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 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 retained earnings reports the cumulative amount of earnings for a corporation less any dividends declared and paid.

9. The income statement and the statement of cash flows are dated "For the Year Ended December 31, 20X," because they report the inflows and outflows of resources during a period of time. In contrast, the balance sheet is dated "At December 31, 20X" 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. Breakeven is when the total revenues and total expenses are exactly equal.

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

13. The accounting equation for the balance sheet 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 accounting 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 accounting equation for the statement of retained earnings is: Ending Retained Earnings = Beginning Retained Earnings + Net Income - Dividends. 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 intended to provide reasonable assurance, at appropriate cost, that transactions are processed in accordance with company authorization and are 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 service involves management advice to the individual business enterprises and other entities. It is like a consulting firm. Tax service involves providing tax planning advice to clients (both individuals and businesses) and preparation of their tax returns.

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	30
		4	20	4	45			4	60
		5	25					5	20
		6	20					6	30
		7	15					7	30
		8	25					8	20
		9	25					9	*
		10	30					10	*
		11	20					11	*
		12	12					12	*
		13	30					13	*
		14	30					14	*

* 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 Retained Earnings
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	

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)	CMA	Certified Management Accountant
(4)	AICPA	American Institute of Certified Public Accountants
(5)	SEC	Securities and Exchange Commission
(6)	FASB	Financial Accounting Standards Board

EXERCISES

E1–1.

	Term or Abbreviation
K	(1) SEC
G	(2) Audit
I	(3) Sole proprietorship
E	(4) Corporation
A	(5) Accounting
D	(6) Separate entity
J	(7) Audit report
F	(8) Cost principle
C	(9) Partnership
O	(10) AICPA
L	(11) FASB
H	(12) CPA
B	(13) Unit of measure
N	(14) GAAP
M	(15) Publicly traded

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 the monetary unit–dollars or other national currency.
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. Initial recording of financial statement elements at acquisition cost.
G. An examination of the financial reports to assure that they represent what they claim and conform with generally accepted accounting principles.
H. Certified Public Accountant.
I. An unincorporated business owned by one person.
J. A report that describes the auditors' opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.
K. Securities and Exchange Commission.
L. Financial Accounting Standards Board.
M. A company that can be bought and sold by investors on established stock exchanges .
N. Generally Accepted Accounting Principles.
O. American Institute of Certified Public Accountants.

E1–2.

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

E1–3.

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

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

E1–4.

Honda Motor Co., Ltd.
Balance Sheet
as of March 31, 20A
(in millions of Yen)

Cash and cash equivalents	¥ 150,554
Trade accounts, notes, and other receivables	817,761
Inventories	606,689
Investments	212,294
Net property, plant and equipment	1,008,196
Other assets	213,845
Total assets	¥3,009,339
Accounts payable and other current liabilities	¥1,308,748
Long-term debt	569,479
Other liabilities	94,485
Contributed capital	281,208
Retained earnings	755,419
Total liabilities and stockholders' equity	¥3,009,339

E1–5.

Req. 1

READ MORE STORE
Balance Sheet
At December 31, 20A

ASSETS		**LIABILITIES**	
Cash	$48,900	Accounts payable	$8,000
Accounts receivable	26,000	Note payable	2,000
Store and office equipment	48,000	Interest payable	120
		Total liabilities	$10,120
		STOCKHOLDERS' EQUITY	
		Contributed capital	$100,000
		Retained earnings	12,780
		Total stockholders' equity	112,780
Total assets	$122,900	Total liabilities and stockholders' equity	$122,900

Req. 2
Net income for the year was $12,780. This is the first year of operations and no dividends were declared or paid to stockholders; therefore, retained earnings is $12,780 (which represents income for one year).

E1–6.

