

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

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

	Assets	=	Liabilities	+	Equity
As of December 31	$285,500	=	?	+	$194,950

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

P 1-51A

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

(a)	Assets	=	Liabilities	+	Stockholders' Equity (all at the end of the year)			
	Assets	=	$126,900	+	$104,100			
	Assets	=	$231,000					
(b)	Assets	=	Liabilities	+	Stockholders' Equity (all at the beginning of the year)			
	$145,200	=	$92,600	+	Stockholders' Equity			
	Stockholders' Equity	=	$52,600					
(c)	Beginning Stockholders' Equity	+	Net Income	–	Dividends	=	Ending Stockholders' Equity	
	$52,600	+	$77,500	–	Dividends	=	$104,100	
	Dividends	=	$26,000					
(d)	Revenues	–	Expenses	=	Net Income			
	$554,800	–	Expenses	=	$77,500			
	Expenses	=	$477,300					

P 1-52A

Powers Wrecking Service
Income Statement
For the year ending December 31

Revenues:		
Service revenue	$425,000	
Sales revenue	137,000	
Interest income	1,575	
Total revenues		$563,575
Expenses:		
Wages expense	$243,200	
Rent expense	84,000	
Supplies expense	48,575	
Depreciation expense	24,150	
Miscellaneous expense	17,300	
Income taxes expense	43,900	
Total expenses		(461,125)
Net income		$102,450

P 1-53A

Cooper Merchandising
Income Statement
For the year ending December 31

Net sales		$625,000
Cost of goods sold		(248,000)
Gross margin		$377,000
Operating expenses:		
Wages expenses	$ 103,600	
Rent expense	65,000	
Supplies expense	23,575	
Depreciation expense	12,150	
Miscellaneous expense	8,300	
Total operating expenses		(212,625)
Income from operations		$164,375
Other income and expenses:		
Interest income		1,250
Income before taxes		$165,625
Income taxes expense		(32,500)
Net income		$133,125

P 1-54A

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

P 1-55A

Rogers Enterprises
Income Statement
For the year ending December 31

Revenues:		
Service revenue		**$463,500**
Expenses:		
Salaries expense	**$235,200**	
Rent expense	**135,000**	
Supplies expense	**34,400**	
Interest expense	**16,000**	
Income taxes expense	**12,800**	**(433,400)**
Net income		**$ 30,100**

Rogers Enterprises
Balance Sheet
December 31
Assets

Current assets:		
Cash	**$13,240**	
Accounts receivable	**72,920**	
Supplies	**42,000**	
Prepaid rent	**31,500**	
Total current assets		**$159,660**
Property, plant, and equipment		**90,000**
Total assets		**$249,660**

P 1-55A (Continued)

Liabilities and Stockholders' Equity

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

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

P 1-56A

Moore Inc.
Income Statement
For the year ending December 31

Sales revenue	$ 863,500	
Cost of goods sold	(395,000)	
Gross margin		$468,500
Operating expenses:		
Salaries expense	$ 235,200	
Rent expense	135,000	
Supplies expense	34,400	
Total operating expenses		($ 404,600)
Income from operations		$ 63,900
Other income and expenses:		
Interest income	2,000	
Interest expense	(16,000)	
Total other income and expenses		(14,000)
Income before income taxes		49,900
Income taxes expense		(8,600)
Net income		$ 41,300

P 1-56A (Continued)

Moore Inc.
Balance Sheet
December 31

Assets

Current assets:		
Cash	$ 16,290	
Accounts receivable	68,910	
Supplies	44,100	
Prepaid rent	31,500	
Total current assets		$160,800
Property, plant, and equipment		90,000
Total assets		$250,800

Liabilities and Stockholders' Equity

Current liabilities:		
Salaries payable	$ 14,800	
Income taxes payable	4,150	
Total current liabilities		$ 18,950
Long-term liabilities:		
Notes payable (due in 10 years)		25,000
Total liabilities		$ 43,950
Stockholders' equity:		
Common stock (10,000 shares)	$ 70,000	
Retained earnings*	136,850	
Total stockholders' equity		206,850
Total liabilities and stockholders' equity		$250,800

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

P 1-57A

Dittman Expositions
Retained Earnings Statement
For the years ending December 31, Year 1, and December 31, Year 2

	Year 1	Year 2
Retained earnings, beginning of year*	$20,900	$36,050
Add: Net income**	25,400	33,000
Less: Dividends declared	(10,250)	(12,920)
Retained earnings, end of year	$36,050	$56,130

* The ending retained earnings balance for Year 1 becomes the beginning retained earnings balance for Year 2

** Net income computed as follows:	Year 1	Year 2
Revenue	$407,500	$451,600
Less: Expenses	(382,100)	(418,600)
Net income	$ 25,400	$ 33,000

P 1-58A

(a) $30,700 – Dividends (a) = $27,200
Dividends (a) = $3,500

(b) Retained Earnings, Beginning (Year 2) = Retained Earnings, Ending (Year 1)
= $27,200

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

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

(e) Retained Earnings, Ending (Year 2) = Retained Earnings, Beginning (Year 3)
= $33,600

(d) Retained Earnings, Ending (e) = (c) – Dividends (d)
$33,600 = $37,300 – Dividends (d)
Dividends (d) = $3,700

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

(g) Retained Earnings, Ending = (g) – Dividends
$41,200 = (g) – $3,900
(g) = $45,100

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

P 1-59A

1.

Ashton Appliances
Income Statement
For the year ending December 31

Revenues:		
Sales revenue		$948,670
Expenses:		
Cost of goods sold	$511,350	
Salaries expense	228,710	
Rent expense	80,800	
Insurance expense	36,610	
Interest expense	15,500	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Income taxes expense	16,650	
Total expenses		(912,670)
Net income		$ 36,000

P 1-59A (Continued)

Ashton Appliances
Retained Earnings Statement
For the year ending December 31

Beginning retained earnings, January 1	$ 54,000
Add: Net income*	36,000
Ending retained earnings, December 31	$ 90,000

* From the income statement

Ashton Appliances
Balance Sheet
December 31

Assets

Current assets:			
Cash		$ 41,450	
Accounts receivable		69,900	
Inventory		59,850	
Total current assets			$171,200
Property, plant, and equipment:			
Building	$ 300,000		
Less: Accumulated depreciation	(104,800)		
Building, net		$195,200	
Furniture	$ 130,000		
Less: Accumulated depreciation	(27,600)		
Furniture, net		102,400	
Total property, plant, and equipment			297,600
Other assets			92,800
Total assets			$ 561,600

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 16,800	
Income taxes payable	12,000	
Salaries payable	7,190	
Total current liabilities	$ 35,990	
Long-term liabilities:		
Bonds payable	192,000	
Total liabilities		$227,990
Stockholders' equity:		
Common stock	$ 243,610	
Retained earnings*	90,000	
Total stockholders' equity		333,610
Total liabilities and stockholders' equity		$ 561,600

* From the retained earnings statement

P 1-59A (Continued)

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 contains only 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.**

2.

