# CHAPTER 1

# Accounting as a Form of Communication

### OVERVIEW OF EXERCISES, PROBLEMS, AND CASES

Estimated

Time in

Learning Outcomes Exercises Minutes Level

**1.** Explain what business is about.

**2.** Distinguish among the forms of organization.

**3.** Describe the various types of business activities. 1 5 Mod

**4.** Define accounting and identify the primary users of accounting 2 5 Easy

information and their needs. 15\* 10 Mod

**5.** Explain the purpose of each of the financial statements 3 15 Mod

and the relationships among them and prepare a set of 4 10 Mod

simple statements. 5 10 Mod

6 15 Easy

7 10 Easy

8 20 Diff

9 15 Mod

10 10 Mod

11 10 Mod

14 15 Mod

15\* 10 Mod

16\* 10 Mod

**6.** Identify and explain the primary assumptions made in 12 10 Mod

preparing financial statements. 16\* 10 Mod

**7.** Identify the various groups involved in setting accounting standards 13 10 Mod

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)

Problems Estimated

and Time in

Learning Outcomes Alternates Minutes Level

**1.** Explain what business is about.

**2.** Distinguish among the forms of organization.

**3.** Describe the various types of business activities.

**4.** Define accounting and identify the primary users of accounting 1 30 Mod

information and their needs. 2 20 Mod

9 20 Mod

**5.** Explain the purpose of each of the financial statements 3 30 Easy

and the relationships among them and prepare a set of 4 30 Easy

simple statements. 5 60 Mod

6 45 Mod

7 60 Diff

8 25 Mod

10\* 45 Diff

**6.** Identify and explain the primary assumptions made in 10\* 45 Diff

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.

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

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

Estimated

Time in

Learning Outcomes Cases Minutes Level

**1.** Explain what business is about.

**2.** Distinguish among the forms of organization.

**3.** Describe the various types of business activities.

**4.** Define accounting and identify the primary users of accounting 1\* 25 Mod

information and their needs. 4 30 Mod

6\* 75 Diff

**5.** Explain the purpose of each of the financial statements 1\* 25 Mod

and the relationships among them and prepare a set of 2 20 Mod

simple statements. 3 30 Mod

5 60 Diff

6\* 75 Diff

**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 6\* 75 Diff

financial information. 7 20 Mod

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

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

questions

**1.** Business is concerned with all the activities necessary to provide the members of an economic system with goods and services. Some businesses are organized to earn a profit, whereas others are organized for some other purpose. Regardless, all businesses are organized to provide goods and/or services to their customers.

**2.** An asset is a future economic benefit to a business. Cash, accounts receivable, merchandise inventories, and property and equipment are all examples of assets. They are located on the left side of the accounting equation.

**3.** A liability is an obligation of a business. Assets and liabilities are related in that most liabilities are satisfied by using assets, most often in the form of cash. They are located on the right side of the equation along with owners’ equity.

**4.** The three forms of business entities are sole proprietorships, partnerships, and corporations.

**5.** The types of activities in which companies engage are financing, investing, and operating. To start a new business, such as renting bicycles and skis, requires initial financing, such as initial contributions by the owners and loans by a bank. Next, the business would need to invest in the assets it will rent—that is, bicycles and skis. Once investments in assets are made, the business would earn revenue by renting out bicycles and skis. The business would also incur various operating expenses, such as wages, advertising, and taxes.

**6.** Accounting is a communication process. Its purpose is to provide economic information about an organization that will be useful to those who need to make decisions regarding that entity. For example, information provided by an accountant about an entity is useful to a banker in reaching a decision about whether to loan money to a business.

**7.** Financial accounting and management accounting differ with regard to the users of the information provided by the two branches of the discipline. Management   
accounting is the branch of accounting that provides management with information to facilitate the planning and control functions. The information provided by a management accounting system can be tailored to meet the needs of managers.   
Alternatively, financial accounting is concerned with the preparation of general-purpose financial statements for use by both management and outsiders. Because the information provided by financial accounting must meet the needs of many   
different groups, it is necessary to rely on a set of generally accepted accounting principles in preparing the financial statements.

