# Chapter 1

# Financial Accounting

# CONCEPT QUESTIONS

1. Accounting is the process of identifying, measuring, and conveying business activities to users of that information.

2. The going concern assumption means that we assume that the entity for which we are accounting will continue to operate into the foreseeable future. Investors and creditors would not do business with an entity if they did not believe it would continue in business.

3. The economic entity assumption means that the financial activities of a business can be accounted for separately from the business owner’s financial activities. This assumption allows us to examine the economic information of a business without concern that the information includes the personal affairs of the owner.

4. The profitability of an entity is described by revenues, expenses, and net income (or net loss).

5. Revenues are recognized when they are earned, when services are rendered or goods delivered to a customer.

6. The matching principle states that expenses are recorded in the time period in which they are incurred to generate revenues.

7. Assets are economic resources owned by a business. Revenue represents the increase in assets from the sale of goods or provision of services.

8. The financial position of an entity is described by assets, liabilities, and equity. Equity consists of contributed capital and retained earnings.

9. Liabilities are the obligations (debts) of a business. Expenses represent the decrease in assets resulting from the sale of goods or provision of services.

10. Contributed equity is equity contributed by owners. Equity is the difference between total assets and total liabilities and represents the share of assets owned by the owners.

11. The three principles used in measuring accounting information are revenue recognition, matching, and the cost principle.

12. Assets are recorded at historical cost, the amount paid to acquire them.

13. The income statement and balance sheet are linked by the statement of retained earnings, which uses net income (or loss) from the income statement to determine ending retained earnings, which appears on the balance sheet.

14. The different financial statements are used to communicate economic information to users. The purpose of the income statement is to show the profitability of a company over a specific period of time by summarizing the flows of revenues and expenses for that period of time. The purpose of a balance sheet is to show the financial position of a company at a specific point in time by summarizing the company’s assets, liabilities, and equity at that point in time. The purpose of the statement of retained earnings is to explain the changes in retained earnings over a specific period of time. The purpose of the statement of cash flows is to show a company’s sources and uses of cash over a period of time.

15. The qualitative characteristics of accounting are understandability, relevance, reliability, comparability, and consistency. Information must be understandable to those who have a reasonable understanding of business and are willing to study the information. If accounting information is relevant, it has the ability to make a difference in decisions. Accounting information must be reliable, meaning it can be depended upon to represent what it claims to represent in number and description. Accounting information is comparable if it can be used to compare or contrast financial activities of different companies. Consistency describes the ability of accounting information to be comparable across different time periods within the same company.

16. Relevance means the accounting information has the capacity to affect decisions. Materiality describes the threshold over which an item could begin to affect decisions.

17. The conceptual framework of accounting is the collection of concepts that guide the manner in which accounting is practiced. It provides guidelines under which businesses operate.

MULTIPLE CHOICE

|  |  |  |  |
| --- | --- | --- | --- |
| 1. c | 5. b | 9. b | 13. a |
| 2. c | 6. c | 10. b | 14. c |
| 3. b | 7. d | 11. b | 15. d |
| 4. d | 8. b | 12. a | 16. c |

## BRIEF EXERCISES

**1.** $4,000 - $1,500 - $200 - $50 = $2,250

**2.**  Revenues – $82,500 = $13,000, therefore Revenues must be $95,500 or higher

**3.**  $10,000 = $6,000 + Equity, therefore Equity = $4,000

**4.**  1: cost principle

2: revenue recognition principle

3: matching principle

**5.**  $175,000 + $110,000 - $10,000 = $275,000

**6.**  $175,000 + $680,000 – $516,000 – $98,000 = $241,000

**7.**  1: going concern assumption

2: relevance

3: consistency

4. materiality

## EXERCISES

**8.** 1. Monetary Unit

2. Economic Entity

3. Time Period

4. Cost Principle

5. Going Concern

**9.** 1. E

2. R

3. N

4. R

5. E

6. N

**10.** a. Accounts receivable: **A**

b. Salaries payable: **L**

c. Office supplies: **A**

d. Land: **A**

e. Contributed capital: **E**

f. Notes payable: **L**

***Teaching Tip:*** A balance sheet reports a company’s assets, liabilities, and equity. An asset is a resource of a business, a liability is an obligation of a business, and equity is the difference between a company’s assets and liabilities that represents the share of assets that owners. Contributed capital is the cash that investors contribute to a business in exchange for an ownership interest. Therefore it is part of equity.

