

CHAPTER 1—Solutions

USES OF ACCOUNTING INFORMATION AND THE FINANCIAL STATEMENTS

Chapter 1, SE 1.

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

Chapter 1, SE 2.

1.	b	4.	b
2.	c	5.	a
3.	a		

Chapter 1, SE 3.

1.	a	4.	c
2.	c	5.	a
3.	b	6.	c

Chapter 1, SE 4.

1.	Assets	=	\$120,000
2.	Stockholders' Equity	=	\$ 72,000
3.	Liabilities	=	\$100,000

Chapter 1, SE 5.

1.	Assets	=	Liabilities	+	Stockholders' Equity
	\$480,000	=	\$180,000	+	Stockholders' Equity
	\$480,000	–	\$180,000	=	\$300,000
	Stockholders' Equity	=	\$300,000		
2.	Assets	=	0.2 Assets	+	\$80,000
	Assets – 0.2 Assets	=	\$80,000		
	0.8 Assets	=	\$80,000		
	Assets	=	\$80,000	÷	0.8
	Assets	=	\$100,000		
	Liabilities	=	\$100,000	× 0.2	= \$20,000

Chapter 1, SE 6.

1.	Beginning:	\$ 90,000	=	Liabilities	+	\$50,000
		Liabilities	=	\$ 40,000		
		\$ 90,000	=	\$ 40,000	+	\$50,000
	Change:	<u>+ 60,000</u>		<u>+ 10,000</u>		
		\$150,000	=	\$ 50,000	+	Stockholders' Equity
	End:	Stockholders' Equity	=	\$100,000		
2.	Beginning:	Assets	=	\$100,000	+	\$192,000
		Assets	=	\$292,000		
		\$292,000	=	\$100,000	+	\$192,000
	Change:	<u>+ 80,000</u>		<u>- 60,000</u>		
		\$372,000	=	\$ 40,000	+	Stockholders' Equity
	End:	Stockholders' Equity	=	\$332,000		

Chapter 1, SE 7.

Net income		=	\$108,000			
Beginning of year	Assets	=	Liabilities	+	Stockholders' Equity	
	\$280,000	=	\$120,000	+	\$160,000	
During year	Investment				\$ 40,000	
	Dividends				48,000	
	Net Income*				108,000	
End of year	\$400,000	=	\$140,000	+	\$260,000	
*(\$260,000 - \$160,000) - \$40,000 + \$48,000 = \$108,000						

Chapter 1, SE 8.

Globe Company Balance Sheet June 30, 2011				
Assets		Liabilities		
Cash *	\$ 5,800	Wages payable		\$ 700
Accounts receivable	1,600			
Building	<u>22,000</u>	Stockholders' Equity		
		Common stock	\$24,000	
		Retained earnings	<u>4,700</u>	
		Total stockholders' equity		<u>28,700</u>
		Total liabilities and		
Total assets	<u>\$29,400</u>	stockholders' equity		<u>\$29,400</u>
* To balance				

Chapter 1, SE 9.

Tarech Corporation				
Income Statement				
For the Year Ended December 31, 2011				
Revenue				
	Service revenue			\$4,800
Expenses				
	Total expenses			<u>2,450</u>
Net income				<u>\$2,350</u>
Tarech Corporation				
Statement of Retained Earnings				
For the Year Ended December 31, 2011				
Retained earnings, December 31, 2010				\$ —
Net income for the year				<u>2,350</u>
Subtotal				<u>\$2,350</u>
Less dividends				<u>410</u>
Retained earnings, December 31, 2011				<u>\$1,940</u>
Tarech Corporation				
Balance Sheet				
December 31, 2011				
Assets		Liabilities		
Cash	\$1,890	Accounts payable		\$ 450
Other assets	<u>1,000</u>			
		Stockholders' Equity		
		Common stock	\$ 500	
		Retained earnings	<u>1,940</u>	
		Total stockholders' equity		<u>2,440</u>
		Total liabilities and		
Total assets	<u>\$2,890</u>	stockholders' equity		<u>\$2,890</u>

Chapter 1, SE 10.

Anatole Company				
Balance Sheet				
April 30, 2011				
Assets		Liabilities		
Cash *	\$12,800	Wages payable		\$ 1,000
Accounts receivable	3,200			
Building	<u>40,000</u>	Stockholders' Equity		
		Common stock	\$48,000	
		Retained earnings	<u>7,000</u>	
		Total stockholders' equity		<u>55,000</u>
		Total liabilities and		
Total assets	<u>\$56,000</u>	stockholders' equity		<u>\$56,000</u>
*To balance				

Chapter 1, SE 11.

Patel Corporation	
Income Statement	
For the Year Ended December 31, 2011	
Revenue	
Service revenue	\$9,600
Expenses	
Total expenses	<u>4,900</u>
Net income	<u>\$4,700</u>

Patel Corporation	
Statement of Retained Earnings	
For the Year Ended December 31, 2011	
Retained earnings, December 31, 2011	\$ —
Net income for the year	<u>4,700</u>
Subtotal	\$4,700
Less dividends	<u>820</u>
Retained earnings, December 31, 2011	<u>\$3,880</u>

Patel Corporation				
Balance Sheet				
December 31, 2011				
Assets		Liabilities		
Cash	\$3,780	Accounts payable		\$ 900
Other assets	<u>2,000</u>			
		Stockholders' Equity		
		Common stock	\$1,000	
		Retained earnings	<u>3,880</u>	
		Total stockholders' equity		<u>4,880</u>
		Total liabilities and		
Total assets	<u>\$5,780</u>	stockholders' equity		<u>\$5,780</u>

Chapter 1, SE 12.