**8.** Many different groups rely on accounting information in making decisions. For   
example, *investors* and *potential* *investors* rely on financial statements and related disclosures in deciding whether to sell or buy stock in a company. This group is particularly concerned with the recent profitability of the company as shown on the   
income statement. *Bankers* and *other* *creditors* need information to decide whether to loan money to a company or whether to extend an existing loan. Many different *government* *agencies* have information needs that are specified by law. The Internal Revenue Service needs to know about a company’s profitability in levying taxes on it. The Securities and Exchange Commission, the Interstate Commerce Commission, and the Federal Trade Commission also depend on the information provided by accountants in making decisions. *Labor* *unions* need information about a company’s profitability and financial position in negotiating contracts with the company for the employees. *Trade associations* rely on the information provided in financial statements in compiling information for use by their members.

**9.** Stockholders’ equity or owners’ equity is the difference between the assets of an entity and its liabilities. Thus, it represents the claims of the owners to the assets of the business. Therefore, it includes the contributions of the owners (e.g., capital stock) and retained earnings.

**10.** The two distinct elements of owners’ equity in a corporation are contributed capital and retained earnings. Contributed capital, as represented by capital stock, is the original contribution to the company by the owners. Retained earnings represents the claims of the owners to the assets of the business. These claims result from the earnings of the company that have not been paid out in dividends.

**11.** The purpose of a balance sheet is to show the financial position of an entity as of a particular point in time. It consists of three distinct elements: assets, liabilities, and owners’ equity.

**12.** A balance sheet should be dated as of a particular day. It is a statement of financial position and shows the assets, liabilities, and owners’ equity of a business at a particular point in time. Unlike an income statement, it is not a flow statement and therefore is not dated for a particular period of time. Balance sheets are typically prepared to coincide with the end of an accounting period, such as the end of the month or the end of the year.

**13.** The cost principle is an accounting requirement to record an asset at the cost to acquire it and report it on subsequent balance sheets at this amount.

**14.** The purpose of an income statement is to summarize the revenues and expenses of a company for a period of time. It is an indicator of the profitability of an entity.

**15.** An income statement should be dated for a particular period of time: for example, for the month of June or for the year ended December 31, 2012. The income statement is a flow statement because it summarizes revenues and expenses for a period of time. Unlike a balance sheet, it is not an indication of position at any one particular point in time.

**16.** If Rogers has $55,000 in Retained Earnings to begin the year and net income for the year of $27,000, the ending balance in Retained Earnings would be $82,000 if no dividends were paid during the year. Because the ending balance in Retained Earnings is $70,000, the company must have paid $12,000 in dividends.

**17.** Various groups are involved in determining the rules companies must follow in preparing their financial statements. In the United States, the Securities and Exchange Commission (SEC) has ultimate authority for companies whose securities are sold to the general public. However, the SEC has relegated much of the standard setting to the private sector in the form of the Financial Accounting Standards Board (FASB). A recent development by the SEC is an indication that standard setters in the United States continue to work closely with those in the international community. For instance, in the past, foreign companies that filed their financial statements with the SEC were required to adjust those statements to conform to U.S. accounting standards. With this recent SEC development, as long as foreign companies follow the standards of the IASB, they are no longer required to make these adjustments. However, there are significant differences between U.S. and international standards; it may be some time before all differences are eliminated.

**18.** In 2002, Congress passed the Sarbanes-Oxley Act. The act was a direct response to corporate scandals and was an attempt to bring about major reforms in corporate accountability and stewardship, given the vast numbers of stockholders, creditors, employees, and others affected in one way or another by these scandals. Among the most important provisions in the act are the following: (1) the establishment of a new Public Company Accounting Oversight Board, (2) a requirement that the external auditors report directly to the company’s audit committee, and (3) a clause to prohibit public accounting firms who audit a company from providing any other services that could impair their ability to act independently in the course of their audit.

**19.** The auditors may be in an excellent position to evaluate a company, but not   
because they have prepared the financial statements. The preparation of the statements is the responsibility of management. The role of the auditor is to perform   
various tests and procedures as a basis for rendering an opinion on the fairness of the presentation of the statements.