***Helpful Hint for Students:*** Most liabilities will have the word *payable* in the account name.

11. Item Appears On Classified As

1. Salaries expense Income statement Expense

2. Equipment Balance sheet Asset

3. Cash Balance sheet Asset

4. Accounts payable Balance sheet Liability

5. Buildings Balance sheet Asset

6. Contributed capital Balance sheet Equity

7. Retained earnings Balance sheet Equity

8. Interest revenue Income statement Revenue

9. Advertising expense Income statement Expense

***Teaching Tip:*** Remind students that the account “retained earnings” also appears on the statement of retained earnings. Contributed capital is a part of equity since it represents resources that investors contribute to a business in exchange for an ownership interest. Revenues are increases and expenses are decreases in resources, resulting from the sale of goods or the provision of services. An asset is a resource of a business, a liability is an obligation of a business, and equity is the difference between a company’s assets and liabilities that represents

the remaining share of assets for the owners.

***Helpful Hint for Students:*** Contributed capital is *not* a revenue account. Revenue accounts normally include the word *revenue, income,* or *earned* in the account name but can also be a single word such as *sales*. Expenses normally include the word *expense* in the account name and occasionally can represent several accounts such as *cost of sales*. Liabilities normally include the word *payable.*

12. Item Appears On Item Appears On

a. Income tax expense **Income statement** f. Inventory **Balance sheet**

b. Interest expense **Income statement** g. Accounts payable **Balance sheet**

c. Service Revenue **Income statement** h. Contributed Capital **Balance sheet**

d. Accounts Receivable **Balance sheet** i. Dividends **Statement of**

e. Retained earnings **Balance sheet and retained earnings**

**Statement of**

**retained earnings**

13. 1. O

2. F

3. I

4. F

5. O

**14.** a. Revenues during the period: **IS**

b. Supplies on hand at the end of the year: **BS**

c. Cash received from borrowings during the year: **SCF**

d. Total liabilities at the end of the period: **BS**

e. Dividends paid during the year: **SRE**

f. Cash paid for a building: **SCF**

g. Cost of buildings owned at year end: **BS**

***Teaching Tip:***Each financial statement reports specific types of accounts or activity. An income statement is a financial statement that shows a company’s revenues and expenses over a specific period of time. A balance sheet reports a company’s assets, liabilities, and equity. The statement of retained earnings reports the change in a business’s retained earnings over a specific period of time, so it reports dividends and net income (or loss). A statement of cash flows reports a company’s cash inflows and outflows from its operating, investing, and financing activities.

*Helpful Hint for Students:* The income statement is “Real Easy” since it reports the company’s revenues and expenses. Expenses are costs of doing business. Assets are items of value and worth, liabilities are what a company owes, and equity is what is left over for the owners. The statement of cash flows reports the sources of cash and the payments of cash during the period. Remember, since *cash* is in the name of the statement, all transactions must directly relate to the inflow or outflow of cash.

15. • Stockholder: Income statement

The stockholder would look at the revenues on the income statement to find out how this year’s sales figures compared with last year’s sales figures.

• Banker: Balance sheet

The banker would look at the liabilities on the balance sheet to find out how much debt the company has on its books.

• Supplier: Balance sheet

The supplier would look at the liabilities on the balance sheet to determine how much the company owes its suppliers in total.

• Stockholder: Statement of retained earnings and Statement of cash flows

The stockholder could find the amount of dividends shown as a reduction on the statement of retaining earnings. Also, the stockholder could find this amount on the statement of cash flows under cash flows from financing.

• Advertising agent: Income statement

The advertising agent could look under the expenses on the income statement to find out how much was used in advertising to generate sales.

• Banker: Income statement

The banker could look under expenses on the income statement to find out what the company’s total interest cost was last year. (Also, the banker could find this amount on the statement of cash flows under cash flows from operations.)

*Teaching Tip:* Each financial statement reports specific types of accounts or activity. An income statement is a financial statement that shows a company’s revenues and expenses over a specific period of time. A balance sheet reports a company’s assets, liabilities, and equity. The statement of retained earnings reports the change in a business’s retained earnings over a specific period of time, so it reports dividends and net income (or loss).

*Helpful Hint for Students:* The income statement is “Real Easy” since it reports the company’s revenues and expenses. Assets are items of value and worth, liabilities are what a company owes, and the equity is what is left over for the owners.

