1 ACCOUNTING AND THE FINANCIAL STATEMENTS

DISCUSSION QUESTIONS

1. Accounting is a system for identifying, measuring, recording, and communicating financial information about an organization's activities to permit informed decisions by users of the information. Bookkeeping is the process—made up of mechanical "steps"—of recording transactions and maintaining accounting records. While bookkeeping is part of accounting, accounting is viewed as the complete information system that communicates the economic activities of a company to interested parties. Accounting is often referred to as the "language of business" because it communicates information about economic activities of a company that help people make decisions.

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

(1) Managers need accounting information to plan and make decisions about the business (e.g., predicting the consequences of their actions and deciding on which actions to take) and to control its operations (e.g., evaluating the effectiveness of their past decisions).

(2) Employees use accounting information about their employer to aid in planning their careers (e.g., judging the future prospects of the company).

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

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

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

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

4. A sole proprietorship is a business entity owned by one person. A partnership is a business entity owned jointly by two or more individuals. Proprietorships and partnerships are not legally separate from the personal affairs of the owners. That is, the owners are responsible for the debts of the business. A corporation is a separate legal entity formed by one or more persons called shareholders. A corporation is legally separate from the affairs of its owners, which limits the shareholders' legal responsibility for the debts of the business to the amount that the shareholders invested in the business. Corporate shareholders may pay more taxes than owners of sole proprietorships or partnerships. The majority of business in Canada is conducted by corporations.

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

6. Assets are the economic resources or future economic benefits obtained or controlled by a business. Liabilities are the creditors' claims on the resources of a business. Shareholders' equity is the ownership claims on the resources of a business. Shareholders' equity is considered a residual interest in the assets of a business that remain after deducting the business's liabilities. All three items appear on the statement of financial position, forming the following equation:

Assets = Liabilities + Shareholders' Equity

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

8. The four primary financial statements are:

(1) The statement of financial position: a presentation of information about a company's economic resources (its assets) and the claims against those resources by creditors and owners (liabilities and shareholders' equity) at a specific point in time.

(2) The income statement: a report on how well a company has performed its operations—the profitability of a company—over a period of time.

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

(4) The statement of cash flows: a report on the changes in a company's cash during a period of time. The statement of cash flows provides information about the company's cash inflows (sources) and outflows (uses) from operating, investing, and financing activities.

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

(1) The statement of financial position:

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

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

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

(2) The income statement:

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

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

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

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

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

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

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

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

11. The fundamental accounting equation is:

Assets = Liabilities + Shareholders' Equity

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

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

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

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

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

14. Current assets are generally listed on the statement of financial position in order of liquidity or nearness to cash, whereas current liabilities are usually listed in the order in which they will be paid.

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

16. Net Income = Total Revenues – Total Expenses

17. The single-step income statement format takes into account only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a single step to arrive at net income. The multiple-step income statement format contains three important subtotals: gross margin (gross profit), income from operations, and net income. Gross margin is the difference between net sales and cost of sales (or cost of goods sold). Income from operations is the difference between gross margin and operating expenses. Net income is the difference between income from operations and any nonoperating revenues and expenses.

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

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

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

21. Other than the financial statements, users will find notes to the financial statements, management's discussion and analysis of the condition of the company, and the auditor's report in the annual report of a company. The notes to the financial statements are an integral part of the financial statements that clarify and expand upon the information in the financial statements. Management's discussion and analysis provides a discussion and explanation of various items reported in the financial statements. Additionally, management uses this opportunity to highlight favourable and unfavourable trends and significant risks facing the company. The auditor's report expresses the opinion of the auditor as to whether the financial statements fairly present the financial position and results of operations of the company.

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

MULTIPLE-CHOICE EXERCISES

1-1. **a**

1-2. **b**

1-3. **a ($10,500 – $5,800)**

1-4. **b**

1-5. **d**

1-6. **d**

1-7. **b ($8,200 + $3,700 + $3,900)**

1-8. **c ($5,900 + $12,200)**

1-9. **a**

1-10. **b ($165,500 – $92,100 – $43,850 – $15,000)**

1-11. **c**

1-12. **c**

1-13. **b**

CORNERSTONE EXERCISES

CE 1-14

Scenario 1:	Assets	=	Liabilities	+	Equity
	X	=	$33,000	+	$44,000
	X	=	$77,000		
Scenario 2:	$110,000	=	X	+	$68,000
	X	=	$42,000		
Scenario 3:	$49,000	=	$32,000	+	X
	X	=	$17,000		