**20.** We assume in the absence of evidence to the contrary that a business will continue indefinitely. This assumption, known as the going concern assumption, helps to justify the use of historical costs in the statements. For example, if we knew that a company was in the process of liquidation, it would not be appropriate to use historical costs in assigning an amount to such assets as land and buildings. Instead, the   
current or market values of the assets would be more meaningful to a user of the balance sheet. Because the normal assumption is that a business will continue   
indefinitely, the objectivity of historical cost makes it more attractive as a basis for valuation.

**21.** Inflation, as evidenced by the changing value of the dollar, poses a problem for the accountant. Accountants make the assumption in preparing a set of financial statements that the dollar is a stable measuring unit. This assumption, called the monetary unit assumption, may or may not be accurate, depending on the level of inflation in the economy. The higher the rate of inflation, the less reliable is the dollar as a measuring unit.

**22.** Any profession must have a set of standards that govern the practice of the profession. In accounting, generally accepted accounting principles, or GAAP, are those methods, rules, practices, and other procedures that have evolved over time and that govern the preparation of financial statements. Two important points are worth noting about GAAP. First, these principles are not static but rather change in response to changes in the ways companies conduct business. Second, there is not a single, identifiable source of GAAP. Both the private and public sectors have contributed to the development of generally accepted accounting principles.

**23.** Although the Securities and Exchange Commission has the ultimate authority to determine the rules in preparing financial statements, it has to a large extent allowed the accounting profession, through the Financial Accounting Standards Board, to establish its own rules. The SEC has at times taken an active role in the setting of accounting standards. It has stepped in when it has believed that the profession has not acted quickly enough or in the correct manner. Since its inception in 1934, the commission has been more involved in the enforcement of GAAP as a means of protecting the rights of investors than it has been in setting standards.

BRIEF exercises

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| LO 1 |  | **BRIEF EXERCISE 1-1 TYPES OF BUSINESSES** |

Students will provide a number of different examples of real companies that are manufacturers, retailers, and service providers.

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| LO 2 |  | **BRIEF EXERCISE 1-2 FORMS OF ORGANIZATION** |

When you own a share of stock in a corporation, you are part owner of that business. In contrast, if you own one of the corporation’s bonds, you have made a loan to the company and you are one of its creditors.

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| LO 3 |  | **BRIEF EXERCISE 1-3 BUSINESS ACTIVITIES** |

The first activity for a new business is to secure financing. Next, investing activities are needed to secure the necessary assets to then begin operating the business. The order of the activities is financing, investing, and operating.

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| LO 4 |  | **BRIEF EXERCISE 1-4 USERS OF ACCOUNTING INFORMATION** |

Stockholders, creditors (including banks, bondholders, and suppliers), and government agencies are all examples of external users.

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| LO 5 |  | **BRIEF EXERCISE 1-5 THE ACCOUNTING EQUATION AND THE BALANCE SHEET** |

Assets = Liabilities + Stockholders’ Equity. The two parts that make up stockholders’ equity are capital stock and retained earnings.

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| LO 6 |  | **BRIEF EXERCISE 1-6 MONETARY UNIT** |

The dollar is the monetary unit used in the United States, and the yen is used in Japan.

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| LO 7 |  | **BRIEF EXERCISE 1-7 THE ROLE OF AUDITORS** |

The external auditors do not prepare the financial statements. Management of the company is responsible for preparation of the statements. The auditors provide an opinion as to the fairness of the financial statements.

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| LO 8 |  | **BRIEF EXERCISE 1-8 MAKING ETHICAL DECISIONS** |

The four steps in the model presented in the chapter to help in making ethical decisions are:

**1.** Recognize an ethical dilemma.

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

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

**4.** Select the best alternative.

exercises

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| LO 3 |  | **EXERCISE 1-1 TYPES OF BUSINESS ACTIVITIES** |

**F 1.** Issued shares of stock to each of the four owners.

**I 2.** Purchased two limousines.

**O 3.** Paid first month’s rent for use of garage.

**F 4.** Obtained loan from local bank.

**O 5.** Received cash from customer for trip to the airport.

**O 6.** Paid driver first week’s wages.

**I 7.** Purchased 500-gallon fuel tank.

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| 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