THE COLLEGIATE SHOP
Income Statement
For the Month of January 20A

Revenue from Sales:		
Sales: Cash	$120,000	
On credit	1,000	
Total sales revenue		$121,000
Expenses:		
Cost of goods sold	$ 40,000	
Salaries, rent, supplies, and other expenses (paid in cash)	38,000	
Utilities	600	
Total Expenses		78,600
Net Income		$42,400

E1–7.

WAL-MART STORES, INC.
Income Statement
For the Quarter ended October 31, 20A
(in thousands)

Net sales	$20,417,717	
Rental and other income	235,116	
Total revenues		$20,652,833
Cost of sales	$16,200,873	
Operating, selling and general and administrative expenses	3,340,263	
Interest costs	184,190	
Total costs and expenses		19,725,326
Pretax income		$ 927,507
Provision for income taxes*		339,422
Net income		$ 588,085

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

E1–8.

HOME REALTY, INCORPORATED
Income Statement
For the Year Ended December 31, 20C

Revenue:		
Commissions earned ($150,000+$16,000)	$166,000	
Rental service fees	20,000	
Total revenues		$186,000
Expenses:		
Salaries expense	$ 62,000	
Commission expense	35,000	
Payroll tax expense	2,500	
Rent expense ($2,200+$200)*	2,400	
Utilities expense	1,600	
Promotion and advertising expense	8,000	
Miscellaneous expenses	500	
Total expenses (excluding income taxes)	112,000	
Pretax income		$74,000
Income tax expense		18,500
Net Income		$55,500

*$2,200 has been paid for 11 months ($200 per month) plus $200 owed for December.

E1–9.

A Net Income = $100,000 - $82,000 = $18,000;
Stockholders' Equity = $150,000 - $70,000 = $80,000.

B Total Revenues = $80,000 + $12,000 = $92,000;
Total Liabilities = $112,000 - $60,000 = $52,000.

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

D Total Expenses = $50,000 - $13,000 = $37,000;
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.

E1–10.

CLAY CORPORATION
Income Statement
For the Month of January 20A

Total revenues	$130,000
Less: Total expenses (excluding income tax)	80,000
Pretax income	$ 50,000
Less: Income tax expense	15,000
Net income	$ 35,000

CLAY CORPORATION
Balance Sheet
At January 31, 20A

Assets		
Cash		$30,000
Receivables from customers		15,000
Merchandise inventory		42,000
Total assets		$87,000
Liabilities:		
Payables to suppliers		$11,000
Income taxes payable		15,000
Total liabilities		26,000
Stockholders' equity:		
Contributed capital (2,600 shares)	$26,000	
Retained earnings *(from income statement above)*	35,000	61,000
Total liabilities and stockholders' equity		$87,000

E1–11.

1. Average monthly revenue, $216,000 ÷ 12 = $18,000.
2. Monthly rent, $21,000 ÷ 12 = $1,750.
3. "Supplies, $25,000" is an expense because it represents the cost of supplies used in performing the services sold. Use of the supplies caused their purchase cost to be an expense of the period when used.
4. "Interest" is an expense because it represents the cost of borrowing. The company has an outstanding loan (from another party) and this $8,000 is the amount of interest (owed, if not already paid) on that debt; therefore the interest for 20A on the loan is an expense of 20A (whether or not paid by December 31).
5. Average income tax rate, $21,000 ÷ $60,000 = 35%.
6. Standing alone, the income statement does not report, or make it possible to determine, the ending cash balance. This financial item is reported on the balance sheet under assets and on the cash flow statement as the final amount reported.
7. Price/earnings ratio, $468,000/$39,000 = 12.

E1–12.

(O)	(1)	Cash paid to suppliers and employees
O	(2)	Cash received from customers
(O)	(3)	Income taxes paid
O	(4)	Interest and dividends received
(O)	(5)	Interest paid
I	(6)	Proceeds from sale of investment in Conner Peripherals, Inc.
(I)	(7)	Purchases of property, plant, and equipment
(F)	(8)	Repayment of borrowings

E1–13.