16. Net income = Revenues – Expenses

Net income = $10,000 – $8,000

Net income = $2,000

Retained earnings = Beginning retained earnings + Net income – Dividends

Retained earnings = $20,000 + $2,000 – $1,000

Retained earnings = $21,000

17. Assets = Liabilities + Equity

$50,000 = $25,000 + Equity Equity = $25,000

$30,000 = Liabilities + $17,000 Liabilities = $13,000

Assets = $45,000 + $15,000 Assets = $60,000

$68,000 = Liabilities + $13,000 Liabilities = $55,000

Assets = $14,000 + $6,000 Assets = $20,000

***Teaching Tip:*** An important issue for any business is its current financial position. What does the business own? What does it owe? A balance sheet reports a company’s *assets*, *liabilities*, and *equity*. Total assets always equal total liabilities plus total equity. This relationship between assets, liabilities, and equity is represented by the accounting equation: *Assets = Liabilities + Equity*.

*Helpful Hint for Students:* The accounting equation (*Assets = Liabilities + Equity*)is like any mathematical equation. It will always be equal (or balance). It can be rewritten in several forms, such as: Assets – Liabilities = Equity, or Assets – Equity = Liabilities.

18. a. Beginning of year: ($50,000 Assets = $40,000 Liabilities + ? Equity)

Equity = $10,000

Beginning equity $10,000 (above) + $12,500 income – $0 dividends = $22,500 Ending equity.

b. End of year: (? Assets = $50,000 Liabilities + $30,000 Equity)

Assets= $80,000

If McCay doubled its assets during the year, then it must have started the year with $40,000. ($80,000 ÷ 2 = $40,000)

c. Beginning of year: ($40,000 Assets = ? Liabilities + $20,000 Equity)

Liabilities = $20,000

If liabilities tripled during the year, then Hudson has $60,000 in liabilities at the end of the year. ($20,000 × 3 = $60,000)

*Teaching Tip:* The relationship between assets, liabilities, and equity is represented by the accounting equation: *Assets = Liabilities + Equity*.Using your knowledge of the accounting equation, you can solve for the missing amounts by making it a simple math problem.

*Helpful Hint for Students*: The accounting equation (*Assets = Liabilities + Equity*)is like any mathematical equation. It will always be equal (or balance). It can be rewritten in several forms, such as: Assets – Liabilities = Equity, or Assets – Equity = Liabilities.

19. First, calculate ending retained earnings at January 31, which is equal to beginning retained earnings at February 1.

Retained earnings, Jan. 1 $245,800

− Net loss ($80,000 – $85,000) (5,000)

− Dividends 0

Retained earnings, Jan. 31 $240,800

War Eagle Company

Statement of Retained Earnings

For the Month Ending Feb. 28

Retained earnings, Feb. 1 $240,800

+ Net income\* 22,000

­− Dividends 7,000

Retained earnings, Feb. 28 $255,800

\*Net income = Revenue – Expenses = $102,000 – $80,000 = $22,000

20. Section of Cash

Item Flow Statement Teaching Tip: Why?

Cash received from customers Operating *Cash generated from operations*

Cash received from lenders Financing *Cash generated from borrowing*

Cash paid to suppliers Operating *Cash paid for operations*

Cash paid for new equipment Investing *Cash paid for assets (other than*

*current assets)*

Cash paid for Cash paid for dividends Financing *Cash paid to owners who finance*

*the business through stock purchase*

###### Pasture’s Net Change in Cash:

Cash Flows from Operating $45,0001

Less: Cash Flows from Investing (50,000)2

Add: Cash Flows from Financing 16,0003

Net Change in Cash—Increase $11,000

1 Cash received from customers – Cash paid to suppliers = $65,000 – $20,000 = $45,000

2 Cash paid for new equipment = $50,000

3 Cash from lenders – Cash paid for dividends = $20,000 – $4,000 = $16,000

*Teaching Tip:* Statement of cash flows is a financial statement that reports an entity’s sources (inflows) and uses of cash (outflows) over a specific period of time.Profits that are distributed to owners are called *dividends*. Remember, dividends are not an expense of the company and therefore are not included in cash flow from operations. They are simply a distribution of company assets to owners.

*Helpful Hint for Students*: The buying and selling of assets other than current assets, such as land, building, and equipment, are considered to be *investing activities*. Think of it as the company “investing in itself.”