CE 1-15

Note: **Be sure to treat situations b. through d. independently.**

a.	Assets	=	Liabilities	+	Equity
	$440,000	=	$285,000	+	X
	X	=	$155,000 at the beginning of the year		

b.	Assets	=	Liabilities	+	Equity
	$525,000 *	=	$323,000 **	+	X
	X	=	$202,000		

* $440,000 + $85,000
** $285,000 + $38,000

c.	Assets	=	Liabilities	+	Equity
	$375,000 *	=	X	+	$200,000 **
	X	=	$175,000		

* $440,000 – $65,000
** $155,000 (from part a) + $45,000

d.	Assets	=	Liabilities	+	Equity
	X	=	$380,000 *	+	$80,000 **
	X	=	$460,000		

* $285,000 + $95,000
** $155,000 (from part a) – $75,000

CE 1-16

a. statement of financial position (SFP)
b. Statement of cash flows (CF)
c. statement of financial position (SFP)
d. Income statement (I)
e. Statement of cash flows (CF)
f. Income statement (I)
g. statement of financial position (SFP)
h. statement of retained earnings (RE)

CE 1-17

1. d
2. b
3. a
4. f
5. e
6. a
7. c
8. g (*Note:* While net income and dividends are reported on other financial statements, the definition of retained earnings is income that has not been distributed to shareholders. Therefore, by definition, this item is part of a company's retained earnings.)
9. b
10. a

CE 1-18

Cavernous Homes Ltd. Statement of Financial Position 31-Dec-14		
Assets		
Cash	$3,200	
Accounts receivable	4,500	
Supplies	8,100	
Total assets		$15,800
Liabilities and Shareholders' Equity		
Liabilities:		
Notes payable	$5,000	
Total liabilities		$5,000
Shareholders' equity:		
Common share	$7,000	
Retained earnings	3,800	
Total shareholders' equity		10,800
Total liabilities and shareholders' equity		$15,800

CE 1-19

Net Income	=	Total Revenue	–	Total Expenses
Net Income	=	$78,000	–	($33,200 + $20,500)
Net Income	=	$24,300		

Note: **The dividends do not appear on the income statement in arriving at net income. Dividends do not affect the income statement. Dividends are a reduction of the balance in retained earnings.**

CE 1-20

	Beginning retained earnings	$25,000
+	Net ($74,000 – $57,000)	17,000
–	Dividends	(8,000)
=	Ending retained earnings	$34,000

EXERCISES

E 1-21

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

E 1-22

1. **Sole proprietorship: 1, 2, 4, 5**
   Partnership: 2, 3, 4, 5, 7
   Corporation: 2, 3, 4, 5, 6, 8
2. **There are many advantages and disadvantages to each particular type of business entity as listed below.**

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

   b. **Partnership:**
   - **Advantages:**
     (i) **Increased access to the financial resources and individual skills of each of the partners**
     (ii) **Partnerships may pay less tax relative to corporations**
   - **Disadvantages:**
     (i) **Control over the operations of the business is shared among the partners**
     (ii) **The partners are personally liable for the debts of the business**
     (iii) **The life of the business is limited to life of the partners**

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

E 1-23

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

E 1-24

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

E 1-25

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

E 1-26

	Assets	=	Liabilities	+	Equity
1.	$112,800		$ 61,800*		$ 51,000
2.	275,000		162,500		112,500**
3.	58,200***		15,000		43,200

* $112,800 – $51,000
** $275,000 – $162,500
*** $15,000 + $43,200

E 1-27

1\.

Huang Company
Statement of Financial Position
Specific Point in Time

Assets

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

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

Intangible assets:
- Trademarks

Total assets

Liabilities and Shareholders' Equity

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

Shareholders' equity:
- Common share
- Retained earnings
  - Total shareholders' equity

Total liabilities and shareholders' equity

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

E 1-28

1. **Since the operating cycle is six months, Dunn would use one year as the breakpoint between current and noncurrent items.**

   a. **There are 17 months of prepaid rent ($8,500 ÷ $500). Dunn should include $6,000 (12 months × $500 per month) as a current asset and $2,500 (the (remaining 5 months × $500 per month) as a long-term asset.**

   b. **The $9,700 is a current liability.**

   c. **Since all items are expected to be sold within 12 months, the entire $46,230 is a current asset.**

   d. **The $700 portion of marketable securities is a current asset. The remaining $1,200 is a long-term investment.**

   e. **The $1,050 of cash is a current asset.**

   f. **The $60,000 note due in March 2019 is a long-term liability. The $3,750 interest related to 2014 is a current liability. The remaining interest of $750 will not be recognized until 2015 and, therefore, is not on the 2014 statement of financial position.**

   g. **The entire $2,850 is a current asset.**

   h. **The store equipment and its accumulated depreciation are not current assets. Instead, they are classified as property, plant, and equipment.**

Dunn Sporting Goods
Partial Statement of Financial Position
December 31, 2014

Current assets:		
Cash	$ 1,050	
Short-term investment in marketable securities	700	
Accounts receivable	2,850	
Inventory	46,230	
Prepaid rent	6,000	
Total current assets		$56,830
Current liabilities:		
Accounts payable	$ 9,700	
Interest payable on equipment loan (see f above)	3,750	
Total current liabilities		$13,450

E 1-28 (Contd)

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

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

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

E 1-29

1.

