Chapter 1
Financial Statements and Business Decisions

ANSWERS TO QUESTIONS

1. Accounting is a system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.

2. Financial accounting involves preparation of the four basic financial statements and related disclosures for external decision makers. Managerial accounting involves the preparation of detailed plans, budgets, forecasts, and performance reports for internal decision makers.

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

4. Investors purchase all or part of a business and hope to gain by receiving part of what the company earns and/or selling the company in the future at a higher price than they paid. Creditors lend money to a company for a specific length of time and hope to gain by charging interest on the loan.

5. In a society each organization can be defined as a separate accounting entity. An accounting entity is the organization for which financial data are to be collected. Typical accounting entities are a business, a church, a governmental unit, a university and other nonprofit organizations such as a hospital and a welfare organization. A business typically is defined and treated as a separate entity because the owners, creditors, investors, and other interested parties need to evaluate its performance and its potential separately from other entities and from its owners.

6.

Name of Statement	*Alternative Title*
(a) Income Statement	(a) Statement of Earnings; Statement of Income; Statement of Operations
(b) Balance Sheet	(b) Statement of Financial Position
(c) Audit Report	(c) Report of Independent Accountants

7. The heading of each of the four required financial statements should include the following:
   (a) Name of the entity
   (b) Name of the statement
   (c) Date of the statement, or the period of time
   (d) Unit of measure

8. (a) The purpose of the income statement is to present information about the revenues, expenses, and the net income of the entity for a specified period of time.
   (b) The purpose of the balance sheet is to report the financial position of an entity at a given date, that is, to report information about the assets, obligations and stockholders' equity of the entity as of a specific date.
   (c) The purpose of the statement of cash flows is to present information about the flow of cash into the entity (sources), the flow of cash out of the entity (uses), and the net increase or decrease in cash during the period.
   (d) The statement of stockholders' equity reports the changes in each of the company's stockholders' equity accounts during the accounting period including issue and repurchase of stock and the way that net income and distribution of dividends affected the retained earnings of the company during that period.

9. The income statement and the statement of cash flows are dated "For the Year Ended December 31, 2013," because they report the inflows and outflows of resources during a period of time. In contrast, the balance sheet is dated "At December 31, 2013," because it represents the resources, obligations and stockholders' equity at a specific date.

10. Assets are important to creditors and investors because assets provide a basis for judging whether sufficient resources are available to operate the company. Assets are also important because they could be sold for cash in the event the company goes out of business. Liabilities are important to creditors and investors because the company must be able to generate sufficient cash from operations or further borrowing to meet the payments required by debt agreements. If a business does not pay its creditors, the law may give the creditors the right to force the sale of assets sufficient to meet their claims.

11. Net income is the excess of total revenues over total expenses. Net loss is the excess of total expenses over total revenues.

12. The equation for the income statement is Revenues - Expenses = Net Income (or Net Loss if the amount is negative). Thus, the three major items reported on the income statement are (1) revenues, (2) expenses, and (3) net income.

13. The equation for the balance sheet (also known as the basic accounting equation) is: Assets = Liabilities + Stockholders' Equity. Assets are the probable (expected) future economic benefits owned by the entity as a result of past transactions. They are the resources owned by the business at a given point in time such as cash, receivables, inventory, machinery, buildings, land, and patents. Liabilities are probable (expected) debts or obligations of the entity as a result of past transactions which will be paid with assets or services in the future. They are the obligations of the entity such as accounts payable, notes payable, and bonds payable. Stockholders' equity is financing provided by owners of the business and operations. It is the claim of the owners to the assets of the business after the creditor claims have been satisfied. It may be thought of as the residual interest because it represents assets minus liabilities.

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. 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 including interest paid and income taxes paid). Cash flows from investing activities include cash flows that are related to the acquisition or sale of productive assets used by the company. Cash flows from financing activities are directly related to the financing of the enterprise itself.

15. The retained earnings equation 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 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. The ending Retained Earnings amount is reported on the end-of-period balance sheet.