Ashton Appliances
Income Statement
For the year ending December 31

Sales revenue		$948,670
Cost of goods sold		($511,350)
Gross margin		$437,320
Operating expenses:		
Salaries expense	228,710	
Rent expense	80,800	
Insurance expense	36,610	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Total operating expenses		(369,170)
Income from operations		$ 68,150
Other income and expenses:		
Interest expense		(15,500)
Income before income taxes		$52,650
Income taxes expense		(16,650)
Net income		$ 36,000

P 1-60A

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 1-61A

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

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

* $385,500 – $152,800 = $232,700
** $420,250 – $156,600 = $263,650

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

Stockholders' Equity	=	Common Stock	+	Retained Earnings
Change in Stockholders' Equity	=	Change in Common Stock	+	Change in Retained Earnings
Change in Retained Earnings	=	Net Income – Dividends		

Therefore,

Change in Stockholders' Equity = Change in Common Stock + Net Income – Dividends

1. ($263,650 – $232,700) = $0 + Net Income – $0
   Net Income = <u>$30,950</u>
2. ($263,650 – $232,700) = $40,000 + Net Income – $0
   Net Loss = <u>($9,050)</u>
3. ($263,650 – $232,700) = $0 + Net Income – $15,000
   Net Income = <u>$45,950</u>
4. ($263,650 – $232,700) = $35,000 + Net Income – $20,000
   Net Income = <u>$15,950</u>

PROBLEM SET B

P 1-50B

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 the year can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

The amount of KJ's assets at December 31 is $710,100. KJ's stockholders' equity at the end of the year 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, Jan. 1	$100,000	+	$134,900	=	$234,900
Net income			205,500		
Dividends			(70,000)		
Common stock issued	75,000			=	
Equity, Dec. 31	$175,000	+	$270,400	=	$445,400

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

	Assets	=	Liabilities	+	Equity
At Dec. 31	$710,100	=	?	+	$445,400

Liabilities = $710,100 – $445,400 = $264,700

P 1-51B

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 1-52B

Parker Renovation Inc.
Income Statement
For the year ending December 31

Revenues:		
Service revenue	$763,400	
Interest income	5,475	
Total revenues		$768,875
Expenses:		
Wages expense	$ 222,900	
Depreciation expense	135,000	
Utilities expense	109,300	
Insurance expense	65,850	
Miscellaneous expense	31,000	
Income taxes expense	61,400	
Total expenses		(625,450)
Net income		$143,425

P 1-53B

Lakas Company
Income Statement
For the year ending December 31

Net sales		$ 425,000
Cost of goods sold		(178,400)
Gross margin		$246,600
Operating expenses:		
Wages expenses	$ 66,100	
Rent expense	35,910	
Supplies expense	13,122	
Depreciation expense	11,590	
Miscellaneous expense	8,800	
Total operating expenses		(135,522)
Income from operations		$111,078
Other income and expenses:		
Interest income	620	
Interest expense	(850)	
Total other income and expenses		(230)
Income before taxes		$ 110,848
Income taxes expense		(23,200)
Net income		$ 87,648

P 1-54B

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

P 1-55B

Ross Airport Auto Service
Income Statement
For the year ending December 31

Revenues:		
Service revenue (parking)	$232,600	
Service revenue (repair)	198,500	
Interest income	4,100	
Total revenues		$435,200
Expenses:		
Wages expense	$246,100	
Rent expense	103,500	
Supplies expense	36,900	
Interest expense	21,300	
Depreciation expense	12,450	
Income taxes expense	2,700	
Total expenses		(422,950)
Net income		$ 12,250

P 1-55B (Continued)

Ross Airport Auto Service
Balance Sheet
December 31

Assets

Current assets:		
Cash	$ 7,700	
Accounts receivable	39,200	
Inventory	6,100	
Prepaid rent	27,300	
Total current assets	$ 80,300	
Long-term investments:		
Investments	35,000	
Property, plant, and equipment:		
Equipment	$ 270,800	
Less: Accumulated depreciation	(42,300)	228,500
Total assets		$ 343,800

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 17,200	
Wages payable	12,500	
Income taxes payable	1,100	
Interest payable	4,800	
Total current liabilities		$ 35,600
Long-term liabilities:		
Notes payable		160,000
Total liabilities		$ 195,600
Stockholders' equity:		
Common stock	$ 100,000	
Retained earnings	48,200	
Total stockholders' equity		148,200
Total liabilities and stockholders' equity		$ 343,800

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

P 1-56B

Cheng Company
Income Statement
For the year ending December 31

Sales revenue	$ 525,100	
Cost of goods sold	(279,800)	
Gross margin		$ 245,300
Operating expenses:		
Salaries expense	$ 115,900	
Rent expense	65,000	
Supplies expense	14,400	
Research and development expense	12,700	
Insurance expense	5,000	
Total operating expenses		($ 213,000)
Income from operations		$ 32,300
Other income and expenses:		
Gain on disposal of property, plant, and equipment	5,000	
Interest expense	(8,450)	
		(3,450)
		28,850
Income taxes expense		(6,000)
Net income		$ 22,850

Cheng Company
Balance Sheet
December 31

Assets

Current assets:		
Cash	$ 14,275	
Accounts receivable	58,930	
Supplies	24,600	
Prepaid rent	8,500	
Total current assets		$106, 305
Property, plant, and equipment		105,000
Patent		12,380
Total assets		$ 223,685

Liabilities and Stockholders' Equity

Current liabilities:		
Salaries payable	$11,400	
Income taxes payable	2,850	
Total current liabilities		$ 14,250
Long-term liabilities:		
Notes payable (due in 10 years)		15,000
Total liabilities		$ 29,250
Stockholders' equity:		
Common stock (10,000 shares)	$ 105,000	
Retained earnings*	89,435	
Total stockholders' equity		194,435
Total liabilities and stockholders' equity		$ 223,685

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

P 1-57B

Magical Experiences Vacation Company
Retained Earnings Statement
For the years ending December 31, Year 1, and December 31, Year 2

	Year 1	Year 2
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 Year 1 becomes the beginning retained earnings balance for Year2.

** Net income is computed as follows:

	Year 1	Year 2
Revenue	$221,900	$325,400
Less: Expenses	(188,500)	(250,800)
Net income	$ 33,400	$74,600

P 1-58B

(a) $26,900 – $11,100 = $15,800

(b) Retained Earnings, Ending (Year 1) = Retained Earnings, Beginning (Year 2)
= $ 19,500

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

(e) Retained Earnings, Ending (Year 2) = Retained Earnings, Beginning (Year 3)
= $ 26,700

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

(d) = Retained Earnings, Ending, Year 2 (e) + Dividends
= $ 26,700 + $5,200
= $ 31,900

(c) Net Income = (d) – Retained Earnings, Beginning (Year 2)
= $ 31,900 (d) – $19,500
= $ 12,400

(f) = Retained Earnings, Beginning (Year 3) + Net Income
= $ 26,700 + $9,500
= $ 36,200

(g) Dividends = (f) – Retained Earnings, Ending (Year 3)
= $ 36,200 (f) – $34,100
= $ 2,100

P 1-59B

McDonald Boat Company
Income Statement
For the year ending December 31

Revenues:		
Sales revenue		$ 1,932,300
Expenses:		
Cost of goods sold	$ 987,200	
Wages expense	348,700	
Depreciation expense (equipment)	142,300	
Utilities expense	131,300	
Interest expense	99,400	
Supplies expense	89,100	
Depreciation expense (building)	21,500	
Rent expense	14,600	
Income taxes expense	21,700	
Total expenses		(1,855,800)
Net income		$ 76,500

P 1-59B (Continued)

McDonald Boat Company
Retained Earnings Statement
For the year ending December 31

Retained earnings, January 1	$ 128,600
Add: Net income	76,500
Less: Dividends	(25,300)
Retained earnings, December 31	$ 179,800

McDonald Marina
Balance Sheet
December 31

Assets

Current assets:			
Cash		$ 22,300	
Accounts receivable		268,700	
Supplies		9,800	
Total current assets			$ 300,800
Property, plant, and equipment:			
Land		$ 875,000	
Building	$ 197,300		
Less: Accumulated depreciation	(64,500)	132,800	
Equipment	$ 2,490,000		
Less: Accumulated depreciation	(950,400)	1,539,600	
Total property, plant, and equipment	2,547,400		
Total assets			$ 2,848,200

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 26,400	
Wages payable	21,600	
Interest payable	18,000	
Rent payable	2,400	
Total current liabilities		$ 68,400
Long-term liabilities:		
Bonds payable		2,000,000
Total liabilities		$ 2,068,400
Stockholders' equity:		
Common stock	$ 600,000	
Retained earnings	179,800	
Total stockholders' equity		779,800
Total liabilities and stockholders' equity		$ 2,848,200

P 1-59B (Continued)

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 contains only 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.**

2.

