

# CHAPTER 1

## Accounting as a Form of Communication

### OVERVIEW OF EXERCISES, PROBLEMS, AND CASES

Learning Outcomes	Exercises	Estimated Time in Minutes	Level
<b>Module 1</b>			
1. Explain what business is about.			
2. Distinguish among the forms of organization.			
3. Describe the various types of business activities.	1	5	Mod
<b>Module 2</b>			
4. Define accounting and identify the primary users of accounting information and their needs.	2 15*	5 10	Easy Mod
5. Explain the purpose of each of the financial statements and the relationships among them and prepare a set of simple statements.	3 4 5 6 7 8 9 10 11 14 15* 16*	15 10 10 15 10 20 15 10 10 15 10 10	Mod Mod Mod Easy Easy Diff Mod Mod Mod Mod Mod Mod
<b>Module 3</b>			
6. Identify and explain the primary assumptions made in preparing financial statements.	12 16*	10 10	Mod Mod
7. Identify the various groups involved in setting accounting standards and the role of auditors in determining whether the standards are followed.	13	10	Mod
8. Explain the critical role that ethics plays in providing useful financial information.			

\*Exercise, problem, or case covers two or more learning outcomes  
 Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

Learning Outcomes	Problems and Alternates	Estimated Time in Minutes	Level
<b>Module 1</b>			
1. Explain what business is about.			
2. Distinguish among the forms of organization.			
3. Describe the various types of business activities.			
<b>Module 2</b>			
4. Define accounting and identify the primary users of accounting information and their needs.	1	30	Mod
	2	20	Mod
	9	20	Mod
5. Explain the purpose of each of the financial statements and the relationships among them and prepare a set of simple statements.	3	30	Easy
	4	30	Easy
	5	60	Mod
	6	45	Mod
	7	60	Diff
	8	25	Mod
	10*	45	Diff
<b>Module 3</b>			
6. Identify and explain the primary assumptions made in preparing financial statements.	10*	45	Diff
7. Identify the various groups involved in setting accounting standards and the role of auditors in determining whether the standards are followed.			
8. Explain the critical role that ethics plays in providing useful financial information.			

\*Exercise, problem, or case covers two or more learning outcomes

Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

Learning Outcomes	Cases	Estimated Time in Minutes	Level
<b>Module 1</b>			
1. Explain what business is about.			
2. Distinguish among the forms of organization.			
3. Describe the various types of business activities.			
<b>Module 2</b>			
4. Define accounting and identify the primary users of accounting information and their needs.	1*	25	Mod
	4	30	Mod
	6*	75	Diff
5. Explain the purpose of each of the financial statements and the relationships among them and prepare a set of simple statements.	1*	25	Mod
	2	20	Mod
	3	30	Mod
	5	60	Diff
	6*	75	Diff
<b>Module 3</b>			
6. Identify and explain the primary assumptions made in preparing financial statements.			
7. Identify the various groups involved in setting accounting standards and the role of auditors in determining whether the standards are followed.			
8. Explain the critical role that ethics plays in providing useful financial information.	6*	75	Diff
	7	20	Mod

\*Exercise, problem, or case covers two or more learning outcomes  
 Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

<b>EXERCISES</b>
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**LO 3****EXERCISE 1-1 TYPES OF BUSINESS ACTIVITIES**

- |              |   |
|--------------|---|
| <u>  F  </u> | 1. Issued shares of stock to each of the four owners.   |
| <u>  I  </u> | 2. Purchased two limousines.                            |
| <u>  O  </u> | 3. Paid first month's rent for use of garage.           |
| <u>  F  </u> | 4. Obtained loan from local bank.                       |
| <u>  O  </u> | 5. Received cash from customer for trip to the airport. |
| <u>  O  </u> | 6. Paid driver first week's wages.                      |
| <u>  I  </u> | 7. Purchased 500-gallon fuel tank.                      |

**LO 4****EXERCISE 1-2 USERS OF ACCOUNTING INFORMATION AND THEIR NEEDS**

1. Company management
2. Stockholder
3. Labor union
4. Securities and Exchange Commission
5. Banker
6. Supplier
7. Internal Revenue Service

**LO 5****EXERCISE 1-3 THE ACCOUNTING EQUATION**

	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
<b>Case 1:</b>	\$125,000	=	\$75,000	+	SE
	SE	=			<u>\$50,000</u>
	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
<b>Case 2:</b>	\$400,000	=	L	+	\$100,000
	L	=	<u>\$300,000</u>		
	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
<b>Case 3:</b>	A	=	\$320,000	+	\$95,000
	A	=	<u>\$415,000</u>		

**LO 5****EXERCISE 1-4 THE ACCOUNTING EQUATION**

1.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
	\$500,000	=	\$250,000	+	SE
	SE	=			<u>\$250,000</u>

2.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
	(\$500,000 + \$100,000)	=	(\$250,000 + \$77,000)	+	SE
	SE	=			<u>\$273,000*</u>

$$*SE = (\$500,000 + \$100,000) - (\$250,000 + \$77,000) = \$273,000$$

3.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
	A	=	(\$250,000 + \$33,000)	+	(\$250,000* – \$58,000)
	A	=	\$283,000	+	\$192,000
	<u>\$475,000</u>				

\*From (1) above

4.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
	\$1,000,000	=	L	+	\$250,000*
	L	=	<u>\$750,000</u>		

\*From (1) above

**LO 5****EXERCISE 1-5 THE ACCOUNTING EQUATION**

1.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
Beginning of year	\$100,000	=	\$80,000	+	\$20,000
Net income				+	25,000
Dividends				–	<u>0</u>
Stockholders' equity at end of year					<u>\$45,000</u>

2.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
End of year (EOY)	\$60,000*	=	\$40,000	+	\$20,000
Reduce by half to beginning of year:	divided by 2				
Assets, beginning of year	<u>\$30,000</u>				

\*Hint: First, solve for EOY asset amount = \$40,000 + \$20,000 = \$60,000.

3.	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
Beginning of year (BOY)	\$30,000	=	\$20,000*	+	\$10,000
Triples during year			<u>× 3</u>		
Liabilities, end of year			<u>\$60,000</u>		

\*Hint: First, solve for BOY liability amount = \$30,000 – \$10,000 = \$20,000.

