

Chapter 1

Business Decisions and Financial Accounting

ANSWERS TO QUESTIONS

1. Accounting is a system of analyzing, recording, and summarizing the results of a business's activities and then reporting them to decision makers.
2. An advantage of operating as a sole proprietorship, rather than a corporation, is that it is easy to establish. Another advantage is that income from a sole proprietorship is taxed only once in the hands of the individual proprietor (income from a corporation is taxed in the corporation and then again in the hands of the individual proprietor). A disadvantage of operating as a sole proprietorship, rather than a corporation, is that the individual proprietor can be held responsible for the debts of the business.
3. Financial accounting focuses on preparing and using the financial statements that are made available to owners and external users such as customers, creditors, and potential investors who are interested in reading them. Managerial accounting focuses on other accounting reports that are not released to the general public, but instead are prepared and used by employees, supervisors, and managers who run the company.
4. Financial reports are used by both internal and external groups and individuals. The internal groups are comprised of the various managers of the business. The external groups include investors, creditors, governmental agencies, other interested parties, and the public at large.
5. The business itself, not the individual stockholders who own the business, is viewed as owning the assets and owing the liabilities on its balance sheet. A business's balance sheet includes the assets, liabilities, and stockholders' equity of only that business and not the personal assets, liabilities, and equity of the stockholders. The financial statements of a company show the results of the business activities of only that company.

6. (a) Operating – These activities are directly related to earning profits. They include buying supplies, making products, serving customers, cleaning the premises, advertising, renting a building, repairing equipment, and obtaining insurance coverage.
(b) Investing – These activities involve buying and selling productive resources with long lives (such as buildings, land, equipment, and tools), purchasing investments, and lending to others.
(c) Financing – Any borrowing from banks, repaying bank loans, receiving contributions from stockholders, or paying dividends to stockholders are considered financing activities.
7. The heading of each of the four primary financial statements should include the following:
 - (a) Name of the business
 - (b) Name of the statement
 - (c) Date of the statement, or the period of time
8. (a) The purpose of the balance sheet is to report the financial position (assets, liabilities and stockholders' equity) of a business at a point in time.
(b) The purpose of the income statement is to present information about the revenues, expenses, and net income of a business for a specified period of time.
(c) The statement of retained earnings reports the way that net income and the distribution of dividends affected the financial position of the company during the period.
(d) The purpose of the statement of cash flows is to summarize how a business's operating, investing, and financing activities caused its cash balance to change over a particular period of time.
9. The income statement, statement of retained earnings, and statement of cash flows would be dated "For the Year Ended December 31, 2012," because they report the inflows and outflows of resources during a period of time. In contrast, the balance sheet would be dated "At December 31, 2012," because it represents the assets, liabilities and stockholders' equity at a specific date.
10. Net income is the excess of total revenues over total expenses. A net loss occurs if total expenses exceed total revenues.
11. The accounting equation for the balance sheet is: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$. Assets are the economic resources controlled by the company. Liabilities are amounts owed by the business. Stockholders' equity is the owners' claims to the business. It includes amounts contributed to the business (by investors through purchasing the company's stock) and the amounts earned and accumulated through profitable business operations.

12. The equation for the income statement is $\text{Revenues} - \text{Expenses} = \text{Net Income}$. Revenues are increases in a company's resources, arising primarily from its operating activities. Expenses are decreases in a company's resources, arising primarily from its operating activities. Net Income is equal to revenues minus expenses. (If expenses are greater than revenues, the company has a Net Loss.)
13. The equation for the statement of retained earnings is: $\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}$. It begins with beginning-of-the-year retained earnings which is the prior year's ending retained earnings reported on the prior year's balance sheet. The current year's net income reported on the income statement is added and the current year's dividends are subtracted from this amount. The ending retained earnings amount is reported on the end-of-year balance sheet.
14. The equation for the statement of cash flows is: $\text{Cash flows from operating activities} + \text{Cash flows from investing activities} + \text{Cash flows from financing activities} = \text{Change in cash for the period}$. $\text{Change in cash for the period} + \text{Beginning cash balance} = \text{Ending cash balance}$. The net cash flows for the period represent the increase or decrease in cash that occurred during the period. Cash flows from operating activities are cash flows directly related to earning income (normal business activity). Cash flows from investing activities include cash flows that are related to the acquisition or sale of the company's long-term assets. Cash flows from financing activities are directly related to the financing of the company.
15. Currently, the Financial Accounting Standards Board (FASB) is given the primary responsibility for setting the detailed rules that become Generally Accepted Accounting Principles (GAAP) in the United States. (Internationally, the International Accounting Standards Board (IASB) has the responsibility for setting accounting rules known as International Financial Reporting Standards (IFRS).)
16. The main goal of accounting rules is to ensure that companies produce useful financial information for present and potential investors, lenders, and other creditors in making decisions in their capacity as capital providers. Financial information must show relevance and faithful representation, as well as be comparable, verifiable, timely, and understandable.
17. An ethical dilemma is a situation where following one moral principle would result in violating another. Three steps that should be considered when evaluating ethical dilemmas are:
 - (a) Identify who will benefit from the situation (often, the manager or employee) and how others will be harmed (other employees, the company's reputation, owners, creditors, and the public in general).
 - (b) Identify the alternative courses of action.
 - (c) Choose the alternative that is the most ethical – that which you would be proud to have reported in the news media. Often, there is no one right answer and hard choices will need to be made. Following strong ethical practices is a key part of ensuring good financial reporting by businesses of all sizes.