NITSU MANUFACTURING CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 20D

Cash flow from operating activities		
Revenues	$270,000	
Expenses	(180,000)	
Net cash flow from operating activities		$90,000
Cash flow from investing activities		
Sale of land	15,000	
Purchase of new machines	(38,000)	
Net cash flow from investing activities		(23,000)
Cash flow from financing activities		
Sale of capital stock	30,000	
Payment on long-term notes	(80,000)	
Payment of cash dividends	(22,000)	
Net cash flow from financing activities		(72,000)
Net decrease in cash		(5,000)
Cash at beginning of year		63,000
Cash at end of year		$ 58,000

E1–14.

Req. 1

PAUL'S PAINTERS
Cash Flow from Operations
For the Month of January 20A

Cash Inflows		
Cash services		$105,000
Cash Outflows:		
Salaries and wages	$50,000	
Other expenses paid	26,000	
Total cash outflows		76,000
Difference: Net increase (decrease) in cash		$29,000

Req. 2

Reconciliation with income:	
Income (positive)	$40,500
Noncash services	(30,500)
Noncash expenses ($3,000 + $2,000 + $500 + $13,500)	19,000
Net increase (decrease) in cash	$29,000

PROBLEMS

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

P1–1.

Req. 1

NUCLEAR COMPANY
Income Statement
For the Year Ended December 31, 20A

Total sales revenue (given)	$140,000
Total expenses (given)	89,100
Pretax income	50,900
Income tax expense ($50,900 x 30%)	15,270
Net income	$ 35,630

Req. 2

NUCLEAR COMPANY
Balance Sheet
At December 31, 20A

Assets:		
Cash (given)		$25,000
Receivables from customers (given)		12,000
Inventory of merchandise (given)		90,000
Equipment (given)		45,000
Total Assets		$172,000
Liabilities:		
Accounts payable	$47,370	
Salary payable (given)	2,000	
Total Liabilities		$ 49,370
Stockholders' equity:		
Contributed capital (given)	$87,000	
Retained earnings*	35,630	
Total stockholders' equity		122,630
Total liabilities and stockholders' equity		$172,000

*Beginning RE ($–0–) + Net income ($35,630) – Dividends ($–0–) = Ending RE ($35,630).

P1–2.

Req. 1

SUSAN'S LAWN SERVICE
Income Statement
For the Three Months Ended August 31, 20A

Revenues from services:		
Lawn service–cash	$12,600	
–credit	800	
Total revenues		$13,400
Expenses:		
Gas, oil, and lubrication ($920+$200)	1,120	
Pickup repairs	210	
Repair of mowers	75	
Miscellaneous supplies used	80	
Helpers (wages)	4,500	
Payroll taxes	175	
Preparation of payroll tax forms	25	
Insurance	125	
Telephone	110	
Interest expense on note paid	75	
Equipment use cost (depreciation)	500	
Total expenses		6,995
Net income		$ 6,405

Req. 2

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

(1) A balance sheet–that is, a statement that reports for the business, at the end of 20A, each asset (name and amount, such as Cash, $XX), each liability (such as Wages Payable, $XX), and stockholders' equity.

(2) A Statement of Cash Flows–that is, a statement of the inflows and outflows of cash during the period in three categories: operations, investing, and financing.

P1–3.

Transaction	Req. 1 Income	Cash	Req. 2–Explanation
(a)	$+66,000	$+55,000	All services performed increase income; cash received during the period was, $66,000 x 5/6 = $55,000.
(b)	–0–	+30,000	Cash borrowed is not income.
(c)	–0–	–2,700	Purchase of the truck does not represent an expense; cash outflow was, $9,000 x 30% = $2,700.
(d)	–36,000	–30,000	All expenses incurred reduce income; cash expended was, $36,000 x 5/6 = $30,000.
(e)	–2,400	–2,250	Not all of the supplies were used; expense is the amount used, $3,000 x 4/5 = $2,400. Cash paid during the quarter was, $3,000 x 3/4 = $2,250.
(f)	–21,000	–10,500	All of the wages incurred reduce income, $21,000; cash paid during the quarter was, $21,000 x 1/2 = $10,500. The $10,500 owed will be paid on the next payroll date.

