Solutions Manual for Financial Accounting 6th Rich

1 ACCOUNTING AND THE FINANCIAL STATEMENTS

DISCUSSION QUESTIONS

1. Accounting is an information system that identifies, measures, records, and communicates financi information about a company's business activities to permit informed decisions by users of the information. Accounting is often referred to as the *language* of business because it communicates relevant and reliable information about economic activities of a company that helps people make better decisions.

2. Accounting information is demanded (or needed) by decision-makers both inside and outside the business to provide information about business activities and finances so that informed decisions can be made. Six groups that create the demand for accounting information and their uses of accounting information are described next:

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

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

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

(4) Governments need accounting information about businesses to determine taxes owed by businesses, to implement a variety of regulatory objectives, and to make national economic policy decisions.

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

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

3. Financial accounting is the accounting *information* that satisfies the needs of external decision-makers. Financial reporting (or disclosure) is the *process* of communicating financial accounting information to those external decision-makers.

4. Data analytics is the process of analyzing data so that businesses can make decisions more effici The four types of analytics are descriptive—summarizes what has happened; diagnostic—explains why things happened; predictive—attempt to predict what will happen in the future; and prescriptiv recommends a possible course of action.

5. An accounting entity is a business that has an identity separate from that of its owners and managers and for which accounting records are kept. There are three main forms that accounting entities take: a sole proprietorship, a partnership, and a corporation.

6. A sole proprietorship is a business entity owned by one person. A partnership is a business entity owned jointly by two or more individuals. The owner of a sole proprietorship and the partners in a partnership are responsible for the debts of the business. A corporation is a separate legal entity formed by one or more persons called *stockholder(s)*. A corporation is legally separate from the affairs of its owners, which limits the stockholders' legal responsibility for the debt of the business to the amount that the stockholders invested in the business. Corporate shareholders generally pay more taxes than owners of sole proprietorships or partnerships. Although the combined number of sole proprietorships and partnerships largely outnumbers the number of corporations, the majority of business in the United States is conducted by corporations.

7. The three main types of business activities are financing activities, investing activities, and operating activities. Financing activities involve obtaining the funds necessary to begin and operate a business. These funds come from either issuing stock or borrowing money. Investing activities involve buying and selling assets that enable a corporation to operate. Operating activities are the normal business activities that a company engages in as it conducts its business. These activities involve selling products or services, purchasing inventory, collecting amounts due from customers, and paying suppliers.

8. Assets are the economic resources (or economic benefits) that a business controls. Liabilities are the creditors' claims on the resources of a business. Stockholders' equity is the ownership claim on the resources of a business. Stockholders' equity is considered a residual interest in the assets of a business that remain after deducting the business's liabilities.

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

10. The four primary financial statements are as follows:

(1) Balance sheet: A presentation of information about a company's economic resources (assets) and the claims against those resources by creditors and owners (liabilities and stockholders' equity) at a specific point in time.

(2) Income statement: A report on how well a company has performed over a period of time.

(3) Retained earnings statement: A report on how much of the company's income was retained in the business and how much was distributed to owners over a period of time.

(4) Statement of cash flows: A report on the changes in a company's cash during a period of time. The statement of cash flows provides information about the company's sources (inflov and uses (outflows) of cash.

11. There are many questions that can be answered based on each of the financial statements:

(1) Balance sheet:

a. What is the total amount of assets (economic resources) of a corporation? What is the total amount of liabilities (claims against the resources) for a corporation?

b. How much equity do the owners of the corporation have in its assets?

c. Is the corporation able to pay its debts as they become due?

(2) Income statement:

a. How much revenue was earned last month? Last quarter? Last year?

b. What was the total amount of expenses incurred to earn that revenue?

c. How much better-off is the corporation at the end of the year than it was at the beginning of the year?

d. Was the corporation profitable, and what are the prospects for the corporation's future profitability?

e. What are the prospects for the future growth of the corporation?

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

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

12. Point-in-time measurement means as of a particular date. The balance sheet is a point-in-time measurement. The period-of-time description applies to what has happened over a time interval. The income statement is a period-of-time measurement that explains the business activities between balance sheet dates. The statement of cash flows and the statement of retained earnings are also period-of-time measurements.

13. The fundamental accounting equation is:

Assets = Liabilities + Stockholders' Equity

The equation is significant because it means that the balance sheet must always balance. This implies that what a company owns (its resources) must always be equal to the claims of its creditors (liabilities) and investors (stockholders' equity).

14. Each financial statement includes a heading that is comprised of (a) the name of the company, (b) the title of the financial statement, and (c) the time period covered—either a point-in-time measurement (an exact date) or a period-of-time description (e.g., a year ended in a specific date).

15. Current assets are cash and other assets that are reasonably expected to be converted to cash within 1 year or the operating cycle, whichever is longer. Current liabilities are obligations that will be satisfied within 1 year or the operating cycle, whichever is longer.

Since current assets are presented separately from other assets, statement users can see if the firm is likely to have enough resources available to meet its current liabilities as they become due. If current assets were presented among other assets, such a determination would be difficult

Current liabilities are separated from long-term liabilities because current liabilities will require asset outflows (or replacement with another liability) much sooner than will long-term liabilities. If all liabilities were presented together, financial statement users would have difficulty determining the assets (economic resources) required in the near future to satisfy the current liabilities.

16. Current assets are generally listed on the balance sheet in order of liquidity or nearness to cash, whereas current liabilities are usually listed in the order in which they will be paid.

17. The two main components of equity are contributed capital and retained earnings. Contributed capital is increased by investments of new capital in a company by its owners (the issue of common stock to stockholders). Retained earnings is the accumulated net income of a company that has not been distributed to owners. Retained earnings is increased by net income and decreased by net losses and dividends.

18. Net Income = Total Revenues – Total Expenses

19. The single-step income statement format takes into account only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a single step to arrive at net income. The multiple-step income statement organizes revenues and expenses into multiple categories. The resulting subtotals (gross margin [gross profit], income from operations, and net income) highlight important relationships between revenues and expenses that financial statement users find useful.

20. A retained earnings statement summarizes and explains the changes in retained earnings during an accounting period. Retained earnings is the income earned by the company but not paid to the owners in the form of dividends. The retained earnings statement starts with the balance in retained earnings at the beginning of the period. To this balance, add net income (or subtract the net loss) obtained from the income statement. Next, subtract any dividends the company declared during the period. The total is the retained earnings at the end of the period that is reported on the balance sheet.

21. The statement of cash flows classifies cash flows into three categories: (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities. Cash flows from operating activities are the cash flows related to the normal operations of the business in earning income, and these include cash sales and collections of accounts receivable minus cash paid for goods, services, wages, salaries, and interest. Cash flows from investing activities are cash flows related to the acquisition or sale of investments and long-term assets, including cash received from the sales of property, plant, and equipment; investments; and other long-lived assets minus the cash spent to purchase long-term assets. The cash flows from investing activities by a healthy, growing business will often reflect an excess of expenditures over receipts. Cash flows from financing activities are the cash flows related to obtaining the capital of the company, including the cash contributed by owners and borrowed from creditors minus amounts paid as dividends and repayments of liabilities.

22. The retained earnings statement describes the changes in retained earnings, a balance sheet account, that occur between two balance sheet dates. One of the major sources of change in retained earnings is the net income (or net loss) for the year, which is determined on the income statement. The other major source of change in retained earnings is dividends, which are not considered a part of income.

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

24. The three elements of ESG reporting are environmental, social and governance. Examples of environmental issues are carbon emissions, water stress, biodiversity, pollution, and energy efficiency. Examples of social issues include health and safety; labor management; diversity, equity and inclusion; and data privacy/security. Examples of governance issues include ethics, tax transparency, board diversity, executive pay.

MULTIPLE-CHOICE QUESTIONS

1-1. **b**

1-2. **a**

1-3. **b**

1-4. **d**

1-5. **d**

1-6. **a** **($12,900 – $6,300)**

1-7. **d**

1-8. **c** **($7,500 + $3,900 + $3,100)**

1-9. **b** **($6,000 + $11,500)**

1-10. **a**

1-11. **b** **($182,300 – $108,800 – $48,600 – $12,000)**

1-12. **c**

1-13. **c**

BRIEF EXERCISES

BE 1-14

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

BE 1-15

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

BE 1-16

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

BE 1-17

Note: **Be sure to treat situations 1. through 4. independently.**

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

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

* $425,000 + $73,000 = $498,000
** $260,000 + $32,000 = $292,000

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

* $425,000 – $52,000 = $373,000
** $165,000 (from part 1) + $35,000 = $200,000

BE 1-17 (Continued)

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

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

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

BE 1-18

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

BE 1-19

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

BE 1-20

Cavernous Homes Inc.
Balance Sheet
December 31

Assets		
Cash	$3,200	
Accounts receivable	4,500	
Supplies	8,100	
Total assets		$15,800
Liabilities and Stockholders' Equity		
Liabilities:		
Notes payable	$5,000	
Total liabilities		$ 5,000
Stockholders' equity:		
Common stock	$7,000	
Retained earnings	3,800	
Total stockholders' equity		10,800
Total liabilities and stockholders' equity		$15,800

BE 1-21

Rutherford Company
Income Statement
For the year ending December 31

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

BE 1-22

Rutherford Company Income Statement For the year ending December 31		
Sales revenue	$65,000	
Cost of goods sold	(28,800)	
Gross margin		$36,200
Operating expenses		
Salaries expense	$22,500	
Insurance expense	4,300	
Total operating expenses		(26,800)
Income from operations		$ 9,400
Other income and expenses:		
Interest income	$ 3,900	
Loss on disposal of property, plant, and equipment	(1,200)	
Total other income and expenses		2,700
Income before income taxes		$ 12,100
Income taxes expense		(2,400)
Net income		$ 9,700

BE 1-23

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

BE 1-24

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

BE 1-25

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

BE 1-26

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

EXERCISES

E 1-27

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

E 1-28

1. Sole proprietorship: 1, 2, 4, 5
   Partnership: 2, 3, 4, 5, 7
   Corporation: 2, 3, 4, 5, 6, 8

2. There are many advantages and disadvantages to each particular type of business entity as listed below.

   a. Sole Proprietorship

   - Advantages
     - (i) The business is easily formed.
     - (ii) Control over the operations of the business is maintained by the owner.
     - (iii) Sole proprietorships pay less taxes relative to corporations.
   - Disadvantages
     - (i) The owner is personally liable for the debt of the business.
     - (ii) The life of the business is limited to the owner's life.

   b. Partnership

   - Advantages
     - (i) Have increased access to the financial resources and individual skills of each of the partners.
     - (ii) Partnerships pay less taxes relative to corporations.
   - Disadvantages
     - (i) Control over the operations of the business is shared among the partners.
     - (ii) The partners are personally liable for the debt of the business.

   c. Corporation

   - Advantages
     - (i) Can more easily raise large amounts of money.
     - (ii) Ownership of the business can be easily transferred by selling stock.
     - (iii) The owners' liability is limited to the amount invested in the business.
   - Disadvantages
     - (i) The formation and organization of the business are more complex.
     - (ii) Corporations generally pay more taxes (double taxation).

