TT TEXTBOOK TESTBANKS

# Solutions Manual for Fundamentals of Financial Accounting 7th Phillips

SOLUTIONS MANUAL SAMPLE PREVIEW

PUBLISHER
McGraw-Hill

COPYRIGHT
2022

RESOURCE TYPE
Solutions Manual

ISBN
9781260771381

# Chapter 1
# Business Decisions and Financial Accounting

## ANSWERS TO QUESTIONS

1. Accounting is a system of analyzing, recording, and summarizing the results of a business's activities and then reporting them to decision makers.

2. An advantage of operating as a sole proprietorship, rather than a corporation, is that it is easy to establish. Another advantage is that income from a sole proprietorship is taxed only once in the hands of the individual proprietor (income from a corporation is taxed in the corporation and then again in the hands of the individual shareholder). A disadvantage of operating as a sole proprietorship, rather than a corporation, is that the individual proprietor can be held responsible for the debts of the business.

3. Financial accounting focuses on preparing and using the financial statements that are made available to owners and external users such as customers, creditors, and potential investors who are interested in reading them. Managerial accounting focuses on other accounting reports that are not released to the general public, but instead are prepared for internal decision making and used by employees, supervisors, and managers who run the company.

4. Financial reports are used by both internal and external groups and individuals. The internal groups are comprised of the various managers of the business. The external groups include investors, creditors, governmental agencies, other interested parties, and the public at large.

5. The business itself, not the individual stockholders who own the business, is viewed as owning the assets and owing the liabilities on its balance sheet. A business's balance sheet includes the assets, liabilities, and stockholders' equity of only that business and not the personal assets, liabilities, and equity of the stockholders. The financial statements of a company show the results of the business activities of only that company.

6. (a) Operating – These activities are directly related to earning profits. They include buying supplies, making products, serving customers, cleaning the premises, advertising, renting a building, repairing equipment, and obtaining insurance coverage.
   (b) Investing – These activities involve buying and selling productive resources with long lives (such as buildings, land, equipment, and tools), purchasing investments, and lending to others.
   (c) Financing – Any borrowing from banks, repaying bank loans, receiving contributions from stockholders, or paying dividends to stockholders are considered financing activities.

7. The heading of each of the four primary financial statements should include the following:
   (a) Name of the business
   (b) Name of the statement
   (c) Date of the statement, or the period of time that the statement covers

8. (a) The purpose of the balance sheet is to report the financial position (assets, liabilities and stockholders' equity) of a business at a point in time.
   (b) The purpose of the income statement is to present information about the revenues, expenses, and net income of a business for a specified period of time.
   (c) The statement of retained earnings reports the way that net income and the distribution of dividends affected the financial position of the company during the period.
   (d) The purpose of the statement of cash flows is to summarize how a business's operating, investing, and financing activities caused its cash balance to change over a particular period of time.

9. The income statement, statement of retained earnings, and statement of cash flows would be dated "For the Year Ended December 31, 2021," because they report the inflows and outflows of resources over a period of time. In contrast, the balance sheet would be dated "At December 31, 2021," because it represents the assets, liabilities and stockholders' equity at a specific date.

10. Net income is the excess of total revenues over total expenses. A net loss occurs if total expenses exceed total revenues.

11. The accounting equation for the balance sheet is: Assets = Liabilities + Stockholders' Equity. Assets are the economic resources controlled by the company. Liabilities are amounts owed by the business. Stockholders' equity is the owners' claims to the business. It includes amounts contributed to the business (by investors through purchasing the company's stock) and the amounts earned and accumulated through profitable business operations.

12. The equation for the income statement is Revenues – Expenses = Net Income. Revenues are increases in a company's resources, arising primarily from its operating activities. Expenses are decreases in a company's resources, arising primarily from its operating activities. Net Income is equal to revenues minus expenses. (If expenses are greater than revenues, the company has a Net Loss.)

13. The equation for the statement of retained earnings is: Beginning Retained Earnings + Net Income - Dividends = Ending Retained Earnings. It begins with beginning-of-the-year retained earnings which is the prior year's ending retained earnings reported on the prior year's balance sheet. The current year's net income reported on the income statement is added and the current year's dividends are subtracted from this amount. (If a net loss occurs, It would be subtracted, along with the dividends, from the prior year's ending retained earnings balance.)The ending retained earnings amount is reported on the end-of-year balance sheet. 14. The equation for the statement of cash flows is: Cash flows from operating activities + Cash flows from investing activities + Cash flows from financing activities = Change in cash for the period. Change in cash for the period + Beginning cash balance = Ending cash balance. The net cash flows for the period represent the increase or decrease in cash that occurred during the period. Cash flows from operating activities are cash flows directly related to earning income (normal business activity). Cash flows from investing activities include cash flows that are related to the acquisition or sale of the company's long-term assets. Cash flows from financing activities are directly related to the financing of the company.

15. Currently, the Financial Accounting Standards Board (FASB) is given the primary responsibility for setting the detailed rules that become Generally Accepted Accounting Principles (GAAP) in the United States. (Internationally, the International Accounting Standards Board (IASB) has the responsibility for setting accounting rules known as International Financial Reporting Standards (IFRS).)

16. The main goal of accounting rules is to ensure that companies produce useful financial information for present and potential investors, lenders, and other creditors in making decisions in their capacity as capital providers. Financial information must show relevance and faithful representation, as well as be comparable, verifiable, timely, and understandable.

17. An ethical dilemma is a situation where following one moral principle would result in violating another. Three steps that should be considered when evaluating ethical dilemmas are:
(a) Identify who will benefit from the situation (often, the manager or employee) and how others will be harmed (other employees, the company's reputation, owners, creditors, and the public in general).
(b) Identify the alternative courses of action.
(c) Choose the alternative that is the most ethical – that which you would be proud to have reported in the news media. Often, there is no one right answer and hard choices will need to be made. Following strong ethical practices is a key part of ensuring good financial reporting by businesses of all sizes.

18. Accounting frauds and cases involving academic dishonesty are similar in many respects. Both involve deceiving others in an attempt to influence their actions or decisions, often resulting in temporary personal gain for the deceiver. For example, when an accounting fraud is committed, financial statement users may be misled into making decisions they wouldn't have made had the fraud not occurred (e.g., creditors might loan money to the company, investors might invest in the company, or stockholders might reward top managers with big bonuses). When academic dishonesty is committed, instructors might assign a higher grade than is warranted by the student's individual contribution. Another similarity is that, as a consequence of the deception, innocent bystanders may be adversely affected by fraud and academic dishonesty. Fraud may require the company to charge higher prices to customers to cover costs incurred as a result of the fraud. Academic dishonesty may lead to stricter grading standards, with significant deductions taken for inadequate documentation of sources referenced. A final similarity is that if fraud and academic dishonesty are ultimately uncovered, both are likely to lead to adverse long-term consequences for the perpetrator. Fraudsters may be fined, imprisoned, and encounter an abrupt end to their careers. Students who cheat may be penalized through lower course grades or expulsion, and might find it impossible to obtain academic references for employment applications.

**Authors' Recommended Solution Time**

**(Time in minutes)**

| *Mini-exercises* | | *Exercises* | | *Problems* | | *Skills Development Cases** | | *Continuing Case* | |
|---|---|---|---|---|---|---|---|---|---|
| *No.* | *Time* | *No.* | *Time* | *No.* | *Time* | *No.* | *Time* | *No.* | *Time* |
| 1 | 3 | 1 | 10 | CP1-1 | 45 | 1 | 20 | 1 | 45 |
| 2 | 12 | 2 | 10 | CP1-2 | 10 | 2 | 20 | | |
| 3 | 12 | 3 | 15 | CP1-3 | 50 | 3 | 30 | | |
| 4 | 6 | 4 | 25 | CP1-4 | 5 | 4 | 30 | | |
| 5 | 4 | 5 | 25 | PA1-1 | 45 | 5 | 20 | | |
| 6 | 6 | 6 | 10 | PA1-2 | 10 | 6 | 30 | | |
| 7 | 6 | 7 | 15 | PA1-3 | 50 | 7 | 45 | | |
| 8 | 4 | 8 | 10 | PA1-4 | 5 | | | | |
| 9 | 4 | 9 | 20 | PB1-1 | 45 | | | | |
| 10 | 3 | 10 | 10 | PB1-2 | 10 | | | | |
| 11 | 3 | 11 | 3 | PB1-3 | 50 | | | | |
| 12 | 6 | 12 | 3 | PB1-4 | 5 | | | | |
| 13 | 5 | | | | | | | | |
| 14 | 5 | | | | | | | | |
| 15 | 4 | | | | | | | | |
| 16 | 12 | | | | | | | | |

* Due to the nature of cases, it is very difficult to estimate the amount of time students will need to complete them. As with any open-ended project, it is possible for students to devote a large amount of time to these assignments. While students often benefit from the extra effort, we find that some become frustrated by the perceived difficulty of the task. You can reduce student frustration and anxiety by making your expectations clear, and by offering suggestions (about how to research topics or what companies to select). The skills developed by these cases are indicated below.

| Case | Financial Analysis | Research | Ethical Reasoning | Critical Thinking | Technology | Writing | Teamwork |
|---|---|---|---|---|---|---|---|
| 1 | x | | | | | | |
| 2 | x | | | | | | |
| 3 | x | x | | | x | x | x |
| 4 | x | | x | x | | | |
| 5 | x | | | x | | x | |
| 6 | x | | | x | | x | |
| 7 | x | | | | x | | |

**Other assignment materials and related solutions can be found in Connect.**

## ANSWERS TO MINI-EXERCISES

### M1-1

| | Abbreviation | Full Designation |
|---|---|---|
| (1) | CPA | Certified Public Accountant |
| (2) | GAAP | Generally Accepted Accounting Principles |
| (3) | FASB | Financial Accounting Standards Board |
| (4) | SEC | Securities and Exchange Commission |
| (5) | IFRS | International Financial Reporting Standards |

### M1-2

| | | Term or Abbreviation |
|---|---|---|
| I | (1) | SEC |
| F | (2) | Investing activities |
| D | (3) | Private company |
| E | (4) | Corporation |
| A | (5) | Accounting |
| C | (6) | Partnership |
| J | (7) | FASB |
| G | (8) | Financing activities |
| B | (9) | Unit of measure |
| L | (10) | GAAP |
| K | (11) | Public company |
| H | (12) | Operating activities |

**Definition**

A. A system that collects and processes financial information about an organization and reports that information to decision makers.
B. Measurement of information about a business in the monetary unit (dollars or other national currency).
C. An unincorporated business owned by two or more persons.
D. A company that sells shares of its stock privately and is not required to release its financial statements to the public.
E. An incorporated business that issues shares of stock as evidence of ownership.
F. Buying and selling productive resources with long lives.
G. Transactions with lenders (borrowing and repaying cash) and stockholders (selling company stock and paying dividends).
H. Activities directly related to running the business to earn profit.
I. Securities and Exchange Commission.
J. Financial Accounting Standards Board.
K. A company that has its stock bought and sold on stock exchanges and is required to publicly release its financial statements.
L. Generally accepted accounting principles.