AICPA:	American Institute of Certified Public Accountants
SEC:	Securities and Exchange Commission
PCAOB:	Public Company Accounting Oversight Board
GAAP:	Generally accepted accounting principles
FASB:	Financial Accounting Standards Board
IFRS:	International financial reporting standards
IRS:	Internal Revenue Service
GASB:	Governmental Accounting Standards Board
IASB:	International Accounting Standards Board
IMA:	Institute of Management Accountants
CPA:	Certified public accountant

Chapter 1, SE 13.

Net Income							\$ 30,000				
Revenues							\$220,000				
Profit Margin		=	Net Income		=	\$30,000		=	0.136	or	13.6%
			Revenues			\$220,000					

Chapter 1, E 1.

- | | |
|----|--|
| 1. | The primary purpose of accounting is to provide decision makers with the financial information they need to make intelligent decisions. It is a valuable discipline because of the usefulness of the information it generates. |
| 2. | Like managers of profit-seeking businesses, managers of government and not-for-profit organizations must report to those who fund them, and they must operate their organizations in a financially prudent way. |
| 3. | No, not all economic events involve exchanges of value between a business and someone else. For example, when a customer places an order, it is an economic event, but until the order is fulfilled, no exchange of value has taken place. |
| 4. | Accounting treats sole proprietorships, partnerships, and corporations as entities separate and apart from their owners because each form represents a business for which financial performance must be measured and reported. |

Chapter 1, E 2.

- | | |
|----|---|
| 1. | Expenses and dividends are the same in that they both reduce the retained earnings component of stockholders' equity. They are different in that expenses are also a component of net income, whereas dividends are a distribution of assets to stockholders resulting from net income. |
| 2. | CVS and Southwest are comparable in that like all companies, they have two main goals: profitability and liquidity. How companies such as CVS and Southwest achieve these goals may make them incomparable in certain ways. For instance, CVS is a retail (pharmacy and related) company, whereas Southwest is a service (air transportation) company. CVS buys and leases retail stores, whereas Southwest buys and leases aircraft. |
| 3. | GAAP differ from the laws of science in that they are not unchanging but rather are constantly evolving. They may change as business conditions change or as improved methods of accounting are introduced. |
| 4. | Unethical ways of accounting include recording and reporting business transactions that did not occur or being dishonest in recording those that did occur. Financial statements are unethically prepared when they misrepresent a company's financial situation or contain false information. |

Chapter 1, E 3.

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

Chapter 1, E 4.

People who are interested in Cellhealth's financial statements are the following:

	Management
	Investors (stockholders in the company)
	Creditors
	Tax authorities
	Regulators
	Labor unions
	Customers
	Economic planners

A partnership is a business that has two or more owners. A corporation is a business unit that has been granted a charter from the state and is legally separate from its owners (stockholders). A major advantage of the corporate form of business over the partnership is that the stockholders' liability is limited to the amount of the stockholders' investments in the company, whereas the personal assets of partners can be called upon to pay the obligations of the partnership. Also, the transfer of ownership is easier with the corporation because the shares owned by a stockholder can be sold to another party. When ownership of a partnership changes, the partnership must be dissolved and another one formed.

Chapter 1, E 5.

1.	This is not a business transaction because no economic exchange has taken place.
2.	Yes, this is properly an expense of the business.
3.	Yes, this is properly an expense of the business.
4.	Yes, this is properly an expense of the business (assuming that Tom intends to repay the loan).

Chapter 1, E 6.

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

Chapter 1, E 7.

Company	Sales				
US.Chip	2,750,000	×	1.000	=	\$2,750,000
Nanhai	5,000,000	×	0.130	=	\$ 650,000
Tova	350,000,000	×	0.011	=	\$3,850,000
Holstein	3,500,000	×	1.430	=	\$5,005,000
Company	Assets				
US.Chip	1,300,000	×	1.000	=	\$1,300,000
Nanhai	2,800,000	×	0.130	=	\$ 364,000
Tova	290,000,000	×	0.011	=	\$3,190,000
Holstein	3,900,000	×	1.430	=	\$5,577,000

Holstein is the largest in terms of sales and assets due to the high value of the euro.

Chapter 1, E 8.

1.		Assets	=	Liabilities	+	Stockholders' Equity
		\$760,000	=	Liabilities	+	\$310,000
		Liabilities	=	\$450,000		
2.		Assets	=	Liabilities	+	Stockholders' Equity
		Assets	=	\$130,000	+	\$159,000
		Assets	=	\$289,000		
3.		Assets	=	1/3 Assets	+	\$90,000
		2/3 Assets	=	\$90,000		
		Assets	=	\$135,000		
		Liabilities	=	1/3	×	\$135,000 = \$45,000
4.	Beginning:	\$620,000	=	Liabilities	+	\$300,000
		Liabilities	=	\$320,000		
		\$620,000	=	\$320,000	+	\$300,000
	Change:	+ 90,000		- 45,000		
		\$710,000	=	\$275,000	+	Stockholders' Equity
	End:	Stockholders' Equity	=	\$435,000		

Chapter 1, E 9.