E 1-29

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

E 1-30

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

E 1-31

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

E 1-32

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

* $116,200 – $55,400 = $60,800
** $212,600 – $145,900 = $66,700
*** $22,500 + $48,300 = $70,800

E 1-33

1.

Higgins Company
Balance Sheet
Specific point in time

Assets

Current assets:
- Cash
- Accounts receivable
- Inventory
- Prepaid insurance
  - Total current assets

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

Intangible assets:
- Trademarks

Total assets

Liabilities and Stockholders' Equity

Liabilities:
- Current liabilities:
  - Accounts payable
  - Income taxes payable
  - Wages payable
    - Total current liabilities
- Long-term liabilities:
  - Notes payable
  - Bonds payable
    - Total long-term liabilities
      - Total liabilities

Stockholders' equity:
- Common stock
- Retained earnings
  - Total stockholders' equity

Total liabilities and stockholders' equity

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

E 1-34

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

Dunn Sporting Goods
Partial Balance Sheet
December 31, 2020

Current assets:		
Cash	$ 1,050	
Investment—Trading Securities	700	
Accounts receivable	2,850	
Inventory	46,230	
Prepaid rent	6,000	
Total current assets		$56,830
Current liabilities:		
Accounts payable	$ 9,700	
Interest payable on equipment loan (see f above)	3,750	
Total current liabilities		$13,450

2. **Working Capital** = Current Assets – Current Liabilities
   = $56,830 – $13,450
   = $43,380

   Current Ratio = Current Assets / Current Liabilities
   = $56,830 / $13,450
   = 4.23

E 1-34 (Continued)

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

E 1-35

1.

Hanson Construction Partial Balance Sheet December 31		
Current assets:		
Cash	$1,380	
Accounts receivable	7,000	
Notes receivable	1,500	
Supplies	6,200	
Total current assets		$16,080
Current liabilities:		
Accounts payable	$2,100	
Notes payable	6,800	
Total current liabilities		$ 8,900

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

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

E 1-36

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

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

E 1-37

Mulcahy Manufacturing Inc. Partial Balance Sheet December 31		
Stockholders' equity:		
Common stock	$150,000	
Retained earnings	37,500	
Total stockholders' equity		$187,500

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

E 1-38

College Spirit Balance Sheet December 31		
Assets		
Current assets:		
Cash	$ 13,300	
Accounts receivable	6,700	
Inventory	481,400	
Prepaid rent	54,000	
Total current assets		$555,400
Long-term investments:		
Investment		110,900
Property, plant, and equipment:		
Furniture	$ 88,000	
Less: Accumulated depreciation	(23,700)	
Furniture, net		64,300
Total assets		$730,600

E 1-38 (Continued)

Liabilities and Stockholders' Equity

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

E 1-39

1. College Spirit has working capital of $389,300 ($555,400 – $166,100) and a current ratio of 3.34 ($555,400 / $166,100).

2. The working capital and current ratios show that College Spirit has adequate current assets to cover all of the current liabilities that will become due in the near future. Therefore, College Spirit's liquidity should not be a major concern. Comparing these items to those of other companies in the same industry and examining the trends in these measures over time will yield additional insights.

E 1-40

1.

Jerrison Company
Balance Sheet
December 31

Assets			
Current assets:			
Cash		$ 11,400	
Investments (short-term)		21,000	
Accounts receivable		95,500	
Prepaid insurance		5,700	
Inventory		187,900	
Total current assets			$321,500
Long-term investments:			
Investment			32,700
Property, plant, and equipment:			
Land		$ 41,000	
Building	$ 419,900		
Less: Accumulated depreciation	(216,800)		
Building, net		203,100	
Trucks	$ 106,100		
Less: Accumulated depreciation	(31,200)		
Trucks, net		74,900	
Equipment (data processing)	$ 309,000		
Less: Accumulated depreciation	(172,400)		
Equipment, net		136,600	
Total property, plant, and equipment			455,600
Total assets			$809,800
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable		$ 65,100	
Notes Payable (due in six months)		150,000	
Salaries payable		14,400	
Income taxes payable		21,600	
Interest payable		12,600	
Total current liabilities			$263,700
Long-term liabilities:			
Bonds payable (due in four years)			200,000
Total liabilities			$463,700
Stockholders' equity:			
Common stock		$150,000	
Retained earnings*		196,100	
Total stockholders' equity			346,100
Total liabilities and stockholders' equity			$809,800

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

First, compute stockholders' equity as:

Total assets	=	Total liabilities + Total stockholders' equity
$809,800	=	$463,700 + X
X	=	$346,100

Next, compute retained earnings:

Total stockholders' equity	=	Common stock + Retained earnings
346,100	=	$150,000 + Y
Y	=	$196,100

2. Jerrison has working capital of $57,800 ($321,500 – $263,700) and a current ratio of 1.22 ($321,500 / $263,700).

3. While Jerrison appears to be liquid, inventory is its largest current asset at $187,900. If a large portion of inventory cannot be sold, Jerrison will most likely not generate sufficient cash flow to pay its obligations as they become due.

E 1-41

a. **Current assets:** (a) + $19,200 + $85,700 + $10,400 = $142,200
(a) = $26,900

b. **Long-term liabilities:** $14,500 + (b) = $50,300
(b) = $35,800

c. **Total liabilities and stockholders' equity:** (e) = Total assets
(e) = $142,200

d. **Total stockholders' equity:** $142,200 (e) = $50,300 + (d)
(d) = $91,900

e. **Contributed capital:** (c) + $56,900 = $91,900 (d)
(c) = $35,000

f. **Total assets:** (g) = Total liabilities and stockholders' equity
(g) = $149,200

g. **Long-term investments:** $25,000 + (f) + $92,800 + $9,200 = $149,200 (g)
(f) = $22,200

h. **Total liabilities:** $12,300 + $34,900 = (h)
(h) = $47,200

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

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

change here first, please ↓

	Year 1
Current assets	
Long-term liabilities	
Intangible assets	**10,400**
Long-term investments	**19,200**
Property, plant, and equipment (net)	**85,700**
Current liabilities	**14,500**
Total assets	**142,200**
Retained earnings	**56,900**
Total liabilities	**50,300**
Contributed capital	
Total stockholders’ equity	
Total liabilities and stockholders’ equity	

	links ↓
Current assets	26,900
Long-term liability	35,800
Total stockholders' equity	91,900
Contributed capital	35,000

Long-term investment

Total liabilities

↓

Year 2
25,000
34,900
9,200
92,800
12,300
67,000
0
0
0
149,200

22,200
47,200

E 1-42

1.

Butler Company Income Statement For a period of time

Revenues:
- **Sales revenue**

Expenses:
- **Cost of goods sold**
- **Advertising expense**
- **Salaries expense**
- **Utilities expense**
- **Depreciation expense**
- **Interest expense**
- **Income taxes expense**

Net income

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

E 1-43

1.

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

E 1-44

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

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

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

*** 15% × $7,400 = $1,110

E 1-45

1.

Wright Auto Supply Income Statement For the year ending December 31		
Revenues:		
Sales revenue		$ 585,600
Expenses:		
Cost of goods sold	$292,000	
Wages expense	96,750	
Salaries expense	33,800	
Depreciation expense	31,250	
Rent expense	21,000	
Interest expense	2,400	
Income taxes expense	32,520	
Total expenses		(509,720)
Net income		$ 75,880

2.

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

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

E 1-46

1. **Net profit margin is 5.75% ($42,320 net income / $736,000 service revenue). This indicates that $0.058 of each sales dollar is profit.**

2. **If Matteo were to increase revenues by $100,000, an additional $5,800 of profit would be recognized. If ERS wanted to achieve larger profits, it should also focus on controlling its expenses.**

3. **A declining profit margin implies that ERS is having difficulty maintaining control over its expenses. While further investigation is warranted to determine the cause of the growing expenses (e.g., is it due to increasing costs that are within management control or are the cost increases due to economic factors beyond ERS's short-term control), the declining profit margin signals that ERS may have difficulty generating future profits that are comparable with its past performance.**

E 1-47

1.

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

2. Sherwood is paying 85% ($38,650 / $45,300) of its income to its shareholders in the form of dividends. This large dividend payout will result in investors receiving relatively more of the company's earnings in the form of cash during the year rather than in share appreciation. Financial statement users should examine the dividend payout ratio in relation to the firm's current ratio and working capital to ensure that Sherwood is not paying too much in dividends so that it will be able to repay its debts when they become due.

E 1-48

1.

Cash flow from operating activities:		
Cash received from customers	$ 139,800	
Cash paid for advertising	(34,200)	
Cash paid to employees for salaries	(46,400)	
Cash paid for supplies	(28,700)	
Net cash provided by operating activities		$ 30,500
Cash flow from investing activities:		
Cash paid for purchase of land and building	$(128,700)	
Cash paid to purchase machine	(32,000)	
Net cash used by investing activities		(160,700)
Cash flow from financing activities:		
Cash received from owners	$ 201,500	
Cash paid for dividends to stockholders	(37,500)	
Net cash provided by financing activities		164,000

2. Walters has positive cash flow, especially from operations, showing the company is in a good financial position to pay its debts as they become due. The negative cash flow (cash outflow) in investing is a sign of a growing company that is investing in revenue-producing assets. In addition, from the large amount of cash received from financing activities, it appears that Walters is able to raise large amounts of capital to finance its operations.

E 1-49

Cash at the end of the year:

Cash flow from operating activities	$ 892,250
Cash outflow for investing activities	(990,300)
Cash flow from financing activities	108,400
Change in cash	$ 10,350
Add: Cash as on January 1	20,400
Cash at December 31	$ 30,750

Retained earnings at the end of the year:

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

E 1-50

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

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

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

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

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

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

Dividends = $15,500

E 1-51

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

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

For each year, solve for retained earnings:

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

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

Beginning retained earnings………………		$ 35,600
+	Net income…………………………	?
–	Dividends declared………………	(20,000)
=	Ending retained earnings………	$ 48,050

Net income = $32,450

E 1-52

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

PROBLEM SET A

P 1-53A

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

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

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

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

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

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

P 1-54A

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

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

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

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

P 1-55A

Powers Wrecking Service
Income Statement
For the year ending December 31

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

P 1-56A

Cooper Merchandising Income Statement For the year ending December 31, Year 2		
Sales revenue		**$625,000**
Cost of goods sold		**($248,000)**
Gross margin		**$377,000**
Operating expenses:		
Wages expenses	**$ 103,600**	
Rent expense	**65,000**	
Supplies expense	**23,575**	
Depreciation expense	**12,150**	
Miscellaneous expense	**8,300**	
Total operating expenses		**(212,625)**
Income from operations		**$ 164,375**
Other income and expenses:		
Interest income		**1,250**
Income before taxes...		**$ 165,625**
Income taxes expense..		**(32,500)**
Net income...		**$ 133,125**

P 1-57A

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

P 1-58A

Rogers Enterprises Income Statement For the year ending December 31		
Revenues:		
Service revenue		$463,500
Expenses:		
Salaries expense	$235,200	
Rent expense	135,000	
Supplies expense	34,400	
Interest expense	16,000	
Income taxes expense	12,800	(433,400)
Net income		$ 30,100