**M1-3**

| | Term | | Definition |
|---|---|---|---|
| F | (1) Relevance | A. | The financial reports of a business are assumed to include the results of only that business's activities. |
| C | (2) Faithful Representation | B. | The resources owned by a business. |
| E | (3) Expenses | C. | Financial information that depicts the economic substance of business activities. |
| A | (4) Separate Entity | D. | The total amounts invested and reinvested in the business by its owners. |
| B | (5) Assets | E. | The costs of business necessary to earn revenues. |
| H | (6) Liabilities | F. | A feature of financial information that allows it to influence a decision. |
| D | (7) Stockholders' Equity | G. | Earned by selling goods or services to customers. |
| G | (8) Revenues | H. | The amounts owed by the business. |

**M1-4**

| | Statement | Account Type |
|---|---|---|
| Cash (Example) | B/S | A |
| (1) Accounts Payable | B/S | L |
| (2) Accounts Receivable | B/S | A |
| (3) Income Tax Expense | I/S | E |
| (4) Sales Revenue | I/S | R |
| (5) Notes Payable | B/S | L |
| (6) Retained Earnings | B/S | SE |

**M1-5**

| | Statement | Account Type |
|---|---|---|
| (1) Accounts Receivable | B/S | A |
| (2) Sales Revenue | I/S | R |
| (3) Equipment | B/S | A |
| (4) Supplies Expense | I/S | E |
| (5) Cash | B/S | A |
| (6) Advertising Expense | I/S | E |
| (7) Accounts Payable | B/S | L |
| (8) Retained Earnings | B/S | SE |

**M1-6**

| | Type | Statement |
|---|---|---|
| (1) Accounts Receivable | A | B/S |
| (2) Office Expense | E | I/S |
| (3) Cash | A | B/S |
| (4) Equipment | A | B/S |
| (5) Advertising Expense | E | I/S |
| (6) Sales Revenue | R | I/S |
| (7) Notes Payable | L | B/S |
| (8) Retained Earnings | SE | B/S |
| (9) Accounts Payable | L | B/S |

**M1-7**

| | Type | Statement |
|---|---|---|
| (1) Accounts Payable | L | B/S |
| (2) Common Stock | SE | B/S |
| (3) Equipment | A | B/S |
| (4) Accounts Receivable | A | B/S |
| (5) Notes Payable | L | B/S |
| (6) Cash | A | B/S |
| (7) Retained Earnings | SE | B/S |
| (8) Office Expense | E | I/S |
| (9) Sales Revenue | R | I/S |
| (10) Supplies | A | B/S |

**M1-8**

| | Type | Statement |
|---|---|---|
| (1) Dividends | D | SRE |
| (2) Common Stock | SE | B/S |
| (3) Sales Revenue | R | I/S |
| (4) Equipment | A | B/S |
| (5) Cash | A | B/S |
| (6) Notes Payable | L | B/S |
| (7) Accounts Payable | L | B/S |
| (8) Retained Earnings, Beginning of Year | SE | SRE |

**M1-9**

| | | **Element** | **Financial Statement** |
|---|---|---|---|
| D | (1) | Cash Flows from Financing Activities | A. Balance Sheet |
| B | (2) | Expenses | B. Income Statement |
| D | (3) | Cash Flows from Investing Activities | C. Statement of Retained Earnings |
| A | (4) | Assets | D. Statement of Cash Flows |
| C | (5) | Dividends | |
| B | (6) | Revenues | |
| D | (7) | Cash Flows from Operating Activities | |
| A | (8) | Liabilities | |

**M1-10**

| | |
|---|---|
| (F) | (1) Cash paid for dividends |
| O | (2) Cash collected from customers |
| F | (3) Cash received when signing a note payable |
| (O) | (4) Cash paid to employees |
| (I) | (5) Cash paid to purchase equipment |
| F | (6) Cash received from issuing stock |

**M1-11**

| | |
|---|---|
| (I) | (1) Cash paid to purchase land |
| O | (2) Cash collected from clients |
| I | (3) Cash received from selling equipment |
| (F) | (4) Cash paid for dividends |
| (O) | (5) Cash paid to suppliers |
| F | (6) Cash received from issuing stock |

**M1-12**

STONE CULTURE CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2020

| | |
|---|---|
| Retained Earnings, January 1, 2020 | $ 0 |
| Add: Net Income | 40,000 |
| Subtract: Dividends | (15,000) |
| Retained Earnings, December 31, 2020 | $ 25,000 |

STONE CULTURE CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2021

| | |
|---|---|
| Retained Earnings, January 1, 2021 | $ 25,000 |
| Add: Net Income | 45,000 |
| Subtract: Dividends | (20,000) |
| Retained Earnings, December 31, 2021 | $ 50,000 |

**M1-13**

| | Alphabet, Inc. | Apple, Inc. | Intel Corp. |
|---|---|---|---|
| Common Stock | $43 | $28 | $26 |
| Dividends | 0 | 14 | 6 |
| Net Income | (a) 31 | (d) 69 | (g) 21 |
| Retained Earnings, Beginning of Year | 104 | 15 | 24 |
| Retained Earnings, End of Year | (b) 135 | (e) 70 | (h) 39 |
| Total Assets | (c) 234 | (f) 367 | (i) 128 |
| Total Expenses | 106 | 195 | 50 |
| Total Liabilities | 56 | 269 | 63 |
| Total Revenues | 137 | 264 | 71 |

Rev – Exp = NI, so (a) = \$137 – \$106 = \$31, (d) = \$264 – \$195 = \$69, (g) = \$71 – \$50 = \$21

RE(beg) + NI – Div = RE(end), so (b)=\$104 + \$31 – \$0 = \$135, (e) = \$15 + \$69 – \$14 = \$70,
(h) = \$24 + \$21 – \$6 = \$39

A = L + SE = L + CS + RE (end), so (c) = \$56 + \$43 + \$135 = \$234,
(f) = \$269 + \$28 + \$70 = \$367, (i) = \$63 + \$26 + \$39 = \$128

**M1-14**

| | Amazin' Corp. | Best Tech, Inc. | Colossal Corp. |
|---|---|---|---|
| Common Stock | $5 | $15 | $100 |
| Dividends | 10 | 5 | 50 |
| Net Income | (a) 25 | (d) 20 | (g) 100 |
| Retained Earnings, Beginning of Year | 30 | 0 | 200 |
| Retained Earnings, End of Year | (b) 45 | (e) 15 | (h) 250 |
| Total Assets | (c) 80 | (f) 60 | (i) 700 |
| Total Expenses | 75 | 30 | 200 |
| Total Liabilities | 30 | 30 | 350 |
| Total Revenues | 100 | 50 | 300 |

Rev – Exp = NI, so (a) = $100 – $75 = $25, (d) = $50 – $30 = $20, (g) = $300 – $200 = $100

RE(beg) + NI – Div = RE(end), so (b) = $30 + $25 – $10 = $45, (e) = $0 + $20 – $5 = $15, (h) = $200 + $100 – $50 = $250

A = L + SE = L + CS + RE (end), so (c) = $30 + $5 + $45 = $80, (f) = $30 + $15 + $15 = $60, (i) = $350 + $100 + $250 = $700

**M1-15**

(a) $1,813 (b) $6,558 (c) $5,687.

Activision Blizzard was profitable because its revenues ($7,500) were greater than its expenses ($5,687), resulting in the net income of $1,813 reported on the income statement.

The above amounts are determined using the various relationships that exist in the financial statements. Because this exercise excludes two pieces of information from both the income statement and statement of retained earnings, students must first work backwards from the balance sheet to the statement of retained earnings to the income statement. Although not required, the following statements show the given and missing information. The ?s in the balance sheet are determined from A = L + SE, as shown below.

**Activision Blizzard, Inc.**
**Income Statement**
**For the Year Ended Dec. 31, 2018**

| | |
|---|---|
| Revenues | $7,500 |
| Expenses | (c) |
| Net Income | (a) |

**Activision Blizzard, Inc.**
**Statement of Retained Earnings**
**For the Year Ended Dec. 31, 2018**

| | |
|---|---|
| RE, beginning | $5,004 |
| Net income | (a) |
| Dividends | (259) |
| RE, ending | (b) |

**Activision Blizzard, Inc.**
**Balance Sheet**
**At Dec. 31, 2018**

| | |
|---|---|
| Total Assets | $17,835 |
| Liabilities and Shareholders' Equity | |
| Total Liabilities | $6,478 |
| Shareholders' Equity | |
| Common Stock | 4,799 |
| Retained earnings | (b) |
| Total SE | ? |
| Total Liabilities & SE | ? |

A = L + SE = L + CS + RE (end), so $17,835 = $6,478 + $4,799 + RE(end), which can be rearranged as RE(end) = $17,835 – $6,478 – $4,799 = $**6,558 = (b)**

RE(beg) + NI – Div = RE(end), so $5,004 + (a) – $259 = $6,558, which can be rearranged as (a) = $6,558 + $259 – $5,004 = $**1,813 = (a)**

Rev – Exp = NI, so $7,500 – (c) = $1,813, which can be rearranged as $7,500 – $1,813 = (c), which equals **$5,687 = (c)**

## M1-16

Req. 1

NATIONAL AIRWAYS, INC.
Income Statement
For the Year Ended December 31
*(Amounts in millions)*

| | |
|---|---|
| Revenues | |
| Ticket Revenues | $ 17,100 |
| Total Revenue | 17,100 |
| Expenses | |
| Aircraft Fuel Expense | 8,700 |
| Salaries and Wages Expense | 3,280 |
| Landing Fees Expense | 3,100 |
| Repairs and Maintenance Expense | 1,200 |
| Interest Expense | 130 |
| Income Tax Expense | 260 |
| Total Expenses | 16,670 |
| Net Income | $ 430 |

Req. 2

NATIONAL AIRWAYS, INC.
Statement of Retained Earnings
For the Year Ended December 31
*(Amounts in millions)*

| | |
|---|---|
| Retained Earnings, January 1 | $ 5,370 |
| Add: Net Income | 430 |
| Subtract: Dividends | (20) |
| Retained Earnings, December 31 | $ 5,780 |

**M1-16 (continued)**

Req. 3

NATIONAL AIRWAYS, INC.
Balance Sheet
At December 31
*(Amounts in millions)*

| | |
|---|---|
| Assets | |
| Cash | $ 2,970 |
| Accounts Receivable | 580 |
| Supplies | 680 |
| Equipment | 14,370 |
| Total Assets | $18,600 |
| | |
| Liabilities | |
| Accounts Payable | $4,650 |
| Notes Payable | 6,950 |
| Total Liabilities | 11,600 |
| Stockholders' Equity | |
| Common Stock | 1,220 |
| Retained Earnings | 5,780 |
| Total Stockholders' Equity | 7,000 |
| Total Liabilities and Stockholders' Equity | $18,600 |

Req. 4

National Airways financed its assets primarily with liabilities ($11,600) as opposed to stockholders' equity ($7,000).