1.	a.	A	2.	a.	IS
	b.	L		b.	BS
	c.	A		c.	IS
	d.	SE		d.	BS
	e.	A		e.	IS
	f.	L		f.	BS
	g.	A		g.	RE

Chapter 1, E 10.

Rojas Services Company				
Balance Sheet				
December 31, 2011				
Assets		Liabilities		
Cash	\$ 25,000	Accounts payable		\$ 50,000
Accounts receivable	62,500			
Supplies	12,500	Stockholders' Equity		
Building	112,500	Common stock	\$125,000	
Equipment	<u>50,000</u>	Retained earnings	<u>87,500</u>	
		Total stockholders' equity		<u>212,500</u>
		Total liabilities and stockholders' equity		<u>\$262,500</u>
Total assets	<u>\$262,500</u>			

Chapter 1, E 11.

Kaisha Corporation		
Income Statement		
For the Year Ended December 31, 2011		
Revenue		
Service revenue		\$13,200
Expenses		
Wages expense	\$8,340	
Advertising expense	1,350	
Rent expense	1,200	
Utilities expense	<u>900</u>	
Total expenses		<u>11,790</u>
Income before income taxes		\$ 1,410
Income taxes expense		<u>200</u>
Net income		<u>\$ 1,210</u>

Kaisha Corporation	
Statement of Retained Earnings	
For the Year Ended December 31, 2011	
Retained earnings, December 31, 2010	\$1,440
Net income for the year	<u>1,210</u>
Subtotal	\$2,650
Less dividends	<u>700</u>
Retained earnings, December 31, 2011	<u>\$1,950</u>

Kaisha Corporation			
Balance Sheet			
December 31, 2011			
Assets		Liabilities	
Cash	\$1,550	Accounts payable	\$ 450
Accounts receivable	750		
Supplies	100	Stockholders' Equity	
Land	<u>1,000</u>	Common stock	\$1,000
		Retained earnings	<u>1,950</u>
		Total stockholders' equity	<u>2,950</u>
		Total liabilities and	
Total assets	<u>\$3,400</u>	stockholders' equity	<u>\$3,400</u>

Chapter 1, E 12.

1.	Net income is:	\$26,500					
		Assets	=	Liabilities	+	Stockholders' Equity	
	End:	\$550,000	=	\$301,000	+	\$249,000	
	Beginning:	\$360,000	=	\$137,500	+	<u>222,500</u>	
	Net income					<u>\$ 26,500</u>	
2.	Net income is:	\$81,500					
	Change in Stockholders' Equity			\$26,500			
	+ Dividends			<u>55,000</u>			
	Net income			<u>\$81,500</u>			
3.	Net loss is:	\$6,000					
	Change in Stockholders' Equity			\$26,500			
	– Stockholders' investments			<u>32,500</u>			
	Net loss			<u>(\$ 6,000)</u>			
4.	Net income is:	\$59,500					
	Change in Stockholders' Equity			\$26,500			
	+ Dividends			<u>58,000</u>			
				\$84,500			
	– Stockholders' investments			<u>25,000</u>			
	Net income			<u>\$59,500</u>			

Chapter 1, E 13.

Primorsk Corporation			
Statement of Cash Flows			
For the Year Ended December 31, 2011			
Cash flows from operating activities			
Net income			\$19,000
Adjustments to reconcile net income to net cash flows from operating activities			
(Increase) in accounts receivable	(\$ 3,900)		
Increase in accounts payable	<u>5,850</u>		<u>1,950</u>
Net cash flows from operating activities			\$20,950
Cash flows from investing activities			
Purchased equipment	(\$62,500)		
Net cash flows from investing activities			(62,500)
Cash flows from financing activities			
Borrowed from bank	\$39,000		
Paid dividends	(9,750)		
Net cash flows from financing activities			<u>29,250</u>
Net increase (decrease) in cash			(\$12,300)
Cash at beginning of year			<u>27,950</u>
Cash at end of year			<u><u>\$15,650</u></u>

Chapter 1, E 14.

Mrs. Bell's Pastry, Inc.	
Statement of Retained Earnings	
For the Year Ended January 31, 2011	
Retained earnings, January 31, 2010	\$105,000
Net income for the year	<u>54,490</u>
Subtotal	\$159,490
Less dividends	<u>—</u>
Retained earnings, January 31, 2011	<u><u>\$159,490</u></u>

Retained earnings represent the equity of the stockholders generated from the income-producing activities of the business and kept for use in the business.

The board of directors of Mrs. Bell's Pastry may have decided not to pay any dividends because it wanted to use the funds for other purposes such as to finance the company's growth or pay off debt.

Chapter 1, E 15.

	2011	2010
Net income	\$ 25,000	\$ 24,000
Total revenues	\$240,000	\$200,000
Profit Margin	10.42%	12.00%

Profit margin has decreased from 12.00 percent to 10.42 percent. The decrease is a result of revenues increasing by 20 percent coupled with a net income increase of less than 5 percent.