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

**A = L + SE**

**Case 1:** $125,000 = $75,000 + SE

SE = $50,000

**A = L + SE**

**Case 2:** $400,000 = L + $100,000

L = $300,000

**A = L + SE**

**Case 3:** A = $320,000 + $95,000

A = $415,000

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

**1. A = L + SE**

$500,000 = $250,000 + SE

SE = $250,000

**2. A = L + SE**

($500,000 + $100,000) = ($250,000 + $77,000) + SE

SE = $273,000\*

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

**3. A = L + SE**

A = ($250,000 + $33,000) + ($250,000\* – $58,000)

A = $283,000 + $192,000

$475,000

\*From (1) above

**4. A = L + SE**

$1,000,000 = L + $250,000\*

L = $750,000

\*From (1) above

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

**1. A = L + SE**

Beginning of year $100,000 = $80,000 + $20,000

+ Net income + 25,000

– Dividends – 0

Stockholders’ equity at end of year $45,000

**2. A = L + SE**

End of year (EOY) $60,000\* = $40,000 + $20,000

Reduce by half to beginning

of year: divided by 2

Assets, beginning of year $30,000

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

**3. A = L + SE**

Beginning of year (BOY) $30,000 = $20,000\* + $10,000

Triples during year × 3

Liabilities, end of year $60,000

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

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| 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.

**A = L + SE**

**2010:** $25,000 = $12,000 + SE

SE = $13,000

**A = L + SE**

**2011:** $79,000 = $67,000 + SE

SE = $12,000

**A = L + SE**

**2012:** $184,000 = $137,000 + SE

SE = $47,000

**Change in stockholders’ equity during 2011:**

$12,000 – $13,000 = ($1,000)

**Change in stockholders’ equity during 2012:**

$47,000 – $12,000 = $35,000

**2. 2011:**

($1,000) = Income – $0 in dividends

Net loss = ($1,000)

**3. 2012:**

$35,000 = Income – $10,000 in dividends

Net income = $45,000\*

Beginning of the year OE $12,000

+ Contributed capital 0

– Dividends 10,000

+ NI x = ? It has to be $45,000 ($12,000 –

$10,000 + $45,000 = $47,000)

= End of year OE $47,000

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

(In thousands of dollars)

**A = L + CS + (Beg. RE + Income – Div.)**

**Case 1:**

40 = L + 10 + (15 + 8 – 2)

Liabilities = 9

**Case 2:**

A = 15 + 5 + (8 + 7 – 1)

Assets = 34

**Case 3:**

75 = 25 + 20 + (10 + Income\* – 3)

Income = 23\*

75 – 52 = 23\*

**Case 4:**

50 = 10 + 15 + (20 + 9 – Div\*.)

Dividends = 4\*

50 = 54 – 4\*

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

**Appears on the Classified as**

**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

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

**Item Appears on the Classified as**

**1.** Trade and other receivables, net BS A

**2.** Common stock of Carnival Corporation BS SE

**3.** Short-term borrowings BS L

**4.** Passenger tickets IS R

**5.** Selling and administrative IS E

**6.** Property and equipment, net BS A

**7.** Accounts payable BS L

**8.** Retained earnings BS SE

**9.** Income tax expense IS E

**10.** Long-term debt BS L

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| 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, Net Retained Earnings,**

**Beginning of Year + Income – Dividends = 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

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

ACE CORPORATION

STATEMENT OF RETAINED EARNINGS

FOR THE MONTH ENDED FEBRUARY 29, 2012

Retained earnings, beginning of month $229,800\*

Add: Net income 14,000\*\*

Deduct: Dividend for the month (5,000)

Retained earnings, end of month $238,800

\*$235,800 + $83,000 – $89,000

\*\*$96,000 – $82,000

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| 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

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| 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

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

Item Section

**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

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

**USER FINANCIAL STATEMENT**

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.

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| LO 5,6 |  | **EXERCISE 1-16 KELLOGG’S LAND** |

Land would be included in “Property, net” on Kellogg’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.

problems

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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:

**Options**

**Issues Stock Bonds Bank deposit**

Risk High Medium Low

Information Market price Market price Interest rate

needed Dividends Interest rate

Maturity date

Information Annual reports Same as for Bank

sources Investor news- the stock advertising

letters Newspaper

Newspapers, articles

business

periodicals

Additional Earnings Alternative Penalties for

information forecasts rates early

needed Brokerage fees Brokerage fees 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.