McDonald Boat Company
Income Statement
For the year ending December 31

Sales revenue		$1,932,300
Cost of goods sold		($ 987,200)
Gross margin		$ 945,100
Operating Expenses:		
Wages expense	348,700	
Depreciation expense (equipment)	142,300	
Utilities expense	131,300	
Interest expense	99,400	
Supplies expense	89,100	
Depreciation expense (building)	21,500	
Rent expense	14,600	
Total operating expenses		(846,900)
Income from operations		$ 98,200
Income taxes expense		($ 21,700)
Net income		$ 76,500

P 1-60B

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)

P 1-60B (Continued)

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 1-61B

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

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

* $256,500 – $92,650 = $163,850

** $358,200 – $121,900 = $236,300

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

Stockholders' Equity	=	Common Stock	+	Retained Earnings
Change in Stockholders' Equity	=	Change in Common Stock	+	Change in Retained Earnings
Change in Retained Earnings	=	Net Income – Dividends		

Therefore,

Change in Stockholders' Equity	=	Change in Common Stock	+	Net Income – Dividends

1. **($236,300 – $163,850) = $0 + Net Income – $0**
   Net Income = <u>$72,450</u>

2. **($236,300 – $163,850) = $15,000 + Net Income – $0**
   Net Income = <u>$57,450</u>

3. **($236,300 – $163,850) = $0 + Net Income – $10,000**
   Net Income = <u>$82,450</u>

4. **($236,300 – $163,850) = $20,000 + Net Income – $12,000**
   Net Income = <u>$64,450</u>

CASES

Case 1-62

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 become due in the near term (e.g., spring tuition, living expenses). He could then know prior to the spring term which bills would become 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 1-63

1. **The following examples are illustrative, and students' 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**
      Journal of Government Financial Management **(governmental accountants), Association of Government Accountants (AGA)**

   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**

   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 1-64

Student responses to this assignment will vary widely, but it is a good basis for classroom discussion. Some students may have interests in various accounting careers, while others may have interests in other business careers or perhaps graduate professional degrees. Of those with plans for graduate education, some may intend to work for several years before returning for additional education, while others may plan to go directly into graduate school. Some may 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 1-65

1. Current assets (1/31/2023) = $5,210 + $28,100 + $7,152 = $40,462
Current liabilities (1/31/2023) = $19,655
Current assets (1/31/2022) = $4,125 + $32,891 + $7,853 = $44,869
Current liabilities (1/31/2022) = $35,483

Agency Rent-A-Car reported a current ratio of 2.06 ($40,462 / $19,655) in 2023 and a current ratio of 1.26 ($44,869 / $35,483) in 2022. Its working capital is $20,807 ($40,462 – $19,655) in 2023 and $9,386 ($44,869 – $35,483) in 2022. 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 2022 and 2023.

2. Net Income = Stockholders' Equity (1/31/2023) – Stockholders' Equity (1/31/2022) + 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 1-66

1. Trends:

(a) Revenues decreased dramatically from 2021 to 2022.
(b) Operating income (loss) has fluctuated dramatically in the 5-year period but shows some improvement (less of a loss) in 2023.
(c) Net income (loss) was down dramatically from 2022 and seems to be slowly recovering in 2023 with a much smaller loss.

2. In 2019 and 2020, Wright Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in 2021, 2022, and 2023, 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 2021.

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 1-67

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 1-68

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 1-69

1. **Apple's fiscal year ended on September 28, 2019. This year-end is different 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 2019, Apple reported total assets of $338,516,000,000, total liabilities of $248,028,000,000, and total stockholders' equity of $90,488,000,000.**
   b. **The dollar amounts for all three categories have changed in the past year. For 2018, Apple reported total assets of $365,725,000,000, total liabilities of $258,578,000,000, and total stockholders' equity of $107,147,000,000. This represented a decrease in total assets of $27,209,000,000 ($338,516,000,000 – $365,725,000,000), a decrease in total liabilities of $10,550,000,000 ($248,028,000,000 – $258,578,000,000), and a decrease in total stockholders' equity of $16,659,000,000 ($90,488,000,000 – $107,147,000,000).**
   c. **For 2019, Apple reported current assets of $162,819,000,000 and current liabilities of $105,718,000,000. For 2018, Apple reported current assets of $131,339,000,000 and current liabilities of $115,929,000,000.**

Case 1-69 (Continued)

d. **Apple reported working capital of $57,101,000,000 ($162,819,000,000 – $105,718,000,000) for 2019 and working capital of $15,410,000,000 ($131,339,000,000 – $115,929,000,000) for 2018. Apple's current ratio was 1.54 ($162,819,000,000 / $105,718,000,000) for 2019 and 1.13 ($131,339,000,000 / $115,929,000,000) for 2018. 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. Apple's working capital and current ratio have increased during 2019 when compared to 2018. Thus, Apple appears to have sufficient liquidity.**

4. **Income statement information:**
   a. **For 2019, Apple reported revenues (net sales) of $260,174,000,000 and expenses of $204,918,000,000 ($161,782,000,000 + $34,462,000,000 + $10,481,000,000 – $1,807,000,000). *Note:* The $18,070,000,000 is a combination of other income and expenses and was subtracted from expenses. Apple's net income was $55,256,000,000.**
   b. **Sales decreased by $11,964,000 from 2018 to 2019 but increased by $29,313,000 from 2017 to 2018, as shown in the comparative income statements. As noted in the management discussion and analysis, the decrease in sales in 2019 is due primarily to decreased iPhone sales. This decrease in sales has caused a corresponding decrease in cost of sales (an expense).**

5. **Statement of cash flows information:**
   a. **For 2019, Apple reported a net cash inflow from operating activities of $69,391,000,000, a net cash inflow from investing activities of $45,896,000,000, and a net cash outflow from financing activities of $90,976,000,000).**
   b. **In 2019, Apple paid $10,495,000,000 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 believes that future gross margins will be under downward pressure due to global product pricing pressures, increased competition, compressed product life cycles, potential increases in cost of components, and a shift to lower gross margin products. Its analysis can be found in the management's discussion and analysis section (Item 7 of the 10-K).**

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

Case 1-70

1. **Kroger is one of the largest retailers in the world based on sales. Its revenues are predominately earned, and cash is generated as consumer products are sold to customers in its stores, fuel centers, and via our online platforms. It manufactures and processes some of the food available in its supermarkets.**

   Sprouts Farmers Market operates as a healthy grocery store that has made healthy living accessible to shoppers for nearly two decades by offering affordable, fresh, natural and organic products. They do offer various private label food products.

