CHAPTER 2
BASIC ACCOUNTING CONCEPTS

CLASS DISCUSSION QUESTIONS

1. The basic elements of a financial accounting system include (1) a set of rules for determining what, when, and the amount that should be recorded; (2) a framework for preparing financial statements; and (3) one or more controls to determine whether errors may have occurred in the recording process. These elements apply to all businesses, from a local restaurant to Google Inc. All businesses require a financial reporting system so that financial statements can be provided to stakeholders.

2. a. Purchase of land for cash affects only assets.

b. Payment of a liability affects assets and liabilities; receipt of cash for fees earned affects assets and stockholders' equity.

c. Incurring an expense that is partially paid in cash decreases assets, increases liabilities, and decreases stockholders' equity (retained earnings). For example, assume that a business hires a lawyer for $10,000 to draft and file the necessary documents to start and incorporate the business. The business pays the lawyer $4,000 and agrees to pay the remaining $6,000 over the next several months. This transaction would decrease assets ($4,000), increase liabilities ($6,000), and decrease stockholders' equity (retained earnings) $10,000. The expense is an organizational expense.

Likewise, a new business might hire a new chief operating officer by agreeing to pay a nonrefundable, noncancellable signing bonus of $50,000, with $30,000 due at signing and the remainder due in four installments. This transaction would decrease assets ($30,000), increase liabilities ($20,000), and decrease stockholders' equity (retained earnings) $50,000. The expense is salary expense or bonus expense.

3. Out of balance. Assets are correct, but retained earnings (utilities expense) should have been decreased by $1,200 rather than $2,100. Thus, retained earnings is understated by $900, and total liabilities plus stockholders' equity would be less than total assets by $900.

4. a. Out of balance. Assets are overstated by $27,000 ($85,000 – $58,000), and thus, total assets would exceed total liabilities plus stockholders' equity by $27,000.

b. In balance. Even though liabilities and stockholders' equity are incorrect, the accounting equation balances. For this error, liabilities are overstated by $7,000, and retained earnings (fees earned) are understated by $7,000; thus, the over- and understatements offset each other, and the accounting equation balances.

5. A primary control for determining the accuracy of record keeping is the equality of the accounting equation. The accounting equation must balance.

6. Total assets are increased by $175,000: an increase in cash of $375,000 and a decrease in land of $200,000. Stockholders' equity (retained earnings) is increased by $175,000, the gain on the sale of the land.

7. a. The payment of $15,000 of dividends decreases total assets (decrease in cash) and decreases stockholders' equity (decrease in retained earnings).

b. Net income is not affected by the payment of dividends. Dividends are a distribution of income to stockholders and are not an expense.

8. a. The equality of the accounting equation would not be affected. That is, the accounting equation would still balance.

b. On the income statement, total operating expenses (salary expense) would be overstated by $30,000, and net income would be understated by $30,000. On the retained earnings statement, the beginning and ending retained earnings would be correct. However, net income and dividends would be understated by $30,000. These understatements offset one another, and thus, ending retained earnings is correct. The balance sheet is not affected by the error. On the statement of cash flows, net cash flows from operating activities is understated, since cash paid for salary expense is overstated. In addition, net cash flows from financing activities is overstated, since cash paid for dividends is understated. The understatement of net cash flows from operating activities is offset by the overstatement of net cash flows from financing activities, and thus, the net increase or decrease in cash for the period is correct, as is the ending cash balance.

9. a. The equality of the accounting equation would not be affected. That is, the accounting equation would still balance.

b. On the income statement, revenues (fees earned) would be overstated by $75,000, and net income would be overstated by $75,000. On the retained earnings statement, the beginning retained earnings would be correct. However, net income and ending retained earnings would be overstated by $75,000. The balance sheet total assets is correct. However, liabilities (notes payable) is understated by $75,000, and stockholders' equity (retained earnings) is overstated by $75,000. The understatement of liabilities is offset by the overstatement of stockholders' equity, and thus, total liabilities and stockholders' equity is correct. On the statement of cash flows, net cash flows from operating activities is overstated, since cash received from fees earned is overstated. In addition, net cash flows from financing activities is understated, since cash received from borrowing (notes payable) is understated. The overstatement of net cash flows from operating activities is offset by the understatement of net cash flows from financing activities, and thus, the net increase or decrease in cash for the period is correct, as is the ending cash balance.

10. a. $350,000 ($500,000 – $150,000)

b.

Stockholders' equity as of December 31, 20Y8	$400,000
Less stockholders' equity as of January 1, 20Y8	350,000
Net income	$ 50,000

11.