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

**Information Management Stockholders Banker**

**1.** a. b. a.

**2.** a. c. a.

**3.** a. c. a.

**4.** a. b. a.

**5.** a. b. b.

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

FREESCIA CORPORATION

BALANCE SHEET

DECEMBER 31, 2012

**Assets Liabilities and Stockholders’ Equity**

Cash $ 4,220 Accounts payable $ 12,550

Accounts receivable 23,920 Notes payable 50,000

Office equipment 12,000 Capital stock 25,000

Buildings 85,000 Retained earnings 37,590

Total liabilities and

Total assets $125,140 stockholders’ equity $125,140

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

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

1. AVON CONSULTING INC.

BALANCE SHEET

DECEMBER 31, 2012

**Assets Liabilities and Stockholders’ Equity**

Cash $21,000 Accounts payable $13,000

Accounts receivable 16,000 Capital stock 20,000

Supplies 9,000 Retained earnings 56,000\*

Furniture and

equipment 43,000 Total liabilities and

Total assets $89,000 stockholders’ equity $89,000

\*$72,000 – $16,000

**2.** Memorandum to the company president:

TO: Company president

FROM: Student’s name

DATE: January 1, 2013

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, December 31, 2012, 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 2012 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.

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| 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, 2012

Revenues:

Ticket sales $95,100

Concessions revenue 60,300

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 6,700

Total expenses 141,740

Net income $ 13,660

2. MAPLE PARK THEATRES CORP.

STATEMENT OF RETAINED EARNINGS

FOR THE MONTH ENDED SEPTEMBER 30, 2012

Retained earnings, beginning balance, September 1, 2012 $73,780

Add: Net income for September 13,660

Deduct: Dividends for September (8,400)

Retained earnings, ending balance, September 30, 2012 $79,040

3. MAPLE PARK THEATRES CORP.

BALANCE SHEET

SEPTEMBER 30, 2012

**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 79,040\*

Furniture and fixtures 34,000

Projection equipment 25,000 Total liabilities and

Total assets $166,640 stockholders’ equity $166,640

\*From (2) above. Note that retained earnings at September 30, 2012, 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.

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

1. GREEN BAY CORPORATION

INCOME STATEMENT

FOR THE MONTH ENDED JULY 31, 2012

Revenues:

Fishing revenue $21,300

Passenger service revenue 12,560

Total revenues $33,860

Expenses:

Rent expense $ 4,000

Salary and wage expense 18,230

Total expenses 22,230

Net income $11,630

2. GREEN BAY CORPORATION

BALANCE SHEET

JULY 31, 2012

**Assets Liabilities and Stockholders’ Equity**

Cash $ 7,730 Notes payable $ 60,000

Accounts receivable 18,500 Capital stock 40,000

Boats 80,000 Retained earnings 6,230\*

Total liabilities and

Total assets $106,230 stockholders’ equity $106,230

\*Beginning retained earnings + net income – dividends:

$0 + $11,630 – $5,400

**PROBLEM 1-6 (Concluded)**

**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?

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

1. HOMETOWN CLEANERS INC.

INCOME STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2012

Revenues:

Cleaning revenue—credit sales $26,200

Cleaning revenue—cash sales 32,500

Total revenues $58,700

Expenses:

Utilities $12,200

Salaries and wages 17,100

Total expenses 29,300

Net income $29,400

2. HOMETOWN CLEANERS INC.

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDED DECEMBER 31, 2012

Retained earnings, beginning of year $42,700\*

Add: Net income for the year 29,400

Deduct: Dividends for the year (4,000)

Retained earnings, end of year $68,100

\*Given in text.

**PROBLEM 1-7 (Concluded)**

3. HOMETOWN CLEANERS INC.

BALANCE SHEET

DECEMBER 31, 2012

**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 40,000 Retained earnings 68,100\*

Total liabilities and

Total assets $142,600 stockholders’ equity $142,600

\*From (2) above. Note that retained earnings at December 31, 2012, is not $42,700 as given in text. This was the amount of retained earnings at the beginning of the year.

**4**. Memorandum to the company president:

TO: Company president

FROM: Student’s name

DATE: January 1, 2013

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 2012 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 2012.