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

**Authors' Recommended Solution Time
(Time in minutes)**

<i>Mini-exercises</i>		<i>Exercises</i>		<i>Problems</i>		<i>Skills Development Cases*</i>		<i>Continuing Case</i>	
<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>
1	3	1	10	CP1-1	45	1	20	1	45
2	12	2	10	CP1-2	10	2	20		
3	12	3	15	CP1-3	60	3	30		
4	6	4	25	CP1-4	5	4	30		
5	4	5	25	PA1-1	45	5	20		
6	6	6	10	PA1-2	10	6	30		
7	6	7	15	PA1-3	50	7	45		
8	4	8	10	PA1-4	5				
9	4	9	20	PB1-1	45				
10	3	10	10	PB1-2	10				
11	3	11	3	PB1-3	50				
12	6	12	3	PB1-4	5				
13	5								
14	5								
15	4								
16	12								

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

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

ANSWERS TO MINI-EXERCISES

M1-1

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

M1-2

	Term or Abbreviation	Definition
<u>I</u>	(1) SEC	A. A system that collects and processes financial information about an organization and reports that information to decision makers.
<u>F</u>	(2) Investing activities	B. Measurement of information about a business in the monetary unit (dollars or other national currency).
<u>D</u>	(3) Private company	C. An unincorporated business owned by two or more persons.
<u>E</u>	(4) Corporation	D. A company that sells shares of its stock privately and is not required to release its financial statements to the public.
<u>A</u>	(5) Accounting	E. An incorporated business that issues shares of stock as evidence of ownership.
<u>C</u>	(6) Partnership	F. Buying and selling productive resources with long lives.
<u>J</u>	(7) FASB	G. Transactions with lenders (borrowing and repaying cash) and stockholders (selling company stock and paying dividends).
<u>G</u>	(8) Financing activities	H. Activities directly related to running the business to earn profit.
<u>B</u>	(9) Unit of measure	I. Securities and Exchange Commission.
<u>L</u>	(10) GAAP	J. Financial Accounting Standards Board.
<u>K</u>	(11) Public company	K. A company that has its stock bought and sold by investors on established stock exchanges .
<u>H</u>	(12) Operating activities	L. Generally accepted accounting principles.

M1-3

	Term	Definition
<u>F</u>	(1) Relevance	A. The financial reports of a business are assumed to include the results of only that business's activities.
<u>I</u>	(2) Faithful Representation	B. The resources owned by a business.
<u>C</u>	(3) Comparability	C. Financial information that can be compared across businesses because similar accounting methods have been applied.
<u>A</u>	(4) Separate Entity	D. The total amounts invested and reinvested in the business by its owners.
<u>B</u>	(5) Assets	E. The costs of business necessary to earn revenues.
<u>H</u>	(6) Liabilities	F. A feature of financial information that allows it to influence a decision.
<u>D</u>	(7) Stockholders' Equity	G. Earned by selling goods or services to customers.
<u>G</u>	(8) Revenues	H. The amounts owed by the business.
<u>E</u>	(9) Expenses	I. Financial information that depicts the economic substance of business activities.
<u>J</u>	(10) Unit of Measure	J. The assumption that states that results of business activities should be reported in an appropriate monetary unit.

M1-4

	<u>Type</u>	<u>Statement</u>
(1) Accounts Payable	L	B/S
(2) Accounts Receivable	A	B/S
(3) Cash	A	B/S
(4) Income Tax Expense	E	I/S
(5) Selling and Administrative Expenses	E	I/S
(6) Sales Revenue	R	I/S
(7) Notes Payable	L	B/S
(8) Retained Earnings	SE	B/S

M1-5

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

M1-6

	<u>Type</u>	<u>Statement</u>
(1) Accounts Receivable	A	B/S
(2) Selling and Administrative Expenses	E	I/S
(3) Cash	A	B/S
(4) Equipment	A	B/S
(5) Advertising Expense	E	I/S
(6) Sales Revenue	R	I/S
(7) Notes Payable	L	B/S
(8) Retained Earnings	SE	B/S
(9) Accounts Payable	L	B/S

M1-7

	<u>Type</u>	<u>Statement</u>
(1) Accounts Payable	L	B/S
(2) Contributed Capital	SE	B/S
(3) Equipment	A	B/S
(4) Accounts Receivable	A	B/S
(5) Notes Payable	L	B/S
(6) Cash	A	B/S
(7) Retained Earnings	SE	B/S
(8) Selling and Administrative Expenses	E	I/S
(9) Sales Revenue	R	I/S
(10) Supplies	A	B/S

M1-8

	<u>Type</u>	<u>Statement</u>
(1) Dividends	D	SRE
(2) Contributed Capital	SE	B/S
(3) Sales Revenue	R	I/S
(4) Equipment	A	B/S
(5) Cash	A	B/S
(6) Long-term Debt	L	B/S
(7) Accounts Payable	L	B/S
(8) Retained Earnings, Beginning of Year	SE	SRE

M1-9

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

M1-10

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

M1-11

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

M1-12

STONE CULTURE CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2012

Retained Earnings, January 1, 2012	\$ 0
Add: Net Income	40,000
Subtract: Dividends	<u>(15,000)</u>
Retained Earnings, December 31, 2012	<u>\$ 25,000</u>

STONE CULTURE CORPORTATION
Statement of Retained Earnings
For the Year Ended December 31, 2013