2. **The fiscal year-end for Kroger is on the Saturday nearest to January 31. Its most current fiscal year-end is February 1, 2020. Sprouts' fiscal year ends on the Sunday closest to December 31. Its most current fiscal year-end is December 29, 2019. The fiscal year-ends are expected to be similar because the two companies are in the same industry and follow the same major trends in sales.**

3. **Balance sheet information:**

   a. **Kroger (as on February 1, 2020):**
      Assets = $45,256,000,000
      Liabilities = $36,663,000,000 ($14,243,000,000 + $22,420,000,000)
      Stockholders' equity = $8,573,000,000

      Sprouts (as on December 29, 2010):
      Assets = $2,722,983,000
      Liabilities = $2,141,031,000 ($416,812,000 + $1,724,219,000)
      Stockholders' equity = $581,952,000

   b. **Kroger (as on February 1, 2020):**
      Current assets = $10,890,000,000
      Current liabilities = $14,243,000,000

      Sprouts (as on December 29, 2010):
      Current assets = $387,839,000
      Current liabilities = $416,812,000

   c. **Kroger's current assets are approximately 76% of its current liabilities. Kroger reported working capital of -$3,353,000,000 ($10,890,000,000 – $14,243,000,000) and a current ratio of 0.76 ($10,890,000,000/$14,243,000,000).**

      The liquidity picture of Sprouts is similar. Sprouts reports working capital of -$28,973,000 ($387,839,000 – $416,812,000) and a current ratio of 0.93 ($387,839,000 / $416,812,000). Both companies may have to seek additional financing to pay off the liabilities coming due in the next year.

   d. **Kroger has almost 17 times the total assets of Sprouts. Thus, Kroger is a much larger company**.

Case 1-70 (Continued)

4. **Income statement information:**

   a. **Kroger (for the fiscal year ending February 1, 2020):**

Revenues	**$ 122,286,000,000**
Expenses	**120,627,000,000**
Net income	**$ 1,659,000,000**

Sprouts (for the fiscal year ending December 29, 2010):

Revenues	**$ 5,634,835,000**
Expenses	**5,485,206,000**
Net income	**$149,629,000**

*** $120,035,000,000 + $270,000,000 + $469,000,000 +-$147,000,000**
**** $5,634,835,000**
***** $3,740,017,000 + $1,677,458,000 + $21,192,000 +$46,539,000**

   b. **For Sprouts, revenues show an increasing trend through the 3 years presented. Cost of sales and other expenses have correspondingly increased, resulting in relatively stable income. Kroger shows relatively stable revenues, costs, and income. This stability is reflected in the earnings per share information, which has remained relatively stable also.**

5. **Obtained from the statements of cash flows for each of the companies:**

   Kroger: In addition to operating activities, its major source of cash includes borrowings related to long-term debt and sales of businesses. Major uses of cash include capital expenditures (purchases of property, plant, and equipment) and repayment of borrowings.

   Sprouts: Its major sources of cash arise from its operations as well as proceeds from revolving credit facilities (long-term borrowings). Major uses of cash include capital expenditures, repayment of borrowings, and repurchases of common stock.

Annual Report Problem

1. a. **$28,477 million**
   b. **$23,166 million**
   c. **$132,110 million**
   d. **$87,257 million**
   e. **$26,575 million**

2. a. **$29,477 million**
   b. **$25,166 million**
   c. **$138,716 million**
   d. **$91,620 million**
   e. **$27,904 million**

3. a. **The Home Depot, Inc.**
   b. **HD**
   c. **Atlanta, GA**
   d. **1.17**
   e. **$47,096 million**
   f. **$19,192 million**

Case 1-72

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 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.**

Case 1-72 (Continued)

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.**

1 ACCOUNTING AND THE FINANCIAL STATEMENTS

DISCUSSION QUESTIONS

1. Accounting is an information system that identifies, measures, records, and communicates financial information about a company's business activities to permit informed decisions by users of the information. Accounting is often referred to as the *language of business* because it communicates relevant and reliable information about economic activities of a company that helps people make better 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. Six groups that create the demand for accounting information and their uses of accounting information are described next:

(1) Managers use accounting information to help decide which actions to take, predict the consequences of their actions, and evaluate the effectiveness of their past decisions. They also use accounting information to control the operations of the company.

(2) Investors (owners) need accounting information about a business to evaluate the future prospects of a business and to decide where to invest their money.

(3) Creditors (lenders) need accounting information to decide whether or not to lend money (extend credit) to a business.

(4) 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.

(5) Labor unions use accounting information when negotiating wage increases for its members.

(6) Financial analysts use accounting information when offering buy or sell recommendations to clients.

3. An accounting entity is a business 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. The owner of a sole proprietorship and the partners in a partnership 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 largely outnumbers 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.

7. Revenues are the increases in assets that result from the sale of products or services. Expenses are the costs of assets used, or the liabilities created, in the operation of the business. If revenues are greater than expenses, a business has earned net income. If expenses are greater than revenues, a business has incurred a net loss.

8. The four primary financial statements are as follows:

(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 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 sources (inflows) and uses (outflows) of cash.

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:
  a. How much income was distributed in dividends by the corporation?
  b. What amount of equity in the business has been generated internally?

(4) Statement of cash flows:
  a. How much cash was taken in or paid out as a result of operations?
  b. How much cash was invested in new equipment?
  c. 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:

Assets = Liabilities + 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 become 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. Net Income = Total Revenues – 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 organizes revenues and expenses into multiple categories. The resulting subtotals (gross margin [gross profit], income from operations, and net income) highlight important relationships between revenues and expenses that financial statement users find useful.

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 these 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 often reflect 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.

20. The retained earnings statement describes the changes in retained earnings, a balance sheet account, that occurs 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. 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. **d**

1-4. **d**

1-5. **a** **($12,900 – $6,300)**

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**

BRIEF EXERCISES

BE 1-13

a. Government
b. Manager
c. Creditor
d. Investor
e. Financial Analyst

BE 1-14

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

BE 1-15

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

BE 1-16

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

BE 1-16 (Continued)

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

BE 1-17

	Assets	=	Liabilities	+	Equity
Scenario 1:					
	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		

BE 1-18

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

BE 1-19

Cavernous Homes Inc.
Balance Sheet
December 31

Assets

Cash	$3,200	
Accounts receivable	4,500	
Supplies	8,100	
Total assets		$15,800

Liabilities and Stockholders' Equity

Liabilities:		
Notes payable	$5,000	
Total liabilities		$5,000
Stockholders' equity:		
Common stock	$7,000	
Retained earnings	3,800	
Total stockholders' equity		10,800
Total liabilities and stockholders' equity		$15,800

BE 1-20

Rutherford Company
Income Statement
For the year ending December 31

Revenues and gains:		
Sales revenue	$65,000	
Interest income	3,900	
Total revenues		$68,900
Expenses and losses:		
Cost of goods sold	$28,800	
Salaries expense	22,500	
Insurance expense	4,300	
Loss on disposal of property, plant, and equipment	1,200	
Income taxes expense	2,400	
Total expenses and losses		(59,200)
Net income		$9,700

BE 1-21

Rutherford Company
Income Statement
For the year ending December 31

Sales revenue	$65,000	
Cost of goods sold	(28,800)	
Gross margin		$36,200
Operating expenses		
Salaries expense	$22,500	
Insurance expense	4,300	
Total operating expenses		(26,800)
Income from Operations		$9,400
Other income and expenses:		
Interest income	$ 3,900	
Loss on disposal of property, plant, and equipment	(1,200)	
Total other income and expenses		2,700
Income before income taxes		$ 12,100
Income taxes expense		(2,400)
Net income		$ 9,700

BE 1-22

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

BE 1-23

	Beginning retained earnings	$35,000
+	Net income ($82,000 – $55,000)	27,000
–	Dividends	(8,000)
=	Ending retained earnings	$54,000

BE 1-24

a. Operating activities (O)
b. Financing activities (F)
c. Financing activities (F)
d. Operating activities (O)
e. Investing activities (I)

BE 1-25

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

EXERCISES

E 1-26

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

E 1-27

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 the 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.**
   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 are more complex.**
        (ii) **Corporations generally pay higher taxes.**

E 1-28

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

E 1-29

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 1-30

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

E 1-31

	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 1-32

1.

Higgins Company
Balance Sheet
Specific point in time

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 the 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 1-33

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 5 years is a long-term liability. The $3,750 interest related to the current year is a current liability. The remaining interest of $750 will not be recognized until the following year and, therefore, is not on the current year 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, 2020

Current assets:		
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
Current liabilities:		
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

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 1-34

1.

