CHAPTER 2

DISCUSSION QUESTIONS

1. Investors, creditors, and other external users need to know a company's financial status. For example, what assets do the company own? Are the assets still productive? How hard would it be to sell the assets, if needed? Also, what debts must be paid? Are the owners' interests in the business increasing or decreasing and why? External users also need information on the profitability of the company. Is the company making or losing money? In addition, external users need to know what the total inflows and outflows of cash are—those from operations as well as those from investing and financing activities. This information is provided in the primary financial statements consisting of a balance sheet, a statement of comprehensive income, and a statement of cash flows.

2. a. A balance sheet shows a company's financial status (the relationships among assets, liabilities, and equity) at a particular date.
   b. A statement of comprehensive income shows the results of an entity's operations during a period of time.
   c. A statement of cash flows shows the major inflows and outflows of cash during a period of time.

3. The answer might seem obvious to you, but you would be surprised at how often people get so caught up in dreaming of the "guaranteed" return that they forget to research the company's financial situation before investing.

   Would you buy a home on your friends' advice without seeing the home yourself? No, you would view the home and most likely hire an inspector to check it for problems before deciding if it would be a good investment. Just as you would inspect a home before investing, so should you inspect the company by, among other things, reviewing the financial statements.

   By researching the past and current financial statements of the company, you can determine (1) if past and present stock performances are indicative of the projected 150% return; (2) if the company has a history of positive or negative cash flows; (3) if sales have been steadily increasing or decreasing over time; and (4) if the company historically has had net earnings or losses.

   These are but a few of the many reasons why it is important to do the research yourself before immediately jumping into an investment just on your friends' advice.

4. Readers of annual reports need to compare the financial status and results of operations of a company with other companies and with the same company's results for previous periods. In this way, users can judge the relative progress of a company toward its goals. Statements covering more than one accounting period and those statements that classify and highlight key relationships assist in this comparative analysis.

5. There are three ways that economic resources can be brought into a business: borrowing from others, owner contributions, and earnings. The first is a liability, whereas the latter two are included in the equity section. Together these two balance sheet sections (liabilities and equity) inform readers of the "sources" of assets.

6. Equity is a residual value showing the amount of net assets (assets minus liabilities) that are claimed by the owners of the business. If a business were to sell all its assets, then pay all its creditors, the remaining amount would go to the owners. The amount of equity reported on a balance sheet generally will not be equal to the current worth of a business since the assets generally are reported at their historical costs, not at their current values. The amount of equity is represented by all assets (after deducting liabilities), not just cash.

7. The balance sheet has two main limitations. First, assets are initially recorded at their purchase cost and subsequent changes in value may or may not be recorded on the books. The second limitation is that some important economic assets, called intangible assets, are not reported at all, although they may be the most valuable assets of the company.

   It is important to be aware of these limitations when evaluating a company's growth potential because the company may be worth much more (or less) than its book value shows.

8. Some people feel that the statement of comprehensive income is more important than the balance sheet because it shows the profitability of a company. In turn, profitability relates to future cash-generating ability, which is of prime interest to most users of financial reports. Others feel that the balance sheet is more important than the statement of comprehensive income because cash flow is eventually translated into the asset and equity balances reported on the balance sheet. Properly informed people realize that all three primary financial statements are equally important and complementary.

9. By looking only at the net income or EPS number, an investor might not see the important relationships of various categories on a statement of comprehensive income. For example, revenues less operating expenses equal operating income. If an unusual gain or loss on some non-operating item is added to or subtracted from operating income, net income and the EPS number may be distorted and would not reflect the results of normal operations for the period.

10. Cash flows should be classified according to operating, investing, and financing activities in order to help investors and others see the sources and uses of cash by major activity. For example, if a company is not providing net cash inflow from operations and instead has to borrow cash to keep the business running, it may not stay in business long. Thus, the amount of net cash provided from operations is a key figure that should be highlighted.