Retained Earnings, January 1, 2013	\$ 25,000
Add: Net Income	45,000
Subtract: Dividends	<u>(20,000)</u>
Retained Earnings, December 31, 2013	<u>\$ 50,000</u>

M1-13

	Apple, Inc.	Google, Inc.	Intel Corp.
Contributed Capital	\$11	\$18	\$17
Dividends	0	0	4
Net Income	(a) 14	(d) 9	(g) 11
Retained Earnings, Beginning of Year	23	20	26
Retained Earnings, End of Year	(b) 37	(e) 29	(h) 33
Total Assets	(c) 75	(f) 59	(i) 63
Total Expenses	51	20	33
Total Liabilities	27	12	13
Total Revenues	65	29	44

M1-14

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

M1-15

(a) (300) (b) 70 (c) 3,900. Electronic Arts was not profitable because its expenses (\$3,900) were greater than its revenues (\$3,600), resulting in the net loss of \$300 reported on the income statement.

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

Electronic Arts, Inc. Income Statement For the Year Ended xxxx	
Revenues	\$3,600
Expenses	(c)
Net Income (Loss)	(a)
Electronic Arts, Inc. Statement of Retained Earnings For the Year Ended xxxx	
RE, beginning	\$370
Net income (loss)	(a)
Dividends	(0)
RE, ending	(b)

Electronic Arts, Inc. Balance Sheet At xxxx	
Total Assets	<u>\$4,900</u>
Liabilities and Shareholders' Equity	
Total Liabilities	<u>\$2,400</u>
Shareholders' Equity	
Contributed capital	\$2,430
Retained earnings	(b)
Total SE	?
Total Liabilities & SE	?

M1-16

Req. 1

SOUTHWEST AIRLINES, INC.
Income Statement
For the Year Ended December 31, 2010
(Amounts in millions)

Revenues	
Ticket Revenues	\$ 11,489
Other Revenue	615
Total Revenue	<u>12,104</u>
Expenses	
Salaries Expense	3,704
Aircraft Fuel Expense	3,620
Other Expenses	2,340
Repairs and Maintenance Expense	751
Landing Fees Expense	807
Interest Expense	136
Income Tax Expense	287
Total Expenses	<u>11,645</u>
Net Income	<u>\$ 459</u>

Req. 2

SOUTHWEST AIRLINES, INC.
Statement of Retained Earnings
For the Year Ended December 31, 2010
(Amounts in millions)

Retained Earnings, January 1, 2010	\$ 4,971
Add: Net Income	459
Subtract: Dividends	<u>(31)</u>
Retained Earnings, December 31, 2010	<u>\$ 5,399</u>

M1-16 (continued)

Req. 3

SOUTHWEST AIRLINES, INC.
Balance Sheet
At December 31, 2010
(Amounts in millions)

Assets	
Cash	\$ 3,538
Accounts Receivable	195
Supplies	243
Property and Equipment	10,578
Other Assets	909
Total Assets	<u>\$ 15,463</u>
Liabilities	
Accounts Payable	\$ 1,602
Notes Payable	5,921
Other Liabilities	1,703
Total Liabilities	<u>9,226</u>
Stockholders' Equity	
Contributed Capital	838
Retained Earnings	5,399
Total Stockholders' Equity	<u>6,237</u>
Total Liabilities and Stockholders' Equity	<u>\$ 15,463</u>

Req. 4

Southwest Airlines financed its assets primarily with liabilities (\$9,226) as opposed to stockholders' equity (\$6,237).

ANSWERS TO EXERCISES

E1-1

- a) Assets = Liabilities + Stockholders' Equity
= \$13,750 + \$4,450
= \$18,200
= Assets reported on the balance sheet
- b) Net Income = Revenue – Expenses
= \$10,500 - \$9,200
= \$1,300
= Net income reported on the income statement
- c) Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E
\$3,500 + \$1,300 - \$500 = \$4,300
- d) Beginning Cash + Cash Flows from Operating Activities + Cash Flows from
(Used in) Investing Activities + Cash Flows from (Used in) Financing Activities =
Ending Cash
\$1,000 + \$1,600 + (\$1,000) + (\$900) = \$700

E1-2

- a) Assets = Liabilities + Stockholders' Equity
= \$18,500 + \$61,000
= \$79,500
= Assets reported on the balance sheet
- b) Net Income = Revenue – Expenses
= \$32,100 – \$18,950
= \$13,150
= Net income reported on the income statement
- c) Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E
\$20,500 + \$13,150 – \$4,900 = \$28,750
- d) Beginning Cash + Cash Flows from Operating Activities + Cash Flows from
(Used in) Investing Activities + Cash Flows from (Used in) Financing Activities =
Ending Cash
\$3,200 + \$15,700 + (\$7,200) + (\$5,300) = \$6,400

E1-3

Req. 1

DSW, Inc.
Balance Sheet
At January 29, 2011
(in thousands)

Assets	
Cash	\$ 93,617
Accounts Receivable	12,514
Property, Plant, and Equipment	210,391
Other Assets	<u>692,375</u>
Total Assets	<u>\$1,008,897</u>
Liabilities	
Accounts Payable	\$149,722
Notes Payable	95,589
Other Liabilities	<u>122,822</u>
Total Liabilities	<u>368,133</u>
Stockholders' Equity	
Contributed Capital	314,382
Retained Earnings	<u>326,382</u>
Total Stockholders' Equity	<u>640,764</u>
Total Liabilities and Stockholders' Equity	<u>\$1,008,897</u>

Req. 2

Most of the financing as of January 29 came from stockholders. The stockholders have financed \$640,764 of the total assets and creditors have financed only \$368,133 of the total assets of the company.