Hanson Construction Partial Statement of Financial Position December 31, 2014	
Current assets:	
Cash	**\$ 475**
Accounts receivable	**8,000**
Notes receivable	**1,200**
Supplies	**8,800**
Total current assets	**\$18,475**
Current liabilities:	
Accounts payable	**\$ 1,800**
Notes payable	**7,600**
Total current liabilities	**\$ 9,400**

The accounts receivable of \$4,000 due in 18 months will be classified as a long-term asset. The construction equipment and related accumulated depreciation are classified as property, plant, and equipment (a noncurrent asset).

2. Hanson Construction's liquidity may be evaluated by examining its current ratio and working capital. Its current ratio is 1.97 (\$18,475 ÷ \$9,400) and its working capital is \$9,075 (\$18,475 – \$9,400). Because current assets well exceed the current liabilities, Hanson appears to be able to pay its debts that become due within the next year.

E 1-30

The statement of financial position at December 31, 2014, will show equipment at its historical cost of $425,000 reduced by accumulated depreciation (a contra-asset) of $40,000. Therefore, the net book value (or carrying value) of the equipment is $385,000. (*Note:* The concepts of *book value* and *carrying value* will be covered in more detail in later chapters.) The equipment and accumulated depreciation will be reported under the caption "Property, plant, and equipment" in the asset section of the statement of financial position.

The 2014 income statement will show depreciation expense of $40,000. In a multiple-step income statement, depreciation expense will be reported as an operating expense.

E 1-31

Mulcahy Manufacturing Inc.
Partial Satement of Financial Position
December 31, 2014

Shareholders' equity:		
Common share……………………………………………	**$135,600**	
Retained earnings…………………………………………	**25,300**	
Total shareholders' equity…………………………………		**$160,900**

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

E 1-32

1.

College Spirit
Statement of Financial Position
31-Dec-14

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

E 1-32 (Contd)

Liabilities and Shareholders' Equity

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

2. **College Spirit has working capital of $389,300 ($555,400 – $166,100) and a current ratio of 3.34 ($555,400 ÷ $166,100).**
3. **The working capital and current ratios show that College Spirit has adequate current assets to cover all of the current liabilities that will become due in the near future. Therefore, College Spirit's liquidity should not be a major concern. Comparing these items to those of other companies in the same industry and examining the trends in these measures over time will yield additional insights.**

E 1-33

1.

Bathsheba Company Statement of Financial Position December 31, 2014		
Assets		
Current assets:		
Cash	$ 11,400	
Investments (short-term)	21,000	
Accounts receivable	95,500	
Prepaid insurance	5,700	
Inventory	187,900	
Total current assets		$321,500
Long-term investments:		
Investment		32,700
Property, plant, and equipment:		
Land		$ 41,000
Building	419,900	
Less: Accumulated depreciation	(216,800)	203,100
Trucks	106,100	
Less: Accumulated depreciation	(31,200)	74,900
Equipment (data processing)	309,000	
Less: Accumulated depreciation	(172,400)	136,600
Total property, plant and equipment		455,600
Total assets		$809,800

E 1-33 (Contd)

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	**$ 65,100**	
Notes payable (due June 1, 2015)	**150,000**	
Salaries payable	**14,400**	
Interest payable	**12,600**	
Income taxes payable	**21,600**	
Total current liabilities		**$263,700**
Long-term liabilities:		
Bonds payable (due 2015)		**200,000**
Total liabilities		**463,700**
Shareholders' equity:		
Common share	**150,000**	
Retained earnings*	**196,100**	
Total shareholders' equity		**346,100**
Total liabilities and shareholders' equity		**$809,800**

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

First, compute shareholders' equity as:

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

Next, compute retained earnings:

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

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

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

E 1-34

1.

Sayed Company
Income Statement
For a Period of Time

Revenues:
- **Sales revenue**

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

Net income

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

E 1-35

1.