2011 Profit Margin

	Net Income	=	\$25,000	=	0.1042	or	10.42%
	Total Revenues		\$240,000				

2010 Profit Margin

	Net Income	=	\$24,000	=	0.1200	or	12.00%
	Total Revenues		\$200,000				

Chapter 1, P 1.**1. Matching completed**

IS	Utilities expense	BS	Accounts payable
BS	Building	IS	Rent expense
BS	Common stock	RE	Dividends
IS/RE	Net income	IS	Income taxes expense
BS	Land	IS	Fees earned
BS	Equipment	BS	Cash
IS	Revenues	BS	Supplies
BS	Accounts receivable	IS	Wages expense

2. User Insight: Statement associated with profitability identified

The income statement is most closely associated with the goal of profitability.

Chapter 1, P 2.

1. Financial statements completed

	Set A		Set B		Set C	
Income Statement						
Revenue	\$1,100		\$ 6,800	(g)	\$240	
Expenses	<u>800</u>	(a)	<u>5,200</u>		<u>160</u>	(m)
Net income	<u>\$ 300</u>	(b)	<u>\$ 1,600</u>	(h)	<u>\$ 80</u>	
Statement of Retained Earnings						
Beginning balance	\$2,900		\$15,400		\$200	
Net income	300	(c)	1,600		80	(n)
Less dividends	<u>200</u>		<u>1,000</u>	(i)	—	(o)
Ending balance	<u>\$3,000</u>		<u>\$16,000</u>	(j)	<u>\$280</u>	(p)
Balance Sheet						
Total assets	<u>\$6,600</u>	(d)	<u>\$31,000</u>		<u>\$580</u>	(q)
Liabilities	\$1,600		\$ 5,000		\$200	(r)
Stockholders' equity						
Common stock	2,000		10,000		100	
Retained earnings	<u>3,000</u>	(e)	<u>16,000</u>	(k)	<u>280</u>	
Total liabilities and stockholders' equity	<u>\$6,600</u>	(f)	<u>\$31,000</u>	(l)	<u>\$580</u>	

2. User Insight: Financial statement order explained

The income statement must be prepared first because the amount of net income is necessary to determine the ending balance of retained earnings. The statement of retained earnings is prepared second because it provides the ending balance of retained earnings for the balance sheet, which is prepared last.

Chapter 1, P 3.

1. Financial statements prepared

Landscape Design, Inc. Income Statement For the Year Ended November 30, 2011		
Revenue		
Design service revenue		\$248,000
Expenses		
Salaries expense	\$96,000	
Marketing expense	19,700	
Office rent expense	18,200	
Utilities expense	<u>3,100</u>	
Total expenses		<u>137,000</u>
Income before income taxes		\$111,000
Income taxes expense		<u>38,850</u>
Net income		<u>\$ 72,150</u>

Landscape Design, Inc. Statement of Retained Earnings For the Year Ended November 30, 2011	
Retained earnings, November 30, 2010	\$ 55,400
Net income for the year	<u>72,150</u>
Subtotal	\$127,550
Less dividends	<u>40,000</u>
Retained earnings, November 30, 2011	<u>\$ 87,550</u>

Landscape Design, Inc. Balance Sheet November 30, 2011				
Assets		Liabilities		
Cash	\$115,750	Accounts payable	\$ 7,400	
Accounts receivable	9,100	Income taxes payable	13,000	
Supplies	<u>800</u>	Salaries payable	<u>2,700</u>	
		Total liabilities		\$ 23,100
		Stockholders' Equity		
		Common stock	\$15,000	
		Retained earnings	<u>87,550</u>	
		Total stockholders' equity		<u>102,550</u>
		Total liabilities and		
Total assets	<u>\$125,650</u>	stockholders' equity		<u>\$125,650</u>

Chapter 1, P 3. (Continued)
2. User Insight: Ability to pay bills evaluated
Salaries Expense is the total expense for the accounting period. Salaries Payable is the amount that has not yet been paid to employees.
3. User Insight: Ability to pay bills evaluated
The company's ability to pay its bills or its liquidity appears good because it has cash of \$115,750 and total liabilities of only \$23,100.

Chapter 1, P 4.

1. Financial statements prepared

Collegiate Painters, Inc.		
Income Statement		
For the Year Ended September 30, 2011		
Revenue		
Painting service revenue		\$78,800
Expenses		
Salaries expense	\$56,000	
Truck rent expense	7,200	
Utilities expense	4,100	
Marketing expense	1,500	
Equipment rental expense	<u>1,300</u>	
Total expenses		<u>70,100</u>
Income before income taxes		\$ 8,700
Income taxes expense		<u>3,000</u>
Net income after taxes		<u>\$ 5,700</u>

Collegiate Painters, Inc.	
Statement of Retained Earnings	
For the Year Ended September 30, 2011	
Retained earnings, September 30, 2010	\$ —
Net income for the year	<u>5,700</u>
Subtotal	\$5,700
Less dividends	<u>1,000</u>
Retained earnings, September 30, 2011	<u>\$4,700</u>

Collegiate Painters, Inc.				
Balance Sheet				
September 30, 2011				
Assets		Liabilities		
Cash	\$ 2,600	Accounts payable	\$10,500	
Accounts receivable	13,200	Income taxes payable	3,000	
Supplies	400	Salaries payable	<u>700</u>	
Equipment	<u>4,700</u>	Total liabilities		\$14,200
		Stockholders' Equity		
		Common stock	\$ 2,000	
		Retained earnings	<u>4,700</u>	
		Total stockholders' equity		<u>6,700</u>
		Total liabilities and		
Total assets	<u>\$20,900</u>	stockholders' equity		<u>\$20,900</u>

Chapter 1, P 4. (Continued)
2. User Insight: Form of business discussed
The corporation has several advantages over the partnership, including limited liability for its stockholders and the ability to exchange shares easily.