16. Marketing managers and credit managers use customers' financial statements to decide whether to extend them credit for their purchases. Purchasing managers use potential suppliers' financial statements to judge whether the suppliers have the resources necessary to meet current and future demand. Human resource managers use financial statements as a basis for contract negotiations, to determine what pay rates the company can afford. The net income figure even serves as a basis to pay bonuses not only to management, but to other employees through profit sharing plans.

17. The Securities and Exchange Commission (SEC) is the U.S. government agency which determines the financial statements that public companies must provide to stockholders and the measurement rules used in producing those statements. The Financial Accounting Standards Board (FASB) is the private sector body given the primary responsibility to work out the detailed rules which become generally accepted accounting principles.

18. Management is responsible for preparing the financial statements and other information contained in the annual report and for the maintenance of a system of internal accounting policies, procedures and controls. These measures are intended to provide reasonable assurance, at appropriate cost, that transactions are processed in accordance with company authorization as well as properly recorded and reported in the financial statements, and that assets are adequately safeguarded. Independent auditors examine the financial reports (prepared by management) and the underlying records to assure that the reports represent what they claim and conform with generally accepted accounting principles (GAAP).

19. A sole proprietorship is an unincorporated business owned by one individual. A partnership is an unincorporated association of two or more individuals to carry on a business. A corporation is a business that is organized under the laws of a particular state whereby a charter is granted and the entity is authorized to issue shares of stock as evidence of ownership by the owners (i.e., stockholders).

20. A CPA firm normally renders three services: auditing, management advisory services, and tax services. Auditing involves examination of the records and financial reports to determine whether they “fairly present” the financial position and results of operations of the entity. Management advisory services involve management advice to the individual business enterprises and other entities. It is like a consulting firm. Tax services involve providing tax planning advice to clients (both individuals and businesses) and preparation of their tax returns.

ANSWERS TO MULTIPLE CHOICE

1. b)	2. d)	3. d)	4. c)	5. a)
6. d)	7. a)	8. a)	9. c)	10. b)

Authors' Recommended Solution Time
(Time in minutes)

Mini-exercises		*Exercises*		*Problems*		*Alternate Problems*		*Cases and Projects*	
No.	*Time*	*No.*	*Time*	*No.*	*Time*	*No.*	*Time*	*No.*	*Time*
1	5	1	12	1	45	1	45	1	20
2	5	2	12	2	45	2	45	2	30
3	5	3	12	3	45	3	45	3	30
		4	20	4	45			4	60
		5	25					5	30
		6	20					6	20
		7	15					7	*
		8	25						
		9	25					*Continuing Case*	
		10	25					1	45
		11	30						
		12	15						
		13	12						

* Due to the nature of these cases and projects, it is very difficult to estimate the amount of time students will need to complete the assignment. 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. For example, when our goal is to sharpen research skills, we devote class time discussing research strategies. When we want the students to focus on a real accounting issue, we offer suggestions about possible companies or industries.

MINI-EXERCISES

M1–1.

	Element	Financial Statement
B	(1) Expenses	A. Balance sheet
D	(2) Cash flow from investing activities	B. Income statement
A	(3) Assets	C. Statement of stockholders’ equity
C*	(4) Dividends	D. Statement of cash flows
B	(5) Revenues	
D	(6) Cash flow from operating activities	
A	(7) Liabilities	
D	(8) Cash flow from financing activities	

*Dividends paid in cash are also subtracted in the Financing section of the Statement of Cash Flows

M1–2.

SE	(1) Retained earnings
A	(2) Accounts receivable
R	(3) Sales revenue
A	(4) Property, plant, and equipment
E	(5) Cost of goods sold expense
A	(6) Inventories
E	(7) Interest expense
L	(8) Accounts payable
A	(9) Land

M1–3.

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

EXERCISES

E1–1.

	Term or Abbreviation
J	(1) SEC
F	(2) Audit
H	(3) Sole proprietorship
E	(4) Corporation
A	(5) Accounting
D	(6) Accounting entity
I	(7) Audit report
L	(8) Publicly traded
C	(9) Partnership
K	(10) FASB
G	(11) CPA
B	(12) Unit of measure
M	(13) GAAP

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 an entity in terms of the dollar or other national monetary unit.
C. An unincorporated business owned by two or more persons.
D. The organization for which financial data are to be collected (separate and distinct from its owners).
E. An incorporated entity that issues shares of stock as evidence of ownership.
F. An examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles.
G. Certified Public Accountant.
H. An unincorporated business owned by one person.
I. A report that describes the auditor's opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.
J. Securities and Exchange Commission.
K. Financial Accounting Standards Board.
L. A company with stock that can be bought and sold by investors on established stock exchanges.
M. Generally accepted accounting principles.