21. Work this problem in reverse. Begin with (e).

Retained earnings, beginning bal. $20,000

+ Net income (e) Net income = $50,000

– Dividends (10,000)

= Retained earnings, ending balance $60,000

Next find (d): (d) = (e) = Net income = $50,000

Next find (c):

Service Revenue $90,000

– Salaries Expense (c) Salaries Expense = $20,000

– Utilities expense (20,000)

= Net income $50,000

Next find (b): (b) = Retained earnings = $60,000 (from Statement of Retained Earnings)

Next find (a):

Total liabilities and equity $70,000

– Total liabilities (7,000)

= Total equity $63,000

Contributed Capital (a) Contributed Capital = $3,000

+ Retained earnings 60,000

= Total equity $63,000

*Teaching Tip:* A balance sheet reports a company’s assets, liabilities, and equity. This relationship between assets, liabilities, and equity is represented by the accounting equation: *Assets = Liabilities + Equity.* Notice that the net income from the income statement is the missing amount of net income on the statement of retained earnings. Also, the ending balance on the statement of retained earnings is the same amount as the retained earnings reported on the balance sheet.

*Helpful Hint for Students:* Work this problem in reverse.Using your knowledge of the accounting equation and the interrelationship among the financial statements, you can solve for the missing amounts by making it a simple math problem.

22. a. Total assets = Cash + Inventory + Building

$64,000 = $6,000 + $20,000 + Building

Building = $38,000

b. Total liabilities and equity – Total liabilities = Total equity

$64,000 – $7,000 = $57,000

Total equity = Contributed Capital + Retained earnings

$57,000 = Contributed Capital + $40,000

Contributed Capital = $17,000

c. Retained earnings = $40,000 (from the statement of retained earnings)

d. Service Revenue – Salaries Expense – Administrative expenses = Net income

$120,000 – $70,000 – $30,000 = Net income

Net income = $20,000

e. Net income = $20,000 (from the income statement)

f. Beginning retained earnings + Net income – Dividends = Ending retained earnings

$20,000 + $20,000 – Dividends = $40,000

Dividends = $0

23. 1. Understandability *(comprehensible to those who have a reasonable understanding of business)*

2. Relevance *(the capacity to affect decisions)*

3. Reliability *(can be depended on to represent what it purports to represent)*

4. Consistency *(compare or contrast the financial activities of the same entity over time)*

5. Materiality *(the threshold at which a financial item begins to affect decision making)*

6. Conservatism *(accounting information should present the least optimistic alternative)*

7. Comparability *(compare or contrast the financial activities of different companies)*

*Teaching Tip:* Accounting information must possess certain qualitative characteristics to be considered useful. Do not get consistency and comparability confused. Consistency applies to the *same* company and comparability applies to *different* companies.

***Helpful Hint for Students:*** Consider how each characteristic impacts accounting. Understandability: Users must spend a reasonable amount of time studying accounting information for it to be understandable. Relevance: Information should have predictive or feedback value and should be timely. Reliability: Information should be free from error, a faithful representation, and neutral. Consistency: An entity should use the same accounting methods year to year and disclose when they change methods. Materiality: When an amount is small enough, normal accounting procedures are not always followed. Conservatism: An entity should choose accounting techniques that guard against overstating revenues or assets. Comparability: Entities must disclose the accounting methods that they use so that comparisons across companies can be made.

24. a. Cost principle—Assets should be reported at historical cost.

b. Time period assumption—An entity cannot randomly change its time period. This also violates *consistency*. An entity should use the same accounting methods year to year and disclose when they change methods.

c. Economic entity assumption*—*Personal affairs of owners should be kept separate from business affairs.

d. Revenue recognition principle*—*Revenue should be recorded in the period during which it is earned.

***Teaching Tip:*** Principles, assumptions, and qualitative characteristics are necessary to communicate the financial activities and position of a business and to help ensure that accounting information is indeed useful. Revenue is earned when the sale of the good or the provision of the service is substantially complete and collection is reasonably assured; it is not dependent on the receipt of cash.

*Helpful Hint for Students:* Economic entity assumption: We do not have to worry that the financial information of the owner is mixed with the financial information of the business. Remember that the receipt of cash is not required to record revenue; we focus on when it is earned (i.e., the company has a right to it).

## PROBLEMS

25. Instructor’s Note: Revenues and expenses are listed in chart of accounts order.

YORK INC.