Hanson Construction
Partial Balance Sheet
December 31

Current assets:		
Cash	$1,380	
Accounts receivable	7,000	
Notes receivable	1,500	
Supplies	6,200	
Total current assets		$16,080
Current liabilities:		
Accounts payable	$2,100	
Notes payable	6,800	
Total current liabilities		$ 8,900

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 1-35

The balance sheet at December 31 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 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 1-36

Mulcahy Manufacturing Inc.
Partial Balance Sheet
December 31

Stockholders' equity:	
Common stock	$150,000
Retained earnings	37,500
Total stockholders' equity	$187,500

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

E 1-37

1.

College Spirit
Balance Sheet
December 31

Assets

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

Liabilities and Stockholders' Equity

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

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 1-38

1.

Jerrison Company
Balance Sheet
December 31

Assets

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

E 1-38 (Continued)

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 65,100	
Notes payable	150,000	
Salaries payable	14,400	
Interest payable	12,600	
Income taxes payable	21,600	
Total current liabilities		$263,700
Long-term liabilities:		
Bonds payable		200,000
Total liabilities		$463,700
Stockholders' equity:		
Common stock	$150,000	
Retained earnings*	196,100	
Total stockholders' equity		346,100
Total liabilities and stockholders' equity		$809,800

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 follows:**

First, compute stockholders' equity:

Total Assets	=	Total Liabilities + Total Stockholders' Equity
$809,800	=	$463,700 + X
X	=	$346,100

Next, compute retained earnings:

Total Stockholders' Equity	=	Common Stock + Retained Earnings
$346,100	=	$150,000 + Y
Y	=	$196,100

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 1-39

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) = 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) = 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

i. **Contributed capital: (i) + $67,000 = $102,000 (j)**
(i) = $35,000

j. **Total stockholders' equity: $47,200 (h) + (j) = $149,200**
(j) = $102,000

E 1-40

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 1-41

1.

ERS Inc.
Income Statement
For the year ending December 31

Revenues:		
Service revenue		$933,800
Expenses:		
Wages expense	$448,300	
Salaries expense	195,600	
Supplies expense	66,400	
Rent expense	58,400	
Utilities expense	26,100	
Advertising expense	24,200	
Depreciation expense	16,250	
Insurance expense	11,900	
Interest expense	10,100	
Income taxes expense	15,150	
Total expenses		(872,400)
Net income		$ 61,400

2. Net profit margin is 6.58% ($61,400 net income / $933,800 service revenue). This indicates that $0.0658 of each sales dollar is profit. If ERS were to increase revenues by $100,000, an additional $6,580 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 1-42

Bergin Pastry Shop
Income Statement
For the year ending December 31

Net sales	$85,300
Cost of goods sold*	(50,600)
Gross margin	$34,700
Operating expenses**	(25,500)
Income from operations	$ 9,200
Other expenses and losses:	
Interest expense	(1,800)
Income before taxes	$ 7,400
Income taxes expense***	(1,110)
Net income	$ 6,290

* 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% × $7,400 = $1,110

E 1-43

1.

Wright Auto Supply
Income Statement
For the year ending December 31

Revenues:		
Sales revenue		$ 585,600
Expenses:		
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	32,520	
Total expenses		(509,720)
Net income		$ 75,880

E 1-43 (Continued)

2.

Wright Auto Supply
Income Statement
For the year ending December 31

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

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 1-44

1.

Beginning retained earnings	$ 18,240
+ Net income ($837,400 – $792,100)	45,300
– Dividends	(38,650)
= Ending retained earnings	$ 24,890

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 1-45

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	(28,700)	
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	(32,000)	
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	(37,500)	
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 become 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 1-46

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	$ 10,350
Add: Cash as on January 1	20,400
Cash at December 31	$ 30,750

Retained earnings at the end of the year:

Retained earnings as on January 1	$ 105,600
Add: Net income ($650,100 – $578,600)	71,500
Less: Dividends declared	(30,000)
Retained earnings as on December 31	$ 147,100

E 1-47

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

	Assets	=	Liabilities	+	Equity
January 1	$82,400	=	$9,200	+	($50,000 + Retained Earnings)
December 31	$88,500	=	$11,300	+	($50,000 + Retained Earnings)

Solve for retained earnings as on January 1 and December 31:

January 1	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$82,400 – $9,200 – $50,000
		=	<u>$23,200</u>
December 31	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$88,500 – $11,300 – $50,000
		=	<u>$27,200</u>

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

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

Dividends = <u>$15,500</u>

E 1-48

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

	Assets	=	Liabilities	+	Equity
January 1	$152,200	=	$56,600	+	($60,000 + Retained Earnings)
December 31	$171,800	=	$63,750	+	($60,000 + Retained Earnings)

For each year, solve for retained earnings:

January 1	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$152,200 – $56,600 – $60,000
		=	<u>$35,600</u>
December 31	Retained Earnings	=	Assets – Liabilities – Common Stock
		=	$171,800 – $63,750 – $60,000
		=	<u>$48,050</u>

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 declared	(20,000)
= Ending retained earnings	<u>$ 48,050</u>

Net income = <u>$32,450</u>

E 1-49

- 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 1-50A

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 the year can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

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

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

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

	Assets	=	Liabilities	+	Equity
As of December 31	$285,500	=	?	+	$194,950

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

P 1-51A

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

(a)	Assets	=	Liabilities	+	Stockholders' Equity (all at the end of the year)
	Assets	=	$126,900	+	$104,100
	Assets	=	$231,000		
(b)	Assets	=	Liabilities	+	Stockholders' Equity (all at the beginning of the year)
	$145,200	=	$92,600	+	Stockholders' Equity
	Stockholders' Equity	=	$52,600		

(c)	Beginning Stockholders' Equity	+	Net Income	–	Dividends	=	Ending Stockholders' Equity
	$52,600	+	$77,500	–	Dividends	=	$104,100
	Dividends	=	$26,000				

(d)	Revenues	–	Expenses	=	Net Income
	$554,800	–	Expenses	=	$77,500
	Expenses	=	$477,300		

P 1-52A

Powers Wrecking Service
Income Statement
For the year ending December 31

Revenues:		
Service revenue	$425,000	
Sales revenue	137,000	
Interest income	1,575	
Total revenues		$563,575
Expenses:		
Wages expense	$243,200	
Rent expense	84,000	
Supplies expense	48,575	
Depreciation expense	24,150	
Miscellaneous expense	17,300	
Income taxes expense	43,900	
Total expenses		(461,125)
Net income		$102,450

P 1-53A

Cooper Merchandising
Income Statement
For the year ending December 31

Net sales		$625,000
Cost of goods sold		(248,000)
Gross margin		$377,000
Operating expenses:		
Wages expenses	$ 103,600	
Rent expense	65,000	
Supplies expense	23,575	
Depreciation expense	12,150	
Miscellaneous expense	8,300	
Total operating expenses		(212,625)
Income from operations		$164,375
Other income and expenses:		
Interest income		1,250
Income before taxes		$165,625
Income taxes expense		(32,500)
Net income		$133,125

P 1-54A

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

P 1-55A

Rogers Enterprises
Income Statement
For the year ending December 31

Revenues:		
Service revenue		**$463,500**
Expenses:		
Salaries expense	**$235,200**	
Rent expense	**135,000**	
Supplies expense	**34,400**	
Interest expense	**16,000**	
Income taxes expense	**12,800**	**(433,400)**
Net income		**$ 30,100**

Rogers Enterprises
Balance Sheet
December 31
Assets

Current assets:		
Cash	**$13,240**	
Accounts receivable	**72,920**	
Supplies	**42,000**	
Prepaid rent	**31,500**	
Total current assets		**$159,660**
Property, plant, and equipment		**90,000**
Total assets		**$249,660**