E1–2.

A	(1)	Accounts receivable
A	(2)	Cash and cash equivalents
R	(3)	Net sales
L	(4)	Notes payable
L	(5)	Taxes payable
SE	(6)	Retained earnings
E	(7)	Cost of products sold
E	(8)	Marketing, administrative, and other operating expenses
E	(9)	Income taxes
L	(10)	Accounts payable
A	(11)	Land
A	(12)	Property, plant, and equipment
L	(13)	Long-term debt
A	(14)	Inventories
E	(15)	Interest expense

E1–3.

L	(1) Notes payable to banks	A	(10) Machinery and equipment
E	(2) General and administrative	R	(11) Net sales
L	(3) Accounts payable	A	(12) Inventories
L	(4) Dividends payable	E	(13) Marketing, selling, and advertising
SE	(5) Retained earnings	A	(14) Buildings
A	(6) Cash and cash equivalents	A	(15) Land
A	(7) Accounts receivable	L	(16) Income taxes payable
E	(8) Provision for income taxes*	E	(17) Distribution and warehousing costs
E	(9) Cost of goods sold	A	(18) Investments (in other companies)

*Note that "Provision for income taxes" is a common synonym for "Income tax expense."

E1–4.

Honda Motor Corporation
Balance Sheet
as of March 31, 2011
(in billions of Yen)

Assets	
Cash and cash equivalents	¥1,279
Trade accounts, notes, and other receivables	788
Inventories	900
Investments	640
Net property, plant and equipment	1,939
Other assets	6,025
Total assets	¥11,571
Liabilities	
Accounts payable and other current liabilities	¥ 3,568
Long-term debt	2,043
Other liabilities	1,377
Total liabilities	6,988
Stockholders' Equity	
Common stock	259
Retained earnings	4,324
Total stockholders' equity	4,583
Total liabilities and stockholders' equity	¥11,571

E1–5.

Req. 1

NEW WORLD BOOK STORE
Balance Sheet
At December 31, 2014

ASSETS		**LIABILITIES**	
Cash	$75,600	Accounts payable	$12,000
Accounts receivable	39,000	Note payable	3,000
Store and office equipment	73,000	Interest payable	300
		Total liabilities	15,300
		STOCKHOLDERS' EQUITY	
		Common stock	160,000
		Retained earnings	12,300
		Total stockholders' equity	172,300
Total assets	$187,600	Total liabilities and stockholders' equity	$187,600

Req. 2
Net income for the year was $12,300. This is the first year of operations and no dividends were declared or paid to stockholders; therefore, the ending retained earnings of $12,300 includes net income for one year.

E1–6.

CAMPUS CONNECTION
Income Statement
For the Month of January 2014

Revenues:		
Sales: Cash	$150,000	
On credit	2,500	
Total sales revenue		$152,500
Expenses:		
Cost of goods sold	70,000	
Salaries, rent, supplies, and other expenses (paid in cash)	37,000	
Utilities	900	
Total expenses		107,900
Net Income		$44,600

E1–7.

WALGREEN CO.
Income Statement
For the Year ended August 31, 2011
(in millions)

Revenues:		
Net sales	$72,184	
Other Income	434	
Total revenues/ income		$72,618
Expenses:		
Cost of sales	51,692	
Selling, general and administration expense	16,561	
Interest Expense	71	
Total expenses		68,324
Pretax income		4,294
Income tax expense		1,580
Net earnings		$2,714

*Note that “Provision for income taxes” is a common synonym for “Income tax expense.”

E1–8.