Chapter 1, P 5.

1. User Insight: Relationship of financial statements

The income statement shows net income of \$3,000 earned by the company over a period of time. The amount of net income is necessary for the preparation of the statement of retained earnings. The statement of retained earnings shows the ending balance of \$6,075. The ending balance of retained earnings appears in the stockholders' equity section of the balance sheet. The statement of cash flows explains the changes in the cash balance on the balance sheet during the year.

2. User Insight: Liquidity and profitability

The income statement is most closely associated with the goal of profitability because it shows the earnings of the business. The cash flow statement is most closely associated with the goal of liquidity because it shows the changes in cash.

3. User Insight: Company's performance evaluated

The company appears to be very profitable because it has earned \$3,000 of net income on revenues of \$5,925. It has also paid dividends in the amount of \$2,400. However, the return on total assets (net income divided by total assets) is only 5.56 percent, or \$0.056 on each dollar of assets invested. Moreover, the company might experience some challenges in its liquidity position in the future because it has liabilities of \$13,350 and cash of only \$6,525.

4. User Insight: Role of CPA

When deciding whether to make a loan to a company, a banker evaluates the company's ability to pay interest charges and repay the loan at the appropriate time. Accordingly, a banker studies the company's liquidity and cash flows as well as its profitability. That information is represented in financial statements, which are prepared by a company's management and can be falsified for personal gain. To lend credibility to the financial statements, the banker may request an independent CPA audit. The audit would verify that the financial statements present the data fairly and conform to GAAP in all material respects.

Chapter 1, P 6.

1. Financial statements completed

	Set A		Set B		Set C	
Income Statement						
Revenue	\$5,320		\$ 8,600		\$2,460	(m)
Expenses	<u>4,810</u>	(a)	<u>7,000</u>	(g)	<u>2,010</u>	
Net income	<u>\$ 510</u>		<u>\$ 1,600</u>	(h)	<u>\$ 450</u>	(n)
Statement of Retained Earnings						
Beginning balance	\$1,780		\$15,400		\$ 200	
Net income	510	(b)	1,600	(i)	450	
Less dividends	<u>190</u>	(c)	<u>1,000</u>		<u>100</u>	(o)
Ending balance	<u>\$2,100</u>	(d)	<u>\$16,000</u>		<u>\$ 550</u>	(p)
Balance Sheet						
Total assets	<u>\$2,700</u>	(e)	<u>\$26,000</u>	(j)	<u>\$1,900</u>	
Liabilities	\$ 400	(f)	\$ 2,000		\$1,300	
Stockholders' equity						
Common stock	200		8,000		50	
Retained earnings	<u>2,100</u>		<u>16,000</u>	(k)	<u>550</u>	(q)
Total liabilities and stockholders' equity	<u>\$2,700</u>		<u>\$26,000</u>	(l)	<u>\$1,900</u>	(r)

2. User Insight: Income statement discussed

The income statement must be prepared first because the amount of net income is necessary to determine the ending balance of retained earnings. The ending balance of retained earnings is necessary for the preparation of the balance sheet.

Chapter 1, P 7.

1. Financial statements prepared

Real Deal, Inc. Income Statement For the Year Ended December 31, 2011		
Revenue		
Commission sales revenue		\$400,000
Expenses		
Commissions expense	\$225,000	
Office rent expense	36,000	
Wages expense	32,000	
Marketing expense	20,100	
Telephone and computer expenses	5,100	
Utilities expense	2,600	
Total expenses		<u>320,800</u>
Income before income taxes		\$ 79,200
Income taxes expense		<u>27,000</u>
Net income		<u>\$ 52,200</u>

Real Deal, Inc. Statement of Retained Earnings For the Year Ended December 31, 2011	
Retained earnings, December 31, 2010	\$35,300
Net income for the year	<u>52,200</u>
Subtotal	\$87,500
Less dividends	<u>33,000</u>
Retained earnings, December 31, 2011	<u>\$54,500</u>

Real Deal, Inc. Balance Sheet December 31, 2011				
Assets		Liabilities		
Cash	\$ 57,700	Accounts payable	\$ 3,600	
Accounts receivable	4,500	Income taxes payable	13,000	
Supplies	700	Commissions payable	<u>22,700</u>	
Equipment	<u>59,900</u>	Total liabilities		\$ 39,300
		Stockholders' Equity		
		Common stock	\$29,000	
		Retained earnings	<u>54,500</u>	
		Total stockholders' equity		<u>83,500</u>
		Total liabilities and		
Total assets	<u>\$122,800</u>	stockholders' equity		<u>\$122,800</u>

Chapter 1, P 7. (Continued)
2. User Insight: Useful statement identified
The statement of cash flows is very useful in assessing whether a company's operations are generating sufficient funds to support expansion. The statement tells whether operations are producing enough cash or whether the company will need to obtain outside financing from creditors or owners.

Chapter 1, P 8.