**LO 5****EXERCISE 1-6 CHANGES IN OWNERS' EQUITY**

1. First, compute the amount of stockholders' equity at the end of each year. Then, compute the change.

	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
<b>2014:</b>	\$25,000	=	\$12,000	+	SE
	SE	=			\$13,000
	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
<b>2015:</b>	\$79,000	=	\$67,000	+	SE
	SE	=			\$12,000
	<b>A</b>	=	<b>L</b>	+	<b>SE</b>
<b>2016:</b>	\$184,000	=	\$137,000	+	SE
	SE	=			\$47,000

**Change in stockholders' equity during 2015:**

$$\$12,000 - \$13,000 = \underline{(\$1,000)}$$

**Change in stockholders' equity during 2016:**

$$\$47,000 - \$12,000 = \underline{\$35,000}$$

**2. 2015:**

$$(\$1,000) = \text{Income} - \$0 \text{ in dividends}$$

$$\text{Net loss} = \underline{(\$1,000)}$$

**3. 2016:**

$$\$35,000 = \text{Income} - \$10,000 \text{ in dividends}$$

$$\text{Net income} = \underline{\$45,000^*}$$

Beginning of the year SE    \$12,000

Contributed capital                    0

Dividends                                (10,000)

NI    x    = ?

= End of year SE                        \$47,000

It has to be \$45,000 (\$12,000 – \$10,000 + \$45,000 = \$47,000)

**LO 5****EXERCISE 1-7 THE ACCOUNTING EQUATION**

(In thousands of dollars)

$$A = L + CS + (\text{Beg. RE} + \text{Income} - \text{Div.})$$

**Case 1:**

$$40 = L + 10 + (15 + 8 - 2)$$

$$\text{Liabilities} = \underline{9}$$

**Case 2:**

$$A = 15 + 5 + (8 + 7 - 1)$$

$$\text{Assets} = \underline{34}$$

**Case 3:**

$$75 = 25 + 20 + (10 + \text{Income}^* - 3)$$

$$\text{Income} = \underline{23}^*$$

$$75 - 52 = 23^*$$

**Case 4:**

$$50 = 10 + 15 + (20 + 9 - \text{Div}^*)$$

$$\text{Dividends} = \underline{4}^*$$

$$50 = 54 - 4^*$$

**LO 5****EXERCISE 1-8 CLASSIFICATION OF FINANCIAL STATEMENT ITEMS**

	<u>Appears on the</u>	<u>Classified as</u>
1.	IS	E
2.	BS	A
3.	BS	L
4.	IS	R
5.	BS	SE
6.	BS	A
7.	BS	A
8.	IS	E
9.	BS	SE

**LO 5****EXERCISE 1-9 CLASSIFICATION OF FINANCIAL STATEMENT ITEMS**

<u>Item</u>	<u>Appears on the</u>	<u>Classified as</u>
1. Trade and other receivables, net	<u>BS</u>	<u>A</u>
2. Class A common stock	<u>BS</u>	<u>SE</u>
3. Inventories	<u>BS</u>	<u>L</u>
4. Admissions	<u>IS</u>	<u>R</u>
5. Cost of concessions	<u>IS</u>	<u>E</u>
6. Equipment	<u>BS</u>	<u>A</u>
7. Accounts payable	<u>BS</u>	<u>L</u>
8. Retained earnings	<u>BS</u>	<u>SE</u>
9. Interest expense, net	<u>IS</u>	<u>E</u>
10. Long-term debt, less current portion	<u>BS</u>	<u>L</u>

**LO 5****EXERCISE 1-10 NET INCOME (OR LOSS) AND RETAINED EARNINGS**

1. **Revenue**      **Expenses**      **Net Income**  
      \$25,000      – (\$6,500 + \$12,000)      = \$6,500
2. **Retained Earnings, Beginning of Year**      **Net Income**      **Dividends**      **Retained Earnings, End of Year**  
      \$8,500      + \$6,500      – \$3,000      = \$12,000
3. **Total Assets:**  
     Cash..... \$13,000  
     Accounts receivable ..... 4,500  
     Office equipment ..... 7,500  
     Total assets ..... \$25,000
4. **Total Liabilities:**  
     Accounts payable ..... \$5,000
5. **Stockholders' Equity:**  
     Capital Stock      +      Retained Earnings      =      Stockholders' Equity  
     \$8,000      +      \$12,000      =      \$20,000  
     (Or \$25,000 in total assets less \$5,000 in total liabilities.)
6. **A**      **=**      **L**      **+**      **SE**  
     \$25,000      =      \$5,000      +      \$20,000

**LO 5****EXERCISE 1-11 STATEMENT OF RETAINED EARNINGS**

**ACE CORPORATION**  
**STATEMENT OF RETAINED EARNINGS**  
**FOR THE MONTH ENDED FEBRUARY 29, 2016**

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Retained earnings, beginning of month.....	\$229,800*
Net income .....	14,000**
Dividends for the month .....	<u>(5,000)</u>
Retained earnings, end of month .....	<u>\$238,800</u>

\*\$235,800 + \$83,000 – \$89,000

\*\*\$96,000 – \$82,000

**LO 6****EXERCISE 1-12 ACCOUNTING PRINCIPLES AND ASSUMPTIONS**

1. Going concern (also economic entity)
2. Cost principle
3. Economic entity
4. Monetary unit
5. Time period

**LO 7****EXERCISE 1-13 ORGANIZATIONS AND ACCOUNTING**

1. Securities and Exchange Commission
2. Financial Accounting Standards Board
3. American Institute of Certified Public Accountants
4. International Accounting Standards Board

**LO 5****EXERCISE 1-14 CLASSIFICATION OF ITEMS ON THE STATEMENT OF CASH FLOWS**

<u>Item</u>	<u>Section</u>
1. Cash paid for land	I
2. Cash received from issuance of note	F
3. Cash paid for dividends	F
4. Cash received from issuance of capital stock	F
5. Cash collected from customers	O
6. Cash paid for income taxes	O

**MULTI-CONCEPT EXERCISES****LO 4,5****EXERCISE 1-15 USERS OF ACCOUNTING INFORMATION AND THE FINANCIAL STATEMENTS**

<u>USER</u>	<u>FINANCIAL STATEMENT</u>
Stockholder	IS
Banker	BS
Supplier	BS
Stockholder	RE*
Advertising account manager	SCF**
Banker	BS

\*Amount of dividends declared would appear on the statement of retained earnings. Amount paid would appear on the statement of cash flows.

\*\*Amount spent on advertising would appear on the statement of cash flows (assuming use of the direct method). Amount incurred would appear on the income statement.

**LO 5,6****EXERCISE 1-16 CHIPOTLE'S LAND**

Land would be included in "Leasehold improvements, property and equipment, net" on Chipotle's balance sheet. The amount represents how much the company paid for the land, that is, its cost. Under current standards, the company is required to carry its land at historical cost rather than market value. The subjectivity in determining market value supports the practice of carrying assets at their cost.