NEIGHBORHOOD REALTY, INCORPORATED
Income Statement
For the Year Ended December 31, 2015

Revenues:		
Commissions earned ($150,900+$16,800)	$167,700	
Rental service fees	20,000	
Total revenues		$187,700
Expenses:		
Salaries expense	62,740	
Commission expense	35,330	
Payroll tax expense	2,500	
Rent expense ($2,475+$225)*	2,700	
Utilities expense	1,600	
Promotion and advertising expense	7,750	
Miscellaneous expenses	500	
Total expenses (excluding income taxes)		113,120
Pretax income		74,580
Income tax expense		24,400
Net Income		$50,180

*$2,475 has been paid for 11 months ($225 per month) plus $225 owed for December.

E1–9.

Net Income (or Loss) = Revenues - Expenses
Assets = Liabilities + Stockholders' Equity

A Net Income = $93,500 - $76,940 = $16,560;
Stockholders' Equity = $140,200 - $66,500 = $73,700.

B Total Revenues = $75,834 + $14,740 = $90,574;
Total Liabilities = $107,880 - $77,500 = $30,380.

C Net Loss = $68,120 - $76,430 = ($8,310);
Stockholders' Equity = $98,200 - $69,850 = $28,350.

D Total Expenses = $55,804 - $21,770 = $34,034;
Total Assets = $20,300 + $78,680 = $98,980.

E Net Income = $84,840 - $75,320 = $9,520;
Total Assets = $25,520 + $80,000 = $105,520.

E1–10.

Net Income (or Loss) = Revenues - Expenses
Assets = Liabilities + Stockholders' Equity

A Net Income = $242,300 - $196,700 = $45,600;
Stockholders' Equity = $253,500 - $75,000 = $178,500.

B Total Revenues = $176,500 + $29,920 = $206,420;
Total Liabilities = $590,000 - $350,600 = $239,400.

C Net Loss = $73,500 - $91,890 = ($18,390);
Stockholders' Equity = $260,400 - $190,760 = $69,640.

D Total Expenses = $35,840 - $9,840 = $26,000;
Total Assets = $190,430 + $97,525 = $287,955.

E Net Income = $224,130 - $209,500= $14,630;
Total Assets = $173,850 + $360,100 = $533,950.

E1–11.

PAINTER CORPORATION
Income Statement
For the Month of January 2013

Total revenues	$305,000
Less: Total expenses (excluding income tax)	189,000
Pretax income	116,000
Less: Income tax expense	35,000
Net income	$ 81,000

PAINTER CORPORATION
Balance Sheet
At January 31, 2013

Assets	
Cash	$ 65,150
Receivables from customers	44,700
Merchandise inventory	94,500
Total assets	$204,350
Liabilities	
Payables to suppliers	$25,950
Income taxes payable	35,000
Total liabilities	60,950
Stockholders' Equity	
Common stock (2,600 shares)	62,400
Retained earnings *(from income statement above)*	81,000
Total stockholders' equity	143,400
Total liabilities and stockholders' equity	$204,350

E1–12.

CLINT'S STONEWORK CORPORATION
Statement of Stockholders' Equity
For the Year Ended December 31, 2014

	Common Stock	Retained Earnings
Balance December 31, 2013*	$100,000	$16,800
Net income		42,000
Dividends		(18,700)
Balance December 31, 2014	$100,000	$40,100

* Beginning retained earnings + Net income – Dividends = Ending retained earnings
For 2013: $0 + 31,000 – 14,200 = $16,800;
Ending retained earnings for 2013 becomes beginning retained earnings for 2014.

E1–13.

(I)	(1)	Purchases of property, plant, and equipment
O	(2)	Cash received from customers
(F)	(3)	Cash paid for dividends to stockholders
(O)	(4)	Cash paid to suppliers
(O)	(5)	Income taxes paid
(O)	(6)	Cash paid to employees
I	(7)	Cash proceeds received from sale of investment in another company
(F)	(8)	Repayment of borrowings

PROBLEMS

(**Note to the instructor**: Most students find the Problems in this chapter to be quite challenging.)

P1–1.