E1-4

Req. 1

READER DIRECT
Balance Sheet
At December 31, 2012

Assets	Liabilities		
Cash	\$ 47,500	Accounts Payable	\$ 8,000
Accounts Receivable	26,900	Note Payable	<u>2,850</u>
Property and Equipment	<u>48,000</u>		
		Total Liabilities	<u>10,850</u>
		Stockholders' Equity	
		Contributed Capital	98,000
		Retained Earnings	<u>13,550</u>
		Total Stockholders' Equity	<u>111,550</u>
		Total Liabilities and Stockholders' Equity	<u>\$122,400</u>
Total Assets	<u>\$122,400</u>		

Req. 2

Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E, so
 Net Income = Ending R/E + Dividends - Beginning R/E
 = \$13,550 + 0 – 0
 = \$13,550

Net income for the year was \$13,550. This is the first year of operations and no dividends were declared or paid to stockholders; therefore, retained earnings is \$13,550 (which represents income for one year).

Req. 3

Most of the financing as of December 31, 2012 came from stockholders. The stockholders have financed \$111,550 of the total assets and creditors have financed only \$10,850 of the total assets of the company.

Req. 4

Beginning Retained Earnings (R/E) + Net Income – Dividends = Ending R/E, so
 Ending R/E = \$13,550 + 3,000 – 2,000
 = \$14,550

Retained Earnings at December 31, 2013 would be \$14,550.

E1-5

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

E1-6

Req. 1

CINEMARK HOLDINGS, INC
Income Statement
For the Quarter Ended March 31, 2011
(in thousands)

Revenues	
Admissions Revenues	\$311,692
Concessions Revenues	146,681
Other Revenues	<u>24,763</u>
Total Revenues	<u>483,136</u>
Expenses	
General and Administrative Expenses	179,047
Film Rental Expenses	165,153
Rent Expense	66,426
Concessions Expenses	23,282
Other Expenses	<u>24,265</u>
Total Expenses	<u>458,173</u>
Net Income	<u>\$24,963</u>

The question marks in the exercise correspond to Total Expenses of \$458,173 and Net Income of \$24,963, as determined above.

Req. 2

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

E1-7

HOME REALTY, INCORPORATED
Income Statement
For the Year Ended December 31, 2012

Revenue:	
Sales Revenue	<u>\$166,000</u>
Expenses:	
Wages Expense	97,000
Advertising Expenses	9,025
Interest Expense	6,300
Income Tax Expense	<u>18,500</u>
Total Expenses	<u>130,825</u>
Net Income	<u>\$ 35,175</u>

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

E1-8

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

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

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

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

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

E1-9

Req. 1

MIAMI MUSIC CORPORATION
Income Statement
For the Month Ended January 31, 2012

Total Revenues	\$131,000
Operating Expenses	<u>90,500</u>
Net Income	<u>\$ 40,500</u>

MIAMI MUSIC CORPORATION
Balance Sheet
At January 31, 2012

Assets:	
Cash	\$30,800
Accounts Receivable	25,300
Supplies	<u>40,700</u>
Total Assets	<u>\$96,800</u>
Liabilities:	
Accounts Payable	<u>\$25,700</u>
Total Liabilities	<u>25,700</u>
Stockholders' Equity:	
Contributed Capital	30,600
Retained Earnings (<i>from the income statement above</i>)	<u>40,500</u>
Total Stockholders' Equity	<u>71,100</u>
Total Liabilities and Stockholders' Equity	<u>\$96,800</u>

Req. 2

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

Req. 3

Miami Music Corporation should have no problem paying its liabilities since it has more total assets than total liabilities. In fact, it has over three times as many total assets as liabilities ($\$96,800/\$25,700 = 3.77$ times). This means that Miami Music Corporation could pay its liabilities more than three times over if all assets on hand at January 31, 2012, were converted to cash. Of course, not all assets will be converted into cash right away. Even so, looking only at the amount of cash at the end of January, we see that Miami Music has enough cash to cover all its liabilities. This is a very strong financial position.

E1-10

Req. 1

Average monthly revenue, $\$216,000 \div 12 = \$18,000$

Req. 2

Average monthly salaries and wages expense, $\$33,000 \div 12 = \$2,750$

Req. 3

Advertising is an expense because it represents the cost of ads that were run during the period to generate revenue.

Req. 4

The dividends are not reported as an expense because they represent a distribution of prior profits to stockholders. Consequently, they appear only on the statement of retained earnings, not the income statement.

Req. 5

Standing alone, the income statement does not report, or make it possible to determine, the ending cash balance. Some revenues might not have been collected, and some expenses might not have been paid by the end of the year. The amount of cash on December 31, 2012, would be reported on the balance sheet under assets and on the cash flow statement as the final amount shown.