Change in stockholders' equity (see Question 10)	$50,000
Plus dividends	18,000
Net income	$68,000

EXERCISES

E2–1

a. $1,000,000 ($250,000 + $750,000)

b. $350,000 ($480,000 – $130,000)

c. $107,500 ($115,000 – $7,500)

E2–2

a. $37,385 ($72,124 – $34,739)

b. $400 increase ($2,774 – $2,374)

c. Total assets = $74,898 ($72,124 + $2,774)
Total liabilities = $35,139 ($34,739 + $400)
Total stockholders' equity = $39,759 ($37,385 + $2,374)

d. Yes. [$74,898 (total assets) = $35,139 (total liabilities) + $39,759 (total stockholders' equity)]

E2–3

a. $1,088 ($6,862 – $5,774)

b. $190 decrease ($332 – $142)

c. Total assets = $6,530 ($6,862 – $332)
Total liabilities = $5,632 ($5,774 – $142)
Total stockholders' equity = $898 ($1,088 – $190)

d. Yes. [$6,530 (total assets) = $5,632 (total liabilities) + $898 (total stockholders' equity)]

E2–4

(a) $11,610 ($14,429 – $2,819)

(b) $46,241 ($57,851 – $11,610)

(c) $72,574 ($57,851 + $14,723)

(d) $58,145 ($72,574 – $14,429) or ($46,241 + $11,904)

(e) $220,005 ($230,461 – $10,456) or ($86,912 + $133,093)

(f) $133,093 ($144,553 – $11,460) or ($220,005 – $86,912)

(g) $10,456 ($11,460 – $1,004)

(h) $(1,004) ($85,908 – $86,912)

(i) $144,553 ($230,461 – $85,908)

E2–5

a. $550,000 ($750,000 – $200,000)

b. $635,000 ($550,000 + $125,000 – $40,000)

c. $434,000 ($550,000 – $80,000 – $36,000)

d. $715,000 ($550,000 + $140,000 + $25,000)

e. Net income: $130,000 ($950,000 – $270,000 – $550,000)

E2–6

a. (3) No effect
b. (3) No effect
c. (1) Increase
d. (3) No effect
e. (2) Decrease
f. (2) Decrease
g. (2) Decrease
h. (1) Increase
i. (1) Increase
j. (2) Decrease

E2–7

a. Increases assets and increases stockholders' equity.

b. Decreases assets and decreases stockholders' equity.

c. Increases assets and increases liabilities.

d. Increases assets and increases stockholders' equity.

e. Increases assets and decreases assets.

E2–8

(1) Total assets decreased $5,000.
(2) Total liabilities decreased $120,000.
(3) Stockholders' equity increased $115,000.

E2–9

1. (a) increase
2. (a) increase
3. (b) decrease
4. (b) decrease
5. (b) decrease

E2–10

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

E2–11

a. (1) Sale of catering services for cash, $28,000.
   (2) Purchase of land for cash, $20,000.
   (3) Payment of expenses, $18,000.
   (4) Payment of cash dividends, $1,000.

b. $11,000 ($40,000 – $29,000)

c. $9,000 ($109,000 – $100,000)

d. $10,000 ($28,000 – $18,000)

e. $9,000 ($10,000 – $1,000)

f. $10,000 ($28,000 – $18,000)

g. $20,000 used for purchase of land

h. $1,000 used for payment of dividends

E2–12

It would be incorrect to say that the business had incurred a net loss of $8,000. The excess of the dividends over the net income for the period is a decrease in the amount of retained earnings in the corporation.

E2–13

Company Sierra

Stockholders’ equity at end of year ($770,000 – $294,000)	$476,000
Stockholders’ equity at beginning of year ($490,000 – $175,000)	315,000
Net income (increase in stockholders’ equity)	$161,000

Company Tango

Increase in stockholders’ equity (as determined for Sierra)	$161,000
Add dividends	55,000
Net income	$216,000

Company Yankee

Increase in stockholders’ equity (as determined for Sierra)	$161,000
Deduct issuance of additional capital stock	75,000
Net income	$ 86,000

Company Zulu

Increase in stockholders’ equity (as determined for Sierra)	$161,000
Deduct issuance of additional capital stock	75,000
	$ 86,000
Add dividends	55,000
Net income	$141,000

E2–14

In each case, solve for a single unknown, using the following equation:

Stockholders' equity (beginning) + Issuance of Capital Stock – Dividends + Revenues – Expenses = Stockholders' equity (ending)