INCOME STATEMENT

FOR THE YEAR ENDING DECEMBER 31

Service revenue $61,000

Expenses:

Advertising $ 2,400

Rent 10,400

Salaries 28,000

Utilities 1,800

Total expenses 42,600

Net income $18,400

YORK INC.

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDING DECEMBER 31

Retained earnings, January 1 $57,000

+ Net income 18,400

− Dividends 7,000

Retained earnings, December 31 $68,400

*Teaching Tip:* The financial statements are interrelated.The income statement is prepared first. Use the net income or net loss from the income statement when preparing the statement of retained earnings.

*Helpful Hint for Students*: The income statement is “Real Easy” since it reports the company’s revenues and expenses. Expenses are costs of doing business. A simple way to remember the statement of retained earnings is “*BIDE*”: Beginning retained earnings plus net Income (or less net loss), less Dividends, equals Ending retained earnings.

**26.** **Instructor’s Note:** The assets and liabilities are listed in the chart of account order. First, solve for net income and then for the ending balance of retained earnings.

HONKY TONK RECORDS INC.

INCOME STATEMENT

FOR YEAR ENDING DECEMBER 31

Service revenue $16,820

Expenses:

Advertising 6,000

Salaries 9,500

Total expenses 15,500

Net income $1,320

HONKY TONK RECORDS INC.

STATEMENT OF RETAINED EARNINGS

FOR THE YEAR ENDING DECEMBER 31

Retained earnings, January 1 $0

+ Net income 1,320

− Dividends 0

Retained earnings, December 31 $1,320

HONKY TONK RECORDS INC.

BALANCE SHEET

DECEMBER 31

#### ASSETS

Cash $ 6,320

Accounts receivable 21,000

Buildings 76,000

Equipment 25,000

Total assets $128,320

#### LIABILITIES AND EQUITY

Accounts payable $27,000

Notes payable 70,000

Total liabilities $ 97,000

Contributed capital $30,000

Retained earnings\* 1,320

Total equity 31,320

Total liabilities and equity $128,320

*Teaching Tip:* Remind students that they will need to “solve” for the net income as well as the amount of retained earnings that is reported on the balance sheet, which may be computed as shown above or by using the accounting equation. This is a great way to reinforce the accounting equation concept: Total liabilities and total equity must equal total assets ($128,320). If we know the liabilities are $97,000, then the equity must total $31,320. The $30,000 of contributed capital is part of equity, so the retained earnings must be $1,320 ($128,320 – $97,000 – $30,000).

*Helpful Hint for Students:* Net income is the difference between revenue and expenses. Which accounts are expenses in the problem? The ending balance of retained earnings is not provided. You can solve for it by using the accounting equation or using the “BIDE” formula (Beginning retained earnings plus net Income (or less net loss), less Dividends equals Ending retained earnings). Remember that the beginning balance of retained earnings is $0 and no dividends were paid.

27. Deficiencies in the income statement include the following:

 “December 31” should read “For the year ending December 31.”

 “Income from services” should read “Service revenue.”

 Accounts Receivable should NOT be reported on the income statement; it should be reported on the balance sheet.

 A “Total income” subtotal is not needed and should read “Total revenue” if it was needed.

 Dividends are not an expense and should be reported on the statement of retained earnings, not the income statement.

 Advertising expense should not be a negative expense; it should be an addition to the total expenses that will be deducted from revenue to reach net income

 Expenses should be listed in chart of account order

The corrected income statement is presented as follows.

MUNCIE GROUP

INCOME STATEMENT

FOR THE YEAR ENDING DECEMBER 31

Service revenue $170,000

Expenses:

Advertising $ 14,000

Salaries 57,000

Utilities 22,000

Total expenses 93,000

Net income $77,000

28. Deficiencies in the balance sheet include the following:

 “For the year ending December 31” should read “December 31.”

 “Resources” should read “assets.”

 “Stuff we can sell” should read “Inventory.”

 Retained earnings should not be reported as an asset; it should be reported in equity.

 “Grand total” should read “Total assets” in the assets section and “Total liabilities and equity” in the liabilities and equity section.

 “Debts” should read “Liabilities and equity.”

 “Money we owe vendors” should read “Accounts payable.”

The corrected balance sheet is presented as follows.

BIZILIA’S INC.