Rogers Enterprises Balance Sheet December 31		
Assets		
Current assets:		
Cash	$ 13,240	
Accounts receivable	72,920	
Supplies	42,000	
Prepaid rent	31,500	
Total current assets		$159,660
Property, plant, and equipment		90,000
Total assets		$249,660
Liabilities and Stockholders' Equity		
Current liabilities:		
Salaries payable	$ 14,800	
Income taxes payable	4,150	
Total current liabilities		$ 18,950
Long-term liabilities:		
Notes payable (due in 10 years)		25,000
Total liabilities		$ 43,950
Stockholders' equity:		
Common stock (10,000 shares)	$ 70,000	
Retained earnings*	135,710	
Total stockholders' equity		205,710
Total liabilities and stockholders' equity		$249,660

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

P 1-59A

Moore Inc. Income Statement For the year ending December 31		
Sales revenue……………………………………	$863,500	
Cost of goods sold………………..…………	(395,000)	
Gross margin……………………..…………		$ 468,500
Operating expenses:		
Salaries expense…………………………………	$235,200	
Rent expense………………………………………	135,000	
Supplies expense…………………………………	34,400	
Total operating expenses		($404,600)
Income from operations		$ 63,900
Other income and expenses:		
Interest income………………………………………	2,000	
Interest expense…………………………………	(16,000)	
Total other income and expenses		(14,000)
Income before income taxes		49,900
Income taxes expense…………………………		(8,600)
Net income……………………………………………		$ 41,300

P 1-59A (Continued)

Moore Inc.
Balance Sheet
December 31

Assets		
Current assets:		
Cash	$ 16,290	
Accounts receivable	68,910	
Supplies	44,100	
Prepaid rent	31,500	
Total current assets		$160,800
Property, plant, and equipment		90,000
Total assets		$250,800
Liabilities and Stockholders' Equity		
Current liabilities:		
Salaries payable	$ 14,800	
Income taxes payable	4,150	
Total current liabilities		$ 18,950
Long-term liabilities:		
Notes payable (due in 10 years)		25,000
Total liabilities		$ 43,950
Stockholders' equity:		
Common stock (10,000 shares)	$ 70,000	
Retained earnings*	136,850	
Total stockholders' equity		206,850
Total liabilities and stockholders' equity		$250,800

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

P 1-60A

Dittman Inc. Retained Earnings Statement For the years ending December 31, Year 1, and December 31, Year 2		
	Year 1	Year 2
Retained earnings, beginning of year*.....	$ 20,900	$ 36,050
Add: Net income**.....	25,400	33,000
Less: Dividends declared.....	(10,250)	(12,920)
Retained earnings, end of year.....	$ 36,050	$ 56,130

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

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

P 1-61A

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

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

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

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

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

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

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

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

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

P 1-62A

1.

Ashton Appliances
Income Statement
For the year ending December 31

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

Ashton Appliances
Retained Earnings Statement
For the year ending December 31

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

* From the income statement

P 1-62A (Continued)

Ashton Appliances
Balance Sheet
December 31

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

* From the retained earnings statement

P 1-62A (Continued)

2.

Ashton Appliances Income Statement For the year ending December 31		
Sales revenue		$948,670
Cost of goods sold		($511,350)
Gross margin		$437,320
Operating expenses:		
Salaries expense	228,710	
Rent expense	80,800	
Insurance expense	36,610	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Total operating expenses		(369,170)
Income from operations		$68,150
Other income and expenses:		
Interest expense		(15,500)
Income before income taxes		$52,650
Income taxes expense		(16,650)
Net income		$ 36,000

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

P 1-63A

Berko Company:

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

Manning Company:

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

Lucas Company:

(i)	$40,000	($66,400 – $26,400)

Must solve for (k) before (j):

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

Corey Company:

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

P 1-64A

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

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

* $385,500 – $152,800 = $232,700

** $420,250 – $156,600 = $263,650

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

Stockholders' Equity = Common Stock + Retained Earnings

Change in Stockholders' Equity = Change in Common Stock + Change in Retained Earnings

Change in Retained Earnings = Net Income – Dividends

Therefore,

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

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

PROBLEM SET B

P 1-53B

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

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

	Common Stock	+	Retained Earnings	=	Stockholders' Equity
Equity, Jan. 1	$100,000	+	$134,900	=	$234,900
Net income			205,500		
Dividends			(70,000)		
Common stock issued	75,000				
Equity, Dec. 31	$175,000	+	$270,400	=	$445,400

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

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

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

P 1-54B

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

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

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

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

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

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

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

P 1-55B

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

P 1-56B

Lakas Company Income Statement For the year ending December 31		
Sales revenue		$425,000
Cost of goods sold		(178,400)
Gross margin		$246,600
Operating expenses:		
Wages expenses	$ 66,100	
Rent expense	35,910	
Supplies expense	13,122	
Depreciation expense	11,590	
Miscellaneous expense	8,800	
Total operating expenses		(135,522)
Income from operations		$ 111,078
Other income and expenses:		
Interest income	620	
Interest expense	(850)	
Total other income and expenses		(230)
Income before taxes		$ 110,848
Income taxes expense		(23,200)
Net income		$ 87,648

P 1-57B

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

P 1-58B

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

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

P 1-58B (Continued)

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

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

P 1-59B

Cheng Company Income Statement For the year ending December 31		
Sales revenue…………………………………	$525,100	
Cost of goods sold………………………………	(279,800)	
Gross margin………………………………………		$ 245,300
Operating expenses:		
Salaries expense……………………………	$115,900	
Rent expense………………………………	65,000	
Supplies expense……………………………	14,400	
Research and development expense…..	12,700	
Insurance expense…………………………	5,000	
Total operating expenses…………………		($213,000)
Income from operations…………………………		$ 32,300
Other income and expenses:		
Gain on disposal of property, plant, and equipment..	5,000	
Interest expense……………………………	(8,450)	
		(3,450)
		28,850
Income taxes expense………………………		(6,000)
Net income…………………………………………		$ 22,850

P 1-59B (Continued)

Cheng Company Balance Sheet December 31		
Assets		
Current assets:		
Cash	$ 14,275	
Accounts receivable	58,930	
Supplies	24,600	
Prepaid rent	8,500	
Total current assets		$106,305
Property, plant, and equipment		105,000
Intangible assets		12,380
Total assets		$223,685
Liabilities and Stockholders' Equity		
Current liabilities:		
Salaries payable	$ 11,400	
Income taxes payable	2,850	
Total current liabilities		$ 14,250
Long-term liabilities:		
Notes payable (due in 10 years)		15,000
Total liabilities		$ 29,250
Stockholders' equity:		
Common stock (10,000 shares)	$ 105,000	
Retained earnings*	89,435	
Total stockholders' equity		194,435
Total liabilities and stockholders' equity		$223,685

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

P 1-60B

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

	Year 1	Year 2
Retained earnings, beginning of year*................................	$ 55,300	$ 74,700
Add: Net income**..	33,400	74,600
Less: Dividends..	(14,000)	(16,000)
Retained earnings, end of year..	$ 74,700	$133,300

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

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

P 1-61B

(a) $26,900 – $11,100 = $15,800

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

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

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

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

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

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

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

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

P 1-62B

McDonald Boat Company Income Statement For the year ending December 31		
Revenues:		
Sales revenue		$1,932,300
Expenses:		
Cost of goods sold	$ 987,200	
Wages expense	348,700	
Depreciation expense (equipment)	142,300	
Utilities expense	131,300	
Interest expense	99,400	
Supplies expense	89,100	
Depreciation expense (building)	21,500	
Rent expense	14,600	
Income taxes expense	21,700	
Total expenses		(1,855,800)
Net income		$ 76,500

McDonald Boat Company Retained Earnings Statement For the year ending December 31	
Retained earnings, January 1	$ 128,600
Add: Net income	76,500
Less: Dividends	(25,300)
Retained earnings, December 31	$ 179,800

P 1-62B (Continued)

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

P 1-62B (Continued)

2.

McDonald Boat Company Income Statement For the year ending December 31		
Sales revenue……………………………………		$1,932,300
Cost of goods sold……………………………		($987,200)
Gross margin……………………………………		$945,100
Operating Expenses:		
Wages expense………………………………	348,700	
Depreciation expense (equipment)……….	142,300	
Utilities expense……………………………	131,300	
Interest expense……………………………	99,400	
Supplies expense……………………………	89,100	
Depreciation expense (building)………..	21,500	
Rent expense…………………………………	14,600	
Total operating expenses		(846,900)
Income from operations………………………		$98,200
Income taxes expense		($21,700)
Net income………………………………………		$ 76,500

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

P 1-63B

Stackhouse Company:

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

Compton Company:

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

Bellefleur Company:

Must solve for (i) first.

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

Merlotte Company:

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

P 1-64B

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

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

* $256,500 – $92,650 = $163,850
** $358,200 – $121,900 = $236,300

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

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

Therefore,

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

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

CASES

Case 1-65

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

Case 1-66

1. **The following examples are illustrative, and students' answers may vary:**
   a. **Nonbusiness entities (including governments and educational institutions):**

      The Accounting Review **(university and college educators), American Accounting Association**

      Issues in Accounting Education **(university and college educators), American Accounting Association**

      Journal of Government Financial Management **(governmental accountants), Association of Government Accountants (AGA)**

   b. **Business entities:**

      Strategic Finance **(management accountants and finance professionals), Institute of Management Accountants**

      Financial Executive **(controllers, treasurers, and senior financial executives), Financial Executives Institute**

      Internal Auditor **(internal auditors), Institute of Internal Auditors**

   c. **Public practice:**

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

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

Case 1-66 (Continued)

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

Case 1-67

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

Case 1-68

1.	**Current assets (12/31/Y3)**	**=**	**$5,210 + $28,100 + $7,152 = $40,462**
	Current liabilities (12/31/Y3)	**=**	**$19,655**
	Current assets (12/31/Y2)	**=**	**$4,125 + $32,891 + $7,853 = $44,869**
	Current liabilities (12/31/Y2)	**=**	**$35,483**

Agency Rent-A-Car Inc. reported a current ratio of 2.06 ($40,462 / $19,655) Year 3 and a current ratio of 1.26 ($44,869 / $35,483) in Year 2. Its working capital is $20,807 ($40,462 – $19,655) in Year 3 and $9,386 ($44,869 – $35,4 in Year 2. These ratios show that the company has adequate current asset to cover the current liabilities in both years. In addition, its liquidity is improving between Year 2 and Year 3.