<b>PROBLEMS</b>
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**LO 4****PROBLEM 1-1 YOU WON THE LOTTERY**

Obviously, there is no single, correct answer to this problem. Students should start by considering their personal circumstances and preference for risk. They should also consider their liquidity requirements. From this point, it is appropriate to consider sources of information.

Students should provide specific justification for their chosen investments. The “bottom line” is that students should justify their selections using financial information from as many sources as is cost effective and relate their choices to their preference or aversion to risk.

Following are guidelines to be used:

<b>Issues</b>	<b>Options</b>		
	<b>Stock</b>	<b>Bonds</b>	<b>Bank deposit</b>
Risk	High	Medium	Low
Information needed	Market price Dividends	Market price Interest rate Maturity date	Interest rate
Information sources	Annual reports Investor news-letters Newspapers, business periodicals	Same as for the stock	Bank advertising Newspaper articles
Additional information needed	Earnings forecasts Brokerage fees	Alternative rates Brokerage fees	Penalties for early withdrawal

This problem provides the instructor with an opportunity to introduce the concept of the time value of money. Certainly, it would be preferable to receive \$1 million today, rather than \$200,000 over each of the next five years. If a lump sum is received immediately, it could be put into one of the investments chosen, as opposed to spreading the investment over a five-year period.

**LO 4****PROBLEM 1-2 USERS OF ACCOUNTING INFORMATION AND THEIR NEEDS**

<u>Information</u>	<u>Management</u>	<u>Stockholders</u>	<u>Banker</u>
1.	a.	b.	a.
2.	a.	c.	a.
3.	a.	c.	a.
4.	a.	b.	a.
5.	a.	b.	b.

**LO 5****PROBLEM 1-3 BALANCE SHEET**

**FREESCIA CORPORATION  
BALANCE SHEET  
END OF THE YEAR**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash.....	\$ 4,220	Accounts payable .....	\$ 12,550
Accounts receivable .....	23,920	Notes payable.....	50,000
Office equipment .....	12,000	Capital stock .....	25,000
Buildings.....	<u>85,000</u>	Retained earnings .....	<u>37,590</u>
Total assets.....	<u>\$125,140</u>	Total liabilities and stockholders' equity.....	<u>\$125,140</u>

Items not shown on a balance sheet and where they would appear:

Advertising expense—income statement  
Salary and wage expense—income statement  
Sales revenue—income statement

**LO 5****PROBLEM 1-4 CORRECTED BALANCE SHEET**

1.

**AVON CONSULTING INC.  
BALANCE SHEET  
END OF THE YEAR**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$21,000	Accounts payable .....	\$13,000
Accounts receivable .....	16,000	Capital stock .....	20,000
Supplies .....	9,000	Retained earnings .....	<u>56,000*</u>
Furniture and equipment .....	<u>43,000</u>	Total liabilities and stockholders' equity .....	<u>\$89,000</u>
Total assets .....	<u>\$89,000</u>		

\*\$72,000 – \$16,000

2. Memorandum to the company president:

TO: Company president  
 FROM: Student's name  
 DATE: Beginning of following year  
 SUBJECT: Corrected balance sheet

Attached please find the original balance sheet your assistant prepared, along with a corrected version of that same statement. The differences can be explained as follows:

1. The balance sheet is always as of a certain date, in this case, the end of the current year, rather than a period of time, such as a year.
2. Accounts payable should be classified as a liability.
3. Cash dividends do not belong on the balance sheet; this amount should appear instead on the statement of retained earnings for the year.
4. Accounts receivable should be classified as an asset.
5. Net income for the year does not belong on the balance sheet; this amount should appear instead on the statement of retained earnings for the year.
6. Supplies should be classified as an asset.
7. Retained earnings should appear with capital stock as a component of stockholders' equity on the balance sheet. Since this is the first year of operations, the Retained Earnings balance comprises the net income for the year less the cash dividends.
8. Totals were added as necessary to provide summary information.

**LO 5****PROBLEM 1-5 INCOME STATEMENT, STATEMENT OF RETAINED EARNINGS,  
AND BALANCE SHEET**

**1. MAPLE PARK THEATRES CORP.  
INCOME STATEMENT  
FOR THE MONTH ENDED SEPTEMBER 30, 2016**

Revenues:		
Ticket sales.....	\$95,100	
Concessions revenue .....	<u>60,300</u>	
Total revenues .....		\$155,400
Expenses:		
Rent expense—movies .....	\$50,600	
Cost of concessions sold .....	23,450	
Advertising expense .....	14,500	
Salaries and wages expense.....	46,490	
Water, gas, and electricity .....	<u>6,700</u>	
Total expenses .....		<u>141,740</u>
Net income.....		<u>\$ 13,660</u>

**2. MAPLE PARK THEATRES CORP.  
STATEMENT OF RETAINED EARNINGS  
FOR THE MONTH ENDED SEPTEMBER 30, 2016**

Retained earnings, beginning balance, September 1, 2016 .....	\$73,780
Net income for September .....	13,660
Dividends for September .....	<u>(8,400)</u>
Retained earnings, ending balance, September 30, 2016 .....	<u>\$79,040</u>

**3. MAPLE PARK THEATRES CORP.  
BALANCE SHEET  
SEPTEMBER 30, 2016**

Assets		Liabilities and Stockholders' Equity	
Cash .....	\$ 15,230	Accounts payable .....	\$ 17,600
Accounts receivable.....	6,410	Notes payable.....	20,000
Land.....	26,000	Capital stock .....	50,000
Buildings .....	60,000	Retained earnings .....	<u>79,040*</u>
Furniture and fixtures .....	34,000		
Projection equipment .....	<u>25,000</u>	Total liabilities and	
Total assets .....	<u>\$166,640</u>	stockholders' equity.....	<u>\$166,640</u>

\*From (2) above. Note that retained earnings at September 30, 2016, is not \$73,780 as shown in the list of accounts. This was the amount of retained earnings at the beginning of the month.

**PROBLEM 1-5 (Concluded)**

4. On the basis of these statements alone, Maple Park would appear to be a good candidate for an investment. It is operating at a profit and is paying dividends. Before one makes an investment in Maple Park stock, it would be useful to see the statement of cash flows. Information about the current market price of the stock, the competitors, the general outlook for the industry, the age of the various long-term assets, and the due date of the note payable would also be useful before one makes an investment. The financial statements of earlier periods would be helpful for purposes of making comparisons.