E1-11

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

E1-12

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

ANSWERS TO COACHED PROBLEMS

CP1-1

Req. 1

NUCLEAR COMPANY
Income Statement
For the Year Ended December 31, 2012

Sales Revenue	<u>\$ 88,000</u>
Expenses	
Operating Expenses	57,200
Other Expenses	<u>8,850</u>
Total Expenses	<u>66,050</u>
Net Income	<u>\$ 21,950</u>

Req.2

NUCLEAR COMPANY
Statement of Retained Earnings
For the Year Ended December 31, 2012

Retained Earnings, January 1, 2012	\$ 0
Add: Net Income	21,950
Subtract: Dividends	<u>(200)</u>
Retained Earnings, December 31, 2012	<u>\$ 21,750</u>

Req. 3

NUCLEAR COMPANY
Balance Sheet
At December 31, 2012

Assets	
Cash	\$ 12,000
Accounts Receivable	59,500
Supplies	8,000
Equipment	<u>36,000</u>
Total Assets	<u>\$115,500</u>
Liabilities	
Accounts Payable	\$ 30,000
Notes Payable	<u>1,470</u>
Total Liabilities	<u>31,470</u>
Stockholders' Equity	
Contributed Capital	62,280
Retained Earnings	<u>21,750</u>
Total Stockholders' Equity	<u>84,030</u>
Total Liabilities and Stockholders' Equity	<u>\$115,500</u>

CP1-2

Req. 1

Nuclear Company's income statement reported net income of \$21,950, suggesting that the company was profitable because revenues exceeded expenses.

Req. 2

Nuclear Company's statement of retained earnings reported a retained earnings balance of \$21,750, after dividends of \$200 had been subtracted. This suggests the company could have sustained additional dividends of \$21,750, if sufficient cash were available to pay them. As it turns out, the company's balance sheet reports cash of \$12,000, suggesting that only \$12,000 in additional dividends could be paid (without borrowing additional cash).

Req. 3

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

Req. 4

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

CP1-3

Req. 1

LIFE TIME FITNESS, INC.
Income Statement
For the Nine Months Ended September 30, 2010
(in thousands)

Service Revenue	<u>\$689,171</u>
Expenses	
Operating Expenses	424,940
Interest Expense	107,431
General and Administrative Expense	32,606
Advertising Expense	18,940
Income Tax Expense	<u>42,156</u>
Total Expenses	<u>626,073</u>
Net Income	<u>\$ 63,098</u>

CP1-3 (continued)

Req. 2

LIFE TIME FITNESS, INC.
Statement of Retained Earnings
For the Nine Months Ended September 30, 2010
(in thousands)

Retained Earnings, January 1, 2010	\$ 343,789
Add: Net Income	63,098
Subtract: Dividends	<u>0</u>
Retained Earnings, September 30, 2010	<u>\$ 406,887</u>

Req. 3

LIFE TIME FITNESS, INC.
Balance Sheet
At September 30, 2010
(in thousands)

Assets	
Cash	\$ 33,502
Accounts Receivable	5,453
Supplies	15,766
Property and Equipment	1,546,749
Other Assets	<u>101,054</u>
Total Assets	<u>\$ 1,702,524</u>
Liabilities	
Accounts Payable	\$ 36,389
Rent Payable	31,455
Notes Payable	631,746
Other Liabilities	<u>190,004</u>
Total Liabilities	<u>889,594</u>
Stockholders' Equity	
Contributed Capital	406,043
Retained Earnings	<u>406,887</u>
Total Stockholders' Equity	<u>812,930</u>
Total Liabilities and Stockholders' Equity	<u>\$ 1,702,524</u>

CP1-3 (continued)

Req. 4

LIFE TIME FITNESS, INC.
Statement of Cash Flows
For the Nine Months Ended September 30, 2010
(in thousands)

Cash Flows from Operating Activities:	
Cash received from customers	\$687,744
Cash paid to suppliers and employees	<u>(541,597)</u>
Cash Provided by Operating Activities	<u>146,147</u>
Cash Flows from Investing Activities:	
Cash paid to purchase equipment	(101,088)
Cash received from sale of long-term assets	<u>2,629</u>
Cash Used in Investing Activities	<u>(98,459)</u>
Cash Flows from Financing Activities:	
Cash received from issuing common stock	3,660
Repayments of borrowings	(38,067)
Cash received from borrowings	<u>13,939</u>
Cash Used in Financing Activities	<u>(20,468)</u>
Change in Cash	27,220
Beginning Cash Balance, January 1, 2010	<u>6,282</u>
Ending Cash Balance, September 30, 2010	<u><u>\$ 33,502</u></u>

CP1-4

Req. 1

With more than \$889 million in total liabilities and less than \$813 million in total stockholders' equity, Life Time Fitness relies slightly more on creditors for its financing at September 30, 2010. This information is presented on the balance sheet.

Req. 2

With just over \$406 million in Contributed Capital (i.e., amounts stockholders contributed directly to the company) and just under \$407 million in Retained Earnings (i.e., amounts the company has earned through profitable business operations), stockholders' equity represents approximately equal amounts of both at September 30, 2010. This information is presented on the balance sheet.

ANSWERS TO GROUP A PROBLEMS

PA1-1

Req. 1

HIGH POWER CORPORATION
Income Statement
For the Year Ended December 31, 2013

Sales Revenue	<u>\$90,000</u>
Expenses	
Operating Expenses	58,700
Other Expenses	<u>7,850</u>
Total Expenses	<u>66,550</u>
Net Income	<u>\$23,450</u>

Req.2

HIGH POWER CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2013

Retained Earnings, January 1, 2013	\$ 0
Add: Net Income	23,450
Subtract: Dividends	<u>(1,950)</u>
Retained Earnings, December 31, 2013	<u>\$ 21,500</u>

Req. 3

HIGH POWER CORPORATION
Balance Sheet
At December 31, 2013

Assets	
Cash	\$ 13,300
Accounts Receivable	9,550
Supplies	5,000
Equipment	<u>86,000</u>
Total Assets	<u>\$113,850</u>
Liabilities	
Accounts Payable	\$ 32,100
Notes Payable	<u>1,160</u>
Total Liabilities	<u>33,260</u>
Stockholders' Equity	
Contributed Capital	59,090
Retained Earnings	<u>21,500</u>
Total Stockholders' Equity	<u>80,590</u>
Total Liabilities and Stockholders' Equity	<u>\$113,850</u>

PA1-2

Req. 1

High Power Corporation's income statement reported net income of \$23,450, suggesting that the company was profitable because revenues exceeded expenses.