## ANSWERS TO EXERCISES

### E1-1

a) Assets = Liabilities + Stockholders' Equity
= \$13,750 + \$4,450
= \$18,200
= Assets reported on the balance sheet

b) Net Income = Revenue – Expenses
= \$10,500 - \$9,200
= \$1,300
= Net income reported on the income statement

c) Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E
\$3,500 + \$1,300 - \$500 = \$4,300

d) Beginning Cash + Cash Flows from Operating Activities + Cash Flows from (Used in) Investing Activities + Cash Flows from (Used in) Financing Activities = Ending Cash
\$1,000 + \$1,600 + (\$1,000) + (\$900) = \$700

### E1-2

a) Assets = Liabilities + Stockholders' Equity
= \$18,500 + \$61,000
= \$79,500
= Assets reported on the balance sheet

b) Net Income = Revenue – Expenses
= \$32,100 – \$18,950
= \$13,150
= Net income reported on the income statement

c) Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E
\$20,500 + \$13,150 – \$4,900 = \$28,750

d) Beginning Cash + Cash Flows from Operating Activities + Cash Flows from (Used in) Investing Activities + Cash Flows from (Used in) Financing Activities = Ending Cash
\$3,200 + \$15,700 + (\$7,200) + (\$5,300) = \$6,400

**E1-3**

Req. 1

| Item | Account Name |
|---|---|
| Amounts owed to suppliers | Accounts Payable |
| Designer Brands' right to collect on account | Accounts Receivable |
| Currency and bank account balances | Cash |
| Common stock issued to stockholders | Common Stock |
| Warehouses, stores, and offices | Buildings |
| Merchandise held for sale | Inventory |
| Amounts owed for promissory notes | Notes Payable |
| Accumulated profits of the company | Retained Earnings |

Req. 2

Designer Brands, Inc.
Balance Sheet
At August 3, 2019
(in millions)

| | |
|---|---|
| Assets | |
| Cash | $ 75 |
| Accounts Receivable | 85 |
| Inventory | 700 |
| Buildings | 1,700 |
| Total Assets | $2,560 |
| | |
| Liabilities | |
| Accounts Payable | $ 650 |
| Notes Payable | 1,180 |
| Total Liabilities | 1,830 |
| Stockholders' Equity | |
| Common Stock | 460 |
| Retained Earnings | 270 |
| Total Stockholders' Equity | 730 |
| Total Liabilities and Stockholders' Equity | $2,560 |

Req. 3

Most of the financing as of August 3, 2019, came from creditors. The creditors have financed $1,830 million of the total assets and stockholders have financed only $730 million of the total assets of the company.

**E1-4**

Req. 1

READER DIRECT
Balance Sheet
At December 31, 2020

| Assets | | Liabilities | |
|---|---|---|---|
| Cash | $ 47,500 | Accounts Payable | $ 8,000 |
| Accounts Receivable | 26,900 | Notes Payable | 2,850 |
| Equipment | 48,000 | | |
| | | Total Liabilities | 10,850 |
| | | Stockholders' Equity | |
| | | Common Stock | 98,000 |
| | | Retained Earnings | 13,550 |
| | | Total Stockholders' Equity | 111,550 |
| Total Assets | $122,400 | Total Liabilities and Stockholders' Equity | $122,400 |

Req. 2

Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E, so
Net Income= Ending R/E + Dividends - Beginning R/E
= $13,550 + 0 – 0
= $13,550
Net income for the year was $13,550. This is the first year of operations and no dividends were declared or paid to stockholders; therefore, retained earnings is $13,550 at December 31, 2020 (which represents income for one year).

Req. 3

Most of the financing as of December 31, 2020 came from stockholders. The stockholders have financed $111,550 of the total assets and creditors have financed only $10,850 of the total assets of the company.

Req.4

Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E, so
Ending R/E = $13,550 + 3,000 – 2,000
= $14,550
Retained Earnings at December 31, 2021 would be $14,550.

**E1-5**

| | | Req. 1<br>Label | Req. 2<br>Type |
|---|---|---|---|
| a. | Coins and currency | Cash | A |
| b. | Amounts K·Swiss owes to suppliers of shoes | Accounts Payable | L |
| c. | Amounts K·Swiss can collect from customers | Accounts Receivable | A |
| d. | Amounts owed to bank for loan to buy building | Notes Payable | L |
| e. | Property on which buildings will be built | Land | A |
| f. | Amounts distributed from profits to stockholders | Dividends | SE |
| g. | Amounts earned by K·Swiss by selling shoes | Sales Revenue | R |
| h. | Unused paper in K·Swiss head office | Supplies | A |
| i. | Cost of paper used up during month | Supplies Expense | E |
| j. | Amounts contributed by stockholders to K·Swiss | Common Stock | SE |

**E1-6**

Req. 1

CINEMARK HOLDINGS, INC.
Income Statement
For the Quarter Ended June 30, 2019
(in thousands)

| | |
|---|---|
| Revenues | |
| Admissions Revenue | $521,000 |
| Concessions Revenue | 345,000 |
| Total Revenues | 866,000 |
| Expenses | |
| Film Rental Expense | 295,000 |
| Office Expense | 171,000 |
| Salaries and Wages Expense | 109,000 |
| Rent Expense | 89,000 |
| Concessions Expense | 63,000 |
| Income Tax Expense | 38,000 |
| Total Expenses | 765,000 |
| Net Income | $101,000 |

The question mark in the exercise corresponds to Net Income of $101,000, as determined above.

Req. 2

Cinemark's main source of revenue is theater admissions and its two biggest expenses are film rental expenses and office expenses.

**E1-7**

HOME REALTY, INCORPORATED
Income Statement
For the Year Ended December 31

| | |
|---|---|
| Revenue: | |
| Sales Revenue | $166,000 |
| Expenses: | |
| Salaries and Wages Expense | 97,000 |
| Advertising Expense | 9,025 |
| Interest Expense | 6,300 |
| Income Tax Expense | 18,500 |
| Total Expenses | 130,825 |
| Net Income | $ 35,175 |

Note that dividends declared are not an expense. As a distribution of the company's prior profits, they will be deducted from Retained Earnings.

**E1-8**

A Net Income = $110,000 - $82,000 = $28,000
Stockholders' Equity = $150,000 - $70,000 = $80,000

B Total Revenues = $80,000 + $12,000 = $92,000
Total Liabilities = $112,000 - $70,000 = $42,000

C Net Income (Loss) = $80,000 - $86,000 = $(6,000)
Stockholders' Equity = $104,000 - $26,000 = $78,000

D Total Expenses = $50,000 - $20,000 = $30,000
Total Assets = $22,000 + $77,000 = $99,000

E Total Revenues = $81,000 - $6,000 = $75,000
Total Assets = $73,000 + $28,000 = $101,000

**E1-9**

Req. 1

MIAMI MUSIC CORPORATION
Income Statement
For the Month Ended January 31

| | |
|---|---|
| Total Revenues | $131,000 |
| Operating Expenses | 90,500 |
| Net Income | $ 40,500 |

MIAMI MUSIC CORPORATION
Balance Sheet
At January 31

| | |
|---|---|
| Assets: | |
| Cash | $30,800 |
| Accounts Receivable | 25,300 |
| Supplies | 40,700 |
| Total Assets | $96,800 |
| | |
| Liabilities: | |
| Accounts Payable | $25,700 |
| Total Liabilities | 25,700 |
| | |
| Stockholders' Equity: | |
| Common Stock | 30,600 |
| Retained Earnings* | 40,500 |
| Total Stockholders' Equity | 71,100 |
| Total Liabilities and Stockholders' Equity | $96,800 |

* Because this is the first month of operations, beginning retained earnings is zero, so ending retained earnings equals $0 (beg RE) + $40,500 (NI) – 0 (dividends) = $40,500.

Req. 2

Miami Music Corporation generated a profit of $40,500, as indicated by "Net Income" on the income statement.

Req. 3

Miami Music Corporation should have no problem paying its liabilities because its total assets are more than three times its total liabilities ($96,800/$25,700 = 3.77 times), as indicated on the balance sheet. This means that Miami Music Corporation could pay its liabilities more than three times over if all assets on hand at January 31, were converted to cash. Of course, not all assets will be converted into cash right away. Even so, looking only at the amount of cash at the end of January, we see that Miami Music has enough cash to cover all its liabilities. This is a very strong financial position.

**E1-10**

Req. 1

Pest Away Corp. generated more revenue from providing services to customers as opposed to selling goods.

Req. 2

Salaries and Wages = \$33,000 x 2 = \$66,000
Net Income = \$39,000 – 33,000 = \$6,000

If salaries and wages expense were to double net income would decrease by \$33,000 resulting in a net income of \$6,000.

Req. 3

Advertising expense: \$22,000 total expense – \$20,000 paid = \$2,000 still owed.

The company would owe \$2,000 and this amount owing would be included in Accounts Payable on the balance sheet.

Req. 4

The \$10,000 in dividends would be reported on the statement of retained earnings.

**E1-11**

| | |
|---|---|
| (O) | (1) Cash paid to suppliers and employees |
| O | (2) Cash received from customers |
| F | (3) Cash received from borrowing using a long-term note |
| F | (4) Cash received from issuing stock |
| (I) | (5) Cash paid to purchase equipment |

**E1-12**

| | |
|---|---|
| (I) | (1) Purchases of equipment |
| O | (2) Cash received from customers |
| F | (3) Cash received from issuing stock |
| (O) | (4) Cash paid to suppliers and employees |
| (F) | (5) Cash paid on notes payable |
| I | (6) Cash received from selling equipment |

## ANSWERS TO COACHED PROBLEMS

### CP1-1

Req. 1

NUCLEAR COMPANY
Income Statement
For the Year Ended December 31

| | |
|---|---|
| Sales Revenue | $ 88,000 |
| Expenses | |
| Operating Expenses | 57,200 |
| Other Expenses | 8,850 |
| Total Expenses | 66,050 |
| Net Income | $ 21,950 |

Req.2

NUCLEAR COMPANY
Statement of Retained Earnings
For the Year Ended December 31

| | |
|---|---|
| Retained Earnings, January 1 | $ 0 |
| Add: Net Income | 21,950 |
| Subtract: Dividends | (200) |
| Retained Earnings, December 31 | $ 21,750 |

**CP1-1 (continued)**

Req. 3

NUCLEAR COMPANY
Balance Sheet
At December 31

| | |
|---|---|
| Assets | |
| Cash | $ 12,000 |
| Accounts Receivable | 59,500 |
| Supplies | 8,000 |
| Equipment | 36,000 |
| Total Assets | $ 115,500 |
| | |
| Liabilities | |
| Accounts Payable | $ 30,000 |
| Notes Payable | 1,470 |
| Total Liabilities | 31,470 |
| | |
| Stockholder's Equity | |
| Common Stock | 62,280 |
| Retained Earnings | 21,750 |
| Total Stockholder's Equity | 84,030 |
| Total Liabilities and Stockholder's Equity | $ 115,500 |

**CP1-2 (continued)**

Req. 1

Nuclear Company is profitable as indicated by the net income of $21,950 reported on the income statement.