Based only on the above:

Income (loss)	$6,600	
Cash inflow (outflow)		$ 39,550

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 $68,000 listed for service trucks and equipment is their cost when acquired or the current market value on December 31, 20A.

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 $68,000 is cost when acquired or current market value on December 31, 20A.

(3) Personal residences–as noted above, these items are not resources of the business entity and should be excluded. Usually they would not be subject to creditors' claims against the corporation. Also, there is no indication whether the $190,000 is cost at acquisition or current market value at December 31, 20A. Also, there is no indication as to any amounts that might be owed on the residences.

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 $50,000 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 net resources (i.e., assets minus liabilities) for West Company, assuming the amounts provided by the owners are acceptable, would be:

Assets ($322,000–$190,000)	$132,000
Liabilities	97,000
Net resources of the company	$35,000

ALTERNATE PROBLEMS

AP1–1.

Req. 1

MCCLAREN CORPORATION
Income Statement
For the Year Ended June 30, 20C

Total sales revenue (given)	$90,000
Total expenses (given)	60,500
Pretax income	29,500
Income tax expense ($29,500 x 30%)	8,850
Net income	$20,650

Req. 2

MCCLAREN CORPORATION
Balance Sheet
At June 30, 20C

Assets:		
Cash (given)		$13,150
Receivables from customers (given)		9,500
Inventory of merchandise (given)		57,000
Equipment (given)		36,000
Total Assets		$115,650
Liabilities:		
Accounts payable (given)	$31,500	
Salary payable (given)	1,500	
Total Liabilities		$ 33,000
Stockholders' equity:		
Contributed capital (given)	$62,000	
Retained earnings*	20,650	
Total stockholders' equity		82,650
Total liabilities and stockholders' equity		$115,650

* Beginning RE ($0) + Net income ($20,650) – Dividends ($0)
= Ending RE ($20,650).

AP1–2.

Req. 1

ABEL ELECTRIC REPAIR COMPANY, INC.
Income Statement
For the Three Months Ended December 31, 20A

Revenues from services:		
Electric repair services–cash	$32,000	
–credit	3,000	
Total revenues		$35,000
Expenses:		
Electrician's assistant (wages)	8,500	
Payroll taxes	175	
Supplies used on jobs	9,500	
Oil, gas, and maintenance on truck	1,200	
Insurance	700	
Rent ($500+$200)	700	
Utilities and telephone	825	
Miscellaneous expenses	600	
Depreciation of truck and tools (use)	1,200	
Total expenses		23,400
Pretax income		11,600
Income taxes ($11,600 x 30%)		3,480
Net income		$ 8,120

Req. 2

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

(1) A statement that reports for the business, at the end of 20A, 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.

CASES AND PROJECTS

FINANCIAL REPORTING AND ANALYSIS CASES

CP1–1.

1. Net income was $54,118 thousand or $54,118,000. 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 $54,118. 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 $587,600,000. This is also disclosed on the income statement.

3. Inventory is $49,688,000. This is disclosed on the balance sheet.

4. Cash and cash equivalents increased by $23,581,000 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 Ernst & Young. This is found on the auditor’s report (in this case, called the “report of independent auditors”).

CP1–2.

1. It sells a variety of general consumer products, especially clothing.

2. Yes. It reported increased sales, record earnings, and increasing growth rates.

3. The company’s fiscal year ends on January 31.

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

5, Yes, it is audited by independent CPAs, as indicated by the “Report of Independent Auditors” on page 34.

6. Its total assets increased from $107,424,000 to $133,363,000.

7. The ending balance in inventories was $21,881,000.

8. Assets = Liabilities + Stockholders’ Equity

$133,363,000 = $28,069,000 + $105,294,000

CP1–3.