Req. 2

High Power Corporation's statement of retained earnings reported a retained earnings balance of \$21,500, after dividends of \$1,950 had been subtracted. This suggests the company could have sustained additional dividends of \$21,500, if sufficient cash were available to pay them. As it turns out, the company's balance sheet reports cash of \$13,300, suggesting that only \$13,300 in additional dividends could be paid (without borrowing additional cash).

Req. 3

High Power Corporation's balance sheet reports total liabilities of \$33,260 and stockholders' equity of \$80,590, indicating that the company is financed mainly by stockholders.

Req. 4

High Power Corporation was founded at the beginning of the year, so it began with no cash. The balance sheet reports a cash balance of \$13,300 at the end of the year. The reasons for this increase of \$13,300 would be shown in the statement of cash flows.

PA1-3

Req. 1

COINSTAR, INC.
Income Statement
For the Year Ended December 31, 2010
(in millions)

Revenues:	
Service Revenue	\$ 1,436
Other Revenues	<u>1</u>
Total Revenues	<u>1,437</u>
Expenses:	
Kiosk Expenses	1,001
Utilities Expense	251
General and Administrative Expenses	129
Legal Expense	<u>5</u>
Total Expenses	<u>1,386</u>
Net Income	<u><u>\$ 51</u></u>

PA1-3 (continued)

Req. 2

COINSTAR, INC.
Statement of Retained Earnings
For the Year Ended December 31, 2010
(in millions)

Retained Earnings, January 1, 2010	\$ 51
Add: Net Income	51
Subtract: Dividends	-0-
Retained Earnings, December 31, 2010	<u>\$ 102</u>

Req. 3

COINSTAR, INC.
Balance Sheet
At December 31, 2010
(in millions)

Assets	
Cash	\$ 183
Accounts Receivable	26
Inventories	140
Prepaid Rent	28
Property and Equipment	445
Other Assets	460
Total Assets	<u>\$ 1,282</u>
Liabilities and Stockholders' Equity	
Liabilities	
Accounts Payable	\$ 270
Notes Payable	377
Wages Payable	97
Other Liabilities	95
Total Liabilities	<u>839</u>
Stockholders' Equity	
Contributed Capital	341
Retained Earnings	102
Total Stockholders' Equity	<u>443</u>
Total Liabilities and Stockholders' Equity	<u>\$ 1,282</u>

PA1-3 (continued)

Req. 4

COINSTAR, INC.
Statement of Cash Flows
For the Year Ended December 31, 2010
(in millions)

Cash Flows from Operating Activities	
Cash received from customers	\$ 1,430
Cash paid for kiosk operations	(887)
Cash paid to suppliers and employees	(238)
Cash Provided by Operating Activities	<u>305</u>
Cash Flows from Investing Activities	
Cash paid to purchase long-term assets	(173)
Cash received from sale of long-term assets	27
Cash used in Investing Activities	<u>(146)</u>
Cash Flows from Financing Activities	
Repayments of borrowings	(111)
Dividends paid in cash	-
Cash outflows for other financing activities	(11)
Cash used in Financing Activities	<u>(122)</u>
Change in Cash	37
Cash at January 1, 2010	146
Cash at December 31, 2010	<u>\$ 183</u>

PA1-4

Req. 1

With \$839 million in total liabilities and \$443 million in total stockholders' equity, Coinstar relies more on creditors for its financing at December 31, 2010. This information is presented on the balance sheet.

Req. 2

Coinstar's \$102 million of retained earnings at December 31, 2010, arises from equal amounts earned in the current year (\$51 million) and earned and retained from prior years (\$51 million). This information is presented on the statement of retained earnings.

ANSWERS TO GROUP B PROBLEMS

PB1-1

Req. 1

APEC AEROSPACE CORPORATION
Income Statement
For the Year Ended December 31, 2012

Sales Revenue	<u>\$ 94,000</u>
Expenses	
Operating Expenses	60,000
Other Expenses	<u>8,850</u>
Total Expenses	<u>68,850</u>
Net Income	<u>\$ 25,150</u>

Req. 2

APEC AEROSPACE CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2012

Retained Earnings, January 1, 2012	\$ 0
Add: Net Income	25,150
Subtract: Dividends	<u>(1,100)</u>
Retained Earnings, December 31, 2012	<u>\$ 24,050</u>

Req. 3

APEC AEROSPACE CORPORATION
Balance Sheet
At December 31, 2012

Assets	
Cash	\$ 13,900
Accounts Receivable	9,500
Supplies	9,000
Equipment	<u>86,000</u>
Total Assets	<u>\$118,400</u>
Liabilities	
Accounts Payable	\$ 33,130
Notes Payable	<u>51,220</u>
Total Liabilities	<u>84,350</u>
Stockholders' Equity	
Contributed Capital	10,000
Retained Earnings	<u>24,050</u>
Total Stockholders' Equity	<u>34,050</u>
Total Liabilities and Stockholders' Equity	<u>\$118,400</u>

PB1-2

Req. 1

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

Req. 2

APEC Aerospace Corporation's statement of retained earnings reported a retained earnings balance of \$24,050, after dividends of \$1,100 had been subtracted. This suggests the company could have sustained additional dividends of \$24,050, if sufficient cash were available to pay them. As it turns out, the company's balance sheet reports cash of \$13,900, suggesting that only \$13,900 in additional dividends could be paid (without borrowing additional cash).