1. Financial statements prepared

Creative Ads, Inc.				
Income Statement				
For the Year Ended January 31, 2011				
Revenue				
Advertising service revenue				\$165,200
Expenses				
Salaries expense		\$86,000		
Equipment rental expense		37,200		
Utilities expense		19,100		
Office rent expense		13,500		
Marketing expense		<u>6,800</u>		
Total expenses				<u>162,600</u>
Income before income taxes				\$ 2,600
Income taxes expense				<u>560</u>
Net income				<u>\$ 2,040</u>
Creative Ads, Inc.				
Statement of Retained Earnings				
For the Year Ended January 31, 2011				
Retained earnings, January 31, 2010				\$ —
Net income for the year				<u>2,040</u>
Subtotal				\$2,040
Less dividends				<u>—</u>
Retained earnings, January 31, 2011				<u>\$2,040</u>
Creative Ads, Inc.				
Balance Sheet				
January 31, 2011				
Assets		Liabilities		
Cash	\$ 1,800	Accounts payable	\$19,400	
Accounts receivable	24,900	Income taxes payable	560	
Supplies	<u>1,600</u>	Salaries payable	<u>1,300</u>	
		Total liabilities		\$21,260
		Stockholders' Equity		
		Common stock	\$ 5,000	
		Retained earnings	<u>2,040</u>	
		Total stockholders' equity		<u>7,040</u>
		Total liabilities and		
Total assets	<u>\$28,300</u>	stockholders' equity		<u>\$28,300</u>

Chapter 1, P 8. (Continued)
2. User Insight: Financial challenges identified
Income Taxes Expense is the total expense for the accounting period. Income Taxes Payable is the amount that has not yet been paid to the government.
3. User Insight: Financial challenges identified
The company is challenged both in terms of profitability and liquidity. Profitability is low in that the company has earned only \$2,040 on revenues of \$165,200. Liquidity is low because the company has cash of only \$1,800 and liabilities of \$21,260.

Chapter 1, P 9.

1. Financial statements completed

	Set A		Set B		Set C	
Income Statement						
Revenue	\$1,100		\$ 6,900 (g)		\$210	
Expenses	<u>600</u> (a)		<u>5,200</u>		<u>130</u> (m)	
Net income	<u>\$ 500</u> (b)		<u>\$ 1,700</u> (h)		<u>\$ 80</u>	
Statement of Retained Earnings						
Beginning balance	\$2,700		\$11,400		\$340	
Net income	500 (c)		1,700		80 (n)	
Less dividends	<u>200</u>		<u>1,000</u> (i)		<u>20</u> (o)	
Ending balance	<u>\$3,000</u>		<u>\$12,100</u> (j)		<u>\$400</u> (p)	
Balance Sheet						
Total assets	<u>\$6,400</u> (d)		<u>\$27,600</u>		<u>\$880</u> (q)	
Liabilities	\$1,500		\$ 7,000		\$200 (r)	
Stockholders' equity						
Common stock	1,900		8,500		280	
Retained earnings	<u>3,000</u> (e)		<u>12,100</u> (k)		<u>400</u>	
Total liabilities and stockholders' equity	<u>\$6,400</u> (f)		<u>\$27,600</u> (l)		<u>\$880</u>	

2. User Insight: Income statement discussed

The income statement must be prepared first because the amount of net income is necessary to determine the ending balance of retained earnings. The ending balance of retained earnings is necessary for the preparation of the balance sheet.

Chapter 1, P 10.

1. Financial statements prepared

Bradford Realty, Inc. Income Statement For the Year Ended October 30, 2011		
Revenue		
Commission sales revenue		\$415,000
Expenses		
Commissions expense	\$230,000	
Office rent expense	40,000	
Wages expense	29,200	
Telephone and computer expenses	6,300	
Utilities expense	<u>2,700</u>	
Total expenses		<u>308,200</u>
Income before income taxes		\$106,800
Income taxes expense		<u>35,700</u>
Net income		<u>\$ 71,100</u>

Bradford Realty, Inc. Statement of Retained Earnings For the Year Ended October 31, 2011	
Retained earnings, October 31, 2010	\$ 15,700
Net income for the year	<u>71,100</u>
Subtotal	\$ 86,800
Less dividends	<u>40,000</u>
Retained earnings, October 31, 2011	<u>\$ 46,800</u>

Bradford Realty, Inc. Balance Sheet October 31, 2011				
Assets		Liabilities		
Cash	\$ 57,500	Accounts payable	\$ 3,500	
Accounts receivable	12,700	Income taxes payable	12,500	
Supplies	900	Commissions payable	<u>21,500</u>	
Equipment	<u>44,200</u>	Total liabilities		\$ 37,500
		Stockholders' Equity		
		Common stock	\$ 31,000	
		Retained earnings	<u>46,800</u>	
		Total stockholders' equity		<u>77,800</u>
		Total liabilities and		
Total assets	<u>\$115,300</u>	stockholders' equity		<u>\$115,300</u>

Chapter 1, P 10. (Continued)
2. User Insight: Ability to pay bills evaluated
Commissions Expense is the total expense for the accounting period. Commissions Payable is the amount that has not yet been paid.
3. User Insight: Ability to pay bills evaluated
The company's ability to pay its bills or its liquidity appears good because it has cash of \$57,500 and total liabilities of only \$37,500.