Carbon	**Stockholders' equity at end of year ($495,000 – $160,000)...**		**$335,000**
	Stockholders' equity at beginning of year ($333,000 – $118,000) .		**215,000**
	Increase in stockholders' equity...		**$120,000**
	Deduct increase due to net income ($90,000 – $39,000).......		**51,000**
			$ 69,000
	Add dividends..		**7,500**
	Additional issuance of capital stock..................................	**(a)**	**$ 76,500**
Krypton	**Stockholders' equity at end of year ($350,000 – $110,000)...**		**$240,000**
	Stockholders' equity at beginning of year ($250,000 – $130,000) .		**120,000**
	Increase in stockholders' equity...		**$120,000**
	Add dividends..		**16,000**
			$136,000
	Deduct additional issuance of capital stock		**50,000**
	Increase due to net income		**$ 86,000**
	Add expenses		**64,000**
	Revenue	**(b)**	**$150,000**
Fluorine	**Stockholders' equity at end of year ($90,000 – $80,000).......**		**$ 10,000**
	Stockholders' equity at beginning of year ($100,000 – $76,000) ..		**24,000**
	Decrease in stockholders' equity...		**$(14,000)**
	Deduct decrease due to net loss ($115,000 – $122,500)		**(7,500)**
			$ (6,500)
	Deduct additional issuance of capital stock		**10,000**
	Dividends	**(c)**	**$(16,500)**
Radium	**Stockholders' equity at end of year ($248,000 – $136,000)...**		**$112,000**
	Add decrease due to net loss ($112,000 – $128,000).............		**16,000**
			$128,000
	Add dividends..		**60,000**
	Stockholders' equity at beginning of year		**$188,000**
	Deduct additional issuance of capital stock		**40,000**
			$148,000
	Add liabilities at beginning of year		**120,000**
	Assets at beginning of year..	**(d)**	**$268,000**

E2–15

a. **$3,492 ($28,236 – $24,744)**

b. **The net cash flows used for investing activities is determined by solving the following equation:**

Net decrease in cash = Net cash flows from operating activities + Net cash flows used for investing activities + Net cash from financing activities

–$61 = $5,527 + Net cash flows used for investing activities + $578
Net cash flows used for investing activities = –$61 – $5,527 – $578
Net cash flows used for investing activities = –$6,166

E2–16

a.

ABBY'S INTERIORS
Balance Sheet
October 31, 20Y6

Assets		
Cash		$ 50,000
Land		500,000
Total assets		$550,000
Liabilities		
Notes payable		$200,000
Stockholders' Equity		
Capital stock	$ 75,000	
Retained earnings	275,000	
Total stockholders' equity		350,000
Total liabilities and stockholders' equity		$550,000

E2–16, Concluded

ABBY'S INTERIORS
Balance Sheet
November 30, 20Y6

Assets		
Cash		$175,000
Land		575,000
Total assets		$750,000
Liabilities		
Notes payable		$250,000
Stockholders' Equity		
Capital stock	$ 90,000	
Retained earnings	410,000	
Total stockholders' equity		500,000
Total liabilities and stockholders' equity		$750,000

b.

Retained earnings, November 30, 20Y6	$410,000
Retained earnings, October 31, 20Y6	275,000
Increase in retained earnings	$135,000
Add dividends	12,000
Net income	$147,000

c. Net cash flows from operating activities = $147,000 = $125,000 + $75,000 – $53,000

d. –$75,000, used for the increase in the land

e. $53,000, the increase in capital stock of $15,000 plus the increase in notes payable of $50,000 less the dividends of $12,000

f. $125,000 ($175,000 – $50,000)

E2–17

BENJAMIN REALTY INC.
Income Statement
For the Month Ending April 30, 20Y9

Revenues:		
Sales commissions		$145,000
Expenses:		
Salaries expense	$75,000	
Utilities expense	15,000	
Rent expense	5,000	
Interest expense	2,000	
Miscellaneous expense	3,000	
Total expenses		100,000
Net income		$ 45,000

E2–18

BENJAMIN REALTY INC.
Retained Earnings Statement
For the Month Ending April 30, 20Y9

Net income	$45,000
Less dividends	10,000
Retained earnings, April 30, 20Y9	$35,000

E2–19

BENJAMIN REALTY INC.
Balance Sheet
April 30, 20Y9

Assets		
Cash		$53,000
Land		42,000
Total assets		$95,000
Liabilities		
Notes payable		$35,000
Stockholders' Equity		
Capital stock	$25,000	
Retained earnings	35,000	
Total stockholders' equity		60,000
Total liabilities and stockholders' equity		$95,000

E2–20

BENJAMIN REALTY INC.
Statement of Cash Flows
For the Month Ending April 30, 20Y9

Cash flows from operating activities:		
Cash receipts from operating activities	$145,000	
Deduct cash payments for operating activities	(100,000)	
Net cash flows from operating activities		$ 45,000
Cash flows used for investing activities:		
Cash payments for land		(42,000)
Cash flows from financing activities:		
Cash receipts from issuing capital stock	$ 25,000	
Cash receipts from issuing notes payable	35,000	
Cash payments for dividends	(10,000)	
Net cash flows from financing activities		50,000
Net increase in cash during April		$ 53,000
Cash as of April 1, 20Y9		0
Cash as of April 30, 20Y9		$ 53,000