2. **Net Income = Stockholders' Equity (12/31/Y3) – Stockholders' Equity (12/31/Y2) + Dividends***

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

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

Case 1-69

1. **Trends:**
   (a) **Revenues decreased dramatically from Year 6 to Year 7**
   (b) **Operating income (loss) has fluctuated dramatically in the 5-year period but shows some improvement (less of a loss) in Year 8.**
   (c) **Net income (loss) was down dramatically in Year 7 and seems to be slowly recovering in Year 8 with a much smaller loss.**
2. **In Year 4 and Year 5, Wright Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in Year 6, Year 7, and Year 8, causing current liabilities to be much larger than current assets. It seems as though Wright Brothers used its assets to pay down its long-term debt in Year 6.**
3. **Yes, the company has shown a considerable decrease throughout the 5-year period in net income and also shows that it may have difficulty in paying current liabilities with the small amount of current assets it has.**

Case 1-70

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

Case 1-71

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

Case 1-72

1. **Apple's fiscal year ended on September 24, 2022. This year-end is different from previous years for the simple reason that Apple has a floating year-end. Apple's year-end always falls on the last Saturday of the month of September, so the actual date changes from year to year.**

2. **Apple presents 2 years of balance sheet information and 3 years of income statement information.**

3. **Balance sheet information:**

   a. **For 2022, Apple reported total assets of $352,755,000,000, total liabilities of $302,083,000,000, and total stockholders' equity of $50,672,000,000.**

   b. **The dollar amounts for all three categories have changed in the past year. For 2021, Apple reported total assets of $351,002,000,000, total liabilities of $287,912,000,000, and total stockholders' equity of $63,090,000,000. This represented an increase in total assets of $1,753,000,000 ($352,755,000,000 – $351,002,000,000), an increase in total liabilities of $14,171,000,000 ($302,083,000,000 – $287,912,000,000), and a decrease in total stockholders' equity of $12,418,000,000 ($50,672,000,000 – $63,090,000,000).**

   c. **For 2022, Apple reported current assets of $135,405,000,000 and current liabilities of $153,982,000,000. For 2021, Apple reported current assets of $134,836,000,000 and current liabilities of $125,481,000,000.**

   d. **Apple reported working capital of -$18,577,000,000 ($135,405,000,000 – $153,982,000,000) for 2022 and working capital of $9,355,000,000 ($134,836,000,000 – $125,481,000,000) for 2021. Apple's current ratio was 0.88 ($135,405,000,000 / $153,982,000,000) for 2022 and 1.07 ($134,836,000,000 / $125,481,000,000) for 2021. Apple's current assets are greater than its current liabilities for 2021, but not for 2022. However, Apple should be able to pay the liabilities that become due within the next year because of its large amount of operating cash flow. Thus, Apple appears to have sufficient liquidity.**

Case 1-72 (Continued)

4. **Income statement information:**

   a. **For 2022, Apple reported revenues (net sales) of $394,328,000,000 and expenses of $294,525,000,000 ($223,546,000,000 + $51,345,000,000 + $19,300,000,000 + $334,000,000). *Note:* The $334,000,0000 is a combination of other income and expenses and was added to expenses. Apple's net income was $99,803,000,000.**

   b. **Sales increased by $28,511,000,000 from 2021 to 2022 and increased by $91,302,000,000 from 2020 to 2021, as shown in the comparative income statements. As noted in the management discussion and analysis, the increase in sales in 2022 is due primarily to increased iPhone, Services and Mac sales. This increase in sales has caused a corresponding increase in cost of sales (an expense).**

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

   a. **For 2022, Apple reported a net cash inflow from operating activities of $122,151,000,000, a net cash outflow from investing activities of $22,354,000,000, and a net cash outflow from financing activities of $110,749,000,000.**

   b. **In 2022, Apple paid $10,708,000,000 for the acquisition of property, plant, and equipment.**

6. **Apple's largest increase in retained earnings was due to net income of $99,803,000,000. Apple's largest decrease in retained earnings is due to repurchases of common stock of $90,186,000,000.**

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

   Apple's management considers several accounting policies critical, including following generally accepted accounting principles, revenue recognition, allowance for doubtful accounts, inventory valuation, warranty costs, valuation of marketable securities, income taxes, and contingencies policy. This information was found in the management's discussion and analysis section of the annual report. More detail on significant accounting policies can also be found in the notes to the financial statements (Note 1).

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

Case 1-73

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

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

2. **The fiscal year-end for Kroger is on the Saturday nearest to January 31. Its most current fiscal year-end is January 28, 2023. Sprouts's fiscal year ends on the Sunday closest to December 31. Its most current fiscal year-end is January 1, 2023. The fiscal year-ends are expected to be similar because the two companies are in the same industry and follow the same major trends in sales.**

3. **Balance sheet information:**

   a. **Kroger (as on January 28, 2023):**
   Assets = $49,623,000,000
   Liabilities = $39,609,000,000 ($17,238,000,000 + $22,371,000,000)
   Stockholders' equity = $10,014,000,000

   Sprouts (as of January 1, 2023):
   Assets = $3,070,380,000
   Liabilities = $2,023,918,000 ($522,380,000 + $1,501,538,000)
   Stockholders' equity = $1,046,462,000

   b. **Kroger (as of January 28, 2023):**
   Current assets = $12,670,000,000
   Current liabilities = $17,238,000,000

   Sprouts (as of January 1, 2023):
   Current assets = $673,804,000
   Current liabilities = $522,380,000

Case 1-73 (Continued)

c. **Kroger's current assets are approximately 74% of its current liabilities. Kroger reported working capital of -$4,568,000,000 ($12,670,000,000 – $17,238,000,000) and a current ratio of 0.74 ($12,670,000,000/$17,238,000,000).**

The liquidity picture of Sprouts is much brighter. Sprouts reports working capital of $151,424,000 ($673,804,000 – $522,380,000) and a current ratio of 1.29 ($673,804,000 / $522,380,000). Sprouts should not have to seek additional financing to pay off the liabilities coming due in the next year.

d. **Kroger has over 15 times the total assets of Sprouts. Thus, Kroger is a much larger company.**

4. **Income statement information:**

a. **Kroger (for the fiscal year ending January 28, 2023):**

Revenues	$	148,258,000,000
Expenses		146,009,000,000
Net income attributable to noncontrolling interests		5,000,000
Net income	$	2,244,000,000

Sprouts (for the fiscal year ending January 1, 2023):

Revenues	$6,404,223,000
Expenses	6,143,059,000
Net income	$ 261,164,000

b. **For Sprouts, revenues show an increasing trend for the most current year presented, with a decrease in revenue between the first two years presented. Cost of sales and other expenses have correspondingly changed. Kroger shows increasing revenue over all three years, and a corresponding increase in costs as expected. However, income in 2020 was significantly higher than the other two years due to a large gain on investments. This pattern is reflected in the earnings per share information.**

Case 1-73 (Continued)

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

   Kroger: Its major source of cash related to cash inflows from operating activities. Major uses of cash include capital expenditures (purchases of property, plant, and equipment), repayment of borrowings, dividends paid and purchase of treasury stock.

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

Annual Report Problem

		Answer to Req. 2 Fiscal 2023 (forecasted)	Answer to Req. 1 Fiscal 2022
1. and 2.	Current Assets	$ 33,471	$ 32,471.00
	Current Liabilities	$ 25,110	$ 23,110.00
	Net Sales	$ 165,273	$ 157,403.00
	Cost of Goods Sold	$ 109,856	$ 104,625.00
	Operating Expenses	$ 30,176	$ 28,739.00
3 a.	What is the company's exact name?	The Home Depot, Inc.	
3 b.	What is the company's common stock trading symbol?	HD	
3 c.	In what city is Home Depot's Headquarters?	Atlanta, Georgia	
3 d.	Calculate Home Depot's Current Ratio. Round to two decimal places.	1.33	
3 e.	Calculate Home Depot's Gross Margin. Round to two decimal places.	$ 55,417	
3 f.	Calculate Home Depot's Income from Operations. Round to two decimal places.	$ 25,241	

Continuing Problem

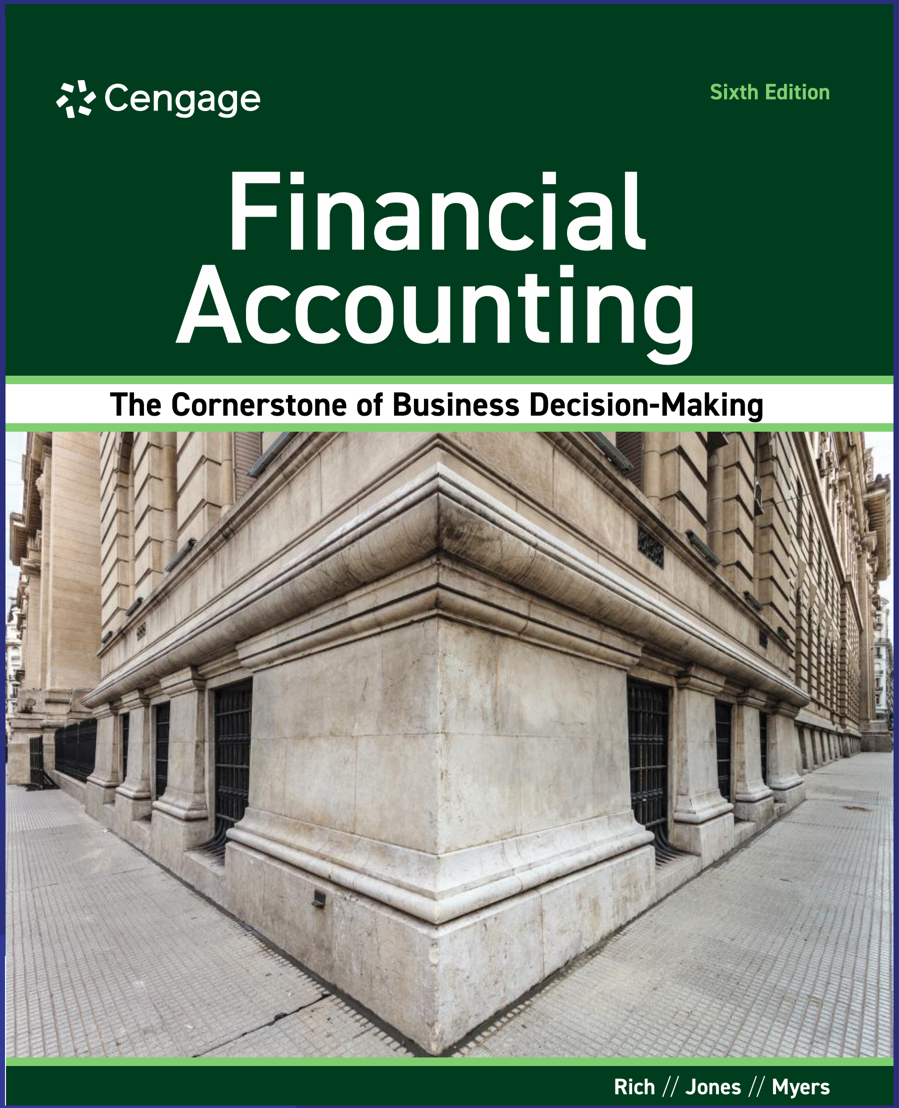
1. **The first concern for Front Row Entertainment is to obtain financing for the business. Normally, a concert promoter must pay a significant amount of up-front cash to secure the venue and advertise the tour. Therefore, it is critical that Front Row Entertainment raise a large amount of cash if the business is to succeed. This cash may be raised by issuing debt (e.g., notes payable, bonds payable), shares of stock (e.g., common stock), or a combination of both. Next, Front Row Entertainment must purchase the assets necessary to operate. Because a concert promoter provides a service, the initial investment in property, plant, and equipment is likely to be relatively small and involve typical office equipment (e.g., desks, telephones, computers). These assets are normally combined and reported as equipment on the balance sheet. The business can now begin to operate. Revenues (e.g., sales revenue, service revenue) will be generated as Front Row Entertainment fulfills its contractual duties (e.g., sells tickets). One of the major expenses for a concert promoter would be the fees paid to the musical artist upon completion of the event (reported as cost of sales). In addition, Front Row Entertainment will likely incur large expenses initially as it books the venue and advertises the concert. Typical expenses may include rent expense (for office space of the business as well as a rental fee on the venue), utilities expense, salaries expense (for Cam and Anna's salaries), advertising expense, and insurance expense. Some of these expenses may be prepaid (resulting in accounts such as prepaid advertising or prepaid rent), while payment for others may be delayed (resulting in accounts such as accounts payable, salaries payable, and rent payable).**