Req. 2

Nuclear Company's statement of retained earnings shows that net income ($21,950) exceeded its dividends ($200).

Req. 3

Nuclear Company's balance sheet reports that total liabilities of $31,470 are less than total stockholders' equity of $84,030, indicating that the company is financed mainly by stockholders.

Req. 4

Nuclear Company was founded at the beginning of the year, so it began with no cash. The balance sheet reports a cash balance of $12,000 at the end of the year. The reasons for this increase of $12,000 would be shown in the statement of cash flows.

**CP1-3**

Req. 1

GARMIN LTD.
Income Statement
For the Six Months Ended June 29, 2019
(in thousands)

| | |
|---|---|
| Sales Revenue | $ 1,720,000 |
| Expenses | |
| Operating Expenses | 693,000 |
| Office Expense | 656,000 |
| Advertising Expense | 69,000 |
| Income Tax Expense | 78,000 |
| Total Expenses | 1,496,000 |
| Net Income | $ 224,000 |

**CP1-3 (continued)**

Req. 2

GARMIN LTD.
Statement of Retained Earnings
For the Six Months Ended June 29, 2019
(in thousands)

| | |
|---|---|
| Retained Earnings, January 1, 2019 | $ 2,725,000 |
| Add: Net Income | 224,000 |
| Subtract: Dividends | (309,000) |
| Retained Earnings, June 29, 2019 | $ 2,640,000 |

Req. 3

GARMIN LTD.
Balance Sheet
At June 29, 2019
(in thousands)

| | |
|---|---|
| **Assets** | |
| Cash | $ 1,060,000 |
| Accounts Receivable | 584,000 |
| Inventory | 648,000 |
| Supplies | 168,000 |
| Equipment | 3,065,000 |
| Total Assets | $ 5,525,000 |
| | |
| **Liabilities** | |
| Accounts Payable | $ 1,027,700 |
| Notes Payable | 347,300 |
| Total Liabilities | 1,375,000 |
| **Stockholder's Equity** | |
| Common Stock | 1,510,000 |
| Retained Earnings | 2,640,000 |
| Total Stockholders Equity | 4,150,000 |
| **Total Liabilities and Stockholder's Equity** | $ 5,525,000 |

**CP1-3 (continued)**

Req. 4

GARMIN LTD.
Statement of Cash Flows
For the Six Months Ended June 29, 2019
(in thousands)

| | |
|---|---|
| Cash Flows from Operating Activities: | |
| Cash received from customers | $1,706,000 |
| Cash paid to suppliers and employees | (1,431,000) |
| Cash Provided by Operating Activities | 275,000 |
| | |
| Cash Flows from Investing Activities: | |
| Cash paid to purchase equipment | (529,000) |
| Cash received from sale of long-term assets | 183,000 |
| Cash Used in Investing Activities | (346,000) |
| | |
| Cash Flows from Financing Activities: | |
| Cash paid for dividends | (309,000) |
| Cash received from issuing common stock | 57,000 |
| Cash Used in Financing Activities | (252,000) |
| | |
| Change in Cash | (323,000) |
| Beginning Cash Balance, January 1, 2019 | 1,383,000 |
| Ending Cash Balance, June 29, 2019 | $ 1,060,000 |

**CP1-4**

Req. 1

With $1,375,000 in total liabilities and $4,150,000 in total stockholders' equity, Garmin relies more on stockholders than on creditors for its financing at June 29, 2019. This information is presented on the balance sheet.

Req. 2

With approximately $1,510,000 in Common Stock and $2,640,000 in Retained Earnings at June 29, 2019, stockholders' equity includes a greater amount of Retained Earnings (i.e., amounts the company has earned through profitable business operations) than Common Stock (i.e., amounts stockholders contributed directly to the company). This information is presented on the balance sheet.

## ANSWERS TO GROUP A PROBLEMS

### PA1-1

Req. 1

HIGH POWER CORPORATION
Income Statement
For the Year Ended December 31

| | |
|---|---|
| Sales Revenue | $90,000 |
| Expenses | |
| Operating Expenses | 58,700 |
| Other Expenses | 7,850 |
| Total Expenses | 66,550 |
| Net Income | $23,450 |

Req.2

HIGH POWER CORPORATION
Statement of Retained Earnings
For the Year Ended December 31

| | |
|---|---|
| Retained Earnings, January 1 | $ 0 |
| Add: Net Income | 23,450 |
| Subtract: Dividends | (1,950) |
| Retained Earnings, December 31 | $ 21,500 |

**PA1-1 (continued)**

Req. 3

HIGH POWER CORPORATION
Balance Sheet
At December 31

| | | |
|---|---|---|
| **Assets** | | |
| Cash | $ | 13,300 |
| Accounts Receivable | | 9,550 |
| Supplies | | 5,000 |
| Equipment | | 86,000 |
| Total Assets | $ | 113,850 |
| | | |
| **Liabilities** | | |
| Accounts Payable | $ | 32,100 |
| Notes Payable | | 1,160 |
| Total Liabilities | | 33,260 |
| **Stockholders' Equity** | | |
| Common Stock | | 59,090 |
| Retained Earnings | | 21,500 |
| Total Stockholders Equity | | 80,590 |
| **Total Liabilities and Stockholders' Equity** | $ | 113,850 |

**PA1-2**

Req. 1

High Power Corporation's balance sheet indicates that the company was financed mainly by stockholders at December 31 because total stockholders' equity ($80,590) was greater than total liabilities ($33,260).

Req. 2

Because this is High Power Corporation's first year of operations, beginning cash would equal zero. Thus, the ending cash balance of $13,300 shown on the balance sheet implies an increase in cash of $13,300. The statement of cash flows would report the reasons for this change in cash.

Req. 3

High Power Corporation was profitable, as indicated by the net income of $23,450 reported on the income statement.

Req. 4

High Power Corporation's dividends ($1,950) did not exceed the net income of $23,450, as reported on the statement of retained earnings.

**PA1-3**

Req. 1

NICE BITE, INC.
Income Statement
For the Year Ended December 31, 2021

| | |
|---|---|
| Revenues: | |
| Service Revenue | $137,800 |
| Total Revenues | 137,800 |
| Expenses: | |
| Salaries and Wages Expense | 35,700 |
| Office Expense | 14,300 |
| Utilities Expense | 25,100 |
| Interest Expense | 29,500 |
| Income Tax Expense | 10,100 |
| Total Expenses | 114,700 |
| Net Income | $ 23,100 |

Req. 2

NICE BITE, INC.
Statement of Retained Earnings
For the Year Ended December 31, 2021

| | |
|---|---|
| Retained Earnings, January 1, 2021 | $ 6,300 |
| Add: Net Income | 23,100 |
| Subtract: Dividends | -0- |
| Retained Earnings, December 31, 2021 | $ 29,400 |

**PA1-3 (continued)**

Req. 3

NICE BITE, INC.
Balance Sheet
At December 31, 2021

| | | |
|---|---|---|
| **Assets** | | |
| Cash | $ | 102,800 |
| Accounts Receivable | | 22,800 |
| Inventory | | 17,200 |
| Prepaid Rent | | 7,000 |
| Equipment | | 136,700 |
| Total Assets | $ | 286,500 |
| | | |
| **Liabilities** | | |
| Accounts Payable | $ | 45,000 |
| Notes Payable | | 23,600 |
| Salaries and Wages Payable | | 8,000 |
| Total Liabilities | | 76,600 |
| **Stockholders' Equity** | | |
| Common Stock | | 180,500 |
| Retained Earnings | | 29,400 |
| Total Stockholders Equity | | 209,900 |
| **Total Liabilities and Stockholders' Equity** | $ | 286,500 |

**PA1-3 (continued)**

Req. 4

NICE BITE INC.
Statement of Cash Flows
For the Year Ended December 31, 2021

| | |
|---|---|
| **Cash Flows from Operating Activities** | |
| Cash received from customers | $137,000 |
| Cash paid for income taxes | (11,000) |
| Cash paid to suppliers and employees | (83,200) |
| Cash Provided by Operating Activities | 42,800 |
| | |
| **Cash Flows from Investing Activities** | |
| Cash paid to purchase long-term assets | (41,000) |
| Cash used in Investing Activities | (41,000) |
| | |
| **Cash Flows from Financing Activities** | |
| Cash from issuing common stock | 21,000 |
| Cash paid to reacquire common stock | (23,500) |
| Cash used in Financing Activities | (2,500) |
| | |
| Change in Cash | (700) |
| Cash at January 1, 2021 | 103,500 |
| Cash at December 31, 2021 | $102,800 |

**PA1-4**

Req. 1

With $76,600 in total liabilities and $209,900 in total stockholders' equity, Nice Bite Inc. relies more on stockholders for its financing at December 31, 2021. This information is presented on the balance sheet.

Req. 2

Nice Bite Inc.'s $29,400 of retained earnings at December 31, 2021, arises primarily from its current year earnings ($23,100) as opposed to its retained earnings from prior years ($6,300). This information is presented on the statement of retained earnings.

## ANSWERS TO GROUP B PROBLEMS

### PB1-1

Req. 1

APEC AEROSPACE CORPORATION
Income Statement
For the Year Ended December 31

| | |
|---|---|
| Sales Revenue | $ 94,000 |
| Expenses | |
| Operating Expenses | 60,000 |
| Other Expenses | 8,850 |
| Total Expenses | 68,850 |
| Net Income | $ 25,150 |

Req. 2

APEC AEROSPACE CORPORATION
Statement of Retained Earnings
For the Year Ended December 31

| | |
|---|---|
| Retained Earnings, January 1 | $ 0 |
| Add: Net Income | 25,150 |
| Subtract: Dividends | (1,100) |
| Retained Earnings, December 31 | $ 24,050 |

**PB1-1 (continued)**

Req. 3

APEC AEROSPACE CORPORATION
Balance Sheet
At December 31

| | |
|---|---|
| Assets | |
| Cash | $ 13,900 |
| Accounts Receivable | 9,500 |
| Supplies | 9,000 |
| Equipment | 86,000 |
| Total Assets | $118,400 |
| | |
| Liabilities | |
| Accounts Payable | $ 33,130 |
| Notes Payable | 51,220 |
| Total Liabilities | 84,350 |
| | |
| Stockholders' Equity | |
| Common Stock | 10,000 |
| Retained Earnings | 24,050 |
| Total Stockholders' Equity | 34,050 |
| Total Liabilities and Stockholders' Equity | $118,400 |

**PB1-2**

Req. 1

APEC Aerospace Corporation’s balance sheet reports total liabilities of $84,350 and stockholders’ equity of $34,050, indicating that the company is financed mainly by creditors.