E2–21

a. Decrease in assets and decrease in stockholders' equity.

b. Increase in assets and decrease in assets.

c. Increase in assets and increase in stockholders' equity.

d. Increase in assets and increase in liabilities.

e. Increase in assets and increase in stockholders' equity.

f. Decrease in assets and decrease in stockholders' equity.

g. Decrease in assets and decrease in stockholders' equity.

h. Increase in assets, decrease in assets, and increase in stockholders' equity.

i. Decrease in assets and decrease in stockholders' equity.

j. Decrease in assets and decrease in stockholders' equity.

k. Decrease in assets and decrease in liabilities.

l. Decrease in assets and decrease in stockholders' equity.

E2–22

a. operating section
b. investing section
c. financing section
d. financing section
e. operating section
f. operating section
g. operating section
h. investing section
i. operating section
j. operating section
k. financing section
l. financing section

PROBLEMS

P2–1

1.

Statement of Cash Flows	Cash	+	Land	=	Notes Payable	+	Capital Stock	+	Retained Earnings	Income Statement
	Assets			=	Liabilities	+	Stockholders' Equity			
a. Investment	50,000						50,000			
b. Issued note payable	25,000				25,000					
Balances	75,000				25,000		50,000			
c. Fees earned	28,000								28,000	c.
Balances	103,000				25,000		50,000		28,000	
d. Rent expense	–3,000								–3,000	d.
Balances	100,000				25,000		50,000		25,000	
e. Paid expenses	–2,700								–2,700	e.
Balances	97,300				25,000		50,000		22,300	
f. Paid salary expense	–4,200								–4,200	f.
Balances	93,100				25,000		50,000		18,100	
g. Paid interest expense	–100								–100	g.
Balances	93,000				25,000		50,000		18,000	
h. Purchased land	–55,000		55,000							
Balances	38,000		55,000		25,000		50,000		18,000	
i. Paid dividends	–4,000								–4,000	
Balances, March 31	34,000		55,000		25,000		50,000		14,000	

Statement of Cash Flows

a.	Financing	50,000
b.	Financing	25,000
c.	Operating	28,000
d.	Operating	–3,000
e.	Operating	–2,700
f.	Operating	–4,200
g.	Operating	–100
h.	Investing	–55,000
i.	Financing	–4,000
	Increase in cash	34,000

Income Statement

c.	Fees earned	28,000
d.	Rent expense	–3,000
e.	Auto expense	–1,800
e.	Misc. expense	–900
f.	Salary expense	–4,200
g.	Interest expense	–100
	Net income	18,000

2. Stockholders' equity is the right of stockholders to the assets of the business. These rights are increased by stockholders' investments and revenues and decreased by dividends and expenses.

P2–1, Continued

3.

JORDAN INSURANCE INC.
Income Statement
For the Month Ending March 31, 20Y5

Revenues:		
Fees earned		$28,000
Expenses:		
Salary expense	$4,200	
Rent expense	3,000	
Auto expense	1,800	
Interest expense	100	
Miscellaneous expense	900	
Total expenses		10,000
Net income		$18,000

JORDAN INSURANCE INC.
Retained Earnings Statement
For the Month Ending March 31, 20Y5

Net income	$18,000
Less dividends	4,000
Retained earnings, March 31, 20Y5	$14,000

4.

JORDAN INSURANCE INC.
Balance Sheet
March 31, 20Y5

Assets		
Cash		$34,000
Land		55,000
Total assets		$89,000
Liabilities		
Notes payable		$25,000
Stockholders' Equity		
Capital stock	$50,000	
Retained earnings	14,000	
Total stockholders' equity		64,000
Total liabilities and stockholders' equity		$89,000

P2–1, Concluded

5. **JORDAN INSURANCE INC.**
Statement of Cash Flows
For the Month Ending March 31, 20Y5

Cash flows from operating activities:		
Cash receipts from operating activities	$28,000	
Deduct cash payments for operating activities	(10,000)	
Net cash flows from operating activities		$18,000
Cash flows used for investing activities:		
Cash payment for land		(55,000)
Cash flows from financing activities:		
Cash receipts from issuing capital stock	$50,000	
Cash receipts from issuing note payable	25,000	
Cash payments for dividends	(4,000)	
Net cash flows from financing activities		71,000
Net increase in cash during March		$34,000
Cash as of March 1, 20Y5		0
Cash as of March 31, 20Y5		$34,000

P2–2

1\.

UP-DATE COMPUTER SERVICES
Income Statement
For the Month Ended August 31, 20Y4

Fees earned		$27,000
Operating expenses:		
Salaries expense	$4,600	
Rent expense	2,500	
Automobile expense	1,200	
Miscellaneous expense	700	
Total operating expenses		9,000
Net income		$18,000

2\.