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| 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, 2010

(amounts in millions)

Retained earnings, beginning of year $41,537

Add: Net income for the year 11,809

Deduct: Dividends for the year (4,068)

Retained earnings, end of year $49,278

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

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| 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 problems

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| 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, 2012

Repair revenue $2,900\*

Rent expense 300

Net income $2,600

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

JOE’S MACHINE REPAIR SHOP

BALANCE SHEET

JULY 31, 2012

**Assets Liabilities and Owner’s Equity**

Cash $ 400

Rent deposit 1,000

Accounts receivable 2,500

Tools 7,500

Equipment 4,200 Total liabilities and

Total assets $15,600 owner’s equity $15,600\*

\*Owner’s contributions:

$300 + $1,000 + $7,500 + $4,200 $13,000

Add: Net income 2,600

Owner’s equity, end of first month $15,600

alternate problems

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| 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:

**Options**

**Issues Stock Bonds Bank deposit**

Risk High Medium Low

Information Market price Market price Interest rate

needed Dividends Interest rate

Maturity date

Information Annual reports Same as for Bank

sources Investor news- the stock advertising

letters Newspaper

Newspapers, articles

business

periodicals

Additional Earnings Alternative Penalties for

information forecasts rates early withdrawal

needed Brokerage fees Brokerage fees

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| 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.

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

VICTOR CORPORATION

BALANCE SHEET

JULY 31, 2012

**Assets Liabilities and Stockholders’ Equity**

Cash $ 21,800 Accounts payable $ 16,900

Accounts receivable 5,700 Notes payable 50,000

Butter and cheese Capital stock 25,000

inventory 12,100 Retained earnings 26,300

Computerized mixers 25,800

Office equipment 12,000

Buildings 35,000

Tools 5,800 Total liabilities and

Total assets $118,200 stockholders’ equity $118,200

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

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

1. ISLAND ENTERPRISES

BALANCE SHEET

DECEMBER 31, 2012

**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 97,850\*

Building and

equipment 177,300 Total liabilities and

Total assets $227,450 stockholders’ equity $227,450

\*$113,850 – $16,000

**2.** Memorandum to the company president:

TO: Company president

FROM: Student’s name

DATE: January 1, 2013

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, December 31, 2012 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 2012 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.

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| 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, 2012

Rental revenue $125,900

Expenses:

Advertising expense $14,500

Rent expense 60,000

Salaries and wages expense 17,900

Water, gas, and electricity 3,600

Total expenses 96,000

Net income $ 29,900

2. STERNS AUDIO BOOK RENTAL CORP.

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDED DECEMBER 31, 2012

Retained earnings, beginning of year $35,390

Add: Net income for the year 29,900

Deduct: Dividends for the year (12,000)

Retained earnings, end of year $53,290

3. STERNS AUDIO BOOK RENTAL CORP.

BALANCE SHEET

DECEMBER 31, 2012

**Assets Liabilities and Stockholders’ Equity**

Cash $ 2,490 Accounts payable $ 4,500

Accounts receivable 300 Notes payable 10,000

Supplies inventory 70,000 Capital stock 50,000

Display fixtures 45,000 Retained earnings 53,290\*

Total liabilities and

Total assets $117,790 stockholders’ equity $117,790

\*From (2) above. Note that retained earnings at December 31, 2012, 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.

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

1. FORT WORTH CORPORATION

INCOME STATEMENT

FOR THE MONTH ENDED JANUARY 31, 2012

Cleaning revenue $45,900

Expenses:

Rent expense $3,600

Salary and wage expense 8,400

Total expenses 12,000

Net income $33,900

2. FORT WORTH CORPORATION

BALANCE SHEET

JANUARY 31, 2012

**Assets Liabilities and Stockholders’ Equity**

Cash $ 51,650 Notes payable $ 30,000

Accounts receivable 24,750 Capital stock 80,000

Equipment 62,000 Retained earnings 28,400\*

Total liabilities and

Total assets $138,400 stockholders’ equity $138,400

\*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?