Req. 3

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

Req. 4

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

PB1-3

Req. 1

CHEESE FACTORY INCORPORATED
Income Statement
For the Year Ended December 31, 2012

Revenues:	
Sales Revenue	\$1,660,000
Total Revenues	<u>1,660,000</u>
Expenses:	
Wages Expense	540,000
Utilities Expense	530,000
Operating Expenses	415,000
General and Administrative Expenses	<u>95,000</u>
Total Expenses	<u>1,580,000</u>
Net Income	<u><u>\$80,000</u></u>

Req. 2

CHEESE FACTORY INCORPORATED
Statement of Retained Earnings
For the Year Ended December 31, 2012

Retained Earnings, Beginning	\$ 410,000
Add: Net Income	80,000
Subtract: Dividends	<u>(10,000)</u>
Retained Earnings, Ending	<u><u>\$ 480,000</u></u>

PB1-3 (continued)

Req. 3

CHEESE FACTORY INCORPORATED
Balance Sheet
At December 31, 2012

Assets:

Cash	\$ 80,000
Accounts Receivable	15,000
Supplies	25,000
Prepaid Rent	50,000
Property and Equipment	<u>755,000</u>
Total Assets	<u><u>\$925,000</u></u>

Liabilities and Stockholders' Equity:

Liabilities:

Accounts Payable	\$ 35,000
Notes Payable	30,000
Wages Payable	170,000
Other Liabilities	<u>110,000</u>
Total Liabilities	<u>345,000</u>
Stockholders' Equity:	
Contributed Capital	100,000
Retained Earnings	<u>480,000</u>
Total Stockholders' Equity	<u>580,000</u>
Total Liabilities and Stockholders' Equity	<u><u>\$925,000</u></u>

PB1-3 (continued)

Req. 4

CHEESE FACTORY INCORPORATED
Statement of Cash Flows
For the Year Ended December 31, 2012

Cash Flows from Operating Activities	
Cash received from customers	\$ 1,661,000
Cash paid to suppliers and employees	<u>(1,490,000)</u>
Cash Provided by Operating Activities	<u>171,000</u>
Cash Flows from Investing Activities	
Cash paid to purchase equipment	<u>(40,000)</u>
Cash Used in Investing Activities	<u>(40,000)</u>
Cash Flows from Financing Activities	
Additional investments by stockholders	34,000
Cash received from borrowings	5,000
Repayments of borrowings	(155,000)
Dividends paid to stockholders	<u>(10,000)</u>
Cash Used in Financing Activities	<u>(126,000)</u>
Change in Cash	5,000
Cash at January 1, 2012	<u>75,000</u>
Cash at December 31, 2012	<u><u>\$ 80,000</u></u>

PB1-4

Req. 1

The statement of cash flows shows that the Cheese Factory increased its cash balance by \$5,000, during the year ended December 31, 2012.

Req. 2

The income statement shows that the Cheese Factory earned net income of \$80,000 during the year ended December 31, 2012, after having deducted wages expense of \$540,000. A 10% increase in wages would result in additional wage expense of \$54,000 ($\$540,000 \times 0.10$), which would decrease net income to \$26,000 ($\$80,000 - \$54,000$). (This answer ignores the possible income tax savings that would be created by having greater wages expense.)

ANSWERS TO SKILLS DEVELOPMENT CASES

S1-1

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

Sources:

Req. 1

The Home Depot's income statement shows net income of \$3,338 (million), which is labeled net earnings. Note that the amounts on the financial statements are rounded to the nearest million, so this is actually \$3,338,000,000 (answer d).

Req. 2

The income statement shows that the amount of sales was \$67,997 (million) for the year ended January 30, 2011 (answer a).

Req. 3

The balance sheet shows that inventory (merchandise inventories) costing \$10,625 (million) was on hand at January 30, 2011 (answer c).

Req. 4

The balance sheet and statement of cash flows show Cash (and Cash Equivalents) totaling \$545 (million) at January 30, 2011 (answer d).

S1-2

Req. 1

Lowe's net income for the year ended January 28, 2011 was \$2,010 (million). This is less than the \$3,338 (million) earned by Home Depot for the year ended January 30th, 2011.

S1-2 (continued)

Req. 2

Lowe's reported sales revenue of \$48,815 (million) for the year ended January 28, 2011. This is lower than the \$67,997 (million) reported by Home Depot for the year ended January 30th, 2011.

Req. 3

Lowe's inventory as of January 28, 2011 was \$8,321 (million). This is lower than the \$10,625 (million) reported by Home Depot as of January 30, 2011.

Req. 4

Lowe's Cash (and Cash Equivalents) on January 28, 2011 was \$652 (million). This is greater than the \$545 (million) reported by Home Depot at January 30, 2011.

Req. 5

Because Home Depot's stock is traded on the New York Stock Exchange, Home Depot must be a public company. Like Home Depot, Lowe's is a public company. Its stock trades on the New York Stock Exchange under the symbol LOW.