**LO 5****PROBLEM 1-6 INCOME STATEMENT AND BALANCE SHEET**

1. **GREEN BAY CORPORATION**  
**INCOME STATEMENT**  
**FOR THE MONTH ENDED JULY 31, 2016**

Revenues:		
Fishing revenue .....	\$21,300	
Passenger service revenue .....	<u>12,560</u>	
Total revenues .....		\$33,860
Expenses:		
Rent expense .....	\$ 4,000	
Salary and wage expense .....	<u>18,230</u>	
Total expenses .....		<u>22,230</u>
Net income .....		<u>\$11,630</u>

2. **GREEN BAY CORPORATION**  
**BALANCE SHEET**  
**JULY 31, 2016**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$ 7,730	Notes payable .....	\$ 60,000
Accounts receivable .....	18,500	Capital stock .....	40,000
Boats .....	<u>80,000</u>	Retained earnings .....	<u>6,230*</u>
		Total liabilities and	
Total assets .....	<u>\$106,230</u>	stockholders' equity .....	<u>\$106,230</u>

\*Beginning retained earnings + net income – dividends:  
\$0 + \$11,630 – \$5,400

3. To fully assess Green Bay's long-term viability, you would need the following information about the \$60,000 note payable:
- When is it due?
  - What is the interest rate?
  - Is interest paid periodically or only at maturity?
  - Have any assets been offered as collateral for the loan?

**LO 5****PROBLEM 1-7 CORRECTED FINANCIAL STATEMENTS**

**1. HOMETOWN CLEANERS INC.  
INCOME STATEMENT  
FOR THE YEAR ENDED DECEMBER 31, 2016**

Revenues:		
Cleaning revenue—credit sales .....	\$26,200	
Cleaning revenue—cash sales .....	<u>32,500</u>	
Total revenues .....		\$58,700
Expenses:		
Utilities .....	\$12,200	
Salaries and wages .....	<u>17,100</u>	
Total expenses .....		<u>29,300</u>
Net income .....		<u>\$29,400</u>

**2. HOMETOWN CLEANERS INC.  
STATEMENT OF RETAINED EARNINGS  
FOR THE YEAR ENDED DECEMBER 31, 2016**

Retained earnings, beginning of year .....	\$42,700*
Net income for the year .....	29,400
Dividends for the year .....	<u>(4,000)</u>
Retained earnings, end of year .....	<u>\$68,100</u>

\*Given in text.

**3. HOMETOWN CLEANERS INC.  
BALANCE SHEET  
DECEMBER 31, 2016**

Assets		Liabilities and Stockholders' Equity	
Cash .....	\$ 7,400	Accounts payable .....	\$ 4,500
Accounts receivable .....	15,200	Notes payable .....	50,000
Building and equipment .....	80,000	Capital stock .....	20,000
Land .....	<u>40,000</u>	Retained earnings .....	<u>68,100*</u>
Total assets .....	<u>\$142,600</u>	Total liabilities and stockholders' equity .....	<u>\$142,600</u>

\*From (2) above. Note that retained earnings at December 31, 2016, is not \$42,700 as given in text. This was the amount of retained earnings at the beginning of the year.

**PROBLEM 1-7 (Concluded)****4. Memorandum to the company president:**

TO: Company president  
 FROM: Student's name  
 DATE: January 1, 2017  
 SUBJECT: Corrected income statement

Attached please find the original income statement you prepared, along with a corrected version of that same statement. Fortunately, your disappointment with the 2016 net income is not warranted, as you will see from my revised statement. The difference between the net income on the original income statement of \$9,900 and the revised amount of \$29,400, or \$19,500, can be explained as follows:

1. Accounts receivable of \$15,200 does not belong on the income statement; instead, services provided on account of \$26,200 should be shown on the income statement; the difference is \$11,000.
2. Dividends are not an expense, and thus they do not belong on the income statement: \$4,000.
3. Accounts payable is a liability and appears on the balance sheet: \$4,500.

These corrections result in increased income of \$19,500. Also, note that notes payable should be reported on the balance sheet as a liability, not as an offset to building and equipment. Please let me know if I can be of any further assistance in interpreting the results of our operations for 2016.

**LO 5****PROBLEM 1-8 STATEMENT OF RETAINED EARNINGS FOR THE COCA-COLA COMPANY**

**1. THE COCA-COLA COMPANY  
 STATEMENT OF RETAINED EARNINGS  
 FOR THE YEAR ENDED DECEMBER 31, 2013  
 (amounts in millions)**

Retained earnings, beginning of year .....	\$58,045
Net income attributable to shareowners of the Coca-Cola Company for the year .....	8,584
Dividends for the year .....	<u>(4,969)</u>
Retained earnings, end of year .....	<u>\$61,660</u>

2. The statement of shareholders' (stockholders') equity would include all changes in shareholders' equity such as issuances and retirements of stock in addition to the information normally provided in a retained earnings statement.

**LO 4****PROBLEM 1-9 INFORMATION NEEDS AND SETTING ACCOUNTING STANDARDS**

The Financial Accounting Standards Board would have been targeting external users with this standard. Because these users would not otherwise have access to information about the separate operating areas of a diversified company, this standard required such disclosure. Most groups of external users would be interested in how much of the business is concentrated in one segment, and thus subject to market fluctuations.

**MULTI-CONCEPT PROBLEM**
**LO 5,6****PROBLEM 1-10 PRIMARY ASSUMPTIONS MADE IN PREPARING FINANCIAL STATEMENTS**

Assumptions violated:

1. **Economic entity**—Should have separated his personal affairs from those of the business.
2. **Cost principle**—Should have recorded the new equipment at the amount paid to acquire it, not its list price.
3. **Matching principle**—Even though this principle has not yet been introduced in the first chapter, it can be pointed out that not all of the cost of the tools should be expensed in the first year. Instead, the cost of the tools and the equipment should be depreciated over their useful lives. Because no useful lives are given in the problem, depreciation is ignored in the solution that follows.

**JOE'S MACHINE REPAIR SHOP  
INCOME STATEMENT  
FOR THE MONTH ENDED JULY 31, 2016**

Repair revenue .....	\$2,900*
Rent expense.....	<u>300</u>
Net income.....	<u><u>\$2,600</u></u>

\*\$400 cash + \$2,500 on account

## PROBLEM 1-10 (Concluded)

**JOE'S MACHINE REPAIR SHOP**  
**BALANCE SHEET**  
**JULY 31, 2016**

<b>Assets</b>		<b>Liabilities and Owner's Equity</b>	
Cash .....	\$ 400		
Rent deposit.....	1,000		
Accounts receivable.....	2,500		
Tools .....	7,500		
Equipment.....	4,200	Total liabilities and	
Total assets .....	<u>\$15,600</u>	owner's equity .....	<u>\$15,600*</u>
*Owner's contributions:			
\$300 + \$1,000 + \$7,500 + \$4,200		\$13,000	
Net income		<u>2,600</u>	
Owner's equity, end of first month		<u>\$15,600</u>	

<b>ALTERNATE PROBLEMS</b>
---------------------------

**LO 4****PROBLEM 1-1A WHAT TO DO WITH A MILLION DOLLARS?**

Obviously, there is no single, correct answer to this problem. Students should start by considering their personal circumstances and preference for risk. They should also consider their liquidity requirements. From this point, it is appropriate to consider sources of information.