P 1-55A (Continued)

Liabilities and Stockholders' Equity

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

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

P 1-56A

Moore Inc.
Income Statement
For the year ending December 31

Sales revenue	$ 863,500	
Cost of goods sold	(395,000)	
Gross margin		$468,500
Operating expenses:		
Salaries expense	$ 235,200	
Rent expense	135,000	
Supplies expense	34,400	
Total operating expenses		($ 404,600)
Income from operations		$ 63,900
Other income and expenses:		
Interest income	2,000	
Interest expense	(16,000)	
Total other income and expenses		(14,000)
Income before income taxes		49,900
Income taxes expense		(8,600)
Net income		$ 41,300

P 1-56A (Continued)

Moore Inc.
Balance Sheet
December 31

Assets

Current assets:		
Cash	$ 16,290	
Accounts receivable	68,910	
Supplies	44,100	
Prepaid rent	31,500	
Total current assets		$160,800
Property, plant, and equipment		90,000
Total assets		$250,800

Liabilities and Stockholders' Equity

Current liabilities:		
Salaries payable	$ 14,800	
Income taxes payable	4,150	
Total current liabilities		$ 18,950
Long-term liabilities:		
Notes payable (due in 10 years)		25,000
Total liabilities		$ 43,950
Stockholders' equity:		
Common stock (10,000 shares)	$ 70,000	
Retained earnings*	136,850	
Total stockholders' equity		206,850
Total liabilities and stockholders' equity		$250,800

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

P 1-57A

Dittman Expositions
Retained Earnings Statement
For the years ending December 31, Year 1, and December 31, Year 2

	Year 1	Year 2
Retained earnings, beginning of year*	$20,900	$36,050
Add: Net income**	25,400	33,000
Less: Dividends declared	(10,250)	(12,920)
Retained earnings, end of year	$36,050	$56,130

* The ending retained earnings balance for Year 1 becomes the beginning retained earnings balance for Year 2

** Net income computed as follows:	Year 1	Year 2
Revenue	$407,500	$451,600
Less: Expenses	(382,100)	(418,600)
Net income	$ 25,400	$ 33,000

P 1-58A

(a) $30,700 – Dividends (a) = $27,200
Dividends (a) = $3,500

(b) Retained Earnings, Beginning (Year 2) = Retained Earnings, Ending (Year 1)
= $27,200

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

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

(e) Retained Earnings, Ending (Year 2) = Retained Earnings, Beginning (Year 3)
= $33,600

(d) Retained Earnings, Ending (e) = (c) – Dividends (d)
$33,600 = $37,300 – Dividends (d)
Dividends (d) = $3,700

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

(g) Retained Earnings, Ending = (g) – Dividends
$41,200 = (g) – $3,900
(g) = $45,100

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

P 1-59A

1.

Ashton Appliances
Income Statement
For the year ending December 31

Revenues:		
Sales revenue		$948,670
Expenses:		
Cost of goods sold	$511,350	
Salaries expense	228,710	
Rent expense	80,800	
Insurance expense	36,610	
Interest expense	15,500	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Income taxes expense	16,650	
Total expenses		(912,670)
Net income		$ 36,000

P 1-59A (Continued)

Ashton Appliances
Retained Earnings Statement
For the year ending December 31

Beginning retained earnings, January 1	$ 54,000
Add: Net income*	36,000
Ending retained earnings, December 31	$ 90,000

* From the income statement

Ashton Appliances
Balance Sheet
December 31

Assets

Current assets:			
Cash		$ 41,450	
Accounts receivable		69,900	
Inventory		59,850	
Total current assets			$171,200
Property, plant, and equipment:			
Building	$ 300,000		
Less: Accumulated depreciation	(104,800)		
Building, net		$195,200	
Furniture	$ 130,000		
Less: Accumulated depreciation	(27,600)		
Furniture, net		102,400	
Total property, plant, and equipment			297,600
Other assets			92,800
Total assets			$ 561,600

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 16,800	
Income taxes payable	12,000	
Salaries payable	7,190	
Total current liabilities	$ 35,990	
Long-term liabilities:		
Bonds payable	192,000	
Total liabilities		$227,990
Stockholders' equity:		
Common stock	$ 243,610	
Retained earnings*	90,000	
Total stockholders' equity		333,610
Total liabilities and stockholders' equity		$ 561,600

* From the retained earnings statement

P 1-59A (Continued)

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 contains only 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.**

2.

Ashton Appliances
Income Statement
For the year ending December 31

Sales revenue		$948,670
Cost of goods sold		($511,350)
Gross margin		$437,320
Operating expenses:		
Salaries expense	228,710	
Rent expense	80,800	
Insurance expense	36,610	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Total operating expenses		(369,170)
Income from operations		$ 68,150
Other income and expenses:		
Interest expense		(15,500)
Income before income taxes		$52,650
Income taxes expense		(16,650)
Net income		$ 36,000

P 1-60A

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 1-61A

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

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

* $385,500 – $152,800 = $232,700
** $420,250 – $156,600 = $263,650

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

Stockholders' Equity	=	Common Stock	+	Retained Earnings
Change in Stockholders' Equity	=	Change in Common Stock	+	Change in Retained Earnings
Change in Retained Earnings	=	Net Income – Dividends		

Therefore,

Change in Stockholders' Equity = Change in Common Stock + Net Income – Dividends

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

PROBLEM SET B

P 1-50B

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 the year can be inferred from the fundamental accounting equation if both assets and stockholders' equity are known.

The amount of KJ's assets at December 31 is $710,100. KJ's stockholders' equity at the end of the year 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, Jan. 1	$100,000	+	$134,900	=	$234,900
Net income			205,500		
Dividends			(70,000)		
Common stock issued	75,000			=	
Equity, Dec. 31	$175,000	+	$270,400	=	$445,400

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

	Assets	=	Liabilities	+	Equity
At Dec. 31	$710,100	=	?	+	$445,400

Liabilities = $710,100 – $445,400 = $264,700

P 1-51B

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 1-52B

Parker Renovation Inc.
Income Statement
For the year ending December 31

Revenues:		
Service revenue	$763,400	
Interest income	5,475	
Total revenues		$768,875
Expenses:		
Wages expense	$ 222,900	
Depreciation expense	135,000	
Utilities expense	109,300	
Insurance expense	65,850	
Miscellaneous expense	31,000	
Income taxes expense	61,400	
Total expenses		(625,450)
Net income		$143,425

P 1-53B

Lakas Company
Income Statement
For the year ending December 31

Net sales		$ 425,000
Cost of goods sold		(178,400)
Gross margin		$246,600
Operating expenses:		
Wages expenses	$ 66,100	
Rent expense	35,910	
Supplies expense	13,122	
Depreciation expense	11,590	
Miscellaneous expense	8,800	
Total operating expenses		(135,522)
Income from operations		$111,078
Other income and expenses:		
Interest income	620	
Interest expense	(850)	
Total other income and expenses		(230)
Income before taxes		$ 110,848
Income taxes expense		(23,200)
Net income		$ 87,648

P 1-54B

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

P 1-55B

Ross Airport Auto Service
Income Statement
For the year ending December 31

Revenues:		
Service revenue (parking)	**$232,600**	
Service revenue (repair)	**198,500**	
Interest income	**4,100**	
Total revenues		**$435,200**
Expenses:		
Wages expense	**$246,100**	
Rent expense	**103,500**	
Supplies expense	**36,900**	
Interest expense	**21,300**	
Depreciation expense	**12,450**	
Income taxes expense	**2,700**	
Total expenses		**(422,950)**
Net income		**$ 12,250**

P 1-55B (Continued)