UP-DATE COMPUTER SERVICES
Retained Earnings Statement
For the Month Ended August 31, 20Y4

Net income for August	$18,000
Less dividends	3,000
Retained earnings, August 31, 20Y4	$15,000

3\.

UP-DATE COMPUTER SERVICES
Balance Sheet
August 31, 20Y4

Assets		
Cash		$10,000
Land		40,000
Total assets		$50,000
Liabilities		
Notes payable		$10,000
Stockholders' Equity		
Capital stock	$25,000	
Retained earnings	15,000	
Total stockholders' equity		40,000
Total liabilities and stockholders' equity		$50,000

P2–2, Concluded

4.

UP-DATE COMPUTER SERVICES
Statement of Cash Flows
For the Month Ended August 31, 20Y4

Cash flows from operating activities:		
Cash receipts from operating activities	$27,000	
Deduct cash payments for operating activities	(9,000)	
Net cash flows from operating activities		$18,000
Cash flows used for investing activities:		
Cash payments for land		(40,000)
Cash flows from financing activities:		
Cash receipts from issuing capital stock	$25,000	
Cash receipts from issuing notes payable	10,000	
Cash payments for dividends	(3,000)	
Net cash flows from financing activities		32,000
Net increase in cash during August		$10,000
Cash as of August 1, 20Y4		0
Cash as of August 31, 20Y4		$10,000

P2–3

1. **HARGROVE SERVICES, INC.**
Income Statement
For the Year Ending May 31, 20Y7

Revenues:		
Fees earned		$300,000
Expenses:		
Salaries expense	$ 87,000	
Utilities expense	40,000	
Rent expense	28,000	
Taxes expense	22,000	
Interest expense	2,000	
Miscellaneous expense	8,000	
Total expenses		187,000
Net income		$113,000

2. **HARGROVE SERVICES, INC.**
Retained Earnings Statement
For the Year Ending May 31, 20Y7

Net income	$113,000
Less dividends	13,000
Retained earnings, May 31, 20Y7	$100,000

P2–3, Concluded

3. **HARGROVE SERVICES, INC.**
Balance Sheet
May 31, 20Y7

Assets		
Cash		$ 62,000
Land		98,000
Total assets		$160,000
Liabilities		
Notes payable		$ 30,000
Stockholders' Equity		
Capital stock	$ 30,000	
Retained earnings	100,000	
Total stockholders' equity		130,000
Total liabilities and stockholders' equity		$160,000

4. **HARGROVE SERVICES, INC.**
Statement of Cash Flows
For the Year Ending May 31, 20Y7

Cash flows from operating activities:		
Cash receipts from operating activities	$300,000	
Deduct cash payments for operating activities	(187,000)	
Net cash flows from operating activities		$113,000
Cash flows used for investing activities:		
Cash payments for land		(98,000)
Cash flows from financing activities:		
Cash receipts from issuing capital stock	$ 30,000	
Cash receipts from issuing notes payable	30,000	
Cash payments for dividends	(13,000)	
Net cash flows from financing activities		47,000
Net increase in cash during the year		$ 62,000
Cash as of June 1, 20Y6		0
Cash as of May 31, 20Y7		$ 62,000

P2–4

1.

HARGROVE SERVICES, INC.
Income Statement
For the Year Ending May 31, 20Y8

Revenues:		
Fees earned		$515,000
Expenses:		
Salaries expense	$155,000	
Utilities expense	52,000	
Rent expense	36,000	
Taxes expense	28,000	
Interest expense	3,000	
Miscellaneous expense	11,000	
Total expenses		285,000
Net income		$230,000

2.

HARGROVE SERVICES, INC.
Retained Earnings Statement
For the Year Ending May 31, 20Y8

Retained earnings, June 1, 20Y7		$100,000
Net income	$230,000	
Less dividends	40,000	
Increase in retained earnings		190,000
Retained earnings, May 31, 20Y8		$290,000

P2–4, Concluded

3.

HARGROVE SERVICES, INC.
Balance Sheet
May 31, 20Y8

Assets		
Cash		$145,000
Land		240,000
Total assets		$385,000
Liabilities		
Notes payable		$ 40,000
Stockholders' Equity		
Capital stock	$ 55,000	
Retained earnings	290,000	
Total stockholders' equity		345,000
Total liabilities and stockholders' equity		$385,000

4.