Students should provide specific justification for their chosen investments. The “bottom line” is that students should justify their selections using financial information from as many sources as is cost effective and relate their choices to their preference or aversion to risk.

Following are guidelines to be used:

<b>Issues</b>	<b>Options</b>		
	<b>Stock</b>	<b>Bonds</b>	<b>Bank deposit</b>
Risk	High	Medium	Low
Information needed	Market price Dividends	Market price Interest rate Maturity date	Interest rate
Information sources	Annual reports Investor news-letters Newspapers, business periodicals	Same as for the stock	Bank advertising Newspaper articles
Additional information needed	Earnings forecasts Brokerage fees	Alternative rates Brokerage fees	Penalties for early withdrawal

**LO 4****PROBLEM 1-2A USERS OF ACCOUNTING INFORMATION AND THEIR NEEDS**

Information	Manager	Stockholders	Franchisor
1.	a.	b.	a.
2.	a.	b.	a.
3.	a.	b.	b.
4.	a.	c.	b.
5.	a.	b.	b.

**LO 5****PROBLEM 1-3A BALANCE SHEET**

**VICTOR CORPORATION  
BALANCE SHEET  
END OF THE YEAR**

Assets		Liabilities and Stockholders' Equity	
Cash .....	\$ 21,800	Accounts payable .....	\$ 16,900
Accounts receivable .....	5,700	Notes payable .....	50,000
Butter and cheese inventory .....	12,100	Capital stock .....	25,000
Computerized mixers .....	25,800	Retained earnings .....	<u>26,300</u>
Office equipment .....	12,000		
Buildings .....	35,000		
Tools .....	<u>5,800</u>	Total liabilities and	
Total assets .....	<u>\$118,200</u>	stockholders' equity .....	<u>\$118,200</u>

Items not shown on a balance sheet and where they would appear:

- Delivery expense—income statement
- Salary and wage expense—income statement
- Sales revenue—income statement

## LO 5

## PROBLEM 1-4A CORRECTED BALANCE SHEET

1.

**ISLAND ENTERPRISES  
BALANCE SHEET  
END OF THE YEAR**

Assets		Liabilities and Stockholders' Equity	
Cash .....	\$ 14,750	Accounts payable .....	\$ 29,600
Accounts receivable .....	23,200	Capital stock .....	100,000
Supplies .....	12,200	Retained earnings .....	<u>97,850*</u>
Building and equipment .....	<u>177,300</u>	Total liabilities and stockholders' equity .....	<u>\$227,450</u>
Total assets .....	<u>\$227,450</u>		

\*\$113,850 – \$16,000

2. Memorandum to the company president:

TO: Company president  
 FROM: Student's name  
 DATE: Beginning of following year  
 SUBJECT: Corrected balance sheet

Attached please find the original balance sheet your assistant prepared, along with a corrected version of that same statement. The differences can be explained as follows:

1. The balance sheet is always as of a certain date, in this case, the end of the current year rather than a period of time, such as a year.
2. Accounts payable should be classified as a liability.
3. Cash dividends paid do not belong on the balance sheet; this amount should appear instead on the statement of retained earnings for the year.
4. Accounts receivable should be classified as an asset.
5. Net income for the year does not belong on the balance sheet; this amount should appear instead on the statement of retained earnings for the year.
6. Supplies should be classified as an asset.
7. Retained earnings should appear with capital stock as a component of stockholders' equity on the balance sheet. Since this is the first year of operations, the Retained Earnings balance comprises the net income for the year less the cash dividends paid.
8. Totals were added as necessary to provide summary information.

**LO 5****PROBLEM 1-5A INCOME STATEMENT, STATEMENT OF RETAINED EARNINGS,  
AND BALANCE SHEET**

**1. STERNS AUDIO BOOK RENTAL CORP.  
INCOME STATEMENT  
FOR THE YEAR ENDED DECEMBER 31, 2016**

Rental revenue .....		\$125,900
Expenses:		
Advertising expense .....	\$14,500	
Rent expense .....	60,000	
Salaries and wages expense .....	17,900	
Water, gas, and electricity .....	<u>3,600</u>	
Total expenses .....		<u>96,000</u>
Net income .....		<u>\$ 29,900</u>

**2. STERNS AUDIO BOOK RENTAL CORP.  
STATEMENT OF RETAINED EARNINGS  
FOR THE YEAR ENDED DECEMBER 31, 2016**

Retained earnings, beginning of year .....	\$ 35,390
Net income for the year .....	29,900
Dividends for the year .....	<u>(12,000)</u>
Retained earnings, end of year .....	<u>\$ 53,290</u>

**3. STERNS AUDIO BOOK RENTAL CORP.  
BALANCE SHEET  
DECEMBER 31, 2016**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$ 2,490	Accounts payable .....	\$ 4,500
Accounts receivable .....	300	Notes payable .....	10,000
Supplies inventory .....	70,000	Capital stock .....	50,000
Display fixtures .....	<u>45,000</u>	Retained earnings .....	<u>53,290*</u>
		Total liabilities and	
Total assets .....	<u>\$117,790</u>	stockholders' equity .....	<u>\$117,790</u>

\*From (2) above. Note that retained earnings at December 31, 2016, is not \$35,390 as shown in the list of accounts in the text. This was the amount of retained earnings at the beginning of the year.

**PROBLEM 1-5A (Concluded)**

4. On the basis of these statements alone, Sterns would appear to be a good candidate for an investment. It is operating at a profit and is paying dividends. It is controlling its costs and has a profit margin (net income divided by rental revenue) of nearly 24%. Before one makes an investment in Sterns stock, it would be useful to see the statement of cash flows. Information about the current market price of the stock, the competitors, the general outlook for the industry, the age of the various long-term assets, and the due date of the note payable would also be useful before one makes an investment. The financial statements of earlier periods would be helpful for purposes of making comparisons.