Ross Airport Auto Service
Balance Sheet
December 31

Assets

Current assets:		
Cash	$ 7,700	
Accounts receivable	39,200	
Inventory	6,100	
Prepaid rent	27,300	
Total current assets	$ 80,300	
Long-term investments:		
Investments	35,000	
Property, plant, and equipment:		
Equipment	$ 270,800	
Less: Accumulated depreciation	(42,300)	228,500
Total assets		$ 343,800

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 17,200	
Wages payable	12,500	
Income taxes payable	1,100	
Interest payable	4,800	
Total current liabilities		$ 35,600
Long-term liabilities:		
Notes payable		160,000
Total liabilities		$ 195,600
Stockholders' equity:		
Common stock	$ 100,000	
Retained earnings	48,200	
Total stockholders' equity		148,200
Total liabilities and stockholders' equity		$ 343,800

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

P 1-56B

Cheng Company
Income Statement
For the year ending December 31

Sales revenue	$ 525,100	
Cost of goods sold	(279,800)	
Gross margin		$ 245,300
Operating expenses:		
Salaries expense	$ 115,900	
Rent expense	65,000	
Supplies expense	14,400	
Research and development expense	12,700	
Insurance expense	5,000	
Total operating expenses		($ 213,000)
Income from operations		$ 32,300
Other income and expenses:		
Gain on disposal of property, plant, and equipment	5,000	
Interest expense	(8,450)	
		(3,450)
		28,850
Income taxes expense		(6,000)
Net income		$ 22,850

Cheng Company
Balance Sheet
December 31

Assets

Current assets:		
Cash	$ 14,275	
Accounts receivable	58,930	
Supplies	24,600	
Prepaid rent	8,500	
Total current assets		$106, 305
Property, plant, and equipment		105,000
Patent		12,380
Total assets		$ 223,685

Liabilities and Stockholders' Equity

Current liabilities:		
Salaries payable	$11,400	
Income taxes payable	2,850	
Total current liabilities		$ 14,250
Long-term liabilities:		
Notes payable (due in 10 years)		15,000
Total liabilities		$ 29,250
Stockholders' equity:		
Common stock (10,000 shares)	$ 105,000	
Retained earnings*	89,435	
Total stockholders' equity		194,435
Total liabilities and stockholders' equity		$ 223,685

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

P 1-57B

Magical Experiences Vacation Company
Retained Earnings Statement
For the years ending December 31, Year 1, and December 31, Year 2

	Year 1	Year 2
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 Year 1 becomes the beginning retained earnings balance for Year2.

** Net income is computed as follows:

	Year 1	Year 2
Revenue	$221,900	$325,400
Less: Expenses	(188,500)	(250,800)
Net income	$ 33,400	$74,600

P 1-58B

(a) $26,900 – $11,100 = $15,800

(b) Retained Earnings, Ending (Year 1) = Retained Earnings, Beginning (Year 2)
= $ 19,500

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

(e) Retained Earnings, Ending (Year 2) = Retained Earnings, Beginning (Year 3)
= $ 26,700

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

(d) = Retained Earnings, Ending, Year 2 (e) + Dividends
= $ 26,700 + $5,200
= $ 31,900

(c) Net Income = (d) – Retained Earnings, Beginning (Year 2)
= $ 31,900 (d) – $19,500
= $ 12,400

(f) = Retained Earnings, Beginning (Year 3) + Net Income
= $ 26,700 + $9,500
= $ 36,200

(g) Dividends = (f) – Retained Earnings, Ending (Year 3)
= $ 36,200 (f) – $34,100
= $ 2,100

P 1-59B

McDonald Boat Company
Income Statement
For the year ending December 31

Revenues:		
Sales revenue		$ 1,932,300
Expenses:		
Cost of goods sold	$ 987,200	
Wages expense	348,700	
Depreciation expense (equipment)	142,300	
Utilities expense	131,300	
Interest expense	99,400	
Supplies expense	89,100	
Depreciation expense (building)	21,500	
Rent expense	14,600	
Income taxes expense	21,700	
Total expenses		(1,855,800)
Net income		$ 76,500

P 1-59B (Continued)

McDonald Boat Company
Retained Earnings Statement
For the year ending December 31

Retained earnings, January 1	$ 128,600
Add: Net income	76,500
Less: Dividends	(25,300)
Retained earnings, December 31	$ 179,800

McDonald Marina
Balance Sheet
December 31

Assets

Current assets:			
Cash		$ 22,300	
Accounts receivable		268,700	
Supplies		9,800	
Total current assets			$ 300,800
Property, plant, and equipment:			
Land		$ 875,000	
Building	$ 197,300		
Less: Accumulated depreciation	(64,500)	132,800	
Equipment	$ 2,490,000		
Less: Accumulated depreciation	(950,400)	1,539,600	
Total property, plant, and equipment	2,547,400		
Total assets			$ 2,848,200

Liabilities and Stockholders' Equity

Current liabilities:		
Accounts payable	$ 26,400	
Wages payable	21,600	
Interest payable	18,000	
Rent payable	2,400	
Total current liabilities		$ 68,400
Long-term liabilities:		
Bonds payable		2,000,000
Total liabilities		$ 2,068,400
Stockholders' equity:		
Common stock	$ 600,000	
Retained earnings	179,800	
Total stockholders' equity		779,800
Total liabilities and stockholders' equity		$ 2,848,200

P 1-59B (Continued)

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 contains only 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.**

2.

McDonald Boat Company
Income Statement
For the year ending December 31

Sales revenue		$1,932,300
Cost of goods sold		($ 987,200)
Gross margin		$ 945,100
Operating Expenses:		
Wages expense	348,700	
Depreciation expense (equipment)	142,300	
Utilities expense	131,300	
Interest expense	99,400	
Supplies expense	89,100	
Depreciation expense (building)	21,500	
Rent expense	14,600	
Total operating expenses		(846,900)
Income from operations		$ 98,200
Income taxes expense		($ 21,700)
Net income		$ 76,500

P 1-60B

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)

P 1-60B (Continued)

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 1-61B

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

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

* $256,500 – $92,650 = $163,850

** $358,200 – $121,900 = $236,300

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

Stockholders' Equity	=	Common Stock	+	Retained Earnings
Change in Stockholders' Equity	=	Change in Common Stock	+	Change in Retained Earnings
Change in Retained Earnings	=	Net Income – Dividends		

Therefore,

Change in Stockholders' Equity	=	Change in Common Stock	+	Net Income – Dividends

1. ($236,300 – $163,850) = $0 + Net Income – $0
   Net Income = <u>$72,450</u>

2. ($236,300 – $163,850) = $15,000 + Net Income – $0
   Net Income = <u>$57,450</u>

3. ($236,300 – $163,850) = $0 + Net Income – $10,000
   Net Income = <u>$82,450</u>

4. ($236,300 – $163,850) = $20,000 + Net Income – $12,000
   Net Income = <u>$64,450</u>

CASES

Case 1-62

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 become due in the near term (e.g., spring tuition, living expenses). He could then know prior to the spring term which bills would become 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 1-63

1. **The following examples are illustrative, and students' 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**
    Journal of Government Financial Management **(governmental accountants), Association of Government Accountants (AGA)**

    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**

    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 1-64

Student responses to this assignment will vary widely, but it is a good basis for classroom discussion. Some students may have interests in various accounting careers, while others may have interests in other business careers or perhaps graduate professional degrees. Of those with plans for graduate education, some may intend to work for several years before returning for additional education, while others may plan to go directly into graduate school. Some may 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 1-65

1. **Current assets (1/31/2023) = \$5,210 + \$28,100 + \$7,152 = \$40,462**
   Current liabilities (1/31/2023) = \$19,655
   Current assets (1/31/2022) = \$4,125 + \$32,891 + \$7,853 = \$44,869
   Current liabilities (1/31/2022) = \$35,483

   Agency Rent-A-Car reported a current ratio of 2.06 (\$40,462 / \$19,655) in 2023 and a current ratio of 1.26 (\$44,869 / \$35,483) in 2022. Its working capital is \$20,807 (\$40,462 – \$19,655) in 2023 and \$9,386 (\$44,869 – \$35,483) in 2022. 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 2022 and 2023.