HARGROVE SERVICES, INC.
Statement of Cash Flows
For the Year Ending May 31, 20Y8

Cash flows from operating activities:		
Cash receipts from operating activities	$515,000	
Deduct cash payments for operating activities	(285,000)	
Net cash flows from operating activities		$ 230,000
Cash flows used for investing activities:		
Cash payment for land		(142,000)
Cash flows from financing activities:		
Cash receipts from issuing capital stock	$ 25,000	
Cash receipts from issuing notes payable	10,000	
Cash payments for dividends	(40,000)	
Net cash flows used for financing activities		(5,000)
Net increase in cash during the year		$ 83,000
Cash as of June 1, 20Y7		62,000
Cash as of May 31, 20Y8		$ 145,000

P2–5

a. **$125,000 (net income for December of $57,500 plus total operating expenses of $67,500; also, the amount of cash received from customers on the statement of cash flows.)**

b. **$10,620 ($67,500 – $33,120 – $18,000 – $1,800 – $3,960)**

c. **$57,500 ($125,000 – $67,500); also, see the net income for December on the retained earnings statement.**

d. **$0 (There is no beginning retained earnings, since December was the first month of operation.)**

e. **$12,000 (See the cash dividends on the statement of cash flows.)**

f. **$45,500 ($57,500 – $12,000)**

g. **$45,500 ($0 + $45,500)**

h. **$50,500 ($225,500 – $175,000)**

i. **$75,000 (See the cash received from capital stock on the statement of cash flows.)**

j. **$45,500 [the same as (g)].**

k. **$120,500 ($75,000 + $45,500) or (i + j)**

l. **$225,500 ($105,000 + $120,500); also the same as total assets.**

m. **$57,500 ($125,000 – $67,500)**

n. **$105,000 (See notes payable on the balance sheet.)**

o. **$180,000 ($75,000 + $105,000)**

p. **$168,000 ($180,000 – $12,000)**

q. **$50,500 ($57,500 – $175,000 + $168,000)**

r. **$0 (December was the first month of operation.)**

s. **$50,500 [the same as (h)].**

P2–6

1. All financial statements should contain the name of the business in their heading. The retained earnings statement is incorrectly headed as “Angela Griffin” rather than Alpine Realty, Inc. The heading of the balance sheet needs the name of the business.

2. The income statement, retained earnings statement, and statement of cash flows cover a period of time and should be labeled “For the Month Ended July 31, 20Y8.”

3. The year in the heading for the retained earnings statement should be 20Y8 rather than 20Y7.

4. The balance sheet should be labeled as of “July 31, 20Y8,” rather than “For the Month Ended July 31, 20Y7.”

5. In the income statement, the dividends should not be listed as an operating expense but should be included in the retained earnings statement.

6. In the income statement, the total operating expenses are incorrectly subtracted from the sales commissions, resulting in an incorrect net income amount. This also affects the retained earnings statement and the amount of retained earnings that appears on the balance sheet.

7. In the retained earnings statement, the net income should be presented, followed by the amount of dividends, which is subtracted from the net income to yield retained earnings as of July 31, 20Y8.

8. Notes payable should be listed as a liability on the balance sheet.

9. Land should be listed as an asset on the balance sheet.

10. The balance sheet assets should equal the sum of the liabilities and stockholders’ equity.

11. The cash payments for operating expenses have been omitted from the operating activities section of the statement of cash flows.

12. The cash flows from financing activities should not include retained earnings. In addition, the financing activities section should include cash received from issuance of capital stock and from the issuance of notes payable. Also, the cash paid for dividends should be included as a deduction to arrive at net cash flows from financing activities.

P2–6, Continued

13. Since this is Alpine Realty's first month of operation, the increase in cash for July should equal $32,000, the cash balance as of July 31, 20Y8.

Corrected financial statements appear as follows:

ALPINE REALTY, INC.
Income Statement
For the Month Ended July 31, 20Y8

Sales commissions		$60,000
Expenses:		
Office salaries expense	$20,000	
Rent expense	6,000	
Automobile expense	3,500	
Miscellaneous expense	1,500	
Total operating expenses		31,000
Net income		$29,000

ALPINE REALTY, INC.
Retained Earnings Statement
For the Month Ended July 31, 20Y8

Net income for July	$29,000
Less dividends during July	2,000
Retained earnings, July 31, 20Y8	$27,000

P2–6, Concluded

ALPINE REALTY, INC.
Balance Sheet
July 31, 20Y8

Assets		
Cash		$32,000
Land		30,000
Total assets		$62,000
Liabilities		
Notes payable		$20,000
Stockholders' Equity		
Capital stock	$15,000	
Retained earnings	27,000	
Total stockholders' equity		42,000
Total liabilities and stockholders' equity		$62,000

ALPINE REALTY, INC.
Statement of Cash Flows
For the Month Ended July 31, 20Y8

Cash flows from operating activities:		
Cash receipts from sales commissions	$ 60,000	
Deduct cash payments for operating expenses	(31,000)	
Net cash flows from operating activities		$ 29,000
Cash flows used for investing activities:		
Cash payments for land		(30,000)
Cash flows from financing activities:		
Cash receipts from issuance of capital stock	$ 15,000	
Cash receipts from issuing notes payable	20,000	
Cash payments for dividends	(2,000)	
Net cash from financing activities		33,000
Net increase in cash during July		$ 32,000
Cash as of July 1, 20Y8		0
Cash as of July 31, 20Y8		$ 32,000

FINANCIAL ANALYSIS

FA2–1

1.