**LO 5****PROBLEM 1-6A INCOME STATEMENT AND BALANCE SHEET**

1. **FORT WORTH CORPORATION**  
**INCOME STATEMENT**  
**FOR THE MONTH ENDED JANUARY 31, 2016**

Cleaning revenue .....		\$45,900
Expenses:		
Rent expense .....	\$3,600	
Salary and wage expense .....	<u>8,400</u>	
Total expenses .....		<u>12,000</u>
Net income .....		<u>\$33,900</u>

2. **FORT WORTH CORPORATION**  
**BALANCE SHEET**  
**JANUARY 31, 2016**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$ 51,650	Notes payable .....	\$ 30,000
Accounts receivable .....	24,750	Capital stock .....	80,000
Equipment .....	<u>62,000</u>	Retained earnings .....	<u>28,400*</u>
		Total liabilities and	
Total assets .....	<u>\$138,400</u>	stockholders' equity .....	<u>\$138,400</u>

\*Beginning retained earnings\*\* + net income – dividends:

\$0\*\* + \$33,900 – \$5,500

\*\*Since it is a new corporation, the beginning retained earnings is \$0.

3. To fully assess Fort Worth's long-term viability, you would need the following information about the \$30,000 note payable:
- When is it due?
  - What is the interest rate?
  - Is interest paid periodically or only at maturity?
  - Have any assets been offered as collateral for the loan?

**LO 5****PROBLEM 1-7A CORRECTED FINANCIAL STATEMENTS****1.**

**HEIDI'S BAKERY INC.  
INCOME STATEMENT  
FOR THE YEAR ENDED DECEMBER 31, 2016**

Revenues:		
Pastry cash sales .....	\$23,700	
Pastry credit sales .....	<u>22,100</u>	
Total revenues .....		\$45,800
Expenses:		
Utilities .....	\$ 9,500	
Salaries and wages .....	<u>18,200</u>	
Total expenses .....		<u>27,700</u>
Net income .....		<u>\$18,100</u>

**2.**

**HEIDI'S BAKERY INC.  
STATEMENT OF RETAINED EARNINGS  
FOR THE YEAR ENDED DECEMBER 31, 2016**

Retained earnings, beginning of year .....	\$39,900
Net income for the year .....	18,100
Dividends for the year .....	<u>(5,600)</u>
Retained earnings, end of year .....	<u>\$52,400</u>

**3.**

**HEIDI'S BAKERY INC.  
BALANCE SHEET  
DECEMBER 31, 2016**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$ 3,700	Accounts payable .....	\$ 6,800
Accounts receivable .....	15,500	Notes payable .....	40,000
Building and equipment .....	60,000	Capital stock .....	30,000
Land .....	<u>50,000</u>	Retained earnings .....	<u>52,400*</u>
		Total liabilities and	
Total assets .....	<u>\$129,200</u>	stockholders' equity .....	<u>\$129,200</u>

\*From (2) above. Note that retained earnings at December 31, 2016, is not \$39,900 as given in the text. This was the amount of retained earnings at the beginning of the year.

**PROBLEM 1-7A (Concluded)****4. Memorandum to the company president:**

TO: Company president  
 FROM: Student's name  
 DATE: January 1, 2017  
 SUBJECT: Corrected income statement

Attached please find the original income statement you prepared, along with a corrected version of that same statement. Fortunately, your disappointment with the 2016 net income is not warranted, as you will see from my revised statement. The difference between the net loss on the original income statement of \$900 and the revised net income of \$18,100, or \$19,000, can be explained as follows:

1. Accounts receivable of \$15,500 does not belong on the income statement; instead, services provided on account of \$22,100 should be shown on the income statement; the difference is \$6,600.
2. Dividends are not an expense and thus they do not belong on the income statement: \$5,600.
3. Accounts payable is a liability and appears on the balance sheet: \$6,800.

These corrections result in increased income of \$19,000. Also, note that notes payable should be reported on the balance sheet as a liability, not as an offset to building and equipment. Please let me know if I can be of any further assistance in interpreting the results of our operations for 2016.

**LO 5****PROBLEM 1-8A STATEMENT OF RETAINED EARNINGS FOR BRUNSWICK CORPORATION****1.**

**BRUNSWICK CORPORATION**  
**STATEMENT OF RETAINED EARNINGS**  
**FOR THE YEAR ENDED DECEMBER 31, 2013**  
 (amounts in millions)

Retained earnings, beginning of year .....	\$ 503.2
Net income for the year .....	769.2
Dividends for the year .....	(9.1)
Retained earnings, end of year .....	<u>\$1,263.3</u>

2. The statement of shareholders' (stockholders') equity would include all changes in shareholders' equity such as issuances and retirements of stock in addition to the information normally provided in a retained earnings statement.

**LO 4****PROBLEM 1-9A INFORMATION NEEDS AND SETTING ACCOUNTING STANDARDS**

The Financial Accounting Standards Board would have been targeting external users with this standard. Because these users would not otherwise have access to information about the separate operating areas of a diversified company, this standard required such disclosure. Most groups of external users would be interested in how much of the business is concentrated in one segment, and thus subject to market fluctuations.

**ALTERNATE MULTI-CONCEPT PROBLEM**
**LO 5,6****PROBLEM 1-10A PRIMARY ASSUMPTIONS MADE IN PREPARING FINANCIAL STATEMENTS**

Assumptions violated:

1. **Economic entity**—Should have separated her personal affairs from those of the business.
2. **Cost principle**—Should have recorded the molds and paint for \$7,500 by increasing assets and owner's equity.
3. **Matching principle**—Even though this principle has not yet been introduced in the first chapter, it can be pointed out that a portion of the cost of the long-term assets should be recognized as depreciation expense. Because no useful lives are given in the problem, depreciation is ignored in the solution that follows. It can also be pointed out that the owner violated the revenue recognition principle by recognizing the entire \$1,400 of revenue when only one-half of the total received had been earned at the end of the first month.

## PROBLEM 1-10A (Concluded)

**MILLIE'S CERAMIC STUDIO  
INCOME STATEMENT  
FOR THE MONTH ENDED JULY 31, 2016**

Revenues:		
Classes.....	\$ 700	
Greenware sales .....	<u>3,000</u>	
Total revenues .....		\$3,700
Expenses:		
Rent.....	\$ 300	
Supplies.....	600*	
Cost of greenware .....	<u>1,000</u>	
Total expenses .....		<u>1,900</u>
Net income.....		<u>\$1,800</u>

\*Assumes the owner brought \$600 of supplies from home and used all of them during the month of July.