Chapter 1, C 1.

The three basic activities Costco will engage in to achieve its goals are financing activities (obtaining adequate funds or capital to operate its business), investing activities (spending the capital it receives so that it will be productive), and operating activities (running its business). Financing activities include obtaining capital from owners and from creditors, such as banks and suppliers. They also include repaying creditors and paying a return to the owners. Investing activities include buying land, buildings, equipment, and other long-lived resources needed in the operation of the business and selling these resources when they are no longer needed by the business. Operating activities include selling merchandise and service to customers; employing managers and workers; buying, producing, and selling goods and services; and paying taxes to the government.

Costco's management is the group of people who have overall responsibility for operating the business and for meeting the company's profitability and liquidity goals. The functions management must perform to fulfill its responsibility are obtaining financial resources so the company can continue operating (financial management); investing the financial resources of the business in productive assets that support the company's goals (asset management); developing and producing goods and services (operations management); selling, advertising, and distributing goods and services (marketing management); hiring, evaluating, and compensating employees (human resource management); and capturing, organizing, and communicating data about all aspects of the company's operations (information management). Accounting is covered by the last function.

Chapter 1, C 2.

Assets are economic resources owned by a business that are expected to benefit future operations. The people in an organization are not assets of the business because they are not owned by the business. Businesses pay their employees on a periodic basis (hourly, weekly, monthly, annually); they do not buy employees. Salaries, wages, and other costs associated with employment are considered expenses and appear on the income statement.

Southwest Airlines considers its people to be its most important asset because of the costs of hiring, training, motivating, and compensating high-quality employees who will benefit future operations. Airlines depend on their ability to develop and keep competent and motivated individuals. Their success in attracting and retaining high-quality employees depends on the opportunities and compensation they provide.

Chapter 1, C 3.

Generally accepted accounting principles (GAAP) encompass the conventions, rules, rules, and procedures necessary to define accepted practice at a particular time. When financial statements are prepared in accordance with GAAP and audited by an independent CPA, financial analysts understand the significance of the amounts in the financial statements and can assess a company's performance with confidence.

Some bodies that influence GAAP are as follows:

Public Company Accounting Oversight Board (PCAOB): Appoints the FASB to issue rules on accounting practice

Financial Accounting Standards Board (FASB): The most important body that issues rules on accounting practice

American Institute of Certified Public Accountants (AICPA): Influences accounting practice through its senior technical committees

Governmental Accounting Standards Board (GASB): Sets accounting standards for government entities

International Accounting Standards Board (IASB): Sets international accounting standards

Internal Revenue Service (IRS): Influences practice through rules for determining income tax liabilities

Chapter 1, C 4.

Liquidity was more important than profitability to Lechters' short-term survival because without the ability to pay its debts, the company was forced into bankruptcy. With the \$86 million in new financing, which provided additional liquidity, the company was able to return to profitability. Achieving profitability enables a company to survive in the long term because profitability is necessary to attract and keep the investments of stockholders.

Chapter 1, C 5.

1. Student A's assumption that an increase in total assets is equal to net income is false. It is true that net income results in an increase in assets, but so do many other transactions. For example, investments by owners and loans from banks also increase assets. Also, assets can be reduced by transactions that do not affect net income—for example, repayment of a loan.

Student B's assumption that the change in cash from one year to the next is equal to net income or net loss is also false. All the examples cited above affect cash but not net income. Moreover, revenue can be recorded before cash is received, as when RIM bills a customer for services performed. And expenses can be recorded before cash is paid, as when RIM is billed by a supplier for services already received.

Student C is correct. To estimate net income from an examination of the balance sheet, the change in retained earnings must be considered. Net income increases retained earnings. So net income can be estimated by taking the difference in retained earnings from one year to the next (there are no dividends).

2. Net income for 2009 was \$1,892,616.

RIM, retained earnings, February 28, 2009	\$3,545,710*
Less RIM, retained earnings, March 1, 2008	<u>1,653,094</u>
Increase in RIM, retained earnings in 2009	\$1,892,616
Plus dividends paid in 2008	<u>—</u>
Net income for the year ended February 28, 2009	<u>\$1,892,616**</u>

*** All numbers are in thousands.**

**** Net income is approximate because there may be effects that are not being considered at this point in the course.**

Chapter 1, C 6.

1.	The names CVS gives its four basic financial statements are as follows:				
	Consolidated Statements of Operations (Income Statement)				
	Consolidated Balance Sheets				
	Consolidated Statements of Cash Flows				
	Consolidated Statements of Shareholders' Equity; includes data for retained earnings				
2.	The accounting equation for CVS on December 31, 2009, is as follows:				
	(in millions)				
	Assets	=	Liabilities	+	Stockholders' Equity
	\$61,641	=	\$25,873	+	\$35,768
3.	Total revenues of CVS for the year ended December 31, 2009, were \$98,729 million.				
4.	Yes, the company earned \$3,696 million. This was an increase from net earnings of \$3,212 million for the year ended December 31, 2008. (<i>Note:</i> Preference dividends are distributions to owners.)				
5.	No, the company's cash and cash equivalents decreased by \$266 million. This number can be found toward the bottom of the statement of cash flows or can be computed by taking the difference of the cash and cash equivalents from the December 31, 2008 and December 31, 2009 balance sheets.				
6.	Cash flows from operating activities increased from 2008 to 2009. Cash flows used by investing activities were negative but significantly lower in 2009 than in 2008, and cash flows used in financing activities increased from 2008 to 2009.				
7.	CVS was audited by KPMG LLP. The auditor's report is important because it tells whether the company's financial statements and accompanying information are prepared in accordance with generally accepted accounting principles. If this is so, the reader of the financial statements can rely on them and analyze them. The auditor's report lends credibility to the financial statements.				