ERS Ltd. Income Statement For the year ended December 31, 2014		
Revenues:		
Service revenue………………………………………...……..………		$933,800
Expenses:		
Wages expense ……………………………..……….…………	$448,300	
Salaries expense …………………..…………………..………………	195,600	
Supplies expense ………..…………………….………………	66,400	
Rent expense ………..……………..…………………………………	58,400	
Utilities expense ..…………………………………..……………	26,100	
Advertising expense…………………………………………………	24,200	
Depreciation expense ………………………………………..	16,250	
Insurance expense …………………………………………………	11,900	
Interest expense……………………………………………………	10,100	
Income tax expense ………………………………………………	15,150	
Total expenses…………………………………………………		872,400
Net income………………………………………………………		$ 61,400

2. Net profit margin is 6.58% ($61,400 net income ÷ $933,800 service revenue). This indicates that $0.066 of each sales dollar is profit. If ERS were to increase revenues by $100,000, an additional $6,600 of profit would be recognized. If ERS wanted to achieve larger profits, it should focus on controlling its expenses.

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

E 1-36

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

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

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

*** $0.15 \times \$7,400$

E 1-37

1.

Wang Auto Supply Income Statement For the year ended December 31, 2014		
Revenues:		
Sales revenue		$583,900
Expenses:		
Cost of goods sold	$277,000	
Wages expense	98,250	
Salaries expense	32,000	
Depreciation expense	29,000	
Rent expense	18,000	
Interest expense	2,700	
Income tax expense	38,085	
Total expenses		495,035
Net income		$ 88,865

2.

Wang Auto Supply Income Statement For the year ended December 31, 2014		
Sales revenue		583,900
Cost of goods sold		277,000
Gross margin		306,900
Operating expenses:		
Wages expense	$ 98,250	
Salaries expense	32,000	
Depreciation expense	29,000	
Rent expense	18,000	177,250
Income from operations		129,650
Other expenses and losses:		
Interest expense		2,700
Income before taxes		126,950
Income tax expense		38,085
Net income		$ 88,865

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

E 1-38

1.

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

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

E 1-39

1.

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

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

E 1-40

Cash at the end of the year:

Cash flow from operating activites	$857,300
Cash outflow for investing activities	(994,500)
Cash flow from financing activities.	156,600
Change in cash	19,400
Add: Cash at 12/31/13	17,400
Cash at 12/31/14	$ 36,800

Retained earnings at end of 2014:

Retained earnings at 12/31/13	$103,600
Add: 2012 net income ($673,900 – $587,100)	86,800
Less: 2014 dividends	(34,200)
Retained earnings at 12/31/14	$156,200

E 1-41

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

	Assets	=	Liabilities	+	Equity
12/31/2013	$72,400	=	$12,100	+	($50,000 + Retained Earnings)
12/31/2014	$78,500	=	$9,800	+	($50,000 + Retained Earnings)

For each year, solve for retained earnings:

12/31/2013	Retained Earnings	=	Assets – Liabilities – Common Shares
	Retained Earnings	=	$72,400 – $12,100 – $50,000
	Retained Earnings	=	$10,300
12/31/2014	Retained Earnings	=	Assets – Liabilities – Common Shares
	Retained Earnings	=	$78,500 – $9,800 – $50,000
	Retained Earnings	=	$18,700

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

	Beginning retained earnings	$10,300
+	Net income	14,300
−	Dividends	?
=	Ending retained earnings	$18,700

Dividends = $5,900

E 1-42

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

	Assets	=	Liabilities	+	Equity
12/31/2013	**$144,200**	**=**	**$52,600**	**+**	**($60,000 + Retained Earnings)**
12/31/2014	**$178,100**	**=**	**$59,700**	**+**	**($60,000 + Retained Earnings)**

For each year, solve for retained earnings:

12/31/2013	**Retained Earnings**	**=**	**$144,200 – $52,600 – $60,000 =**	**$31,600**
12/31/2014	**Retained Earnings**	**=**	**$178,100 – $59,700 – $60,000 =**	**$58,400**

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

Beginning retained earnings……………………………		**$31,600**
+	**Net income**……………………………………	**?**
–	**Dividends**………………………………………	**(14,500)**
=	**Ending retained earnings**…………………	**$58,400**

Net income = $41,300

E 1-43

- **a.** **Management's discussion and analysis**
- **b.** **Notes to the financial statements**
- **c.** **Notes to the financial statements**
- **d.** **Financial statements (statement of financial position)**
- **e.** **Management's discussion and analysis**
- **f.** **Financial statements (statement of retained earnings)**
- **g.** **Report of independent accountants**
- **h.** **Financial statements (income statement)**

E 1-44

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

PROBLEM SET A

P 1-45A

The fundamental accounting equation requires that there be an equality between assets and liabilities plus shareholders' equity. Therefore, the amount of liabilities that Huffer must have at the end of 2014 can be inferred from the fundamental accounting equation if both assets and shareholders' equity are known.

The amount of Huffer's assets at 12/31/14 is $278,200. Huffer's shareholders' equity at the end of 2014 is the amount of shareholders' equity at the beginning of the year plus (minus) net income (loss) less dividends plus the sale of common share.