Req. 2

APEC Aerospace Corporation’s income statement reported net income of $25,150, suggesting the company was profitable because revenues exceeded expenses.

Req. 3

APEC Aerospace Corporation was founded at the beginning of the year, so it began with no cash. The balance sheet reports a cash balance of $13,900 at the end of the year. The reasons for this increase of $13,900 would be shown in the statement of cash flows.

**PB1-2 (continued)**

Req. 4

APEC Aerospace Corporation's dividends ($1,100) did not exceed the net income of $25,150, as reported on the statement of retained earnings.

**PB1-3**

Req. 1

CHEESE FACTORY INCORPORATED
Income Statement
For the Year Ended August 31, 2021

| | |
|---|---|
| Revenues: | |
| Sales Revenue | $1,660,000 |
| Total Revenues | 1,660,000 |
| Expenses: | |
| Salaries and Wages Expense | 955,000 |
| Utilities Expense | 530,000 |
| Office Expense | 95,000 |
| Total Expenses | 1,580,000 |
| Net Income | $80,000 |

Req. 2

CHEESE FACTORY INCORPORATED
Statement of Retained Earnings
For the Year Ended August 31, 2021

| | |
|---|---|
| Retained Earnings, Beginning | $ 410,000 |
| Add: Net Income | 80,000 |
| Subtract: Dividends | (10,000) |
| Retained Earnings, Ending | $ 480,000 |

**PB1-3 (continued)**

Req. 3

CHEESE FACTORY INCORPORATED
Balance Sheet
At August 31, 2021

| | |
|---|---|
| Assets: | |
| Cash | $ 80,000 |
| Accounts Receivable | 15,000 |
| Supplies | 25,000 |
| Prepaid Rent | 50,000 |
| Equipment | 755,000 |
| Total Assets | $925,000 |
| Liabilities: | |
| Accounts Payable | $ 145,000 |
| Notes Payable | 30,000 |
| Salaries and Wages Payable | 170,000 |
| Total Liabilities | 345,000 |
| Stockholders' Equity: | |
| Common Stock | 100,000 |
| Retained Earnings | 480,000 |
| Total Stockholders' Equity | 580,000 |
| Total Liabilities and Stockholders' Equity | $925,000 |

**PB1-3 (continued)**

Req. 4

CHEESE FACTORY INCORPORATED
Statement of Cash Flows
For the Year Ended August 31, 2021

| | |
|---|---|
| Cash Flows from Operating Activities | |
| Cash received from customers | $ 1,661,000 |
| Cash paid to suppliers and employees | (1,490,000) |
| Cash Provided by Operating Activities | 171,000 |
| | |
| Cash Flows from Investing Activities | |
| Cash paid to purchase equipment | (40,000) |
| Cash Used in Investing Activities | (40,000) |
| | |
| Cash Flows from Financing Activities | |
| Additional investments by stockholders | 34,000 |
| Cash received from borrowings | 5,000 |
| Repayments of borrowings | (155,000) |
| Dividends paid to stockholders | (10,000) |
| Cash Used in Financing Activities | (126,000) |
| | |
| Change in Cash | 5,000 |
| Cash at September 1, 2021 | 75,000 |
| Cash at August 31, 2021 | $ 80,000 |

**PB1-4**

Req. 1

The statement of cash flows shows that the Cheese Factory increased its cash balance by $5,000, during the year ended August 31, 2021.

Req. 2

The income statement shows that the Cheese Factory earned net income of $80,000 during the year ended August 31, 2021, after having deducted salaries and wages expense of $955,000. A 5% increase in pay would result in additional salaries and wage expense of $47,750 ($955,000 x 0.05), which would decrease net income to $32,250 ($80,000 – $47,750). (This answer ignores the possible income tax savings that would be created by having greater salaries and wages expense.)

## ANSWERS TO SKILLS DEVELOPMENT CASES

### S1-1

1. C
2. A
3. B
4. A

*Sources:*

Req. 1
The Home Depot's income statement (called "Consolidated Statements of Earnings") shows net income of $11,242 (million), which is labeled net earnings (answer c).

Req. 2

The income statement (called "Consolidated Statements of Earnings") shows that the amount of net sales was $110,225 (million) (answer a).

Req. 3

The (consolidated) balance sheet shows that inventory (called "merchandise inventories") costing $14,531 (million) was on hand at February 2, 2020 (answer b).

Req. 4

The (consolidated) balance sheet and statement of cash flows show Cash (and Cash Equivalents) totaling $2,133 (million) at February 2, 2020 (answer a).

**S1-2**

1. A
2. D
3. C
4. B

*Sources:*

Req. 1
Lowe's income statement (called "Consolidated Statements of Earnings") shows net income of $4,281 (million), which is labeled net earnings (answer a).

Req. 2

The income statement (called "Consolidated Statements of Earnings") shows that the amount of net sales was $72,148 (million) (answer d).

Req. 3

The (consolidated) balance sheet shows that inventory (called "merchandise inventory-net") costing $13,179 (million) was on hand at January 31, 2020 (answer c).

Req. 4

The (consolidated) balance sheet and statement of cash flows show Cash (and Cash Equivalents) totaling $716 (million) at January 31, 2020 (answer b).

**S1-3**

The solutions to this case will depend on the company and/or accounting period selected for analysis.

**S1-4 (Available in the eBook)**

Req. 1

The accounting concept that the Rigas family is accused of violating is the separate entity assumption.

Req. 2

Based on the limited information available, it is difficult to categorize particular dealings as appropriate or inappropriate. Dealings would clearly be inappropriate if they involved Adelphia paying for items for the owners' personal use or to unfairly transfer some of the resources of Adelphia (and its stockholders) to the Rigas family. However, we cannot determine the propriety of the payments from the limited information available.

Req. 3

Stockholders should take at least two actions to ensure this kind of behavior does not occur or does not occur without their knowledge. First, stockholders should ensure that the managers of the business are accountable for their actions. The most common way of doing this is to appoint a board of directors who are independent of top management. These directors should review and challenge the actions taken by management and require that the financial statements disclose significant transactions with related parties. Second, stockholders should read the financial statements, including any notes describing related party transactions. Any questionable dealings should be raised with top management at the company's annual meeting. If stockholders don't receive satisfactory answers to their concerns, they should sell their investment in the company's stock.

Req. 4

Other parties that might be harmed by the actions committed by the Rigas family are creditors (such as suppliers and banks), the company's auditors, governmental agencies (such as the IRS and SEC), and the public at large.

**S1-5**

Req. 1

You should take the position that an *independent* annual audit of the financial statements is an absolute must. This is the best way to ensure that the financial statements are complete, are free from bias, and conform with GAAP. You should be prepared to reject the stockholder's uncle as the auditor because there is no evidence about his competence as an accountant or auditor. Also, he does not appear independent because he is related to the stockholder who prepares the financial statements, resulting in a potential conflict of interest.

Req. 2

You should strongly recommend the selection of an independent CPA in public practice because the financial statements should be audited by a competent and independent professional who must follow prescribed accounting and auditing standards on a strictly independent basis. An audit by an uncle would not meet these requirements.

**S1-6**

Req. 1

A balance sheet lists items owned (assets) and owed (liabilities) at a particular point in time, producing a "net worth" that represents the excess of assets over liabilities. Two balance sheets are presented below, one based on historical costs (similar to GAAP) and one based on fair values (similar to a personal financial planning approach). Notes for these balance sheets also are presented, along with a conclusion about which individual is better off.

Based on historical cost:

| **Ashley** | | **Jason** | |
|---|---|---|---|
| Assets | | Assets | |
| Cash | $ 1,000 | Cash | $6,000 |
| Artwork | 800 | Game Console | 250 |
| Total Assets | 1,800 | Total Assets | 6,250 |
| | | | |
| Liabilities | | Liabilities | |
| Loan Payable | 250 | Tuition Payable | 800 |
| Total Liabilities | 250 | Loan Payable | 4,800 |
| | | Total Liabilities | 5,600 |
| | | | |
| Net Worth | $ 1,550 | Net Worth | $ 650 |

**S1-6 (continued):**

Req. 1 (continued)

Based on fair value:

**Ashley**

| | |
|---|---|
| Assets | |
| Cash | $ 1,000 |
| Artwork | 1,400 |
| Total Assets | 2,400 |
| | |
| Liabilities | |
| Loan Payable | 250 |
| Total Liabilities | 250 |
| | |
| Net Worth | $ 2,150 |

**Jason**

| | |
|---|---|
| Assets | |
| Cash | $6,000 |
| Game Console | 180 |
| Total Assets | 6,180 |
| | |
| Liabilities | |
| Tuition Payable | 800 |
| Loan Payable | 4,800 |
| Total Liabilities | 5,600 |
| | |
| Net Worth | $ 580 |

The notes are an important part of these balance sheets.

Notes:

1) The goal in preparing these balance sheets is to estimate each individual's net worth, represented as the excess of assets over liabilities.
2) Use of historical cost is consistent with generally accepted accounting principles. Note that these asset values have not been adjusted for "value" consumed through use, which is not consistent with generally accepted accounting principles. The fair value balance sheets are based on the estimated current values of assets, some of which are greater and others less than their cost.
3) Some potential assets (e.g., Porsche) are not recorded because their likelihood of occurrence is not certain.

Req. 2

Based on the calculations of net worth and underlying assumptions indicated above, Ashley is "better off" because her net worth ($1,550 or $2,150) is greater than Jason's ($650 or $580). A creditor is more likely to lend money to Ashley because she has a greater net worth. Alternatively, a creditor might lend to both characters, but charge Jason a higher interest rate to compensate for the increased risk that he might not be able to repay the loan.

Note that choosing between historical cost and fair values inevitably requires trading off the reliability of accounting information (cost is not as subjective as fair values) and the potential relevance of that information (fair values may be more relevant when determining an individual's net worth).

**S1-6 (continued):**

Req. 3

An income statement lists the amounts earned (revenues) and costs incurred (expenses) during a particular period of time, producing "net income" that represents the excess of revenues over expenses. An income statement is presented below for both Ashley and Jason. Notes for these income statements are presented below, along with a conclusion about which individual is more successful.

| **Ashley** | | **Jason** | |
|---|---|---|---|
| Revenue | | Revenue | |
| Part Time Job (for October) | $ 1,500 | Lottery Ticket Winnings | $ 1,950 |
| Expenses | | Expenses | |
| Rent Expense (for October) | 470 | Rent Expense (for October) | 800 |
| Living Expenses (for October) | 950 | Living Expenses (for October) | 950 |
| Total Expenses | 1, 420 | Total Expenses | 1,750 |
| Net Income | $ 80 | Net Income | $ 200 |

Notes:
1) Jason's lottery ticket winnings are not likely to recur in the future.
2) Income taxes are not reported (although they would apply to both Ashley and Jason).