11. When financial statements are prepared in accordance with generally accepted accounting principles (GAAP), certain guidelines or rules have been followed in measuring and reporting the yearly financial activities. In expressing an opinion, an auditor

attests and affirms that the guidelines followed are commonly accepted by the accounting profession. Thus, the auditor's opinion gives assurance that the results of operations have not been distorted because a firm uses different or incorrect accounting principles and procedures. The auditor's opinion also gives some assurance that management's financial statements fairly represent what actually occurred during the year. Without such assurances, misleading or ill-prepared financial statements could cause substantial losses to unwary investors.

12. Auditors cannot assure that the financial statements are accurate, because their examination is not based on a test of every item and every transaction. Time and fee constraints require that an audit be based on a sample of items. Auditors review a sufficient sample of evidential material to form a professional opinion, but accuracy is still the responsibility of the preparer of the statements—management. The auditor's function is to express an opinion about the financial statements.

13. The four types of financial statement notes typically included in an annual report are (1) summary of significant accounting policies, (2) additional information about summary totals, (3) disclosure of information not recognized, and (4) supplementary information.

14. The importance of the basic accounting concepts or assumptions is as follows:

a. The separate entity concept identifies the particular organizational unit for which accounting data are compiled. The entity is the focal point for accumulating, measuring, and communicating accounting data.

b. Arm's-length transactions are those in which the buyer and seller are rational and free to act independently. Accounting for and analyzing economic transactions enable the accountant to measure the successes and failures of a reporting entity. If transactions between entities involve any favoritism or irregularity, the data measured by the accountant will lose validity; that is, the data will not accurately measure the success of the reporting entity.

c. The cost principle requires transactions to be recorded at historical costs, the amounts originally paid in an arm's-length transaction. This ensures that accounting data are objective, since the exchange price (historical cost) at the date of the transaction is presumed to reflect the fair market value of an item at that date.

d. Monetary measurement provides a quantitative means of measuring transactions and comparing the results of operations for various reporting entities.

e. The going concern assumption states that unless there is evidence to the contrary, the entity will continue in operation for the foreseeable future. If the opposite assumption were made—that the entity was about to go out of business—accountants would record liquidation values on the books of the entity.

f. The time-period assumption is to report the results of business activity over a standard time period, which is usually monthly, quarterly, or annually. With the time-period assumption, financial statements can be periodically prepared by a company thereby users of financial statements can be informed of the performance of the company.

PRACTICE EXERCISES

PE 2–1 (LO1) Total Assets

Computation of total assets:

Cash	$ 2,800
Accounts receivable	6,000
Inventory	9,000
Equipment	30,000
Total assets	$47,800

PE 2–2 (LO1) Total Liabilities

Computation of total liabilities:

Accounts payable	$ 3,600
Wages payable	1,800
Loan payable	26,000
Total liabilities	$31,400

PE 2–3 (LO1) Total Equity

Computation of total equity:

Capital stock	$5,600
Retained earnings	10,800
Total equity	$16,400

Refer to the solutions for PE 2–1, 2–2, and 2–3. To confirm the accuracy of the solutions, we can verify assets are equal to liabilities plus equity:

Total assets	$47,800
Total liabilities	$31,400
Total equity	16,400
Total liabilities and equity	$47,800

PE 2–4 (LO1) The Accounting Equation

Case A $10,000 – $4,000 = $6,000 Equity

Case B $8,000 – $3,500 = $4,500 Liabilities

Case C $5,500 + $7,000 = $12,500 Assets

Case D $13,000 – $15,000 = ($2,000) Equity
Note that in this case, total equity is negative because liabilities are greater than assets.

PE 2–5 (LO1) Balance Sheet

Assets	
Cash	$ 2,800
Accounts receivable	6,000
Supplies	9,000
Equipment	30,000
Total assets	$47,800
Liabilities	
Accounts payable	$ 3,600
Wages payable	1,800
Loan payable	26,000
Total liabilities	$31,400
Equity	
Capital stock	$ 5,600
Retained earnings	10,800
Total equity	$16,400
Total liabilities and equity	$47,800

PE 2–6 (LO1) Current Assets

Computation of total current assets:

Cash	$ 950
Accounts receivable	1,400
Supplies	3,300
Total current assets	$5,650

PE 2–7 (LO1) Current Liabilities

Computation of total current liabilities:

Accounts payable	$700
Loan payable (due in 6 months)	250
Total current assets	$950

For simplicity, the entire $10,000 amount of the mortgage payable is assumed to be a long-term liability. However, if monthly payments are to be made on the mortgage during the next year, some part of the liability is current. This portion might be labeled as "current portion of mortgage payable."