	Common Shares	+	Retained Earnings	=	Shareholders' Equity
Equity, 1/1/13	$80,000	+	$62,600	=	$142,600
Net income			42,750		
Dividends			(11,900)		
Common shares issued	12,800				
Equity, 12/31/13	$92,800	+	$93,450	=	$186,250

The amount of liabilities that Huffer must have at the end of 2012 is determined by using the statement of financial position equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/14	$278,200	=	?	+	$186,250

Liabilities = $278,200 – $186,250 = $91,950

P 1-46A

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

(a)	**Assets**	**=**	**Liabilities**	**+**	**Shareholders' Equity (all at end of the year)**			
	Assets	**=**	**$126,900**	**+**	**$104,100**			
	Assets	**=**	**$231,000**					
(b)	**Assets**	**=**	**Liabilities**	**+**	**Shareholders' Equity (all at the beginning of the year)**			
	$145,200	**=**	**$92,600**	**+**	**Shareholders' Equity**			
	Shareholders' Equity	**=**	**$52,600**					
(c)	**Beginning Shareholders' Equity**	**+**	**Net Income**	**–**	**Dividends**	**=**	**Ending Shareholders' Equity**	
	$52,600	**+**	**$77,500**	**–**	**Dividends**	**=**	**$104,100**	
	Dividends	**=**	**$26,000**					
(d)	**Revenues**	**–**	**Expenses**	**=**	**Net Income**			
	$554,800	**–**	**Expenses**	**=**	**$77,500**			
	Expenses	**=**	**$477,300**					

P 1-47A

Perez Wrecking Service
Income Statement
For the year ended December 31, 2014

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

P 1-48A

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

P 1-49A

Roget Enterprises
Income Statement
For the year ended December 31, 2014

Revenues:		
Service revenue		**$463,500**
Expenses:		
Salaries expense	**$235,200**	
Rent expense	**135,000**	
Supplies expense	**34,400**	
Interest expense	**16,000**	
Income taxes expense	**12,800**	**433,400**
Net income		**$ 30,100**

P 1-49A (Contd)

Roget Enterprises
Statement of Financial Position
December 31, 2014

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

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

P 1-50A

Dittman Expositions Statement of Retained Earnings For the years ended December 31, 2013, and December 31, 2014		
	2013	**2014**
Retained earnings, beginning of year*	**$16,900**	**$41,850**
Add: Net income**	**33,200**	**29,800**
Less: Dividends	**(8,250)**	**(9,910)**
Retained earnings, end of year	**$41,850**	**$61,740**

* The ending retained earnings balance for 2013 becomes the beginning retained earnings balance for 2014.

** Net income computed as follows:	2013	2014
Revenue	$419,700	$442,400
Less: Expenses	(386,500)	(412,600)
Net income	$ 33,200	$ 29,800

P 1-51A

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

(b) Retained Earnings, Beginning (2013) = Retained Earnings, Ending (2012) = $27,200

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

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

(e) Retained Earnings, Ending (2013) = Retained Earnings, Beginning (2014) = $33,600

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

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

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

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

P 1-52A

1.

Ishtar Appliances Income Statement For the year ended December 31, 2014		
Revenues:		
Sales revenue		$948,670
Expenses:		
Cost of goods sold	$511,350	
Wages expense	127,710	
Salaries expense	101,000	
Rent expense	80,800	
Insurance expense	36,610	
Interest expense	15,500	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Income taxes expense	16,650	
Total expenses		912,670
Net income		$ 36,000

Ishtar Appliances Statement of Retained Earnings For the year ended December 31, 2014	
Beginning retained earnings, 12/31/13 or 1/1/14	$ 54,000
Add: Net income*	36,000
Ending retained earnings, 12/31/14	$ 90,000

* From the income statement

P 1-52A (Contd)

Ishtar Appliances Statement of Financial Position December 31, 2014			
Assets			
Current assets:			
Cash……		$ 41,450	
Accounts receivable……		69,900	
Inventory……		59,850	
Total current assets……			$171,200
Property, plant, and equipment:			
Building……	$300,000		
Less: Accumulated depreciation……	(104,800)	195,200	
Furniture……	130,000		
Less: Accumulated depreciation……	(27,600)	102,400	
Total property, plant & equipment ……			297,600
Other assets……			92,800
Total assets……			$561,600
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable……		$ 16,800	
Income taxes payable……		12,000	
Salaries payable……		7,190	
Total current liabilities……			$ 35,990
Long-term liabilities:			
Bonds payable……			192,000
Total liabilities ……			$227,990
Shareholders' equity:			
Common shares……		$243,610	
Retained earnings*……		90,000	
Total shareholders' equity……			333,610
Total liabilities and shareholders' equity……			$561,600

* From the retained earnings statement

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

P 1-53A

Berko Company:

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

Manning Company:

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

Lucas Company:

(i)	$40,000	($66,400 – $26,400)

Must solve for (k) before (j):

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

Perlman Company:

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

P 1-54A

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

	Assets	=	Liabilities	+	Shareholders' Equity	
Beginning	**$392,500**	**=**	**$148,550**	**+**	**$243,950**	*
End	**$415,100**	**=**	**$149,600**	**+**	**$265,500**	**

* $392,500 – $148,550 = $243,950
** $415,100 – $149,600 = $265,500

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

Shareholders' Equity = Common Share + Retained Earnings

Change in Shareholders' Equity = Change in Common Shares + Change in Retained Earnings

Change in Retained Earnings = Net Income – Dividends

Therefore,
Change in Shareholders' Equity = Change in Common Shares + Net Income – Dividends

1. ($265,500 – $243,950) = $0 + Net Income – $0
   Net Income = $21,550
2. ($265,500 – $243,950) = $33,000 + Net Income – $0
   Net Loss = $11,450
3. ($265,500 – $243,950) = $0 + Net Income – $11,000
   Net Income = $32,550
4. ($265,500 – $243,950) = $29,000 + Net Income – $17,000
   Net Income = $9,550

PROBLEM SET B

P 1-45B

The fundamental accounting equation requires that there be an equality between assets and liabilities plus shareholders' equity. Therefore, the amount of liabilities that KJ Corporation must have at the end of 2014 can be inferred from the fundamental accounting equation if both assets and shareholders' equity are known.

The amount of KJ's assets at 12/31/13 is $721,800. KJ's shareholders' equity at the end of 2014 is the amount of shareholders' equity at the beginning of the year plus (minus) net income (loss) less dividends plus the sale of common share.

	Common Shares	+	Retained Earnings	=	Shareholders' Equity
Equity, 1/1/14	$139,000	+	$152,900	=	$291,900
Net income			225,200		
Dividends			(74,400)		
Common share issued	94,000				
Equity, 12/31/14	$233,000	+	$303,700	=	$536,700

The amount of liabilities that KJ must have at the end of 2011 is determined by using the statement of financial position equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/14	$721,800	=	?	+	$536,700

Liabilities = $721,800 – $536,700 = $185,100

P 1-46B

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

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

P 1-46B (Contd)

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

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

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

(c)	**Beginning Shareholders' Equity**	**+**	**Net Income**	**–**	**Dividends**	**=**	**Ending Shareholders' Equity**
	$272,900	**+**	**$94,120**	**–**	**$35,500**	**=**	**Ending Shareholders' Equity**
	Ending Shareholders' Equity			**=**	**$331,520**		
(b)	**Assets**	**=**	**Liabilities**	**+**	**Shareholders' Equity (all at end of year)**		
	$758,150	**=**	**Liabilities**	**+**	**$331,520**		
	Liabilities	**=**	**$426,630**				

P 1-47B

Kim Renovation Inc.
Income Statement
For the year ended December 31, 2014

Revenues:		
Service revenue……	**$763,400**	
Interest income……	**5,475**	
Total revenues……		**$768,875**
Expenses:		
Wages expense……	**$222,900**	
Depreciation expense……	**135,000**	
Utilities expense……	**109,300**	
Insurance expense……	**65,850**	
Miscellaneous expense……	**31,000**	
Income taxes expense……	**61,400**	
Total expenses……		**625,450**
Net income……		**$143,425**

P 1-48B

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

P 1-49B

Ross Airport Auto Service
Income Statement
For the year ended December 31, 2014

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

P 1-49B (Contd)

Ross Airport Auto Service
Statement of Financial Position
December 31, 2014

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

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

P 1-50B

Magical Experiences Vacation Company
Statement of Retained Earnings
For the years ended December 31, 2013, and December 31, 2014

	2013	2014
Retained earnings, beginning of year*....	$ 47,100	$ 93,500
Add: Net income**....	59,600	82,800
Less: Dividends....	(13,200)	(15,900)
Retained earnings, end of year....	$ 93,500	$160,400

* The ending retained earnings balance for 2013 becomes the beginning retained earnings balance for 2014.