Req. 6

The Home Depot and Lowe's might choose to end their fiscal years in January because, as retailers, the weeks surrounding December 31st are the busiest of the year. Sales are usually greater immediately before Christmas, and gift returns are usually greater during the first weeks of the following new year. The Home Depot's year end of January 30, 2011, is the final Sunday in January. Lowe's year end of January 28, 2011, is the final Friday in January.

Req. 7

Two measures of financial success are Net Income and Sales Revenues. As noted for requirements 1 and 2, Home Depot reported greater amounts for both measures, suggesting that the company was more successful during the 2010 fiscal year. Note that Home Depot is slightly bigger than Lowe's, with more locations, more inventory (requirement 3), and more total assets. Given these differences, Home Depot is likely to produce more sales and net income than Lowe's. To determine whether Home Depot is truly run more successfully than Lowe's, a complete analysis is required and should take into account size differences between the two companies. (You'll learn about this kind of analysis in later chapters).

S1-3

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

S1-4

Req. 1

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

Req. 2

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

Req. 3

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

Req. 4

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

S1-5

Req. 1

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

Req. 2

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

S1-6

Req. 1

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

Based on historical cost:

Ashley		Jason	
Assets		Assets	
Cash	\$ 1,000	Cash	\$6,000
Artwork	800	PlayStation Console	250
Total Assets	<u>1,800</u>	Total Assets	<u>6,250</u>
Liabilities		Liabilities	
Loan Payable	250	Tuition Payable	800
Total Liabilities	<u>250</u>	Loan Payable	4,800
		Total Liabilities	<u>5,600</u>
Net Worth	<u>\$ 1,550</u>	Net Worth	<u>\$ 650</u>

S1-6 (continued):

Req. 1 (continued)

Based on fair value:

Ashley		Jason	
Assets		Assets	
Cash	\$ 1,000	Cash	\$6,000
Artwork	1,400	PlayStation Console	180
Total Assets	<u>2,400</u>	Total Assets	<u>6,180</u>
Liabilities		Liabilities	
Loan Payable	250	Tuition Payable	800
Total Liabilities	<u>250</u>	Loan Payable	4,800
		Total Liabilities	<u>5,600</u>
Net Worth	<u>\$ 2,150</u>	Net Worth	<u>\$ 580</u>

The notes are an important part of these balance sheets.

Notes:

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

Req. 2

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

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

S1-6 (continued):

Req. 3

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

Ashley		Jason	
Revenue		Revenue	
Part Time Job (for October)	<u>\$ 1,500</u>	Lottery Ticket Winnings	<u>\$ 1,950</u>
Expenses		Expenses	
Rent Expense (for October)	470	Rent Expense (for October)	800
Living Expenses (for October)	<u>950</u>	Living Expenses (for October)	<u>950</u>
Total Expenses	<u>1,420</u>	Total Expenses	<u>1,750</u>
Net Income	<u>\$ 80</u>	Net Income	<u>\$ 200</u>

Notes:

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

Req.4

Conclusion:

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

S1-7

	A	B	C
1		Electronic Arts, Inc.	
2		Balance Sheet	
3		As of September 30	
4		(in millions)	
5			
6		ASSETS	
7	Cash		\$ 2,412
8	Accounts Receivable		328
9	Inventories		367
10	Property and Equipment		364
11	Other Assets		283
12	Total Assets		\$ 3,754
13			
14		LIABILITIES	
15	Accounts Payable		\$ 171
16	Notes Payable		12
17	Other Liabilities		587
18	Total Liabilities		770
19		STOCKHOLDERS' EQUITY	
20	Contributed Capital		986
21	Retained Earnings		1,998
22	Total Stockholders' Equity		2,984
23	Total Liabilities and Stockholders' Equity		\$ 3,754
24			

S1-7 (continued)

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

ANSWERS TO CONTINUING CASE

CC1-1

Req. 1

NICOLE'S GETAWAY SPA
Income Statement (forecasted)
For the Year Ended December 31, 2013

Sales Revenue	<u>\$ 40,000</u>
Expenses:	
Wages Expense	24,000
Supplies Expense	7,000
Selling and Administrative Expenses	5,000
Income Tax Expense	1,600
Total Expenses	<u>37,600</u>
Net Income	<u><u>\$ 2,400</u></u>

CC1 (continued)

Req. 2

NICOLE'S GETAWAY SPA
Statement of Retained Earnings (forecasted)
For the Year Ended December 31, 2013

Retained Earnings, January 1, 2013	\$ 0
Add: Net Income	2,400
Subtract: Dividends	<u>(2,000)</u>
Retained Earnings, December 31, 2013	<u>\$ 400</u>

Req. 3

NICOLE'S GETAWAY SPA
Balance Sheet (forecasted)
At December 31, 2013

Assets:	
Cash	\$ 2,150
Accounts Receivable	1,780
Building and Equipment	<u>70,000</u>
Total Assets	<u>\$73,930</u>
Liabilities:	
Accounts Payable	\$ 4,660
Notes Payable	<u>38,870</u>
Total Liabilities	<u>43,530</u>
Stockholders' Equity:	
Contributed Capital	30,000
Retained Earnings	<u>400</u>
Total Stockholders' Equity	<u>30,400</u>
Total Liabilities and Stockholders' Equity	<u>\$73,930</u>

Req. 4

As of December 31, 2013, more financing is expected to come from creditors (\$43,530) than from stockholders (\$30,400).