Req. 1

HIGHLIGHT CONSTRUCTION COMPANY
Income Statement
For the Year Ended December 31, 2014

Total sales revenue (given)	$128,400
Total expenses (given)	80,200
Pretax income	48,200
Income tax expense ($48,200 x 30%)	14,460
Net income	$ 33,740

Req. 2

HIGHLIGHT CONSTRUCTION COMPANY
Statement of Stockholders' Equity
For the Year Ended December 31, 2014

	Common Stock	Retained Earnings
Balance December 31, 2013	$ 0	$ 0
Stock issuance (given)	87,000	
+Net income (from req. 1)		33,740
–Dividends (given)		10,000
Balance December 31, 2014	$ 87,000	$ 23,740

Req. 3

HIGHLIGHT CONSTRUCTION COMPANY
Balance Sheet
At December 31, 2014

Assets		
Cash (given)		$25,600
Receivables from customers (given)		10,800
Inventory of merchandise (given)		81,000
Equipment (given)		42,000
Total assets		$159,400
Liabilities		
Accounts payable (given)	$46,140	
Salary payable (given)	2,520	
Total liabilities		$ 48,660
Stockholders' Equity		
Common stock (given)	$87,000	
Retained earnings (from req. 2)	23,740	
Total stockholders' equity		110,740

Total liabilities and stockholders' equity	$159,400

P1–2.

Req. 1

JAMES COOK LAWN SERVICE
Income Statement
For the Three Months Ended August 31, 2014

Revenues from services		
Lawn service–cash	$15,000	
–credit	700	
Total revenues		$15,700
Expenses		
Gas, oil, and lubrication ($1,050+$180)	1,230	
Pickup repairs	250	
Repair of mowers	110	
Miscellaneous supplies used	80	
Helpers (wages)	5,400	
Payroll taxes	190	
Preparation of payroll tax forms	25	
Insurance	125	
Telephone	110	
Interest expense on note paid	78	
Equipment use cost (depreciation)	600	
Total expenses		8,198
Net income		$ 7,502

Req. 2

Because the above report reflects only revenues, expenses, and net income, it is reasonable to suppose that James would need the following:

(1) A balance sheet–that is, a statement that reports for the business, at the end of August 2014, each asset (name and amount, such as Cash, $XX), each liability (such as Wages Payable, $XX), and stockholders' equity.

(2) A statement of retained earnings that shows how income and dividends (if any) affect retained earnings on the balance sheet.

P1–3.

	Req. 1		***Req. 2–Explanation***
Transaction	*Income*	*Cash*	
(a)	+$66,000	+$55,000	All services performed increase income; cash received during the period was, $66,000 – 11,000 = $55,000.
(b)	–0–	+56,000	Cash borrowed is not income.
(c)	–0–	–12,500	Purchase of the truck does not represent an expense until it is used (it is an asset); cash outflow was $12,500.
(d)	–25,000	–12,500	All of the wages incurred reduce income, $25,000; cash paid during the quarter was, $25,000 x 1/2 = $12,500. The $12,500 owed will be paid on the next payroll date.
(e)	–2,900	–3,800	Not all of the supplies were used; expense is the amount used, $3,800 – 900 = $2,900. Cash paid during the quarter was $3,800.
(f)	–38,000	–31,500	All expenses incurred reduce income; cash expended was, $38,000 – 6,500 = $31,500.
Based only on the above:			
Income (loss)	$100		
Cash inflow (outflow)		$ 50,700	

P1–4.

Req. 1
The personal residences of the organizers are not resources of the business entity. Therefore, they should be excluded.

Req. 2
It is not indicated whether the $57,000 listed for service trucks and equipment is their cost when acquired or the current market value on December 31, 2014.

Req. 3
The list of company resources (i.e., assets) suggests the following areas of concern:

Company resources:
(1) Cash, inventories, and bills due from customers (i.e., accounts receivable)–these items tend to fluctuate; they may be significantly more or less at date of the loan and during the term of the loan.

(2) Service trucks and equipment–as noted above, it is not indicated whether the $57,000 is cost when acquired or current market value on December 31, 2014.

(3) Personal residences–as noted above, these items are not resources of the business entity and should be excluded.

Company obligations:
(4) Unpaid wages of $19,000, which are now due, pose a serious problem because only $12,000 cash currently is available.

(5) Unpaid taxes and accounts payable to suppliers–it is not clear when these payments of $8,000 and $10,000, respectively, are due (cash needed to pay them is a problem).