Chapter 1, C 7.

1.	With sales of \$98,729 million and total assets of \$61,641 million, CVS is much larger than Southwest, which has revenues of \$10,350 million and total assets of \$14,269 million. Note that CVS generates 9.5 times as much sales on about 4.3 times the total assets of Southwest.
	Neither assets nor revenues are better than the other to measure the size of a company. Assets tell how large a company's resources are, and revenues tell how well the company is able to generate revenue. Both are useful measures of a company's size.
2.	CVS has net income (earnings) of \$3,696 million, which is about 37 times more than Southwest's earnings of \$99 million. CVS has had increasing net income over the three years, whereas Southwest's net income has been decreasing over the past three years.
3.	In 2009, CVS had profit margin of 3.74 percent ($\$3,696 \div \$98,729$), and Southwest had profit margin of 0.96 percent ($\$99 \div \$10,350$). By this measure, CVS is significantly more profitable than Southwest.
4.	CVS has cash and cash equivalents of \$1,086 million compared to Southwest's cash and cash equivalents of \$1,114 million. CVS's cash decreased by \$266 million compared to the \$254 million decrease by Southwest. CVS had cash flows from operating activities of \$4,035 million compared with Southwest's cash flows from operating activities of \$985 million. CVS has slightly less cash on hand, but by the measure of cash flows from operating activities, it has a lot more liquidity.

Chapter 1, C 8.

The ethical situations are presented for discussion purposes. Students are likely to have many different viewpoints.

- | | |
|-----------|---|
| 1. | The alternative courses of action are to disclose or not to disclose the employee's hourly rate. The information should not be disclosed because of its confidential nature. |
| 2. | The alternative courses of action are to ignore the inappropriate expenses or to report them to the home office. It might also be possible to discuss them with the manager in private. This is a difficult situation because of the possibility of retribution. If the manager does not take appropriate remedial action, the accountant should report his actions—and be prepared to look for another job. |
| 3. | The alternative courses of action are to accept the gift or to return it. To avoid a conflict of interest, the appropriate action would be to return the gift. |
| 4. | This is a common problem faced by young accountants. The alternative courses of action are to do the work and not report it, to do the work and report it, or to talk to a superior as soon as the problem is recognized. The third alternative is the best because there may be some other reason that the job cannot be done in the allotted time. Underreporting hours usually is not tolerated by CPA firms. |
| 5. | The alternative courses of action are to report or not to report the \$200 in cash. Accountants must maintain their integrity, which means being honest. The \$200 should be reported; it would be illegal not to report it. |
| 6. | The courses of action are to disclose the investment or not to disclose the investment. A CPA must avoid even the appearance of a conflict of interest. To be independent, the CPA should disclose the investment and then sell the stock. |

Chapter 1, C 9.

1. Balance sheets prepared

Murphy Lawn Services, Inc.				
Balance Sheet				
June 1, 2011				
Assets		Liabilities		
Cash	<u>\$2,700</u>	Loan payable		\$1,000
		Stockholders' Equity		
		Common stock		<u>1,700</u>
		Total liabilities and		
Total assets	<u>\$2,700</u>	stockholders' equity		<u>\$2,700</u>
Murphy Lawn Services, Inc.				
Balance Sheet				
August 31, 2011				
Assets		Liabilities		
Cash	\$3,520	Accounts payable		\$ 525
Accounts receivable	875	Wages payable		100
Supplies	50	Loan payable		<u>700</u>
Deposit	<u>200</u>	Total liabilities		\$1,325
		Stockholders' Equity		
		Common stock	\$1,700	
		Retained earnings	<u>1,620</u>	
		Total stockholders' equity		<u>3,320</u>
		Total liabilities and		
Total assets	<u>\$4,645</u>	stockholders' equity		<u>\$4,645</u>

Chapter 1, C 9. (Continued)	
2. Memorandum prepared	
Memorandum	
Date:	Today's date
To:	Beth Murphy
From:	(Student's name)
Re:	Assessment of Performance
I have reviewed the balance sheets for Murphy Lawn Services, Inc., at June 1, 2011, and August 31, 2011.	
With regard to your business goal of profitability, your net income for the summer is \$1,620. Because you did not pay any dividends to yourself, the only factors that can affect retained earnings are revenues and expenses. Because retained earnings increased during the period from \$0 to \$1,620, your net income must have been \$1,620.	
With regard to your business goal of liquidity, you have increased your cash from \$2,700 to \$3,520, an increase of \$820. At the same time, your liabilities increased only \$325, from \$1,000 to \$1,325. Also, you have total assets of \$4,645.	
Finally, I suggest in the future that you also prepare an income statement, which will show details of your revenues and expenses related to profitability, and the statement of cash flows, which will show the details of the changes to your cash balance.	
Let me know if you have any further questions.	