2. **Cam and Anna can choose to organize Front Row Entertainment as either a partnership or a corporation. Relative to the corporate form of organization, partnerships are easier to organize. In addition, the control of the partnership would be shared by Cam and Anna, and the business would have access to the financial resources and skills of each partner. Finally, a partnership would also pay less taxes than a corporation. This is because the corporate tax rate is higher than the individual tax rate and the corporation's income is taxed twice: once at the corporate level and again at the stockholder level as earnings are distributed. However, the corporate form also has advantages. First, it can raise larger amounts of resources through the issuance of stock. Second, the corporate form limits the liability of its stockholders to the amount they have invested in the business. If the business were to fail, shareholders would only lose their investment. On the other hand, creditors could attempt to recover their losses from the personal assets of the partners. Finally, corporations have an unlimited life, with**

Continuing Problem (Continued)

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

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



Chapter 1

Accounting and the Financial Statements

Learning Objectives

By the end of this chapter you should be able to:

1.1 Explain the nature of accounting.

1.2 Identify the forms of business organizations and the types of business activities.

1.3 Describe the relationships shown by the fundamental accounting equation.

1.4 Prepare a classified balance sheet and explain the information it communicates.

1.5 Prepare an income statement and explain the information it communicates.

1.6 Prepare the retained earnings statement and explain the information it communicates.

1.7 Identify the information communicated by the statement of cash flows.

1.8 Describe the relationships among the financial statements.

1.9 Explain the importance of ESG reporting and ethics.

Icebreaker

A patient with a medical condition generates medical information with many users. These users may include the patient themselves, doctors, nurses, laboratory technicians, pharmacists, technicians, health insurance personnel, and other specialists.

- Similarly, who are the users of the financial information generated by accountants?

Icebreaker Debrief

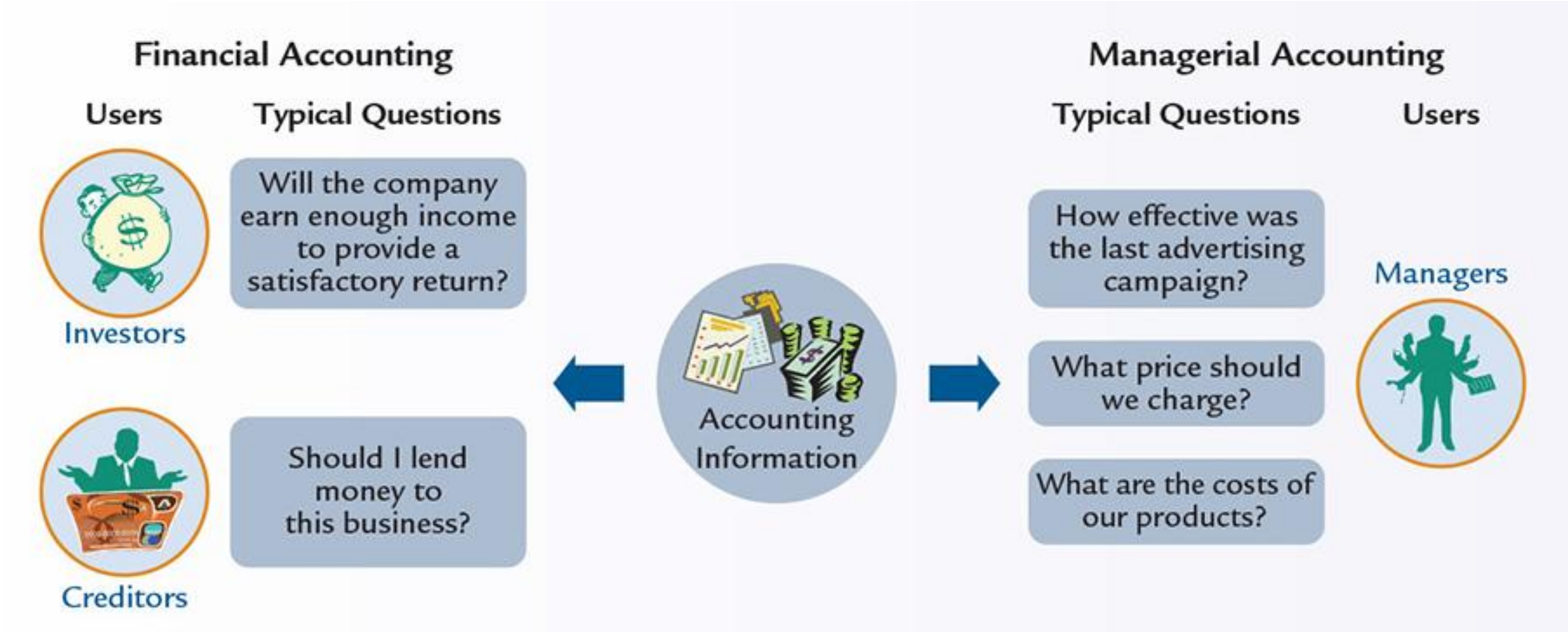
- The demand for accounting information comes from both inside and outside a business. Its users are wide-ranging with varied needs and different objectives:
  - A company's managers and employees
  - Investors
  - Government and regulatory agencies
  - Vendors and customers
  - Lenders and creditors
  - Credit rating organizations and financial analysts
  - Labor unions (who negotiate for employees)

Why Is Accounting Important?
(Learning Objective 1.1)

- **Accounting***: The process of identifying, measuring, recording, and communicating financial information about a company's activities so decision-makers can make informed decisions.
  - The "language of business"—It communicates relevant and reliable information about the economic activities of a company that helps people make better decisions.
  - Multiple decision-makers, both inside and outside of a company, use the financial information provided by accountants.

* Words accompanied by an asterisk are key terms from the chapter.

Exhibit 1.1—The Demand for Accounting Information



- **Financial accounting***: Accounting and reporting to satisfy the outside demand (primarily investors and creditors) for accounting information.
- Managerial accounting: Accounting that is designed to meet the needs of internal users.

Financial Reporting

- **Financial reporting** (or **disclosure**)*: The process of communicating financial accounting information to external decision-makers.
  - Allows investors to make informed decisions
  - Increases the transparency of a company's operations
  - Reduces the risk of manipulation and fraud
  - Adds stability to the capital markets
- Objective: To provide external decision-makers with information that assists in assessing amounts, timing, and uncertainties of a company's future cash flows.
- There are four basic financial statements: the balance sheet, the income statement, the retained earnings statement, and the statement of cash flows.

Data Analytics

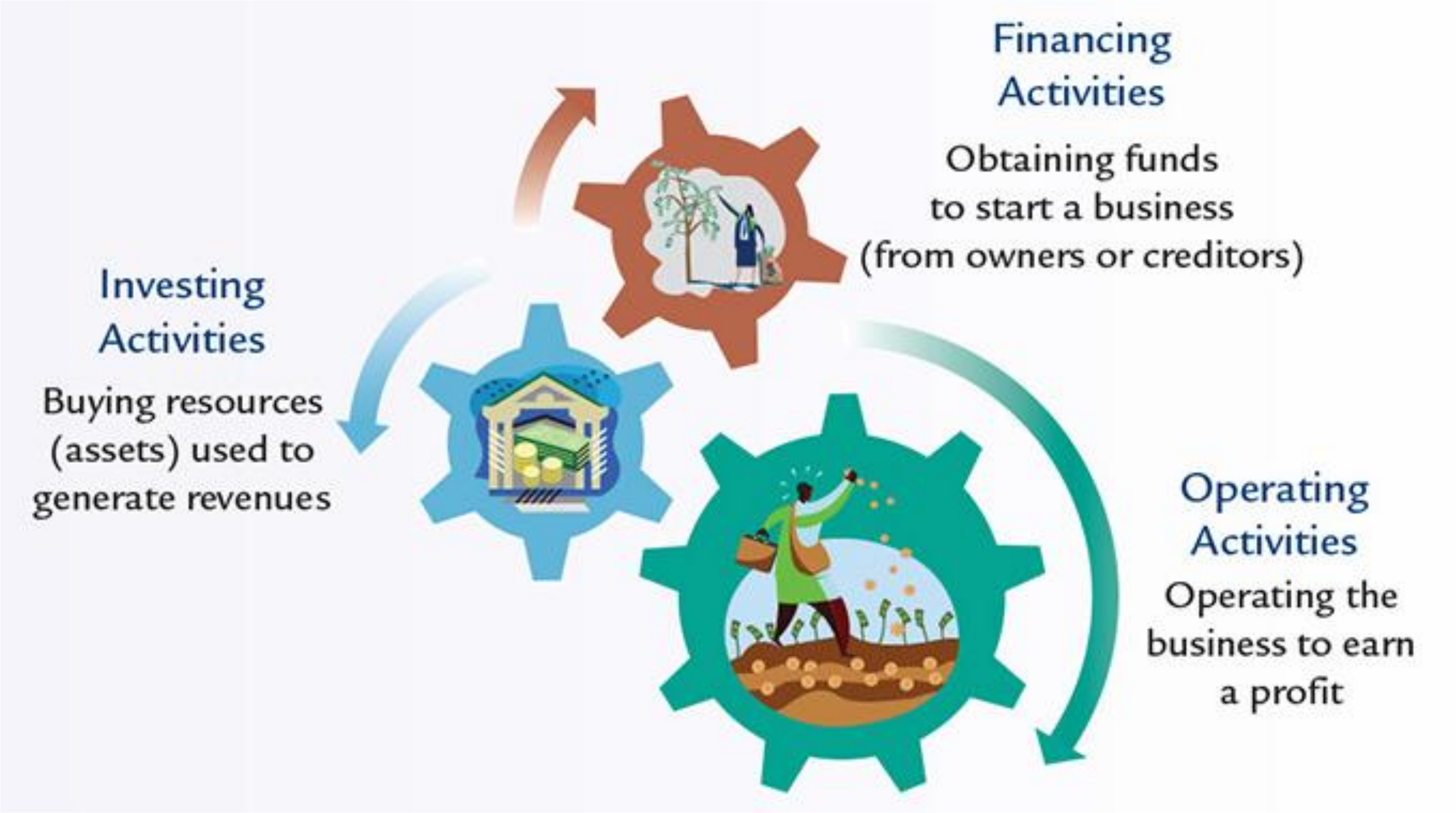
- **Data analytics***: The process of analyzing data so that businesses can make decisions more efficiently.