PE 2–8 (LO1) Book Value and Market Value of Equity

1. Book value of equity:

	Assets	=	Liabilities	+	Equity
Case A	$ 10,000		$ 4,000		$ 6,000
Case B	8,000		7,000		1,000
Case C	13,500		5,500		8,000
Case D	100,000		150,000		(50,000)

2. Market value of equity:

	Shares of Stock Outstanding	×	Price per Share	=	Market Value
Case A	1,000		$15		$15,000
Case B	500		10		5,000
Case C	300		20		6,000
Case D	1,000		7		7,000

Cases A and B illustrate the normal case in which the accounting book value understates the actual value of the company. In Case C, the market value is actually less than the book value; this can occur when a company makes unwise investment and operating decisions after the owners have invested their money. Case D illustrates that a company can have positive market value even when the book value of equity is negative. Surprisingly, about 5% of publicly traded U.S. companies have negative equity book values.

PE 2–9 (LO2) Total Revenues

Computation of total revenues:

Consulting revenue	$36,600
Interest revenue	1,400
Total revenues	$38,000

PE 2–10 (LO2) Total Expenses

Computation of total expenses:

Advertising expense	$ 5,300
Wages expense	29,200
Total expenses	$34,500

Chapter 2

PE 2–11 (LO2) Computation of Net Income

Computation of net income (or net loss):

	Case A	Case B	Case C	Case D
Services revenue	$100,000	$150,000	$70,000	$ 200,000
Rent revenue	5,000	1,000	12,000	10,000
Wages expense	(60,000)	(30,000)	(60,000)	(110,000)
Interest expense	(18,000)	(47,000)	(25,000)	(31,000)
Net income (loss)	$ 27,000	$ 74,000	$ (3,000)	$ 69,000

PE 2–12 (LO2) Statement of Comprehensive Income

Statement of comprehensive income:

Services revenue		$4,700
Expenses:		
Wage expense	$ 900	
Interest expense	1,200	
Income tax expense	800	
Total expenses		2,900
Net income		$ 1,800
Other comprehensive income		0
Comprehensive income		$1,800

PE 2–13 (LO3) Computation of Ending Retained Earnings

Computation of ending retained earnings:

	Case A	Case B	Case C	Case D
Beginning retained earnings	$50,000	$15,000	$31,000	$70,000
Net income (loss)	5,000	1,000	12,000	(10,000)
	$55,000	$16,000	$43,000	$60,000
Less: Dividends	3,000	4,500	2,100	6,000
Ending retained earnings	$52,000	$11,500	$40,900	$54,000

PE 2–14 (LO1, LO3) Missing Amounts in Financial Statements

Renald Company $34,000 – $16,000 – $9,500 = $8,500 Capital stock

Jim's Retail Shop $14,500 – $5,300 – $3,100 = $6,100 Liabilities

Shakira Company $22,000 + $13,000 + $29,000 = $64,000 Assets

Oliver Company $80,000 – $57,000 – $28,000 = ($5,000) Retained earnings

Note that for Oliver company, retained earnings is negative indicati that either the company has reported a cumulative loss over its histo or cumulative dividends have exceeded cumulative income.

PE 2–15 (LO4) Computing Cash from Operating Activities

Computation of cash flow from operating activities:

Cash collected from customers	$10,000
Cash received from tenants renting part of a building	600
Cash paid for interest	(450)
Cash paid for income taxes	(1,320)
Cash flow from operating activities	$ 8,830

Note:IAS7 permits there are alternative classifications in statement of cash flows for the interest/dividends payments/receipts, which is shown below. IAS7 states that companies can choose from the alternative classifications but need to apply consistently across periods for comparativeness. For more details, please refer to Ch.13.