1.

	Urban Outfitters	American Eagle Outfitters
Price/Earnings Ratio = Market Price per Share / Net Income per Share	$18 / $0.89 = 20.22	$34.19 / $1.20 = 28.49

American Eagle Outfitters has the highest price/earnings ratio.

2. A higher price/earnings ratio indicates that investors expect American Eagle Outfitters to experience faster earnings growth in the future.

3.

	Industry Average	Urban Outfitters	American Eagle Outfitters
Price/Earnings Ratio =	26.13	20.22	28.49

American Eagle Outfitters price/earnings ratio is above the industry average and Urban Outfitters price/earnings ratio is below the industry average.

American Eagle is perceived to have better growth opportunities than the average firm in the industry. Urban Outfitters future is more clouded by problems in its wholesale division.

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 20A” should be “Net income.”
(4) Balance sheet should separately report assets, liabilities, and stockholders' equity.
(5) Retained earnings, $30,000, 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, $10,000, should be subtracted from service vehicles.

CP1–4. (continued)
Req. 2–Financial Statements:

PERFORMANCE CORPORATION
Income Statement
For the Year Ended December 31, 20A

Revenues:		
Sales	$175,000	
Services	52,000	
Total revenues		$227,000
Expenses:		
Cost of goods sold	$ 90,000	
Selling expenses	25,000	
Depreciation expense	10,000	
Salaries and wages	62,000	
Total expenses (excluding income tax)		187,000
Pretax income		$40,000
Income tax expense (25% x $40,000)		10,000
Net income		$30,000

PERFORMANCE CORPORATION
Balance Sheet
At December 31, 20A

Assets:		
Cash		$ 32,000
Merchandise inventory (for resale)		42,000
Supplies inventory (for use in rendering services)		15,000
Accounts receivable (from customers)		13,000
Service vehicles	50,000	
Less accumulated depreciation	(10,000)	40,000
Total assets		$142,000
Liabilities:		
Accounts payable (to suppliers)		$22,000
Note payable (to bank)		25,000
Total liabilities		47,000
Stockholders' equity:		
Contributed capital, 6,500 shares	$65,000	
Retained earnings	30,000	
Total stockholders' equity		95,000
Total liabilities and stockholders' equity		$142,000

CP1–5.

Req. 1

Case	Cash Received for Assets	Balances Immediately After Sale: Assets	= Liabilities	+ Stockholders' Equity
A	$90,000	$90,000	$50,000	$40,000
B	80,000	80,000	50,000	30,000
C	100,000	100,000	50,000	50,000

Req. 2

Case	To Creditors	To Stockholders	Total
A	$50,000	$40,000	$90,000
B	50,000	30,000	80,000
C	50,000	50,000	100,000

Explanation: Legally, creditors' claims have a priority over stockholders' claims. Therefore, cash necessary to satisfy all creditors' claims would be disbursed first. Any remaining cash would be distributed to the owners in proportion to their ownership interests.

CRITICAL THINKING CASES

CP1–6.

Req. 1 The personal items owned by Watkins should not be included in the financial statements of the company. The company is a separate entity for accounting purposes.

The list of liabilities was correct because it excluded the personal debts of Watkins.

Req. 2 The comment by Watkins poses an important accounting issue; that is, the separate entity assumption indicated in Req. 1. Also, deception is involved because of the listing of personal assets (coupled with an exclusion of the related liabilities). Such reporting would be misleading and dishonest.

The financial statements (lists) are not correct even if it were clearly stated that the accounting entity represents the company and owner combined as one entity. If this assumption were used, which would be appropriate only if clearly specified, it would require that ***all*** of the assets and ***all*** of the liabilities of both the company and Watkins be included. Preferably the business should be reported as a separate entity. The personal assets and liabilities should be reported as another separate entity.

CP1–7.

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).

CP1–8.

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 many 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

CP1–9 through CP1–14.

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