Type	**Description**	**Example**
Descriptive	Describes what has happened or summarizes outcomes	Did we meet our sales quota for the month?
Diagnostic	Explains why things happened by trying to understand how variables are related	Is there a relation between the volume of product sold and its appearance in a video with a popular YouTuber?
Predictive	Attempts to predict what will happen in the future	What is the probability of the video going viral, and is this likely to lead to increased product demand?
Prescriptive	Recommends a possible course of action	If the video has a 70% probability of going viral, we should increase production.

Businesses: Forms and Activities
(Learning Objective 1.2)

- **Sole proprietorship***: A business owned by one person.
- **Partnership***: A business owned jointly by two or more individuals.
- **Corporation***: A company chartered by the state to conduct business as an "artificial person" and owned by one or more stockholders.

Exhibit 1.3—Business Activities



Financing Activities

- A corporation's financing activities include obtaining the funds necessary to begin and operate a business.
  - These funds come from either borrowing money or issuing stock.
    - **Creditor***: The person to whom money is owed.
    - **Liability***: Probable future sacrifices of economic benefits; liabilities usually require the payment of cash, the transfer of assets other than cash, or the performance of services.
    - **Assets***: Economic resources representing expected future economic benefits controlled by the business (e.g., cash, accounts receivable, inventory, land, buildings, equipment, and intangible assets).
    - **Stockholders' equity***: The owners' claims against the assets of a corporation after all liabilities have been deducted.

Investing Activities

- Once a corporation has obtained funds through its financing activities, it buys assets (land, buildings, machinery, equipment) that enable it to operate.
  - The purchase and sale of the assets that are used in operations (commonly referred to as operating assets) are a corporation's investing activities.
  - Regardless of its form, assets are economic benefits that a corporation controls.
  - The assets purchased by a corporation vary depending on the type of business that the corporation engages in, and the composition of these assets is likely to vary across different companies and different industries.

Operating Activities

- Once a corporation has acquired the assets it needs, it can begin to operate. While different businesses have different purposes, they all want to generate revenue.
  - **Revenue***: The increase in assets that results from the sale of products or services.
  - **Expenses***: The cost of assets used, or the liabilities created, in the operation of the business.
  - **Net income***: The excess of a company's revenues over its expenses during a period of time.
  - **Net loss***: The excess of a company's expenses over its revenue during a period of time.

Knowledge Check 1

Which of the following is considered a disadvantage of the corporate business form?

a) Liability

b) Ownership transfer

c) Raising funds

d) Taxation

Knowledge Check 1 Debrief

Which of the following is considered a disadvantage of the corporate business form?

a) Liability

b) Ownership transfer

c) Raising funds

d) Taxation

The ability to raise capital by selling new shares, the limited legal liability of owners, and the transferability of the shares give the corporation an advantage over other forms of business organization. However, corporations generally pay more taxes. This occurs because corporate earnings are taxed at the corporate level and individual shareholders are taxed again at the individual level when earnings are distributed (known as double taxation).

Communication of Accounting Information
(Learning Objective 1.3)

How well did the company perform during the year?

From what sources did a company's cash come and for what did the company use cash during the year?

What are the economic resources of the company and the claims against those resources?

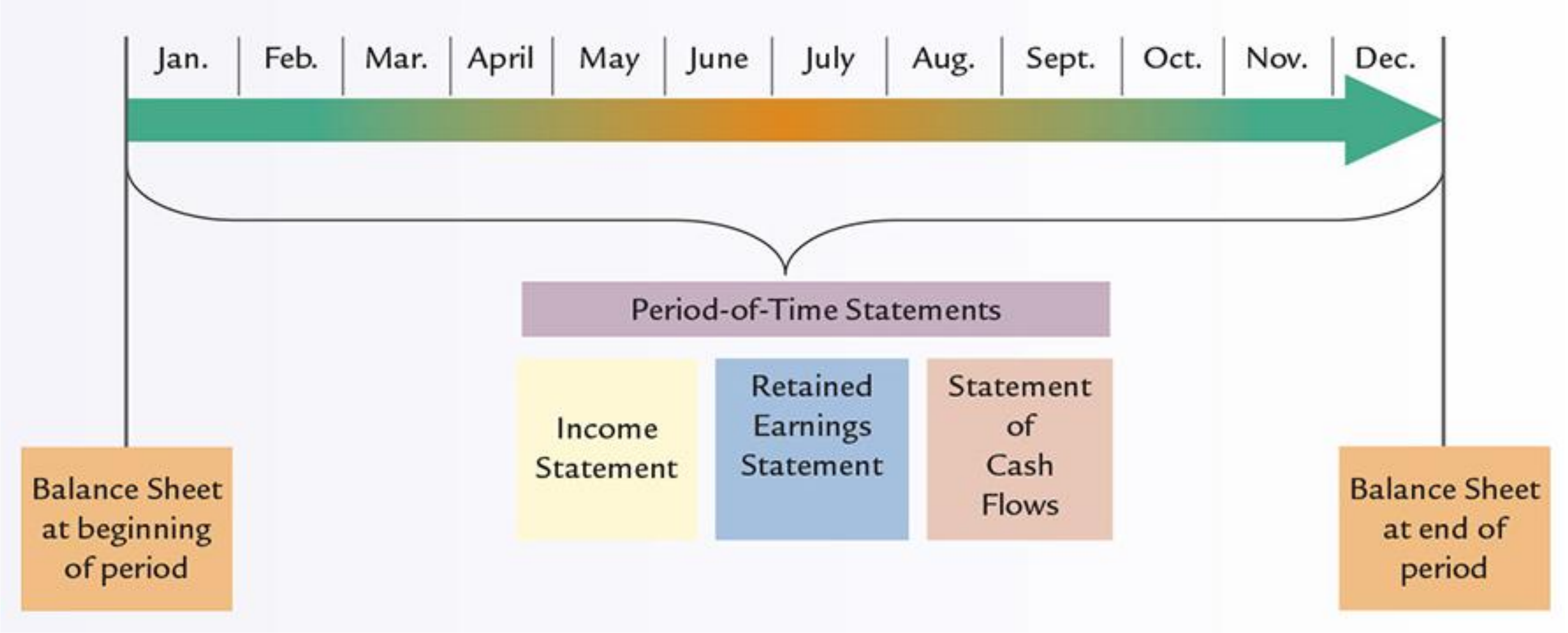
How much better off is the company at the end of the year compared to the beginning of the year?

- **Financial statements***: A set of standardized reports in which the detailed transactions of a company's activities are reported and summarized so they can be communicated to decision-makers.

The Four Basic Financial Statements

- **Balance sheet***: A financial statement that reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time.
- **Income statement***: A financial statement that reports the profitability of a business over a specific period of time.
- **Retained earnings statement***: A financial statement that reports how much of the company's income was retained in the business and how much was distributed to owners for a period of time.
- **Statement of cash flows***: A financial statement that provides relevant information about a company's cash receipts (inflows of cash) and cash payments (outflows of cash) during an accounting period.

Exhibit 1.5—
Financial Statement Time Periods



Rules and Conventions

- **Generally accepted accounting principles (G A A P)***: The rules and conventions used to prepare financial statements. By following these rules and conventions financial statements users are able to compare performance over time and across companies.
  - **Securities and Exchange Commission (S E C)***: The federal agency established by Congress to regulate securities markets and ensure effective public disclosure of accounting information. The S E C has the power to set accounting rules for publicly traded companies.
    - **Financial Accounting Standards Board (F A S B)***: The primary accounting standard-setter in the United States which has been granted this power to set standards by the Securities and Exchange Commission.
- The F A S B has been working closely with the **International Accounting Standards Board (I A S B)*** in its development of **international financial reporting standards (I F R S)*** globally.

The Fundamental Accounting Equation

- The **fundamental accounting equation*** states that a company's resources (its assets) must always be equal to the claims on those resources (its liabilities and stockholders' equity).
  - The left side shows the assets, or economic resources, of a company.
  - The right side of the accounting equation indicates who has a claim on the company's assets.

$$\underbrace{\text{Assets}}_{\substack{\text{economic}\\\text{resources}}} = \underbrace{\text{Liabilities}}_{\substack{\text{creditor}\\\text{claims}}} + \underbrace{\text{Stockholders' Equity}}_{\substack{\text{owner}\\\text{claims}}}$$

Example 1.1—Using the Fundamental Accounting Equation

Why: A company's resources (its assets) must always equal the claims on those resources (its liabilities and stockholders' equity).

Information: On January 1, Gundrum Company reported assets of $125,000 and liabilities of $75,000. During the year, assets increased by $44,000 and stockholders' equity increased by $15,000.

Required:

1. What is the amount reported for stockholders' equity on January 1?
2. What is the amount reported for liabilities on December 31?

Solution:

1. Stockholders' equity on January 1 is $50,000. This amount is calculated by rearranging the fundamental accounting equation as follows:

Assets = Liabilities + Stockholders' Equity

$125,000 = $75,000 + Stockholders' Equity

Stockholders' Equity = $125,000 – $75,000 = <u>$50,000</u>

2. At December 31, liabilities are $104,000. This amount is computed by adding the change to the appropriate balance sheet elements and then rearranging the fundamental accounting equation as follows:

Assets = Liabilities + Stockholders' Equity

($125,000 + $44,000) = Liabilities + ($50,000 + $15,000)

Liabilities = ($125,000 + $44,000) – ($50,000 + $15,000)

= $169,000 – $65,000 = <u>$104,000</u>

Knowledge Check 2

Which of the four basic financial statements reports the profitability of a business over a specific period of time?

a) Balance sheet

b) Income statement

c) Retained earnings statement

d) Statement of cash flows

Knowledge Check 2 Debrief

Which of the four basic financial statements reports the profitability of a business over a specific period of time?

a) Balance sheet

b) Income statement
The income statement reports the profitability of a business over a specific period of time.