	Year 2	Year 1
Sales	100.0%	100.0%
Cost of sales	(73.0)	(71.7)
Gross profit	27.0	28.3
Operating expenses	(24.4)	(25.5)
Operating income	2.6	2.8
Other income (expense):		
Interest expense	(0.6)	(0.7)
Tax expense	(0.8)	(0.7)
Other income	0.0	0.0
Net income	1.2	1.4

2. Safeway's financial performance declined slightly in Year 2. Cost of sales as a percent of sales increased 1.3% from 71.7% to 73.0%. This had the effect of decreasing gross profit as a percent of sales by the same amount (1.3%). The decrease in operating expense of 1.1% (25.5% – 24.4%) offset the increase in cost of sales so that operating income decreased by only 0.2% (2.8% – 2.6%). The other income and expense did not change significantly. Further investigation should be done as to what cost of sales increased in Year 2. The increase may be due to increasing cost of merchandise in which case Safeway might consider being more aggressive in passing on cost increases to customers through prices increases.

FA2–2

In Year 1, operating income and net income were comparable for Safeway and Kroger. For example, Safeway had operating income of 2.8% of sales compared to Kroger's 2.7%. Likewise, Safeway had net income of 1.4% of sales compared to Kroger's 1.3%. However, Safeway's cost of sales and operating expenses as a percent of sales differ significantly. Safeway's cost of sales as a percent of sales of 71.7% in Year 1 and 73.0% in Year 2 are significantly less than Kroger's 77.8% in Year 1 and 79.1% in Year 2. However, Safeway's operating expenses of 25.5% in Year 1 and 24.4% in Year 2 are significantly more than Kroger's 19.6% in Year 1 and 19.5% in Year 2. These results should be investigated and provide opportunities for both companies to improve their operations. For example, Kroger should explore why its cost of sales are higher than Safeway's cost of sales, and Safeway should explore why its operating expenses are higher than Kroger's operating expenses. The other income and expense results are relatively insignificant and comparable.

FA2–3

1.

	Year 2	Year 1
Sales	100.0%	100.0%
Cost of sales	(58.7)	(57.3)
Gross profit	41.3	42.7
Operating expenses	(26.3)	(26.6)
Operating income	15.0	16.1

2. As a percent of sales, Kellogg's operating income decreased from 16.1% in Year 1 to 15.0% in Year 2. In Year 2, operating expenses as a percent of sales decreased by 0.3 percent from 26.6 in Year 1 to 26.3. The primary cause of the decrease in operating income in Year 2 was the increase of 1.4% in the cost of sales from 57.3% in Year 1 to 58.7% in Year 2. This increase should be investigated as to its cause, and it should be determined whether the increase should be passed on to customers.

FA2–4

1.

	Year 2	Year 1
Sales	100.0%	100.0%
Cost of sales	(63.7)	(60.0)
Gross profit	36.3	40.0
Operating expenses	(20.9)	(21.4)
Operating income	15.4	18.6

2. As a percent of sales, General Mill's operating income decreased from 18.6% in Year 1 to 15.4% in Year 2. In Year 2, operating expenses as a percent of sales decreased by 0.5 percent from 21.4 in Year 1 to 20.9. The primary cause of the decrease in operating income in Year 2 was the increase of 3.7% in the cost of sales from 60.0% in Year 1 to 63.7% in Year 2. This increase should be investigated as to its cause, and it should be determined whether the increase should be passed on to customers.

FA2–5

In Year 2, operating income as a percent of sales is comparable for Kellogg (15.0%) and General Mills (15.4%). The primary differences between the two companies involve operating expenses and cost of sales. Operating expenses as a percent of sales for Kellogg are 26.3%, which is 5.4% higher than the 20.9% of General Mills. In contrast, cost of sales as a percent of sales for Kellogg is 58.7%, which is 5.0% lower than the 63.7% of General Mills. The net of these effects is that General Mills has a slightly higher operating profit as a percent of sales than Kellogg.

These results provide opportunities for both companies to improve their operations. For example, Kellogg should explore why its operating expenses are higher than General Mills, and General Mills should explore why its cost of sales is higher than Kellogg's.

Note: **Comparison of Year 1 common-sized income statements provide similar conclusions.**

FA2–6

1.