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

1. HEIDI’S BAKERY INC.

INCOME STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2012

Revenues:

Pastry cash sales $23,700

Pastry credit sales 22,100

Total revenues $45,800

Expenses:

Utilities $ 9,500

Salaries and wages 18,200

Total expenses 27,700

Net income $18,100

2. HEIDI’S BAKERY INC.

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDED DECEMBER 31, 2012

Retained earnings, beginning of year $39,900

Add: Net income for the year 18,100

Deduct: Dividends for the year 5,600

Retained earnings, end of year $52,400

3. HEIDI’S BAKERY INC.

BALANCE SHEET

DECEMBER 31, 2012

Assets Liabilities and Stockholders’ Equity

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 50,000 Retained earnings 52,400\*

Total liabilities and

Total assets $129,200 stockholders’ equity $129,200

\*From (2) above. Note that retained earnings at December 31, 2012, 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, 2013

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 2012 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 2012.

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| 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, 2010

(amounts in millions)

Retained earnings, beginning of year $ 505.3

Deduct: Net loss for the year (110.6)

Dividends for the year (4.4)

Retained earnings, end of year $ 390.3

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

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| 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

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| 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 for 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.

MILLIE’S CERAMIC STUDIO

INCOME STATEMENT

FOR THE MONTH ENDED JULY 31, 2012

Revenues:

Classes $ 700

Greenware sales 3,000

Total revenues $3,700

Expenses:

Rent $ 300

Supplies 600\*

Cost of greenware 1,000

Total expenses 1,900

Net income $1,800

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

**PROBLEM 1-10A (Concluded)**

MILLIE’S CERAMIC STUDIO

BALANCE SHEET

JULY 31, 2012

**Assets Liabilities and Owner’s Equity**

Cash $ 4,400 Unearned revenue $ 700

Deposit 1,000 Owner’s equity 16,600\*\*

Molds and paint 6,900\*

Kiln 5,000 Total liabilities and

Total assets $17,300 owner’s equity $17,300

\*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

Add: Net income 1,800

Owner’s equity, end of first month $16,600

decision CASES

**READING AND INTERPRETING FINANCIAL STATEMENTS**

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| 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. Information about 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   
equity.

**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 Kellogg’s at the end of the year is reported on its consolidated balance sheet as a current liability, most likely as part of “Other current liabilities.”

**5.** Information about the company’s long-term debt can be found on the balance sheet and in notes to the consolidated financial statements. Specifically, Note 6 in Kellogg’s annual report provides detail on the various long-term obligations of the company, including due dates.

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| LO 5 |  | **DECISION CASE 1-2 READING AND INTERPRETING KELLOGG’S FINANCIAL STATEMENTS** |

**1.** 2010 Net income: $1,247,000,000

**2. Assets = Liabilities + Stockholders’ Equity\***

$11,847,000,000 = $9,693,000,000 + $2,154,000,000

\*Kellogg's uses the term “Equity” rather than “Stockholders’ Equity.”

**3.** Property, net increased during the 2010 fiscal year by $3,128,000,000 – $3,010,000,000 or $118,000,000. Acquisitions would increase the amount of property from the beginning to the end of the year.

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| LO 5 |  | **DECISION CASE 1-3 COMPARING TWO COMPANIES IN THE SAME INDUSTRY: KELLOGG’S AND GENERAL MILLS** |

**1.** Kellogg’sreported net sales for the year ended January 1, 2011, of$12,397,000,000. This amount represented a slight decrease from the sales reported in the prior year. General Mills reported net sales for the year ended May 30, 2010, of $14,796,500,000, which represented a slight increase from the amount reported in the prior year.

**2.** Kellogg’s reported net income for the year ended January 1, 2011, of $1,247,000,000, an increase from the net income in the prior year. General Mills reported net income for the year ended May 30, 2010, of $1,530,500,000, which was also an increase from the prior year’s amount.

**3.** Kellogg’stotal assets on January 1, 2011, amounted to $11,847,000,000. Goodwill was the largest asset category on the company’s balance sheet. General Mills reported total assets on May 30, 2010, of $17,678,900,000, and the largest of its assets was its Goodwill.

**4.** The statement of cash flows for both companies indicates that they both paid their stockholders dividends during the year.

**MAKING FINANCIAL DECISIONS**

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| 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.