**MILLIE'S CERAMIC STUDIO  
BALANCE SHEET  
JULY 31, 2016**

<b>Assets</b>		<b>Liabilities and Owner's Equity</b>	
Cash .....	\$ 4,400	Unearned revenue .....	\$ 700
Deposit.....	1,000	Owner's equity .....	<u>16,600**</u>
Molds and paint.....	6,900*		
Kiln.....	<u>5,000</u>	Total liabilities and	
Total assets .....	<u>\$17,300</u>	owner's equity .....	<u>\$17,300</u>

\*Assumes that the \$600 of supplies used during the month were part of the \$7,500 of molds and paint brought from home.

**Owner's contributions:	
\$300 + \$1,000 + \$7,500 + \$5,000 + \$1,000	\$14,800
Net income	<u>1,800</u>
Owner's equity, end of first month	<u>\$16,600</u>

## DECISION CASES

### READING AND INTERPRETING FINANCIAL STATEMENTS

#### LO 4,5

#### DECISION CASE 1-1 AN ANNUAL REPORT AS READY REFERENCE

1. Earnings per share is reported at the bottom of the consolidated statement of income and comprehensive income. Information about any dividends paid to stockholders would appear on the consolidated statement of cash flows. The amount reinvested in the company is equal to net income less dividends and would appear on the consolidated statement of shareholders' equity. Note that Chipotle did not pay any dividends in 2014.
2. The historical financial statements can provide some information that would be useful in predicting future earnings. It is impossible for anyone, though, to know exactly what earnings in the future will be.
3. Information about the company's current liquid assets, such as cash and accounts receivable, can be found on the consolidated balance sheet. The balance sheet will also provide bankers and other creditors with information about existing debts of the company. The statement of cash flows is also useful in learning about a company's operating, financing, and investing activities over the past year.
4. The amount of current taxes owed by Chipotle at the end of the year is reported on its consolidated balance sheet as a current liability, most likely as part of "Accrued liabilities."
5. Information about a company's long-term debt can be found on the balance sheet and in notes to the consolidated financial statements. Note that Chipotle does not report separately any long-term debt on its balance sheet and any amount they do have would likely be included in "other liabilities."

#### LO 5

#### DECISION CASE 1-2 READING AND INTERPRETING CHIPOTLE'S FINANCIAL STATEMENTS

1. 2014 Net income: \$445,374,000
2.
 

<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Stockholders' Equity</b>
\$2,546,285,000	=	\$533,916,000	+	\$2,012,369,000
3. Leasehold improvements, property and equipment, net increased during 2014 by \$1,106,984,000 – \$963,238,000, or \$143,746,000. Acquisitions would increase the amount of this long-term asset from the beginning to the end of the year.

**LO 5****DECISION CASE 1-3 COMPARING TWO COMPANIES IN THE SAME INDUSTRY:  
CHIPOTLE AND PANERA BREAD**

1. Chipotle reported total revenues for 2014 of \$4,108,269,000. This amount represented an increase of 27.8% from the prior year. Panera Bread reported total revenues for 2014 of \$2,529,195,000, which represented an increase of 6.0% from the prior year.
2. Chipotle reported net income for 2014 of \$445,374,000, an increase of 36.0% from the prior year. Panera Bread reported net income for 2014 of \$179,293,000, which was a decrease of 8.6% from the prior year's amount.
3. Chipotle's total assets on December 31, 2014 amounted to \$2,546,285,000. Leasehold improvements, property and equipment, net was the largest asset category on the company's balance sheet. Panera Bread reported total assets on December 30, 2014, of \$1,390,902,000, and the largest of its assets was its Property and equipment, net.
4. Neither company paid dividends during the year. The statement of cash flows reports any dividends paid during the year.

**MAKING FINANCIAL DECISIONS****LO 4****DECISION CASE 1-4 AN INVESTMENT OPPORTUNITY**

All investments require a trade-off between risk and return. A college education may have intrinsic value, but it is risky in that it does not assure anyone of a job upon graduation. However, the return may be worth the risk involved in committing one's life savings to a college education if the degree allows one the opportunity to make a start on a career. Certainly, the offer to commit your savings to your high school friend's art gallery involves a significant amount of risk. The friend's prediction that you will be able to sell the artwork for ten times the cost of your investment is subject to considerable uncertainty. Both investments, in a college education and in an art gallery, require an assessment of the risks and returns.

The profit split between you and your friend if you decide to open the art gallery is a matter of negotiation. You will certainly want a significant share of the profits for the risk you are taking in investing your savings. However, other factors must be considered as well, such as the amount of time each of you will spend in running the business.

**LO 5****DECISION CASE 1-5 PREPARATION OF PROJECTED STATEMENTS FOR A NEW BUSINESS**

**1. REMOTE FITNESS WORLD INC.  
PROJECTED INCOME STATEMENT  
FOR THE FIRST MONTH**

Revenues:		
Fitness classes ( $\$10 \times 240$ ).....	\$2,400	
Monthly memberships ( $\$50 \times 100$ ).....	<u>5,000</u>	\$7,400
Expenses:		
Wages ( $\$20$ per hour $\times 15$ hours $\times 4$ weeks) .....	\$1,200	
Rent.....	<u>1,000</u>	<u>2,200</u>
Net income.....		<u><u>\$5,200</u></u>

**2. REMOTE FITNESS WORLD INC.  
PROJECTED BALANCE SHEET  
END OF FIRST MONTH**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$ 200*	Notes payable.....	\$10,000
Accounts receivable.....	5,000	Capital stock.....	10,000
Exercise equipment .....	<u>20,000</u>	Retained earnings .....	<u>5,200</u>
		Total liabilities and	
Total assets .....	<u><u>\$25,200</u></u>	stockholders' equity.....	<u><u>\$25,200</u></u>

\* $\$10,000 + \$10,000 - \$20,000 + 240(\$10) - \$1,200 - \$1,000$

3. On the surface, the decision to invest in the business appears to be an easy one. With net income of \$5,200 per month, it seems as if the \$10,000 loan from the bank could be repaid in two months (of course, interest would have to be paid also). However, net income is not always the same as cash flow from operations. In this case, the ability to generate \$5,200 in cash flow each month depends on whether the \$5,000 in monthly memberships can be collected each month (the assumption is that the first month's memberships will not be collected until the second month). A second concern is whether the company will be able to attain and then sustain the projected revenue forecasts of 240 classes per month and 100 monthly memberships. Will the demand for classes and memberships increase, decrease, or stay relatively stable in the future? For example, it is likely demand will decrease during the summer months when members would rather spend time outside. A third issue concerns the useful life of the exercise equipment. A sizable investment of \$20,000 has been made in the equipment. The useful life of the equipment will be affected not only by wear and tear but also on the members' demands for newer, improved versions of the equipment. Also, will the company be able to rent space in the area for \$1,000 per month in the future? What is the possibility that the rent will be increased? Finally, is it likely that someone else will open an exercise facility in the area? What effect would this have on revenues?