(6) The $45,000 owed on the service trucks probably is long term; however, short-term installments may be required–these details are very important to the bank.

(7) Loan from organizer–the expected payment date and interest rate are important issues for which details are not provided. This is a major cash demand.

In general, the bank should request more details about the specific resources and debts. The personal residences are not a part of the resources of the business entity. The bank should request that the owners provide audited information about the entity's assets and debts.

P1–4. (continued)

Req. 4
The amount of stockholders' equity (i.e., assets minus liabilities) for Northwest Company, assuming the amounts provided by the owners are acceptable, would be:

Assets ($311,000–$190,000)	$121,000
Liabilities	92,000
Stockholders' equity	$29,000

ALTERNATE PROBLEMS

AP1–1.

Req. 1

INFLUENCE CORPORATION
Income Statement
For the Year Ended June 30, 2014

Total sales revenue (given)	$100,000
Total expenses (given)	68,500
Pretax income	31,500
Income tax expense ($31,500 x 30%)	9,450
Net income	$22,050

Req. 2

INFLUENCE CORPORATION
Statement of Stockholders' Equity
For the Year Ended June 30, 2014

	Common Stock	Retained Earnings
Balance, July 1, 2013	$ 0	$ 0
Common stock issuance (given)	62,000	
+Net income (from req. 1)		22,050
–Dividends (given)		0
Balance, June 30, 2014	$ 62,000	$ 22,050

Req. 3

INFLUENCE CORPORATION
Balance Sheet
At June 30, 2014

Assets		
Cash (given)		$13,150
Receivables from customers (given)		10,900
Inventory of merchandise (given)		27,000
Equipment (given)		66,000
Total assets		$117,050
Liabilities		
Accounts payable (given)	$31,500	
Salary payable (given)	1,500	
Total liabilities		$ 33,000
Stockholders' Equity		
Common stock (given)	$62,000	
Retained earnings (from req. 2)	22,050	
Total stockholders' equity		84,050
Total liabilities and stockholders' equity		$117,050

AP1–2.

Req. 1

LIST ELECTRIC REPAIR COMPANY, INC.
Income Statement
For the Three Months Ended December 31, 2014

Revenues from services:		
Electric repair services–cash	$32,000	
–credit	3,500	
Total revenues		$35,500
Expenses:		
Electrician's assistant (wages)	7,500	
Payroll taxes	175	
Supplies used on jobs	9,500	
Oil, gas, and maintenance on truck	1,200	
Insurance	700	
Rent ($500+$250)	750	
Utilities and telephone	825	
Miscellaneous expenses	600	
Depreciation of truck and tools (use)	1,200	
Total expenses		22,450
Pretax Income		13,050
Income taxes		3,930
Net Income		$ 9,120

Req. 2

Because the above report reflects only revenues, expenses, and net income, it is reasonable to suppose that Sam would have need for the following:

(1) A statement that reports for the business, at the end of 2014, each asset (name and amount such as Cash, $XX), and each liability (such as Income taxes payable, $XX), and stockholders' equity; that is, a balance sheet.

(2) A statement of the sources and uses of cash during the period; that is, a statement of cash flows.

(3) A statement of stockholders’ equity that shows the change in common stock and how net income and dividends affect retained earnings on the balance sheet.

AP1–3.

	Req. 1		***Req. 2–Explanation***
Transaction	*Income*	*Cash*	
(a)	+$85,000	+$70,000	All services performed increase income; cash received during the period was, $85,000 – 15,000 = $70,000.
(b)	–0–	+25,000	Cash borrowed is not income.
(c)	–0–	–8,000	Purchase of the truck does not represent an expense until it is used (it is an asset); cash outflow was $8,000.
(d)	–36,000	–30,000	All of the wages incurred reduce income, $36,000; cash paid during the quarter was, $36,000 x 5/6 = $30,000. The $6,000 owed will be paid on the next payroll date.
(e)	–3,000	–4,000	Not all of the supplies were used; expense is the amount used, $4,000 – 1,000 = $3,000. Cash paid during the quarter was $4,000.
(f)	–31,000	–15,500	All expenses incurred reduce income; cash expended was, $31,000 – 15,500 = $15,500.
Based only on the above:			
Income (loss)	$15,000		
Cash inflow (outflow)		$ 37,500	

CASES AND PROJECTS

ANNUAL REPORT CASES

CP1–1.