** Net income computed as follows:

	2013	2014
Revenue....	$244,900	$391,400
Less: Expenses....	(185,300)	(308,600)
Net income....	$ 59,600	$ 82,800

P 1-51B

(a) $26,900 – $11,100 = $15,800

(b) Retained Earnings, Ending (2012) = Retained Earnings, Beginning (2013) = $19,500

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

(e) Retained Earnings, Ending (2013) = Retained Earnings, Beginning (2014) = $26,700

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

(d) $26,700 (e) + $5,200 = $31,900

(c) $31,900 (d) – $19,500 = $12,400

(f) $26,700 + $9,500 = $36,200

(g) $36,200 (f) – $34,100 = $2,100

P 1-52B

McDonald Marina
Income Statement
For the year ended December 31, 2014

Revenues:		
Service revenue (docking)……	$1,460,000	
Service revenue (cleaning)……	472,300	
Total service revenues……		$1,932,300
Expenses:		
Wages expense……	987,200	
Depreciation expense (equipment)……	246,300	
Utilities expense……	239,400	
Interest expense……	236,000	
Supplies expense……	89,100	
Depreciation expense (building)……	21,500	
Rent expense……	14,600	
Income taxes expense……	21,700	
Total expenses……		1,855,800
Net income……		$ 76,500

McDonald Marina
Statement of Retained Earnings
For the year ended December 31, 2014

Retained earnings, 12/31/13……	$ 128,600
Add: Net income for 2014……	76,500
Less: Dividends……	(25,300)
Retained earnings, 12/31/14……	$ 179,800

P 1-52B (Contd)

McDonald Marina
Statement of Financial Position
December 31, 2014

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

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

P 1-53B

Stackhouse Company:

(a) $5,000 ($21,700 – $18,800 + $2,100)

(b) $66,700 ($45,000 + $21,700)

(c) $81,100 ($14,400 + $66,700)

Compton Company:

(d) $54,300 ($39,000 + $15,300)

(e) $21,600 ($15,300 + $7,100 – $800)

(f) $60,600 ($21,600 + $39,000)

(g) $27,600 ($88,200 – $60,600)

Bellefleur Company:

Must solve for (i) first.

(i) $15,300 ($95,300 – $80,000)

(h) $1,300 ($6,900 + $9,700 – $15,300)

(j) $18,100 ($113,400 – $95,300)

Merlotte Company:

(k) $13,900 ($38,900 – $25,000)

(l) $9,400 ($13,900 – $4,500 – $0)

(m) $34,400 ($25,000 + $9,400)

(n) $50,100 ($15,700 + $34,400)

P 1-54B

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

	Assets	=	Liabilities	+	Shareholders' Equity	
Beginning	$231,500	=	$84,550	+	$146,950	*
End	$348,100	=	$125,900	+	$222,200	**

* $231,500 – $84,550 = $146,950
** $348,100 – $125,900 = $222,200

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

Shareholders' Equity = Common Share + Retained Earnings

Change in Shareholders' Equity = Change in Common Shares + Change in Retained Earnings

Change in Retained Earnings = Net Income – Dividends

Therefore,

Change in Shareholders' Equity = Change in Common Shares + Net Income – Dividends

1. ($222,200 – $146,950) = $0 + Net Income – $0
   Net Income = $75,250

2. ($222,200 – $146,950) = $12,000 + Net Income – $0
   Net Income = $63,250

3. ($222,200 – $146,950) = $0 + Net Income – $8,000
   Net Income = $83,250

4. ($222,200 – $146,950) = $15,000 + Net Income – $11,000
   Net Income = $71,250

CASES

Case 1-55

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

Case 1-56

1. **The following examples are illustrative:**

   a. **Nonbusiness entities (including governments and educational institutions):**
   The Accounting Review **(university and college educators), American Accounting Association**
   Issues in Accounting Education **(university and college educators), American Accounting Association**

   b. **Business entities:**
   Strategic Finance **(management accountants and finance professionals), Institute of Management Accountants**
   Financial Executive **(controllers, treasurers, and senior financial executives), Financial Executives Institute**
   Internal Auditor **(internal auditors), Institute of Internal Auditors**

Case 1-56 (Contd)

c. Public practice:
***CA Magazine*, Canadian Institute of Chartered Accountants**
***Journal of Accountancy* (certified public accountants), American Institute of Certified Public Accountants**
***The CPA Journal* (certified public accountants), New York State Society of CPAs**

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

Case 1-57

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

Case 1-58

1. Current assets (1/31/14)	**=**	**\$4,850 + \$27,409 + \$6,864**	**=**	**\$39,123**
Current liabilities (1/31/14)	**=**	**\$18,602**		
Current assets (1/31/13)	**=**	**\$3,408 + \$30,989 + \$7,440**	**=**	**\$41,837**
Current liabilities (1/31/13)	**=**	**\$33,384**		

Gekas Rent-A-Car reported a current ratio of 2.10 (\$39,123 ÷ \$18,602) in 2014 and a current ratio of 1.25 (\$41,837 ÷ \$33,384) in 2013. Its working capital is \$20,521 (\$39,123 - \$18,602) in 2012 and \$8,453 (\$41,837 - \$33,384) in 2013. These ratios show that the company has adequate current assets to cover the current liabilities in both years. In addition, its liquidity is improving between 2013 and 2014.