BALANCE SHEET

DECEMBER 31

#### ASSETS

Cash $ 30,000

Inventory 40,000

Land 53,000

Total assets $123,000

#### LIABILITIES AND EQUITY

Accounts payable $ 43,000

Total liabilities $ 43,000

Contributed Capital $63,000

Retained earnings 17,000

Total equity 80,000

Total liabilities and equity $123,000

**29.**

Violations:

1) Economic entity: The balance sheet is prepared for the company. Therefore, Mock should not include his personal assets such as a beach house on the financial statements of the company. Neither the building nor the building loan should appear on the balance sheet

2) Cost principle: Assets should be recorded and reported at the cost paid to acquire them. Therefore, Mock should not report inventory at its current value. It should be reported at its original cost of $12,000.

3) Revenue recognition: Revenues should not be recognized and recorded until they are earned. If Mock provides the service in the next year, the company should record the revenue in that year’s income, which would then be reported in retained earnings on the balance sheet. Therefore, accounts receivable and retained earnings should be reduced by $5,000.

MOCK CORPORATION

BALANCE SHEET

DECEMBER 31

#### ASSETS

Cash $ 25,000

Accounts receivable 35,000

Inventory 12,000

Total assets $72,000

#### LIABILITIES AND EQUITY

Accounts payable $ 40,000

Total liabilities $ 40,000

Retained earnings 32,000

Total equity 32,000

Total liabilities and equity $72,000

**30.** **Instructor’s Note:** Revenues and expenses are listed in chart of accounts order. The balance for cash must be computed.

OCEAN TOURS

INCOME STATEMENT

FOR THE MONTH ENDING JUNE 30

Service revenue (240 \* $25) $6,000

Expenses:

Advertising $ 25

Fuel ($135 + $200) 335

Interest 5

Rent 480

Total expenses 845

Net income $5,155

OCEAN TOURS

STATEMENT OF RETAINED EARNINGS

FOR THE MONTH ENDING JUNE 30

Retained earnings, June 1 $ 0

+ Net income 5,155

− Dividends 0

Retained earnings, June 30 $5,155

OCEAN TOURS

BALANCE SHEET

JUNE 30

#### ASSETS

Cash\* $6,130

Accounts receivable 225

Total assets $6,355

#### LIABILITIES AND EQUITY

Notes payable $600

Contributed capital 600

Retained earnings 5,155

Total liabilities and equity $6,355

\*Computations:

Cash on hand at end of month:

$600 personal contribution + $600 loan + $5,7751 cash collections of revenue – $480 rental – $335 fuel – $5 interest – $25 advertising = $6,130

1 Revenue equals: $25 × 240 = $6,000; cash collected equals: $6,000 – $225 = $5,775

*Teaching Tip:* The financial statements are interrelated.The income statement is prepared first. Use the net income or net loss from the income statement when preparing the statement of retained earnings. The new ending balance on the statement of retained earnings is the balance reported for retained earnings on the balance sheet.

*Helpful Hint for Students:* The income statement is “Real Easy” since it reports the company’s revenues and expenses. Expenses are costs of doing business. Assets are items of value and worth, liabilities are what a company owes, and the equity is what is left over for the owners. A simple way to remember the statement of retained earnings is “*BIDE*”: Beginning retained earnings plus net Income (or less net loss), less Dividends equals Ending retained earnings. The amount of cash reported on the balance sheet must be computed. Consider all the sources of cash and all payments of cash for the month.

31. Income Statement

For the Month Ending April 30

Service revenue ($20 × 80) $1,600

Expenses:

Advertising $ 50

Interest 5

Rent 25

Supplies ($400 – $30) 370

Total expenses 450

Net income $1,150

Statement of Retained Earnings

For the Month Ending April 30

Retained earnings, April 1 $ 0

+ Net income 1,150

− Dividends 0

Retained earnings, April 30 $1,150

Balance Sheet

April 30

Assets

Cash (See Note 1) $1,540

Accounts receivable ($20 × 4 payments not received) 80

Supplies 30

Total assets $1,650

Liabilities and Equity

Notes payable $ 500

Retained earnings 1,150

Total liabilities and equity $1,650

Note 1: $1,540 = $500 – $400 – $50 – $25 + $1,520 – $5

## CASES

## 32. a. and b.

Data from Financial Statements

CVS Walgreens

Net revenues $96,413 $67,420

Net earnings 3,424 2,091

Total assets 62,169 26,275

Cash flows from operating activities 4,779 3,744

Date prepared Dec 31, 2010 Aug 31, 2010

c.