	Year 2	Year 1
Current assets:		
Cash	4.2%	6.3%
Accounts receivable	4.0	3.6
Inventories	21.8	21.1
Prepaid and other assets	1.2	1.4
Total current assets	31.2	32.4
Fixed assets:		
Property, plant, and equipment	61.6	60.2
Intangibles	4.9	4.9
Other assets	2.3	2.5
Total fixed assets	68.8	67.6
Total assets	100.0%	100.0%
Current liabilities:		
Accounts payable	18.4%	18.0%
Salaries and wages payable	4.5	3.8
Debt due within one year	5.6	2.5
Other liabilities	10.2	10.1
Total current liabilities	38.8	34.3
Long-term liabilities:		
Debt and other financing obligations	29.2	31.1
Other liabilities	15.1	12.0
Total long-term liabilities	44.3	43.1
Total liabilities	83.1	77.4
Stockholders' Equity		
Capital stock	18.7	18.5
Retained earnings	32.9	32.7
Other equity items	(34.7)	(28.6)
Total stockholders' equity	16.9	22.6
Total liabilities and stockholders' equity	100.0%	100.0%

2. A comparison of assets for Years 1 and 2 does not indicate any significant change in the mix of assets. Current assets have decreased 1.2% as a percent of total assets while fixed assets have increased by the same amount. A comparison of liabilities for Years 1 and 2 indicates an increase in both current and long-term liabilities as a percent of total liabilities plus stockholders' equity. As a result, total liabilities have increased 5.7% of total liabilities plus stockholders' equity. A corresponding decrease of 5.7% occurred in stockholders' equity. This decrease in stockholders' equity was caused primarily by other equity items, which includes the purchase of a company's stock by itself. Such stock is called Treasury Stock and is often purchased when a company feels its shares of stock are undervalued. Overall, Kroger appears to have a strong balance sheet with no major areas of concern.

CASES

Case 2–1

1. **From our discussions in Chapter 1, the two possible business emphases that could be used are low-cost emphasis and premium-price emphasis.**

2. **Real-world examples of each emphasis are as follows:**

   Low-cost emphasis: Ann Taylor, SteinMart, Walmart, Kmart, Costco
   Premium-price emphasis: GAP, The Limited, Talbots

3. **The answers will vary among the student groups. Normally, venture capital firms demand a large percentage of ownership, which may be the majority (over 50%) ownership.**

Case 2–2

Dr. Turner's comment is not correct. The difference in the cash balance of \$55,000 (\$100,000 – \$45,000) represents the net result of operating, investing, and financing cash activities. To determine the profit, the effects of Dr. Turner's investing and financing activities would also need to be considered. For example, Dr. Turner might have invested in buildings, land, computer equipment, or software programs that would be classified as investing activities. Also, Dr. Turner may have borrowed cash from a bank or withdrawn cash from SickCo as dividends.

Case 2–3

	Year 1	Year 2	Year 3
Net cash flows from operating activities	negative	positive	positive
Net cash flows from investing activities	negative	negative	negative
Net cash flows from financing activities	positive	positive	positive

Start-up companies normally experience negative cash flows from operating and investing activities. Also, start-up companies normally have positive cash flows from financing activities from raising capital.

Case 2–4

Note to Instructors: **The objective of this case is to familiarize students with financial reporting resources available on the Internet. The following solution is based upon the Apple Inc. data as of June 19, 2013, from Yahoo.com's finance Web site.**

1. **$423.00 (See opening page for AAPL)**

2. **$385.10 to $705.07 (See opening page for AAPL)**

3. **September 21, 2012, at a price of $705.07 (See Key Statistics)**

4. **126,116 shares (net) were sold and purchased in the last 6 months ending June 19, 2013. (See Insider Transactions)**

5. **Timothy D. Cook; he is 52 years old. (See Profile)**

6. **$4,170,000 (See Profile)**

7. **$12.20 (See Key Statistics)**

8. **Strong Buy = 19**
   Buy = 23
   Hold = 13
   Sell = 1
   Strong Sell = 1

   Average broker recommendation is 2.0 (See Analyst Opinion)

9. **$50,856,000,000 (See Financials: Cash Flows)**

10. **30.92% (See Key Statistics)**

Case 2–5

Note to Instructors: **The purpose of this case is to make students aware of alternative sources of information useful for investment decisions.**

1. **Although some may disagree, most would characterize the article as unfavorable concerning Apple's prospects for the future.**

2. **No. It would be unwise to sell Apple Inc. stock based only upon this article. Other information would include analysts' recommendations and Apple Inc.'s published financial statements.**

3. **No. Other sources of information should also be obtained, such as analysts' recommendations, current newspaper articles concerning the company, and statements by the company's management.**

4. **Analysts use a variety of sources of information in making investment decisions and recommendations. In addition to published financial statements, analysts rely upon statements and interviews with management, economy-wide data, industry trends, consumer trends, newspaper articles, etc.**