Case 1-58 (contd)

2. **Net Income = Shareholders' Equity (1/31/2012) – Shareholders' Equity (1/31/2013) + Dividends***

   $157,515 – $147,288 + $18,100 = $28,327

   * **Beg. Shareholders' Equity $147,288 + Net Income – Dividends $18,100 = End. Shareholders' Equity $157,515**

Case 1-59

1. **Trends:**
   - **(a) Revenues decreased dramatically from 2010 to 2014.**
   - **(b) Operating income (loss) has fluctuated dramatically in the five-year period, but shows some improvement (less of a loss) in 2014.**
   - **(c) Net income (loss) took a major hit in 2014 and seems to be slowly recovering in 2014 with a much smaller loss.**
2. **In 2012 and 2013, Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in 2012, 2013, and 2014, causing current liabilities to be much larger than current assets. It seems as though Brothers used its assets to pay down its long-term debt in 2012.**
3. **Yes, the company has shown a considerable decrease throughout the five-year period in net income and also shows that it may have difficulty in paying current liabilities with the small amount of current assets it has.**

Case 1-60

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

Case 1-61

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

Case 1-62

1. **Canadian Tire's fiscal year ended on December 31, 2011. This year-end was different from previous years since the company has a floating year-end date (see Note 2 to the financial statements).**

2. **Canadian Tire presents three years of statement of financial position information and two years of income statement information.**

3. **Statement of Financial Position Information:**
   a. **For December 31, 2011, Canadian Tire reported total assets of $12,338,800,000, total liabilities of $7,929,800,000, and total stockholders' equity of $34,409,030,000.**
   b. **The dollar amounts for all three categories have changed in the past year. For 2010, Canadian Tire reported total assets of $11,048,500,000, total liabilities of $7,043,600,000, and total stockholders' equity of $4,004,900,000. This represented an increase in total assets of $1,290,300,000 ($12,338,800,000 – $11,048,500,000), an increase in total liabilities of $886,200,000 ($7,929,800,000 – $7,043,600,000), and an increase in total stockholders' equity of $765,900,000 ($4,409,000,000 – $4,004,900,000). Canadian Tire experienced significant growth in its resources and claims against those resources during 2011.**
   c. **For December 31, 2011, Canadian Tire reported current assets of $6,956,600,000 and current liabilities of $4,153,000,000. For January 1, 2011, Canadian Tire reported current assets of $6,549,200,000 and current liabilities of $3,251,500,000.**
   d. **Canadian Tire reported working capital of $2,803,600,000 ($6,956,600,000 – $4,153,000,000) for 2011 and working capital of $3,297,700,000 ($6,549,200,000 – $3,251,500,000) for 2010. Canadian Tire's current ratio was 1.68 ($6,956,600,000 ÷ $4,153,000,000) for 2011 and 2.01 ($6,549,200,000 ÷ $3,251,500,000) for 2010. Canadian Tire's current assets are greater than its current liabilities for both years, which indicates that Canadian Tire should be able to pay the liabilities that become due within the next year. The reduction in both of these numbers reveals that Canadian Tire's liquidity has declined during 2011 relative to 2010, although in absolute terms**

Case 1-62 (Contd)

4. **Income statement information:**
   a. **For 2011, Canadian Tire reported revenues (net sales) of $10,387,100,000 and expenses of $9,920,100,000 ($7,326,400,000 + $329,200,000 + $1,286,300,000 + 162,900,000 + 701,500,000 – $18,400,000 + $155,200,000 - $23,000,000). Note: The $9,920,100,000 is a combination of other income and expenses. Canadian Tire's net income was $467,000,000.**
   b. **Sales have increased in the two-year period shown in the comparative income statements. This has caused cost of sales (an expense) to increase as well. The sales increase was smaller than the cost of sales increase, which has led to a decrease in gross margin percentage. Both gross margin and net income have increased in absolute terms in 2011.**

5. **Statement of cash flows information:**
   a. **For 2011, Canadian Tire reported a net cash inflow from operating activities of $1,405,500,000, a net cash outflow for investing activities of $1,161,400,000, and a net cash outflow for financing activities of $493,700,000.**

6. **Management's discussion and analysis information:**
   a. **Canadian Tire's management considers several accounting policies critical, including following international financial reporting standards. Detailed information can be found in the management's discussion and analysis section of the annual report. More detail on significant accounting policies can also be found in the notes to the financial statements (Note 3).**
   b. **The company does believe that it has performed well during the current year. Its analysis can be found in the management's discussion and analysis section in the annual report. Management lays out its beliefs on current operations as well as future prospects in this section of the annual report.**

7. **The financial statements are audited by Deloitte & Touche LLP.**

Case 1-63

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

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

Case 1-64 (Contd.)

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

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