1. It sells its own brand of high quality, on-trend clothing, accessories, and personal care products targeting 15 to 25 year-old customers.

2. The company's most recent fiscal year ended on January 28, 2012.

3. a. Balance Sheets–2 years
   b. Income Statements–3 years
   c. Cash Flow Statements–3 years

4. Yes, it is audited by independent CPAs, as indicated by the "Report of Independent Registered Public Accounting Firm" on page 69 of the annual report.

5. Its total assets increased from $1,879,998,000 to $1,950,802,000. The instructor should note that the reported numbers are in thousands.

6. As of January 28, 2012, the company had $378,426,000 in inventory.

7.

Assets	=	Liabilities*	+	Stockholders' Equity
$1,950,802,000	=	$533,951,000	+	$1,416,851,000

*Liabilities are determined by either adding current ($405,401,000) and long term liabilities ($128,550,000) or by solving the accounting equation: Assets ($1,950,802,000) = Liabilities + Stockholders' Equity ($1,416,851,000)

CP1–2.

1. Net income was $185,251 thousand or $185,251,000 for the year ended January 31, 2012. This is disclosed on the income statement. The instructor should note that the reported numbers are in thousands. Some students will erroneously report income as $185,251. Students should also be warned that different companies often use different terminology—some companies may use the term “net earnings” to describe net income.

2. Net sales were $2,473,801,000. This is also disclosed on the income statement.

3. Inventory is $250,073,000. This is disclosed on the balance sheet.

4. Cash and cash equivalents decreased by $194,984,000 during the year. This amount can be computed from the balance sheet or it can be found on the statement of cash flows.

5. The auditor is Deloitte & Touche LLP. This is found on the auditor’s report (in this case, called the “report of independent registered public accounting firm”).

CP1–3.

1. American Eagle Outfitters had total assets of $1,950,802,000 at the end of the most recent year, whereas Urban Outfitters had total assets of $1,483,708,000. Clearly American Eagle Outfitters is the larger of the two companies in terms of total assets at the end of the most recent year.

2. Urban Outfitters had net sales of $2,473,801,000 in the most recent year, while American Eagle Outfitters had greater net sales in the amount of $3,159,818,000. Again, American Eagle Outfitters is the larger of the two companies in terms of net sales.

3. In the most recent year, Urban Outfitters had a decrease in total assets of ($1,483,708,000-$1,794,321,000)/($1,794,321,000) = -17.3%, while American Eagle Outfitters had growth in total assets of ($1,950,802,000 - $1,879,998,000)/($1,879,998,000) = 3.8%.

   Similarly, Urban Outfitters had growth in net sales of ($2,473,801,000 - $2,274,102,000)/($2,274,102,000) = 8.8%, while American Eagle Outfitters had lower growth in net sales of ($3,159,818,000 - $2,967,559,000)/($2,967,559,000) = 6.5%.

   Urban Outfitters is growing faster in sales, but American Eagle grew in total assets while Urban Outfitters declined.

FINANCIAL REPORTING AND ANALYSIS CASES

CP1–4.

Req. 1–Deficiencies:

(1) Heading: titles of the reports are missing and dates are not in proper form.
(2) Income statement should show revenues and expenses separately.
(3) "Profit earned in 2012" should be "Net income."
(4) Balance sheet should separately report assets, liabilities, and stockholders' equity.
(5) Retained earnings, $32,250, should be reported under stockholders' equity.
(6) Due from customers, $13,000, should be reported under assets.
(7) Supplies on hand, $15,000, should be reported under assets.
(8) Accumulated depreciation, $12,000, should be subtracted from service vehicles.