## ETHICAL DECISION MAKING

LO 4,5,8

## DECISION CASE 1-6 IDENTIFICATION OF ERRORS IN FINANCIAL STATEMENTS AND PREPARATION OF REVISED STATEMENTS

## 1. Recognize an ethical dilemma:

Errors made in preparing the financial statements:

- a. The recognition of the 2017 season ticket sales as revenue in 2016. Because Lakeside has not provided these fans with any service yet (the games), the sale of the 2017 season tickets does not result in revenue in 2016.
- b. The recognition of \$100,000 in advertising revenue. The contract with the advertisers required Lakeside to average 2,000 fans per game. Because it averaged only 1,500, the revenue should not be recorded.
- c. The treatment of the player contracts. The \$5,000 paid to the parent club for each of the 25 players on the roster is an expense, not an asset. Also, the amount owed to the parent club is not an element of stockholders' equity but instead is a liability, since this amount is due by February 1, 2017.
- d. The recognition of the value of the controller's personal residence as an asset. Under the economic entity assumption, the personal affairs of the owner of a business should not be intermingled with those of the company. The controller's personal residence is not an asset of the business.

Revised financial statements:

**LAKESIDE SLAMMERS INC.**  
**INCOME STATEMENT**  
**FOR THE YEAR ENDED DECEMBER 31, 2016**

<b>Revenues:</b>		
Single-game ticket revenue .....	\$420,000	
Concessions revenue .....	<u>280,000</u>	
Total revenues .....		\$ 700,000
<b>Expenses:</b>		
Cost of concessions sold .....	\$110,000	
Player contracts .....	125,000	
Salary expense—players .....	225,000	
Salary and wage expense—staff .....	150,000	
Rent expense .....	<u>210,000</u>	
Total expenses .....		<u>820,000</u>
Net loss .....		<u><u>\$(120,000)</u></u>

## DECISION CASE 1-6 (Continued)

**LAKESIDE SLAMMERS INC.**  
**STATEMENT OF RETAINED EARNINGS**  
**FOR THE YEAR ENDED DECEMBER 31, 2016**

Retained earnings, beginning of year .....	\$ 0
Net loss for the year .....	(120,000)
Dividends for the year .....	(40,000)
Retained earnings, end of year .....	<u>\$(160,000)</u>

**LAKESIDE SLAMMERS INC.**  
**BALANCE SHEET**  
**DECEMBER 31, 2016**

<b>Assets</b>		<b>Liabilities and Stockholders' Equity</b>	
Cash .....	\$ 5,000	Notes payable .....	\$ 50,000
Equipment .....	<u>50,000</u>	Due to parent club .....	125,000
		Capital stock .....	40,000
		Retained earnings (deficit) .....	<u>(160,000)</u>
		Total liabilities and	
Total assets .....	<u>\$55,000</u>	stockholders' equity .....	<u>\$ 55,000</u>

Both net income and total assets have been grossly overstated. As one of the investors, the ethical dilemma you now face is whether to share the revised statements with the other owners as well as the bank.

**2. Analyze the key elements in the situation:**

- a. The owners of the company may benefit in the short term, because the bank may be more likely to give them a loan based on the original financial statements. All outsiders are harmed, because the financial information they receive does not represent the economic activity of the firm.
- b. The owners of the company will benefit because outsiders will evaluate the company more favorably based on the original financial statements than the revised statements (e.g., bankers will offer loans at lower interest rates, grant loans with longer terms). The bankers will be harmed if they are not aware of the correct financial statement numbers, because they will assess the risk of the firm based on the incorrect numbers and will use a lower interest rate on the debt than they would if the risk more accurately reflected the future cash flow. Those who currently own shares of stock may not make the correct decisions about holding the stock and potential stockholders may make the wrong decision about purchasing the stock.

**DECISION CASE 1-6 (Concluded)**

- c. The company may lack the resources to pay the claims of the creditors (the notes payable and the liability to the parent club). The dividend payment probably violated the corporate charter for the company (most companies would not be permitted to pay dividends without positive stockholders' equity).
- d. The interests of the shareholders are in conflict with the interests of the creditors of the company. The shareholders appear to want to withdraw cash from the company. The creditors would prefer that the company keep its cash to pay debts.
- e. As one of the owners/managers of the company, it is your responsibility to make sure that the company follows the accounting rules. Company management is responsible for the accuracy of the financial statements.

**3. List alternatives and evaluate the impact of each on those affected:**

As one of the investors, your options are to either ignore the errors made in preparing the financial statements or call them to the attention of your fellow owners.

The information in the original set of financial statements is not relevant: the revenue numbers are not useful for predicting future revenue numbers, since they include both earned and unearned revenue. The information regarding season ticket revenue does not provide reliable information to the outsider. Reliable information represents what it claims to represent. The \$140,000 recognized by the initial preparer of the financial statements is actually revenue for the following year. It should not be recognized as revenue in the current year.

The \$100,000 of advertising revenue that was recognized on the initial income statement does not represent the economic reality of the transaction. Revenue must be collectible to be recognized. Since the company knows that the revenue is not likely to be collected, it should not be recognized. (The economic reality of this transaction must reflect the future cash flows.)

The original statements are not complete because they fail to take into account all the facts known at the time they are prepared. These statements are not neutral and are clearly presented in a way that is biased toward the owners. Also, as has been shown in (a) above, the original statements are not free from error. The season-ticket and advertising revenue are overstated, expenses are understated, assets are overstated, and stockholders' equity is overstated. Alternatively, the revised statements are relevant, complete, neutral, and free from error.

**4. Select the best alternative:**

Because you are aware of these errors, it is your responsibility to share the revisions with the other owners as well as the bank. It appears that a deliberate attempt has been made to overstate the assets and income of the business for the express purpose of obtaining an extension of the loan. Both the other owners and the banker rely on the statements in making decisions, and it is your responsibility to inform them of any major deficiencies in the statements.

**LO 8****DECISION CASE 1-7 RESPONSIBILITY FOR FINANCIAL STATEMENTS AND THE ROLE OF THE AUDITOR**

1. Preparation of the financial statements in a company's annual report is the responsibility of that company.
2. The financial statements are audited by an independent public accounting firm.
3. Independence is critical to the integrity of the audit of a company's financial statements. A company's financial statements are relied on by stockholders, bankers, analysts, and others when they make various decisions. The certified public accountant has a responsibility to these various users to ensure that management is fairly presenting the information in the financial statements. The users must feel assured that the statements have been audited by someone who is independent of those who actually prepared the statements.