Req.4

Conclusion:
Based on the net income numbers alone, Jason was more successful in the current period. However, his revenues are likely to be non-recurring, whereas Ashley's appear more stable and likely to recur in the future. For this reason, one might conclude that Ashley actually was more successful, but that the current period's net income does not yet reflect this greater success. As a long-term creditor, it would be better to lend money to Ashley as she has a more stable source of income to meet future expenses. Notice that you should not reach a conclusion based only on the numbers.

## S1-7 (Available in the eBook)

S1-7.xlsx - Excel

| | | |
|---|---|---|
| **Electronic Arts, Inc.** | | |
| **Balance Sheet** | | |
| **As of September 30** | | |
| **(in millions)** | | |
| | | |
| **ASSETS** | | |
| Cash | $ | 2,412 |
| Accounts Receivable | | 328 |
| Inventories | | 367 |
| Property and Equipment | | 364 |
| Other Assets | | 283 |
| ***Total Assets*** | $ | 3,754 |
| | | |
| **LIABILITIES** | | |
| Accounts Payable | $ | 171 |
| Notes Payable | | 12 |
| Other Liabilities | | 587 |
| Total Liabilities | | 770 |
| **STOCKHOLDERS' EQUITY** | | |
| Common Stock | | 986 |
| Retained Earnings | | 1,998 |
| Total Stockholders' Equity | | 2,984 |
| ***Total Liabilities and Stockholders' Equity*** | $ | 3,754 |

Balance Sheet | Income Statement

## S1-7 (continued)

S1-7.xlsx - Excel

| | A | B | C |
|---|---|---|---|
| 1 | | **Electronic Arts, Inc.** | |
| 2 | | **Income Statement** | |
| 3 | | **For the Period Ending September 30** | |
| 4 | | **(in millions)** | |
| 5 | | | |
| 6 | | **Revenue** | |
| 7 | | Sales | $ 675 |
| 8 | | **Expenses** | |
| 9 | | Cost of Goods Sold Expense | 284 |
| 10 | | Promotion Expense | 107 |
| 11 | | Selling Expense | 223 |
| 12 | | Other Expenses | 1 |
| 13 | | Income Tax Expense | 9 |
| 14 | | Total Expenses | 624 |
| 15 | | **Net Income** | $ 51 |
| 16 | | | |

Income Statement

READY 100%

## ANSWERS TO CONTINUING CASE

### CC1-1

Req. 1

NICOLE'S GETAWAY SPA
Income Statement (forecasted)
For the Year Ended December 31, 2021

| | |
|---|---|
| Revenues: | |
| Sales Revenue | $ 40,000 |
| Expenses: | |
| Salaries and Wages Expense | 24,000 |
| Supplies Expense | 7,000 |
| Office Expense | 5,000 |
| Income Tax Expense | 1,600 |
| Total Expenses | 37,600 |
| Net Income | $ 2,400 |

### CC1-1 (continued)

Req. 2

NICOLE'S GETAWAY SPA
Statement of Retained Earnings (forecasted)
For the Year Ended December 31, 2021

| | |
|---|---|
| Retained Earnings, January 1, 2021 | $ 0 |
| Add: Net Income | 2,400 |
| Subtract: Dividends | (2,000) |
| Retained Earnings, December 31, 2021 | $ 400 |

Req. 3

NICOLE'S GETAWAY SPA
Balance Sheet (forecasted)
At December 31, 2021

| | |
|---|---|
| Assets: | |
| Cash | $ 2,150 |
| Accounts Receivable | 1,780 |
| Building and Equipment | 70,000 |
| Total Assets | $73,930 |
| Liabilities: | |
| Accounts Payable | $ 4,660 |
| Notes Payable | 38,870 |
| Total Liabilities | 43,530 |
| Stockholders' Equity: | |
| Common Stock | 30,000 |
| Retained Earnings | 400 |
| Total Stockholders' Equity | 30,400 |
| Total Liabilities and Stockholders' Equity | $73,930 |

Req. 4

As of December 31, 2021, more financing is expected to come from creditors ($43,530) than from stockholders ($30,400).

## TABLE OF CONTENTS



*To activate hyperlink, simultaneously press Control Key and click the mouse.

## STUDENT LEARNING OBJECTIVES & RELATED ASSIGNMENT MATERIALS (CHART A)

| *LO#* | *Student Learning Objective* | *Textbook Coverage (Page Ref.)* | *Mini-Exercise* | *Exercises* | *Coached Problems* | *Problems (Groups A & B)* | *Skills Development Cases* | *Continuing Case*** | *Reserved* |
|---|---|---|---|---|---|---|---|---|---|
| **LO1-1** | Describe various organizational forms and business decision makers. | 4 – 8 | 2 | | | | 1, 2, 3 | | |
| **LO1-2** | Describe the purpose, structure, and content of the four basic financial statements. | 8 – 17 | 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16 | 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12 | 1, 3 | A: 1, 3<br>B: 1, 3 | 1, 2, 3, 4, 6, 7 | 1 | |
| **LO1-3** | Explain how financial statements are used by decision makers. | 17 | 16 | 3, 4, 6, 9, 10 | 2, 4 | A: 2, 4<br>B: 2, 4 | 1, 2, 3, 4, 6 | 1 | |
| **LO1-4** | Describe factors that contribute to useful financial information. | 17 - 20 | 1, 2, 3 | | | | 4, 5, 6 | | |
| **LO1-S1** | Describe examples where accounting helps in pursuing other business careers. | 20 – 21 | | | | | | | |
| **LO1-S2** | Describe the decision to become a public company and explain the implications for accounting. | 21 - 23 | | | | | | | |
| | **Continuous case assignment relates to entrepreneur Nicole Mackisey and is extended to each future chapter. | | | | | | | | |

## STUDENT LEARNING OBJECTIVES & RELATED TECHNOLOGY ASSIGNMENT MATERIALS (CHART B)

| ***LO#*** | ***Student Learning Objective*** | ***Excel Simulation*** | ***Data Analytics (Tableau)*** |
|---|---|---|---|
| **LO1-1** | Describe various organizational forms and business decision makers. | | |
| **LO1-2** | Describe the purpose, structure, and content of the four basic financial statements. | *Relationships among Financial Statements using Excel's SUM and Basic Math Functions* | 1-1 |
| **LO1-3** | Explain how financial statements are used by decision makers. | | |
| **LO1-4** | Describe factors that contribute to useful financial information. | | |
| **LO1-S1** | Describe examples where accounting helps in pursuing other business careers. | | 1-2 |
| **LO1-S2** | Describe the decision to become a public company and explain the implications for accounting. | | |

**STUDENT LEARNING OBJECTIVES & RELATED INSTRUCTOR MATERIALS / ONLINE DELIVERY (CHART C)**

| *LO#* | *Student Learning Objective* | *Textbook Coverage (Page Ref.)* | *Textbook Exhibit* | *Concept Overview Video**** | *PowerPoint Slide #* | *PowerPoint Animated Builds & Solutions* | *PowerPoint Animated Slide #* |
|---|---|---|---|---|---|---|---|
| **LO1-1** | Describe various organizational forms and business decision makers. | 4 – 8 | 1, 2 | 3 videos | 2 - 5 | | |
| **LO1-2** | Describe the purpose, structure, and content of the four basic financial statements. | 8 – 17 | 3, 4, 5, 6, 7, 8 | 9 videos | 6 - 21 | Mini-Exercise M1-12<br>Exercise 1-3, 1-6, 1-8<br>Skills Development Case S1-6 (Requirement 1) | 37 - 38<br>39 - 45<br>46 - 48 |
| **LO1-3** | Explain how financial statements are used by decision makers. | 17 | | 3 videos | 22, 23 | Exercise 1-3, 1-6<br>Skills Development Case S1-6 (Requirement 1) | 39 - 43<br>46 - 48 |
| **LO1-4** | Describe factors that contribute to useful financial information. | 17 - 20 | 9 | 2 videos | 24 - 27 | Skills Development Case S1-6 (Requirement 1) | 46 - 48 |
| **LO1-S1** | Describe examples where accounting helps in pursuing other business careers. | 20 - 21 | 1A.1 | | 28 – 30 | | |
| **LO1-S2** | Describe the decision to become a public company and explain the implications for accounting. | 21 - 23 | 1B.1, 1B.2 | | 31 - 35 | | |
| | ***Individual videos are available for viewing and assignment in Connect | | | | | | |

**CHAPTER ONE**
**BUSINESS DECISIONS AND FINANCIAL ACCOUNTING**

## OVERVIEW

A real entrepreneur meets with his local CPA, who walks him through the decisions he must make when planning his business. Students discover the role of accounting, with an emphasis on financial statement reporting and use.

## SYNOPSIS OF CHAPTER REVISIONS

Focus Company: Noodlecake Studios

- Updated chapter opener describing the latest developments at this private company and its development of award-winning video games
- Updated Supplement 1B to describe the SEC's direct listing option, as pursued by Spotify
- New discussion of COVID-19 impact on 8-K reporting in Spotlight on Financial Reporting
- Updated demonstration case featuring WD-40 Company
- Reviewed and updated all end-of-chapter material, including financial data for Apple, Alphabet, Intel, Designer Brands, Cinemark, Garmin, and others

## LEARNING STRATEGY – GETTING STARTED

☑ Overview the textbook:
- Margin Boxes
- You Should Know
- Coach's Tip
- How's It Going? — Self Study Practice
- Review the Chapter — Demonstration Case
- Chapter Summary
- Key Terms
- Homework Helper
- Practice Material

☑ Highlight and demonstrate Connect:
- LearnSmart, Concept Overview Videos, PowerPoint slides, assignments, etc.

## CHAPTER SUMMARY

**LO 1-1 Describe various organizational forms and business decision makers.**

- Sole proprietorships are owned by one individual, are relatively inexpensive to form, and are not treated legally as separate from their owners. Thus, all profits or losses become part of the taxable income to the owner, who is also responsible personally for all debts of the business.
- Partnerships are businesses legally similar to proprietorships, but with two or more owners.
- Corporations are separate legal entities (thus, corporations pay taxes) that issue shares of stock to investors (stockholders) and are more costly to establish. Stockholders cannot be held liable for more than their investment in the corporation. Private corporations issue stock to a few individuals while public corporations issue stock to many in the stock market.
- Business decision makers include creditors (banks, suppliers), investors (stockholders), customers, governments, and other external users.