Comparison

1. Largest company—When using net revenues or total assets, CVS is larger than Walgreens.

2. Most profitable—CVS shows greater net income in the current year. Therefore, it is more profitable.

3. Best able to generate cash from operations—CVS generated more cash from its operating activities in the current year. Therefore, it was better able to generate cash from operations than Walgreens.

33. Ethical Dilemma

Your boss wants you to ignore the fact that previous and current financial statements are misstated and therefore misleading to investors. He is arguing that over the total six-year period, net income will be reported correctly, so the incorrect reporting each year is not important.

Possible Responses

Option 1: “I understand that our income is large enough this year to absorb the previous losses and to still be profitable, but the information that we will be reporting is not correct. It is therefore not reliable. We should report unbiased information to our investors. We should disclose the errors in the previous years and report current year results truthfully.”

Consequence: Although it will be hard to stand up to your boss, this is the right action to take in this situation. By recognizing the error in restating prior financial statements, you avoid committing another error by misstating current net income. There may be negative consequences to this action in that you may be criticized for not being “a team player.”

Option 2: “I understand, Mr. Boss. I will do what I am told.”

Consequence: The current year’s net income will be understated and prior years’ income will remain overstated. If someone outside the company discovers that the company knew of and ignored the error, there could be more severe consequences than just restating the financial statements. Additionally, if you do as your boss says this time, he may expect you to act in unethical ways in the future.

34. An example letter might appear as follows:

Uncle Ted,

Congratulations on winning the lottery! I am honored that you would think of me when seeking advice.

First, in order for you to decide where to invest your money, it is a great idea to examine the financial statements of each potential company. To do this you must understand what information is presented in each of the four financial statements.

The Income Statement: The income statement presents all revenues earned by the corporation and all expenses incurred. The purpose of the income statement is to present the net income of the company. This tells you how profitable the company was during the specified period of time. A good idea would be to look at the income statements for the past few years and make sure the company has had consistent positive net income, and even better, to look and see if they are growing.

The Statement of Retained Earnings: The statement of retained earnings shows the change in a company’s retained earnings over a specific period of time. Net income increases retained earnings, while dividends and net losses decrease retained earnings. Retained earnings serve as a link between the income statement and balance sheet; net income increases retained earnings, and the calculated ending retained earnings is shown on the balance sheet as a part of equity.

The Balance Sheet: The balance sheet shows assets, liabilities, and equity at a specific point in time. It shows a company’s resources, or assets, and the claims, or liabilities, against those resources. The basic structure of the statement is assets equal liabilities plus equity. The balance sheet tells you about the financial structure of the company. It tells you how the company finances their operations, whether from lenders (liabilities) or investors (equity).

The Statement of Cash Flows: The statement of cash flows reports a company’s cash inflows and outflows. There are three sections on the statement: operating, investing, and financing. This statement reveals where a company gets its cash, and then where that cash goes.

I hope this helps. If you have any extra money after you finish investing, I know you have a niece who could use some extra cash!

Your Niece

## LOWE’S COMPARATIVE ANALYSIS

## FROM PREP CARD

**1.** (1) economic entity, (2) monetary unit, (3) time period

**2.** (A) **Revenue:**

Net sales

#### Expenses:

Cost of sales

Selling, general and administrative

Depreciation

Interest – net

Income tax provision

(B) Net earnings for 2010: $2,010 (in millions)

**3.** (A) Lowe’s 2010 = (A = L + E)

$33,699= $15,587 + $18,112 (in millions)

(B)The company lists the following eight asset accounts on its balance sheet:

Cash and cash equivalents

Short-term investments

Merchandise inventory – net

Deferred income taxes – net

Other current assets

Property, less accumulated depreciation

Long-term investments

Other assets

**4.** (A) The statement of shareholders’ equity for Lowe’s has six columns of numerical data. The fourth numerical column from the left (with “Retained Earnings” as the header) is Lowe’s statement of retained earnings. In 2010, the amount for net earnings is $2,010\*\*, which is also the number shown on the statement of earnings.

(B) 2010 Beginning balance of retained earnings = $18,307\*\* and ending balance = $17,371\*\*

(C) Yes. The amount of net earnings is the same—$2,010\*\*—in both places.

(D) Yes. The amount shown for retained earnings—$17,371\*\*—is the same in both places.

\*\* in millions

**5.** Operating activities: Generated $3,852 million

Investing activities: Used $2,184 million

Financing activities: Used $1,651 million