CP1–4. (continued)

Req. 2–Financial Statements:

PERFORMANCE CORPORATION
Income Statement
For the Year Ended December 31, 2012

Revenues:		
Sales	$180,000	
Services	52,000	
Total revenues		$232,000
Expenses:		
Cost of goods sold	$ 90,000	
Selling expenses	25,000	
Depreciation expense	12,000	
Salaries and wages	62,000	
Total expenses (excluding income tax)		189,000
Pretax income		43,000
Income tax expense (25% x $43,000)		10,750
Net income		$32,250

PERFORMANCE CORPORATION
Balance Sheet
At December 31, 2012

Assets		
Cash		$ 32,000
Accounts receivable (from customers)		13,000
Merchandise inventory (for resale)		42,000
Supplies inventory (for use in rendering services)		15,000
Service vehicles	$50,000	
Less accumulated depreciation	(12,000)	38,000
Total assets		$140,000
Liabilities		
Accounts payable (to suppliers)		$17,750
Note payable (to bank)		25,000
Total liabilities		42,750
Stockholders' equity		
Common stock, 6,500 shares	$65,000	
Retained earnings	32,250	
Total stockholders' equity		97,250
Total liabilities and stockholders' equity		$140,000

CRITICAL THINKING CASES

CP1–5.

Req. 1 You should forcefully assert the need for an independent audit of the financial statements each year because this is the best way to assure credibility–conformance with GAAP, completeness and absence of bias.

You should firmly reject “Uncle Ray” as the auditor because there is no evidence about his competence as an accountant or auditor. Also, he is related to the partner who prepares the financial statements; there is a 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 “Uncle Ray” would not meet any of these requisites, particularly the important one in this case–independence (and absence of bias).

CP1–6.

The textbook does not explicitly cover the elements of independence. The case is designed to permit the students to develop their own values. We have found that it is useful to emphasize the difference between independence in fact and in appearance during these discussions.

1. Most students feel that there is no problem with independence if the stock held is immaterial in amount. When asked about a possible headline that might read “Auditor who was shareholder is accused of fraud,” most students see a problem with the appearance. In fact, the AICPA does not apply a materiality threshold where there is a direct financial interest. Any holding of stock is a problem.

2. This is an example of an indirect holding of stock. A materiality threshold is applied in these situations. There could be a question of independence if the auditor held a material interest in the mutual fund (relative to her net worth) and the mutual fund held a material interest in the company that she audited.

3. The AICPA Code of Professional Conduct applies only to audit professionals who are members (though most state laws incorporate similar rules). Bob's employers may want to assign him to a different company but there is no conflict with the Code.

4. Clearly there is an ethics violation in this case because she would audit statements that covered a period of time where she was responsible for the accounting operations of the company. This is a problem both in appearance and in fact.

5. The original Code indicated that a loan from a bank that was made under normal lending procedures, terms, and requirements was not an impairment of independence. This issue is currently under a review that will probably result in a modification of the rule. It is an excellent example of how ethics rules can change over time. The savings and loan debacle with the resulting lawsuits has caused the profession to reconsider the appearance of loans to auditors.

FINANCIAL REPORTING AND ANALYSIS PROJECTS

CP1–7.

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

CONTINUING CASE

CC1–1.

Req. 1

Penny's Pool Service & Supply.
Income Statement
For the Year Ended December 31, 2014

Revenues	
Sales revenue	$ 60,000
Expenses	
Cost of supplies used	8,200
Wage expense	24,000
Other administrative expense	4,500
Total expenses	36,700
Pretax income	23,300
Income tax expense	4,000
Net income	$19,300

Req. 2

Penny's Pool Service & Supply.
Statement of Stockholders' Equity
For the Year Ended December 31, 2014

	Common Stock	Retained Earnings
Balance December 31, 2013	$ 0	$ 0
Issue common stock	20,000	
Net income for 2014		19,300
Dividends for 2014		(10,000)
Balance December 31, 2014	$ 20,000	$ 9,300

CC1. (continued)

Req. 3

Penny's Pool Service & Supply
Balance Sheet
At December 31, 2014

Assets:	
Cash	$ 2,900
Accounts receivable	2,300
Inventories	4,600
Equipment	28,000
Total assets	$ 37,800
Liabilities and Stockholders' Equity:	
Liabilities	
Accounts payable	$3,500
Notes payable to banks	5,000
Total liabilities	8,500
Stockholders' equity	
Common Stock	20,000
Retained earnings	9,300
Total stockholders' equity	29,300
Total liabilities and stockholders' equity	$ 37,800