2. **Net Income = Stockholders' Equity (1/31/2023) – Stockholders' Equity (1/31/2022) + 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 1-66

1. **Trends:**
   (a) Revenues decreased dramatically from 2021 to 2022.
   (b) Operating income (loss) has fluctuated dramatically in the 5-year period but shows some improvement (less of a loss) in 2023.
   (c) Net income (loss) was down dramatically from 2022 and seems to be slowly recovering in 2023 with a much smaller loss.

2. **In 2019 and 2020, Wright Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in 2021, 2022, and 2023, 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 2021.**

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 1-67

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 1-68

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 1-69

1. **Apple's fiscal year ended on September 28, 2019. This year-end is different 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 2019, Apple reported total assets of $338,516,000,000, total liabilities of $248,028,000,000, and total stockholders' equity of $90,488,000,000.**
   b. **The dollar amounts for all three categories have changed in the past year. For 2018, Apple reported total assets of $365,725,000,000, total liabilities of $258,578,000,000, and total stockholders' equity of $107,147,000,000. This represented a decrease in total assets of $27,209,000,000 ($338,516,000,000 – $365,725,000,000), a decrease in total liabilities of $10,550,000,000 ($248,028,000,000 – $258,578,000,000), and a decrease in total stockholders' equity of $16,659,000,000 ($90,488,000,000 – $107,147,000,000).**
   c. **For 2019, Apple reported current assets of $162,819,000,000 and current liabilities of $105,718,000,000. For 2018, Apple reported current assets of $131,339,000,000 and current liabilities of $115,929,000,000.**

Case 1-69 (Continued)

d. Apple reported working capital of $57,101,000,000 ($162,819,000,000 – $105,718,000,000) for 2019 and working capital of $15,410,000,000 ($131,339,000,000 – $115,929,000,000) for 2018. Apple's current ratio was 1.54 ($162,819,000,000 / $105,718,000,000) for 2019 and 1.13 ($131,339,000,000 / $115,929,000,000) for 2018. 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. Apple's working capital and current ratio have increased during 2019 when compared to 2018. Thus, Apple appears to have sufficient liquidity.

4. Income statement information:

a. For 2019, Apple reported revenues (net sales) of $260,174,000,000 and expenses of $204,918,000,000 ($161,782,000,000 + $34,462,000,000 + $10,481,000,000 – $1,807,000,000). *Note:* The $18,070,000,000 is a combination of other income and expenses and was subtracted from expenses. Apple's net income was $55,256,000,000.

b. Sales decreased by $11,964,000 from 2018 to 2019 but increased by $29,313,000 from 2017 to 2018, as shown in the comparative income statements. As noted in the management discussion and analysis, the decrease in sales in 2019 is due primarily to decreased iPhone sales. This decrease in sales has caused a corresponding decrease in cost of sales (an expense).

5. Statement of cash flows information:

a. For 2019, Apple reported a net cash inflow from operating activities of $69,391,000,000, a net cash inflow from investing activities of $45,896,000,000, and a net cash outflow from financing activities of $90,976,000,000).

b. In 2019, Apple paid $10,495,000,000 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 believes that future gross margins will be under downward pressure due to global product pricing pressures, increased competition, compressed product life cycles, potential increases in cost of components, and a shift to lower gross margin products. Its analysis can be found in the management's discussion and analysis section (Item 7 of the 10-K).

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

Case 1-70

1. **Kroger is one of the largest retailers in the world based on sales. Its revenues are predominately earned, and cash is generated as consumer products are sold to customers in its stores, fuel centers, and via our online platforms. It manufactures and processes some of the food available in its supermarkets.**

   Sprouts Farmers Market operates as a healthy grocery store that has made healthy living accessible to shoppers for nearly two decades by offering affordable, fresh, natural and organic products. They do offer various private label food products.

2. **The fiscal year-end for Kroger is on the Saturday nearest to January 31. Its most current fiscal year-end is February 1, 2020. Sprouts' fiscal year ends on the Sunday closest to December 31. Its most current fiscal year-end is December 29, 2019. The fiscal year-ends are expected to be similar because the two companies are in the same industry and follow the same major trends in sales.**

3. **Balance sheet information:**

   a. **Kroger (as on February 1, 2020):**
      Assets = $45,256,000,000
      Liabilities = $36,663,000,000 ($14,243,000,000 + $22,420,000,000)
      Stockholders' equity = $8,573,000,000

      Sprouts (as on December 29, 2010):
      Assets = $2,722,983,000
      Liabilities = $2,141,031,000 ($416,812,000 + $1,724,219,000)
      Stockholders' equity = $581,952,000

   b. **Kroger (as on February 1, 2020):**
      Current assets = $10,890,000,000
      Current liabilities = $14,243,000,000

      Sprouts (as on December 29, 2010):
      Current assets = $387,839,000
      Current liabilities = $416,812,000

   c. **Kroger's current assets are approximately 76% of its current liabilities. Kroger reported working capital of -$3,353,000,000 ($10,890,000,000 – $14,243,000,000) and a current ratio of 0.76 ($10,890,000,000/$14,243,000,000).**

      The liquidity picture of Sprouts is similar. Sprouts reports working capital of -$28,973,000 ($387,839,000 – $416,812,000) and a current ratio of 0.93 ($387,839,000 / $416,812,000). Both companies may have to seek additional financing to pay off the liabilities coming due in the next year.

   d. **Kroger has almost 17 times the total assets of Sprouts. Thus, Kroger is a much larger company**.

Case 1-70 (Continued)

4. **Income statement information:**

   a. **Kroger (for the fiscal year ending February 1, 2020):**

Revenues	**$ 122,286,000,000**
Expenses	**120,627,000,000**
Net income	**$ 1,659,000,000**

Sprouts (for the fiscal year ending December 29, 2010):

Revenues	**$ 5,634,835,000**
Expenses	**5,485,206,000**
Net income	**$149,629,000**

*** $120,035,000,000 + $270,000,000 + $469,000,000 +-$147,000,000**
**** $5,634,835,000**
***** $3,740,017,000 + $1,677,458,000 + $21,192,000 +$46,539,000**

   b. **For Sprouts, revenues show an increasing trend through the 3 years presented. Cost of sales and other expenses have correspondingly increased, resulting in relatively stable income. Kroger shows relatively stable revenues, costs, and income. This stability is reflected in the earnings per share information, which has remained relatively stable also.**

5. **Obtained from the statements of cash flows for each of the companies:**

   Kroger: In addition to operating activities, its major source of cash includes borrowings related to long-term debt and sales of businesses. Major uses of cash include capital expenditures (purchases of property, plant, and equipment) and repayment of borrowings.

   Sprouts: Its major sources of cash arise from its operations as well as proceeds from revolving credit facilities (long-term borrowings). Major uses of cash include capital expenditures, repayment of borrowings, and repurchases of common stock.

Annual Report Problem

1. a. $19,810 million

b. $18,375 million

c. $110,225 million

d. $72,653 million

e. $21,729 million

2. a. $20,810 million

b. $20,375 million

c. $115,736 million

d. $76,286 million

e. $22,815 million

3. a. The Home Depot, Inc.

b. HD

c. Atlanta, GA

d. 1.02

e. $39,541 million

f. $16,635 million

Case 1-72

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 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.**

Case 1-72 (Continued)

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.**