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

1. REMOTE DVD WORLD INC.

PROJECTED INCOME STATEMENT

FOR THE FIRST MONTH

Revenues:

Daily rentals ($3 × 800) $2,400

Monthly memberships ($25 × 200) 5,000 $7,400

Expenses:

Wages ($10 per hour × 15 hours × 4 weeks

× 2 employees) $1,200

Rent 1,000 2,200

Net income $5,200

2. REMOTE DVD WORLD INC.

PROJECTED BALANCE SHEET

END OF FIRST MONTH

Assets Liabilities and Stockholders’ Equity

Cash $ 200\* Notes payable $10,000

Accounts receivable 5,000 Capital stock 10,000

DVDs 20,000 Retained earnings 5,200

Total liabilities and

Total assets $25,200 stockholders’ equity $25,200

\*$10,000 + $10,000 – $20,000 + 800($3) – $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 sales forecasts of 800 rentals per month and 200 monthly memberships. Will the demand for rentals and memberships increase, decrease, or stay relatively stable in the future? A third issue concerns the useful life of the DVDs. A sizable investment of $20,000 has been made in the initial inventory of DVDs. How long will it be before more DVDs will need to be purchased to keep customers returning to the store? 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 a rental store in the area? What effect would this have on sales?

**ETHICAL DECISION MAKING**

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| LO 4,5,8 |  | **DECISION CASE 1-6 IDENTIFICATION OF ERRORS IN FINANCIAL STATEMENTS AND PREPARATION OF REVISED STATEMENTS** |

**1.** Errors made in preparing the financial statements:

**a.** The recognition of the 2013 season ticket sales as revenue in 2012. Because Lakeside has not provided these fans with any service yet (the games), the sale of the 2013 season tickets does not result in revenue in 2012.

**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, 2013.

**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.

2. LAKESIDE SLAMMERS INC.

INCOME STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2012

Revenues:

Single-game ticket revenue $420,000

Concessions revenue 280,000

Total revenues $ 700,000

Expenses:

Cost of concessions sold $110,000

Player contracts 125,000

Salary expense—players 225,000

Salary and wage expense—staff 150,000

Rent expense 210,000

Total expenses 820,000

Net loss $(120,000)

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

LAKESIDE SLAMMERS INC.

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDED DECEMBER 31, 2012

Retained earnings, beginning of year $ 0

Deduct: Net loss for the year (120,000)

Dividends for the year (40,000)

Retained earnings, end of year $(160,000)\*

LAKESIDE SLAMMERS INC.

BALANCE SHEET

DECEMBER 31, 2012

Assets Liabilities and Stockholders’ Equity

Cash $ 5,000 Notes payable $ 50,000

Equipment 50,000 Due to parent club 125,000

Capital stock 40,000

Retained earnings (deficit) (160,000)\*

Total liabilities and

Total assets $55,000 stockholders’ equity $ 55,000

**3.** The original financial statements grossly overstate the income of the company and its assets.

The information regarding season ticket revenue does not provide reliable in-formation 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.)

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 the controller has made a deliberate attempt 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.

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

**4. 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 give loans at lower interest rates, the stock valuations will be higher). 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. Stockholders who currently own shares of stock may not make the correct decisions about holding the stock. Potential stockholders may make the wrong decision about purchasing the stock.

**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.

**f.** 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. Also, the information is not a faithful representation. The season-ticket and advertising revenue do not represent revenue as claimed (revenue is too high, expenses are too low, assets are overstated, and stockholders’ equity is overstated). The original financial statements are not neutral and are clearly presented in a way that is biased toward the owners.

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| 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 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.

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| REAL WORLD PRACTICE 1.1 |

**Assets = Liabilities + Stockholders’ Equity\***

**$11,847,000,000 = $9,693,000,000 + $2,154,000,000**

\*Kellogg's uses the term “Equity” rather than “Stockholders’ Equity.”

The amount owed by Kellogg’s customers is shown in Accounts Receivable, net and amounts to $1,190,000,000 at the end of 2010. The amount Kellogg’s owes its suppliers is $1,149,000,000 as shown in the Accounts Payable account.

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| REAL WORLD PRACTICE 1.2 |

Net sales decreased by ($12,397,000,000 – $12,575,000,000)/$12,575,000,000, or 1.4%. Cost of goods sold decreased by a very similar percentage: ($7,108,000,000 – $7,184,000,000)/$7,184,000,000, or 1.1%. This means that management was able to control the cost of the inventory it makes, relative to the selling price of these products.