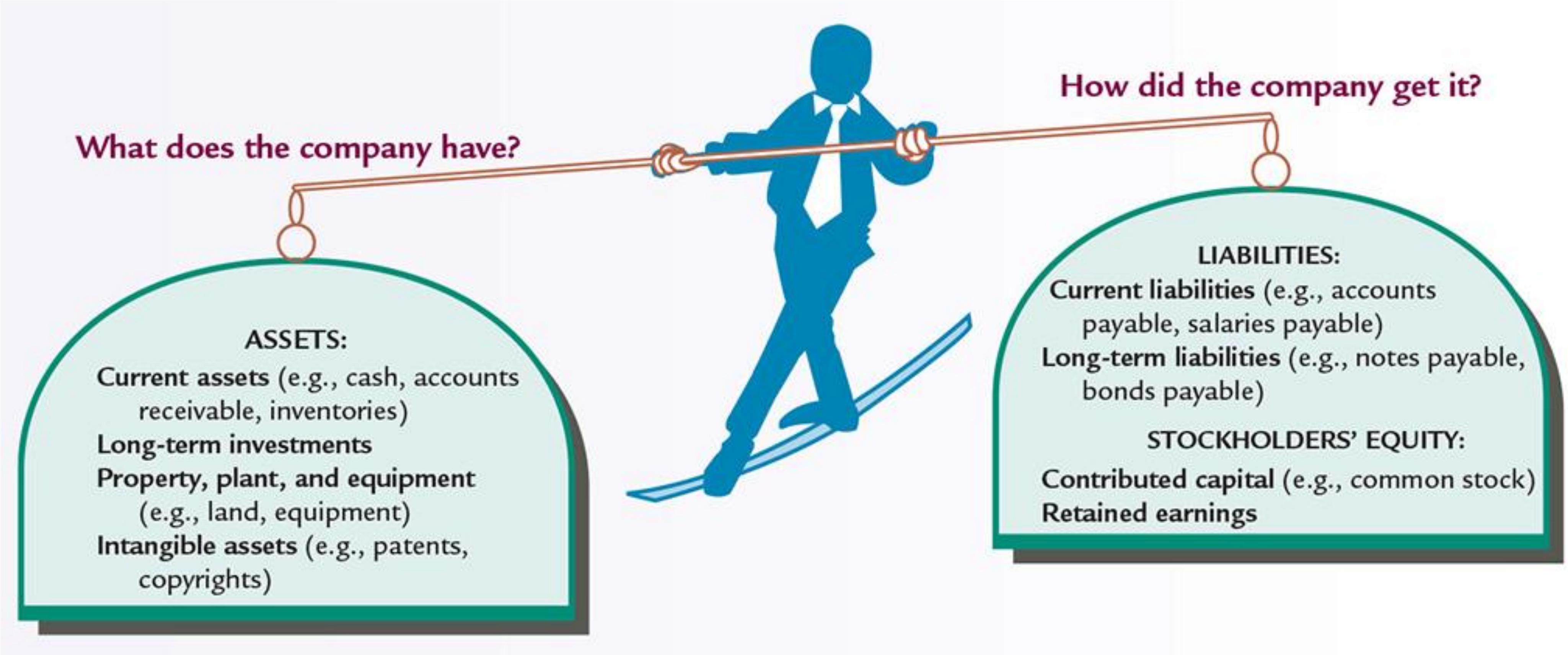
c) Retained earnings statement

d) Statement of cash flows

The Classified Balance Sheet
(Learning Objective 1.4)

- The purpose of the balance sheet is to report the financial position of a company (its assets, liabilities, and stockholders' equity) at a specific point in time.
- The balance sheet gets its name because the economic resources of a company (assets) must always equal, or be in balance with, the claims against those resources (liabilities and stockholders' equity).
- The balance sheet is organized, or classified, to help users identify the fundamental economic similarities and differences between the various items within the balance sheet.

Exhibit 1.6—
Common Balance Sheet Classifications



Current Assets

- **Current assets***: Cash and other assets that are reasonably expected to be converted into cash within one year or one operating cycle, whichever is longer.
  - **Operating cycle***: The average time that it takes a company to purchase goods, resell them, and collect the cash from customers.
  - Common types of current assets are:
    - Cash
    - Marketable securities—Short-term investments in the debt and stock of other companies as well as government securities
    - Accounts receivable—The right to collect an amount due from customers
    - Inventories—Goods or products held for resale to customers
    - Other current assets—A “catch-all” category that includes items such as prepaid expenses (advance payments for rent, insurance, and other services) and supplies

Noncurrent Assets

- Assets that are not classified as current are classified as long-term or noncurrent assets.
  - **Long-term investments***: Investments that the company expects to hold for longer than one year. This includes land or buildings that a company is not currently using in operations, as well as debt and equity securities.
  - **Property, plant, and equipment***: The tangible, long-lived, productive assets used by a company in its operations to produce revenue. This includes land, buildings, machinery, manufacturing equipment, office equipment, and furniture.
  - **Intangible assets***: Intangible assets are similar to property, plant, and equipment in that they provide a benefit to a company over a number of years; however, these assets lack physical substance.
  - Other noncurrent assets: A catch-all category that includes items such as deferred charges (long-term prepaid expenses) and other long-term miscellaneous items.

Current Liabilities

- **Current liabilities***: Obligations that require a firm to pay cash or another current asset, create a new current liability, or provide goods or services within one year or one operating cycle, whichever is longer.
  - Typically listed in the order in which they will be paid and include:
    - Accounts payable—An obligation to repay a vendor or supplier for merchandise supplied to the company
    - Salaries payable—An obligation to pay an employee for services performed
    - Unearned revenue—An obligation to deliver goods or perform a service for which a company has already been paid
    - Interest payable—An obligation to pay interest on money that a company has borrowed
    - Income taxes payable—An obligation to pay taxes on a company's income

Long-Term Liabilities and Stockholders' Equity

- **Long-term liabilities***: The obligations of the company that will require payment beyond one year or the operating cycle, whichever is longer.
- **Stockholders' equity***: The owners' claims against the assets of a corporation after all liabilities have been deducted.
  - **Contributed capital***: The owners' contributions of cash and other assets to the company (includes the common stock of a company).
  - **Retained earnings***: The accumulated earnings (or losses) over the entire life of the corporation that have not been paid out in dividends.
- Together, a company's liabilities and equity make up the **capital*** of a business.

Preparing a Classified Balance Sheet

Step 1: Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.

Step 2: List the assets of the company in order of their liquidity or nearness to cash. Use appropriate classifications. Add the assets and double underline the total.

Step 3: List the liabilities of the company in order of their time to maturity. Use appropriate classifications.

Step 4: List the stockholders' equity balances with appropriate classifications.

Step 5: Add the liabilities and stockholders' equity and double underline the total.

Example 1.2—
Preparing a Classified Balance Sheet (1 of 3)

Why: The balance sheet reports the financial position of a company (it's assets, liabilities, and stockholders' equity) at a specific point in time.

Information: Hightower Inc. reported the following account balances at December 31:

Inventories	$ 2,300	Accumulated depreciation	$ 5,800
Land	12,100	Accounts payable	3,750
Salaries Payable	1,200	Common stock	14,450
Accounts receivable	4,200	Patents	2,500
Cash	2,500	Notes payable, long-term	8,100
Equipment	21,000		

Required: Prepare Hightower's balance sheet at December 31.

Example 1.2—
Preparing a Classified Balance Sheet (2 of 3)

Solution:

Hightower Inc.
Balance Sheet
December 31
Assets

Step 1

Current assets:		
Cash	$ 2,500	
Accounts receivable	4,200	
Inventories	2,300	
Total current assets		$ 9,000
Property, plant, and equipment:		
Land	$12,100	
Equipment	21,000	
Less: accumulated depreciation	(5,800)	
Total property, plant, and equipment		27,300
Intangible assets:		
Patents		2,500
Total assets		$38,800

Step 2

Example 1.2—
Preparing a Classified Balance Sheet (3 of 3)

Solution continued:

Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	$ 3,750		
Salaries payable	1,200		
Total current liabilities		$ 4,950	Step 3
Long-term liabilities:			
Notes payable		8,100	
Total liabilities		$13,050	
Stockholders' equity:			
Common stock	$14,450		Step 4
Retained earnings	11,300		
Total stockholders' equity		25,750	
Total liabilities and stockholders' equity		$38,800	Step 5

Using Balance Sheet Information

- The balance sheet conveys important information about the structure of assets, liabilities, and stockholders' equity, which is used to judge a company's financial health, such as its liquidity.
- **Liquidity***: A company's ability to pay obligations as they become due.
  - **Working capital***: A measure of liquidity computed as:

    Working Capital = Current Assets – Current Liabilities

  - **Current ratio***: A measure of liquidity that is computed as:

    Current Ratio = Current Assets ÷ Current Liabilities

Knowledge Check 3

What does a balance sheet “balance”?

a) A company’s retained earnings against its contributed capital

b) A company’s current assets against its intangible assets

c) A company’s assets against its liabilities and stockholders’ equity

d) A company’s long-term investments against its long-term liabilities

Knowledge Check 3 Debrief

What does a balance sheet “balance”?

a) A company’s retained earnings against its contributed capital

b) A company’s current assets against its intangible assets

c) **A company’s assets against its liabilities and stockholders’ equity**
The balance sheet gets its name because the economic resources of a company (assets) must always equal, or be in balance with, the claims against those resources (liabilities and stockholders’ equity).

d) A company’s long-term investments against its long-term liabilities

The Income Statement
(Learning Objective 1.5)

- The income statement reports the results of a company's operations—the sale of goods and services and the associated cost of operating the company—for a given period.
- The income statement consists of two major items:
  - Revenues and gains
    - **Revenue***: The increase in assets that results from the sale of products or services.
    - **Gains***: Increases in net assets that occur from peripheral or incidental transactions.
  - Expenses and losses
    - **Expenses***: The cost of assets used, or the liabilities created, in the operation of the business.
    - **Losses***: Decreases in net assets that occur from peripheral or incidental transactions.

Preparing a Single-Step Income Statement

Step 1: Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.

Step 2: List the revenues of the company, starting with sales revenue (or service revenue) and then listing other revenue items. Add the revenues to get total revenue.

Step 3: List the expenses of the company, usually starting with cost of goods sold. Add the expenses to get total expenses.

Step 4: Subtract the expenses from the revenues to get net income (or net loss if expenses exceed revenues). Double-underline net income.

Example 1.3—Preparing a Single-Step Income Statement (1 of 2)

Why: The income statement reports the results of a company's operations (revenues minus expenses) for a given period of time.

Information: Hightower Inc. reported the following account balances for the year ending December 31:

Cost of goods sold	$31,300	Interest expense	$ 540
Salaries expense	8,800	Sales revenue	50,600
Insurance expense	700	Depreciation expense	1,500
Interest income	1,200	Rent expense	2,100
Income taxes expense	2,000		

Required: Prepare a single-step income statement for Hightower for the year ending December 31.

Example 1.3—Preparing a Single-Step Income Statement (2 of 2)

Solution:

Hightower Inc. Income Statement For the year ended December 31			
			Step 1
Revenues:			Step 2
Sales revenue	$50,600		
Interest income	1,200		
Total revenues		$ 51,800	
Expenses:			Step 3
Cost of goods sold	$31,300		
Salaries expense	8,800		
Rent expense	2,100		
Depreciation expense	1,500		
Insurance expense	700		
Interest expense	540		
Income taxes expense	2,000		
Total expenses		(46,940)	
Net income		$ 4,860	Step 4

Multiple-Step Income Statement

- The multiple-step income statement organizes revenues and expenses into multiple categories.
  - The resulting subtotals highlight important relationships between revenues and expenses that financial statement users find useful.
  - A multiple-step income statement contains three important subtotals:
    - **Gross margin** (**gross profit**)*: A key performance measure that is computed as sales revenue less cost of goods sold.
    - **Income from operations** (**operating income**)*: Gross margin less operating expenses. This represents the results of the core operations of the business.
    - **Nonoperating activities***: Revenues and expenses from activities other than the company's principal operations.