**LO 1-2 Describe the purpose, structure, and content of the four basic financial statements.**

- The *income statement* reports the net amount that a business earned (net income) over a period of time by subtracting the costs of running the business (expenses) from the total amount generated by selling its goods and services (revenues).
- The *statement of retained earnings* explains changes in the Retained Earnings account over a period of time by considering increases (from net income) and decreases (from dividends to stockholders).
- The *balance sheet* reports what the business owns (reported as assets) at a particular point in time and how much of the financing for these assets came from creditors (reported as liabilities) or stockholders (reported as stockholders' equity).
- The *statement of cash flows* explains changes in the cash account over a period of time by reporting inflows and outflows of cash from the business's operating, investing, and financing activities.

**LO 1-3 Explain how financial statements are used by decision makers.**

- Creditors are mainly interested in assessing whether the company (1) is generating enough cash to make payments on its loan and (2) has enough assets to cover its liabilities. Answers to these questions are indicated by the statement of cash flows and the balance sheet.

**CHAPTER SUMMARY (continued):**

- Investors look closely at the income statement for information about a company's ability to generate profits, and at the statement of retained earnings for information about a company's dividend distributions.

**LO 1-4 Describe factors that contribute to useful financial information.**

- Companies generate useful financial information by applying generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS) in an ethical business environment.
- To be useful, information must be relevant and a faithful representation of reality. Information is more useful when it is timely, verifiable, comparable and understandable.

**LO 1-S1 Describe examples where accounting helps in pursuing other business careers.**

- Knowledge of accounting is beneficial to accounting and business majors.

**LO 1-S2 Describe the decision to become a public company and explain the implications for accounting.**

- Going public provides a company with additional options for financing and creates additional reporting responsibilities (press releases, financial statement, SEC, etc.).

## CHAPTER OUTLINE

I. Understand the Business

***LO 1-1 Describe various organizational forms and business decision makers.***

A. Organizational Forms:
   1. Sole proprietorship—A business owned (and usually operated) by one individual.
   2. Partnership—Similar to a sole proprietorship, except that profits, taxes, and legal liability are the responsibility of two or more owners instead of just one.
   3. Corporation—A separate entity from both a legal and accounting perspective. The corporation, not its owners, is legally responsible for its own taxes and debts. Thus, owners cannot lose more than their investment in the corporation.
      *Teaching Note: This textbook focuses on corporations.*
   4. Other—Other organizational forms exist, such as a limited liability company (LLC), which combines characteristics of a partnership and a corporation.

B. Accounting for Business Decisions
   1. Most companies exist to earn profits for their stockholders; profits are earned by selling goods or services to customers for more than they cost to produce.
   2. **Accounting**—A system of analyzing, recording, and summarizing the results of a business's operating, investing, and financing activities and then reporting them to decision makers.
   3. Business people talk about their companies using accounting terms; accounting is the "language of business."
   4. Accountants assist in reporting financial information for decision making and help its owners understand the financial effects of those business decisions.
   5. The accounting system produces two kinds of reports (*Illustrated in Text Exhibit 1.1, p. 1-6*):
      a. Managerial accounting reports—Include detailed financial plans and continually updated reports about the financial performance of the company. These reports are made available only to employees of the company for making business decisions.
      b. Financial accounting reports, called **financial statements**—Reports that summarize the financial results of business activities.
         i. Prepared periodically to provide information to people not employed by the business.
         ii. External financial statement users aren't given access to detailed internal records of the company, so they rely extensively on the financial statements.
   6. Users of financial information (*Illustrated in Text Exhibit 1.2, p. 1-7*):
      a. Creditors include suppliers, banks, and anyone to whom money is owed.

b. Investors include existing and potential future stockholders.

c. Directors is the short title for the members of a company's board of directors; elected by stockholders to oversee the company's managers.

d. Government agencies include the Securities and Exchange Commission and the Internal Revenue Service.

II. Study the Accounting Methods

***LO 1-2 Describe the purpose, structure, and content of the four basic financial statements.***

A. The **Basic Accounting Equation**

Assets = Liabilities + Stockholders' Equity

*Teaching Note: "What a company owns must equal what a company owes to its creditors and stockholders."*

1. **Separate entity assumption**—The financial reports of a business are assumed to include the results of only that business's activities.
2. Asset—Economic resource presently controlled by the company; it has measurable value and is expected to benefit the company by producing cash inflows or reducing cash outflows in the future.

*Teaching Note: Does company own/have legal rights to it? If yes, will it have benefit beyond the end of the current month? If so, it's an asset.*

3. Liabilities—Measurable amounts that the company owes to creditors.
4. Stockholders' Equity—Represents the owners' claims on the business; claims arise for two reasons:
   a. Paid-in capital—The owners have a claim on amounts they contributed directly to the business in exchange for its stock (Common Stock).
   b. Earned capital—The owners have a claim on profits the company has earned for them through its business operations (Retained Earnings).

   *Teaching Note: Particularly important because a business can survive only if it is profitable.*

   c. Profits are generated when the total amount earned from selling goods and services is greater than all the costs incurred to generate those sales.
      i. Revenues—Earned by selling goods or services to customers.
      ii. Expenses—All costs of doing business that are necessary to earn revenues.

      *Teaching Note: Expenses are "incurred" to generate revenues.*

      iii. Net Income (preferred term in accounting for profit)—Revenues minus expenses (net loss if revenues are less than expenses); generating net income increases stockholders' equity.
      iv. Dividends—Distribution of a company's profits to its stockholders; reported as a reduction in Retained Earnings.

*Teaching Note: Dividends are not an expense "incurred" to generate earnings.*

B. Financial Statements (*Summarized in Text Exhibit 1-8, p. 1-16)*
   1. Reports prepared at any time during year.
      a. Most commonly monthly, quarterly, and annually using calendar year or fiscal year (a 12-month period ending on a day other than December 31).
      b. Each financial statement has a heading (name of company, name of statement, and time period).
      c. Each major caption has an underlined subtotal; "bottom line" amount has a double underline.
      d. A dollar sign appears at the top and bottom of each column of numbers.
   2. There are four basic financial statements *(IM Activity Handout 1-1)*:
      a. **Income statement**—Reports the revenues less expenses of the accounting period. *(Illustrated in Text Exhibit 1.3, p. 1-11)*
         i. **Unit of measure assumption**—Financial results of business activities should be measured and reported using a single monetary unit.
         ii. **Accounts**—A standardized format that organizations use to accumulate and report the dollar effects of each financial statement item.
         iii. When listing the accounts on the income statement, revenues are on top, usually with largest, most relevant revenue listed first, then expenses are subtracted, again from largest to smallest, except that Income Tax Expense is the last expense listed.
         iv. Net Income is difference between total revenues and total expenses.
         v. Single-step income statement format groups revenues separately from expenses and reports a single measure of income.

      *Teaching Note: Other income statement formats explained in Chapter 6.*

      b. **Statement of retained earnings**—Reports the way that net income and the distribution of dividends affected the financial position of the company during the accounting period. *(Illustrated in Text Exhibit 1.4, p. 1-12)*
         i. Retained earnings are profits that have accumulated in the company over time.
         ii. Retained earnings at beginning of period + Net income (or – Net loss) – Dividends = Retained earnings at end of period.
      c. **Balance sheet**—Reports the amount of assets, liabilities, and stockholders' equity of an accounting entity at a point in time. *(Illustrated in Text Exhibit 1.5, p. 1-13; IM Activity Handout 1-2)*
         i. Assets = Liabilities + Stockholders' equity

ii. Assets listed in order of how soon they are to be used or turned into cash; liabilities in order of how soon each is to be paid or settled.

d. **Statement of cash flows**—Reports inflows and outflows of cash during the accounting period in the categories of operating, investing, and financing. *(Illustrated in Text Exhibit 1.6, p. 1-14; IM Activity Handout 1-3)*

i. Operating—These cash flows arise directly from running the business to earn profit.

ii. Investing—These cash flows arise from buying and selling productive resources with long lives, purchasing investments, and lending to others.

iii. Financing—These cash flows include borrowing from banks, repaying bank loans, receiving cash from stockholders for company stock, or paying dividends to stockholders.

e. Notes to the Financial Statements—Help financial statement users understand how the amounts were derived and what other information may affect their decisions.

3. Relationships among the Financial Statements—The four basic financial statements connect to one another: *(Illustrated in Text Exhibit 1.7, p. 1-15; IM Activity Handout 1-4)*

a. Net income, from the income statement, is a component in determining ending Retained Earnings on the statement of retained earnings.

b. Ending Retained Earnings is then reported on the balance sheet.

c. Cash on the balance sheet is equal to the ending Cash reported on the statement of cash flows.

III. Evaluate the Results

***LO 1-3 Explain how financial statements are used by decision makers.***

A. Using Financial Statements

1. Creditors—Mainly interested in assessing two things:

a. Is the company generating enough cash to make payments on its loans? Answers come from statement of cash flows.

b. Does the company have assets to cover its liabilities? Answers come from comparing assets and liabilities reported on the balance sheet.

2. Investors—Expect a return on their contribution to the company:

a. Return may be immediate (through dividends) or long-term (through selling stock certificates at a price higher than their original cost).

b. Investors look closely at the income statement (and statement of retained earnings) for information about the company's ability to generate profits (and distribute dividends).

**CHAPTER OUTLINE (continued):**

***LO 1-4 Describe factors that contribute to useful financial information.***

B. Useful Financial Information

1. **Generally Accepted Accounting Principles (GAAP)**—The rules used in the United States to calculate and report information in the financial statements.
   a. Financial Accounting Standards Board (FASB)—Currently has primary responsibility for setting the underlying rules of accounting.
   b. Accounting rules in U.S. are similar to those used elsewhere, with some important differences.
   c. FASB has been working with the International Accounting Standards Board (IASB) to eliminate differences so that investors can more easily compare the financial statements of companies from different countries.
2. Main goal of GAAP and IFRS is to ensure companies produce financial information that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the companies.
3. For financial information to be judged useful, it must possess two fundamental characteristics:
   a. Relevance—Information is relevant if it makes a difference in decision making.
   b. Faithful representation—Information is a faithful representation if it fully depicts the economic substance of business activities.
4. Usefulness of financial information is enhanced when it is: *(Illustrated in Text Exhibit 1.9, p. 1-18)*
   a. Timely—It is available in time to influence decision makers.
   b. Verifiable—Others, such as external auditors, reach similar values using similar methods.
   c. Comparable—The same accounting principles are used over time and across companies.
   d. Understandable—Reasonably informed users can comprehend and interpret.
5. To achieve these objectives, the FASB and IASB have developed a framework that outlines the financial elements to be measured and the main external users for whom the financial information is intended.
   a. A company's managers have primary responsibility for following GAAP.
   b. To provide additional assurance, some private companies and all public companies hire independent auditors to scrutinize their financial records.
      i. Following rules approved by the Public Company Accounting Oversight Board (PCAOB) and other accounting bodies, these auditors report whether, beyond reasonable doubt, the financial statements represent what they claim to represent and whether they comply with GAAP.

ii. In a sense, GAAP is to auditors and accountants what the criminal code is to lawyers and the public.