Exhibit 1.10—Typical Nonoperating Items

Other Revenues and Gains

- Interest income on investments
- Dividend income from investments in stock of other companies
- Rent revenue
- Gains on disposal of property, plant, and equipment

Other Expenses and Losses

- Interest expense from loans
- Losses from disposal of property, plant, and equipment
- Losses from accidents or vandalism
- Losses from employee strikes
- Income taxes expense

Preparing a Multiple-Step Income Statement

Step 1: Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.

Step 2: Compute gross profit as the difference between net sales and cost of goods sold.

Step 3: Compute income from operations by subtracting operating expenses from gross profit.

Step 4: Compute income before income taxes by subtracting nonoperating activities from income from operations.

Step 5: Compute net income (or net loss) by subtracting income taxes expense from income before income taxes. Double-underline net income.

Example 1.4—
Preparing a Multiple-Step Income Statement (1 of 2)

Why: The multiple-step income statement reports the results of a company's operations, with revenues and expenses organized into multiple categories to highlight important relationships.

Information: Hightower Inc. reported the following account balances for the year ending December 31:

Cost of goods sold	$31,300	Interest expense	$ 540
Salaries expense	8,800	Sales revenue	50,600
Insurance expense	700	Depreciation expense	1,500
Interest income	1,200	Rent expense	2,100
Income taxes expense	2,000		

Required: Prepare a multiple-step income statement for Hightower for the year ending December 31.

Example 1.4—
Preparing a Multiple-Step Income Statement (2 of 2)

Solution:

Hightower Inc. Income Statement For the year ended December 31			
			Step 1
Sales revenue	$ 50,600		
Cost of goods sold	(31,300)		Step 2
Gross margin		$ 19,300	
Operating expenses:			
Salaries expense	$ 8,800		
Rent expense	2,100		
Depreciation expense	1,500		Step 3
Insurance expense	700		
Total operating expenses		(13,100)	
Income from operations		$ 6,200	
Other income and expenses:			
Interest income	$ 1,200		
Interest expense	(540)		Step 4
Total other income and expenses		660	
Income before income taxes		$ 6,860	
Income taxes expense		(2,000)	Step 5
Net income		$ 4,860	

Using Income Statement Information

- A company's ability to generate current income is useful in predicting its ability to generate future income.
  - Investors' and creditors' estimates of the future profitability and growth of a company are aided by a careful examination of how a company has earned its revenue and managed its expenses.
- **Net profit margin***: A measure of the proportion of each sales dollar that is profit, determined by dividing net income by net sales.

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Sales (or Service) Revenue}}$$

Knowledge Check 4

What is a useful measure of a company's ability to generate profit?

a) Gross margin

b) Net profit margin

c) Net income

d) Income from operations

Knowledge Check 4 Debrief

What is a useful measure of a company's ability to generate profit?

a) Gross margin

b) Net profit margin
Net profit margin shows the percentage of profit in each dollar of sales revenue (or service revenue). Gross margin represents the initial profit made from selling a product, but it is not a measure of total profit because other operating expenses have not yet been subtracted.

c) Net income

d) Income from operations

Retained Earnings Statement
(Learning Objective 1.6)

- The owners of a company contribute capital in one of two ways:
  - Directly—Though purchases of common stock from the company
  - Indirectly—By the company retaining some or all of the net income earned each year rather than paying it out in dividends
- The retained earnings statement summarizes and explains the changes in retained earnings during the accounting period.
  - The beginning balance in retained earnings is increased by net income earned during the year and decreased by any dividends that were declared.

Preparing a Retained Earnings Statement

Step 1: Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.

Step 2: List the retained earnings balance at the beginning of the period obtained from the balance sheet.

Step 3: Add net income obtained from the income statement.

Step 4: Subtract any dividends declared during the period. Double-underline the total, which should equal retained earnings at the end of the period as reported on the balance sheet.

Example 1.5—
Preparing a Retained Earnings Statement (1 of 2)

Why: The retained earnings statement explains the changes in retained earnings during an accounting period.

Information: Hightower Inc. reported the following account balances for the year ending December 31:

Net income	$4,860	Retained earnings, Jan 1	$ 9,440
Dividends declared	3,000	Retained earnings, Dec 31	11,300

Required: Prepare Hightower's retained earnings statement for the year ending December 31.

Example 1.5—
Preparing a Retained Earnings Statement (2 of 2)

Solution:

Hightower Inc. Retained Earnings Statement For the year ended December 31		
Retained earnings, January 1	$ 9,440	Step 2
Add: Net income	4,860	Step 3
Less: Dividends declared	(3,000)	Step 4
Retained earnings, December 31	$11,300	

Step 1

Use of the Retained Earnings Statement

- The retained earnings statement is used to monitor and evaluate a company’s dividend payouts to its shareholders.
  - Some older investors seek out companies with high dividend payouts so that they will receive cash during the year.
  - Other investors are more interested in companies that are reinvesting a sufficient amount of earnings that will enable them to pursue profitable growth opportunities.
  - Creditors are interested in a company’s dividend payouts.
    - If a company pays out too much in dividends, the company may not have enough cash on hand to repay its debt when it becomes due.

Statement of Cash Flows
(Learning Objective 1.7)

- The statement of cash flows describes the company's cash receipts (cash inflows) and cash payments (cash outflows) for a period of time.
  - **Cash flows from operating activities***: Any cash flows directly related to earning income, including cash sales and collections of accounts receivable as well as cash payments for goods, services, salaries, and interest.
  - **Cash flows from investing activities***: The cash inflows and outflows that relate to acquiring and disposing of operating assets, acquiring and selling investments (current and long-term), and lending money and collecting loans.
  - **Cash flows from financing activities***: Any cash flow related to obtaining capital resources from creditors or owners, which includes the issuance and repayment of debt, common and preferred stock transactions, and the payment of dividends.
- A company with healthy cash flow is in a good position to repay debts as they come due and is usually a low-risk borrower.

Relationships Among the Statements
(Learning Objective 1.8)

- **Articulation***: Describes the linkages between the financial statements.
  - The income statement links the beginning and ending balance sheet through retained earnings.
  - The statement of shareholders' equity links the beginning and ending balances of equity.
  - The statement of cash flows links the beginning and ending balances of cash.

Exhibit 1.13—Relationships Among the Financial Statements

Beginning of the Period → End of the Period

Hightower Inc.
Balance Sheet
Jan. 1

Assets:	
Cash	$ 2,030
Other assets	32,360
Total assets	$34,390
Liabilities:	
Total liabilities	$ 10,500
Stockholders' equity:	
Common stock	14,450
Retained earnings	9,440
Total liabilities & stockholders' equity	$ 34,390

Hightower Inc.
Income Statement
For the year ended Dec. 31

Revenues	$51,800
Expenses	46,940
Net income	$ 4,860

Hightower Inc.
Retained Earnings Statement
For the year ended Dec. 31

Retained earnings, Jan. 1	$ 9,440
Add: Net income	4,860
Less: Dividends declared	(3,000)
Retained earnings, Dec. 31	$11,300

Hightower Inc.
Statement of Cash Flows
For the year ended Dec. 31

Net cash provided from operating activities	$3,470
Net cash used by investing activities	(4,800)
Net cash provided from financing activities	1,800
Net change in cash	$ 470
Cash, Jan. 1	2,030
Cash, Dec. 31	$2,500

Hightower Inc.
Balance Sheet
Dec. 31

Assets:	
Cash	$ 2,500
Other assets	36,300
Total assets	$38,800
Liabilities:	
Total liabilities	$13,050
Stockholders' equity:	
Common stock	14,450
Retained earnings	11,300
Total liabilities & stockholders' equity	$38,800

Knowledge Check 5

The income statement links the beginning and ending balance sheet through which of the following?

a) Retained earnings

b) Revenues generated

c) Statement of cash flows

d) Statement of shareholders’ equity

Knowledge Check 5 Debrief

The income statement links the beginning and ending balance sheet through which of the following?

a) **Retained earnings**
   The income statement links the beginning and ending balance sheet through retained earnings. The statement of shareholders' equity links the beginning and ending balances of equity. The statement of cash flows links the beginning and ending balances of cash.

b) Revenues generated

c) Statement of cash flows

d) Statement of shareholders' equity

Additional Reporting Considerations
(Learning Objective 1.9)

- **Environmental, social, and governance (E S G)***: A framework used to assess a company's business practices and performance on various sustainability and ethical issues.
  - Evidence suggests that E S G strategies increase growth, reduce costs, ease regulatory pressure, improve productivity, and optimize capital allocation.
- Accountants also have an ethical responsibility to accurately and dependably report financial statement information.
  - The American Institute of Certified Public Accountants (A I C P A) has adopted a code of professional conduct for accountants.
  - The violation of ethical standards may not always bring clear and direct penalties; however, it often has subtle and long-lasting negative consequences for individuals and companies.

Exhibit 1.14—
Guidelines in Ethical Decision-Making

Recognize the Ethical Issue	Use your personal ethics to recognize the problem.	Gather the facts.	Look to written codes of conduct for guidance.
Analyze Your Options	Consider the impact on the affected person or groups.	Is the action respectful of others' rights?	Is the action fair and just?
Make a Decision	Choose the best option that fulfills your ethical responsibilities.	Recognize that there may be more than one "right" answer.	

Discussion Activity

There has been a recent backlash in the US against E S G initiatives, with politicians, employees, investors, consumers, and the media accusing asset managers of failing to honor their fiduciary duty, arguing that applying E S G to business decisions compromises financial returns.

However, a focus on E S G issues does not necessarily compromise a company’s financial performance. In fact, some evidence suggests that E S G strategies increase growth, reduce costs, ease regulatory pressure, improve productivity, and optimize capital allocation.

- How might a company proceed with its E S G strategies in a manner that addresses this backlash?

Discussion Activity Debrief

- A 2023 report by The Conference Board (a nonprofit think tank and business membership organization) recommends that corporate boards and management view backlash as an opportunity to clarify their E S G strategy and communications.
  - Ensure the company's E S G positions align with company's core business strategy, are supported by empirical data, and serve the long-term welfare of the company, its stakeholders, and society.
  - Reevaluate E S G strategies, priorities, and commitments.
  - Facilitate candid discussion between the board and senior management to discuss how E S G and multistakeholder capitalism fit into the company's strategy.
  - Increase focus on how E S G connects with shareholder value.
  - Adjust terminology from E S G (which resonates well with investors) to "sustainability" (which tends to be more readily understood by employees, customers, and policymakers).
  - Put the company's commitment to E S G in the context of the company's longstanding commitment to delivering profitable performance in a responsible manner.
  - Constructively engage with policymakers in private conversations, through trade associations, and in concert with small businesses.

Summary

- Regardless of which functional area in which you are employed in a company, you will use financial statement data.
- You also will be evaluated based on the impact of your decisions on your company’s financial statement data.
- For financial statements are to be of value to the wide range of users, they must have confidence in the information they present.
- Therefore, it is important to understand the elements in each statement and how these elements are interrelated through the key linkages between statements.