6. Ethical Conduct
   a. **Ethics**—The standards of conduct for judging right from wrong, honest from dishonest, and fair from unfair.
   b. Intentional misreporting is both unethical and illegal.
   c. The American Institute of Certified Public Accountants (AICPA) requires all its members to adhere to a Code of Professional Conduct to help ensure decisions are made in a professional and ethical manner.
   d. Regardless of the above, some individuals have been involved in accounting scandals and fraud. *The "Spotlight on Ethics" feature (Text p. 1-20) summarizes recent accounting scandals*.
   e. **Sarbanes-Oxley Act (SOX)**—A set of laws established to strengthen corporate reporting in the United States; SOX requires top managers of public companies to:
      i. Sign a report certifying their responsibilities for the financial statements.
      ii. Maintain an audited system of internal controls to ensure accuracy in the accounting reports.
      iii. Maintain an independent committee to ensure that managers cooperate with auditors.
   f. Ethical conduct is just as important for small private businesses as it is for large public companies.
   g. When faced with an ethical dilemma, follow a three-step process:
      i. Identify who will benefit from the situation (often the manager or employee) and how others will be harmed (other employees, the company's reputation, owners, creditors, and the public in general).
      ii. Identify the alternative courses of action.
      iii. Choose the alternative that is the most ethical; that you would be proud to have reported in the news.

***LO 1-S1 Describe examples where accounting helps in pursuing other business careers.***

IV. Supplement 1A—Careers That Depend on Accounting Knowledge *(Illustrated in Text Exhibit 1A.1, p. 1-21)*

***LO 1-S2 Describe the decision to become a public company and explain the implications for accounting.***

V. Supplement 1B—Public Companies

A. Going Public

1. When a company needs more financing than it can access privately, it may choose to issue shares to investors through a public stock exchange.

**CHAPTER OUTLINE (continued):**

2. Going public offers many positive outcomes; the public company:
   a. Keeps the money it raises when issuing shares.
   b. Can more easily raise money in the future by issuing additional shares.
   c. Can pay employees using company shares not just cash.
   d. Gives founders and other stockholders a way to sell their shares.
   e. Can buy other companies by paying with shares rather than cash.
3. There are downsides to going public:
   a. Greater public reporting of significant events affecting the company.
   b. Increased accounting disclosures.
   c. Greater risk of litigation for misstatements in and omissions from these reports.
4. The first step in going public is to register with the Securities and Exchange Commission (SEC) for an initial public offering (IPO).

B. Public Company Financial Reporting

1. After completing the IPO, a public company is required to provide frequent updates about its business.
   a. A public company will announce annual (and quarterly) results through a press release sent to news agencies; many companies follow up with a conference call broadcast on the Internet.
   b. A public company will release its complete financial statements as part of an annual report posted at its investor relations website; a typical annual report contains two parts:
      i. The first part usually begins with a letter to investors from the company's Chief Executive Officer (CEO), followed by glossy pictures and comments about the company's business.
      ii. The second part presents the financial section; the comparative financial statements cover multiple years by including a column of numbers for each year. (*The typical elements of the financial section are listed and described in Text Exhibit 1B.1, p. 22).*
   c. A company's quarterly report is a highly condensed version of its annual report.
   d. To ensure sufficient, relevant information is available to investors, the SEC requires each public company to file certain reports with the SEC, including:
      i. An annual report on Form 10-K, which requires disclosure of information beyond that required in an annual report, so often companies will use the 10-K in place of a glossy annual report.
      ii. Quarterly reports on Form 10-Q.

**CHAPTER OUTLINE (continued):**

iii. Current event reports on Form 8-K, which is prepared any time a significant business event occurs between financial statement dates.

*The "Spotlight on Financial Reporting" feature (Text p. 1-23) discusses the impact of COVID-19*.

(*Typical timing of significant financial reporting events is shown in Text Exhibit 1B.2, p. 1-23)*

*To find SEC filings, click on "Company Filings Search" in the Filings tab at http:// www.sec.gov.):*

## SUPPLEMENTAL ACTIVITIES / HANDOUTS

The following handouts are suitable for individual or group in-class activities. Solutions are provided immediately following each handout master.

Activity handouts may also be assigned in Connect using the **file attachment assignment** option provided at the **+Add Assignment** tab. To do so, save the handout as a separate file and upload to the Connect assignment you have created. File attachment assignments require manual grading.

1. Handout 1–1
   Handout designed to review the classification of various accounts, elements, or transactions on the financial statements.
2. Handout 1–2
   Handout designed to review the classification of various accounts on the balance sheet.
3. Handout 1–3
   Handout designed to review various cash inflow and outflow transactions and related classifications on the statement of cash flows.
4. Handout 1–4
   Handout designed to review the individual financial statements and the relationships among the financial statements.

**HANDOUT 1–1**

## COMPONENTS OF FINANCIAL STATEMENTS

Identify the financial statement(s) on which each account, element or transaction would be reported.

| Account, Element or Transaction | Income Statement | Statement of Retained Earnings | Balance Sheet | Statement of Cash Flows |
|---|---|---|---|---|
| a. Service Revenue | | | | |
| b. Cash | | | | |
| c. Notes Payable | | | | |
| d. Common Stock | | | | |
| e. Supplies | | | | |
| f. The amount of cash collected from customers | | | | |
| g. Accounts Receivable | | | | |
| h. Retained earnings | | | | |
| i. Salaries and Wages Expense | | | | |
| j. Equipment | | | | |
| k. Dividends paid to stockholders | | | | |
| l. Accounts Payable | | | | |

## HANDOUT 1–1 SOLUTION

**COMPONENTS OF FINANCIAL STATEMENTS**

Identify the financial statement(s) on which each account, element or transaction would be reported.

| Account, Element or Transaction | Income Statement | Statement of Retained Earnings | Balance Sheet | Statement of Cash Flows |
|---|---|---|---|---|
| a. Service Revenue | X | | | |
| b. Cash | | | X | X |
| c. Notes Payable | | | X | |
| d. Common Stock | | | X | |
| e. Supplies | | | X | |
| f. The amount of cash collected from customers | | | | X |
| g. Accounts Receivable | | | X | |
| h. Retained earnings | | X | X | |
| i. Salaries and Wages Expense | X | | | |
| j. Equipment | | | X | |
| k. Dividends paid to stockholders | | X | | X |
| l. Accounts Payable | | | X | |

**HANDOUT 1–2**

**BASIC BALANCE SHEET ELEMENTS**

For each account, identify its proper classification on the balance sheet.

| Account | Asset | Liability | Stockholders' Equity |
|---|---|---|---|
| a. Notes Payable | | | |
| b. Cash | | | |
| c. Common Stock | | | |
| d. Supplies | | | |
| e. Accounts Receivable | | | |
| f. Accounts Payable | | | |
| g. Equipment | | | |
| h. Land | | | |
| i. Retained Earnings | | | |

**HANDOUT 1–2 SOLUTION**

**BASIC BALANCE SHEET ELEMENTS**

For each account, identify its proper classification on the balance sheet.

| Account | Asset | Liability | Stockholders' Equity |
|---|---|---|---|
| a. Notes Payable | | X | |
| b. Cash | X | | |
| c. Common Stock | | | X |
| d. Supplies | X | | |
| e. Accounts Receivable | X | | |
| f. Accounts Payable | | X | |
| g. Equipment | X | | |
| h. Land | X | | |
| i. Retained Earnings | | | X |

**HANDOUT 1–3**

## STATEMENT OF CASH FLOWS

For each activity, identify as a cash inflow or (outflow) and its proper classification on the statement of cash flows.

| Activity | Inflow or (Outflow) | Operating | Investing | Financing |
|---|---|---|---|---|
| a. Cash paid to employees and suppliers | | | | |
| b. Cash used to buy equipment and software | | | | |
| c. Cash dividends paid to stockholders | | | | |
| d. Cash received from customers | | | | |
| e. Cash received from selling equipment | | | | |
| f. Cash borrowed from the bank | | | | |
| g. Cash from issuing stock | | | | |

**HANDOUT 1–3 SOLUTION**

**STATEMENT OF CASH FLOWS**

For each activity, identify as a cash inflow or (outflow) and its proper classification on the statement of cash flows.

| Activity | Inflow or (Outflow) | Operating | Investing | Financing |
|---|---|---|---|---|
| a. Cash paid to employees and suppliers | Outflow | X | | |
| b. Cash used to buy equipment and software | Outflow | | X | |
| c. Cash dividends paid to stockholders | Outflow | | | X |
| d. Cash received from customers | Inflow | X | | |
| e. Cash received from selling equipment | Inflow | | X | |
| f. Cash borrowed from the bank | Inflow | | | X |
| g. Cash from issuing stock | Inflow | | | X |

HANDOUT 1–4

## OVERVIEW OF FINANCIAL STATEMENTS

Identify the purpose (i.e. what is measured/reported) and equation used to complete each of the financial statements.

| Financial Statement | Purpose | Equation |
|---|---|---|
| **Income Statement** | | |
| **Statement of Retained Earnings** | | |
| **Balance Sheet** | | |
| **Statement of Cash Flows** | | |

## RELATIONSHIPS AMONG FINANCIAL STATEMENTS

Answer the following questions.

1. How does the income statement tie to the statement of retained earnings?

2. How does the statement of retained earnings tie to the balance sheet?

3. How does the balance sheet tie to the statement of cash flows?

**HANDOUT 1–4 SOLUTION**

## OVERVIEW OF FINANCIAL STATEMENTS

Identify the purpose (i.e. what is measured/reported) and equation used to complete each of the financial statements.

| Financial Statement | Purpose | Equation |
|---|---|---|
| **Income Statement** | The financial performance of the business during the current accounting period. | Revenues<br>– Expenses<br>= Net Income (Loss) |
| **Statement of Retained Earnings** | Earnings retained in the business during the current accounting period added to those of prior periods. | Beginning Retained Earnings<br>+ Net Income (this period)<br>– Dividends (this period)<br>= Ending Retained Earnings |
| **Balance Sheet** | The financial position of a business at a point in time. | Assets = Liabilities + Stockholders' Equity |
| **Statement of Cash Flows** | Activities that caused increases and decreases in cash during the current accounting period. | +/– Cash Flows from Operating Activities<br>+/– Cash Flows from Investing Activities<br>+/– Cash Flows from Financing Activities<br>= Change in Cash<br>+ Beginning Cash<br>= Ending Cash |

## RELATIONSHIPS AMONG FINANCIAL STATEMENTS

Answer the following questions.

1. How does the income statement tie to the statement of retained earnings?

   Net income, from the income statement, is a component in determining ending retained earnings on the statement of retained earnings.

2. How does the statement of retained earnings tie to the balance sheet?

   Ending Retained Earnings on the statement of retained earnings is then reported in the stockholders' equity section of the balance sheet.

3. How does the balance sheet tie to the statement of cash flows?

   Cash on the balance sheet is equal to the ending Cash reported on the statement of cash flows.