	Operating activities	Investing activities	Financing activities
Interest payment	V		V
Interest receipt	V	V	
Dividends payment	V		V
Dividends receipt	V	V	

PE 2–16 (LO4) Computing Cash from Investing Activities

Computation of cash flow from investing activities:

Cash received from sale of a building	$ 5,600
Cash paid to purchase land	(12,000)
Cash flow used by investing activities	$ (6,400)

PE 2–17 (LO4) Computing Cash from Financing Activities

Computation of cash flow from financing activities:

Cash paid to repay a loan	$(1,000)
Cash paid for dividends	(780)
Cash received upon the issuance of new shares of stock	3,000
Cash flow from financing activities	$ 1,220

PE 2–18 (LO4) Preparing a Statement of Cash Flows

Statement of Cash Flows

OPERATING ACTIVITIES:		
Cash collected from customers	$10,000	
Cash received from tenants renting part of a building	600	
Cash paid for interest	(450)	
Cash paid for income taxes	(1,320)	
Cash flow from operating activities		$ 8,830
INVESTING ACTIVITIES:		
Cash received from sale of a building	$ 5,600	
Cash paid to purchase land	(12,000)	
Cash flow used by investing activities		(6,400)
FINANCING ACTIVITIES:		
Cash paid to repay a loan	$ (1,000)	
Cash paid for dividends	(780)	
Cash received upon the issuance of new shares of stock	3,000	
Cash flow from financing activities		1,220
Net increase in cash		$ 3,650
Cash balance, beginning of year		2,000
Cash balance, end of year		$ 5,650

PE 2–19 (LO4) Financial Statement Articulation

	Case A	Case B	Case C	Case D
Cash, beginning	$ 9,000	$35,000[C]	$ 6,700	$41,000
Net increase (decrease) in cash	5,800	11,000	(4,200)[E]	(9,200)
Cash, ending	$14,800[B]	$46,000	$ 2,500	$31,800[H]

	Case A	Case B	Case C	Case D
Beginning retained earnings	$37,000	$ (1,800)[D]	$17,000	$43,000
Net income (loss)	21,000	34,000	(3,200)[F]	(19,000)
	$58,000	$32,200	$13,800	$24,000
Less: Dividends	4,500	9,200	1,300	6,000[G]
Ending retained earnings	$53,500[A]	$23,000	$12,500	$18,000

EXERCISES

E 2–1 (LO1) Classification of Financial Statement Elements

1. L	7. A	13. L
2. A	8. E	14. A
3. SCI	9. SCI	15. SCI
4. A	10. A	16. E
5. A	11. A	17. SCI
6. SCI	12. L	

E 2–2 (LO1) Accounting Equation

	Johnson Company	Best Company	Coury Company
Cash	$11,500	$ 5,800	$17,000
Accounts receivable	5,500	11,000	11,750
Land and buildings	48,500	*20,200*	41,000
Accounts payable	*6,000*	3,500	16,000
Mortgage payable	37,500	19,000	32,250
Equity	22,000	14,500	*21,500*

E 2–3 (LO1) Analyze the effect of transactions on assets, liabilities, and equity.

1.	(c)	5.	(d)
2.	(d)	6.	(b)
3.	(a)	7.	(e)
4.	(b)	8.	(f)

E 2–4 (LO1, LO2) Comprehensive Accounting Equation

	Davis Company	Conaton Company	Seipke Company
Assets: January 1, 2017	$360	*$1,080*	$230
Liabilities: January 1, 2017	280	460	*80*
Equity: January 1, 2017	*80*	620	150
Assets: December 31, 2017	380	*1,240*	310
Liabilities: December 31, 2017	*320*	520	90
Equity: December 31, 2017	*60*	720	*220*
Revenues in 2017	80	*216*	400
Expenses in 2017	100	116	*330*

E 2–5 (LO1, LO2) Computing Elements of Equity

1.

Total assets at December 31 ($220,000 + $25,000)	$245,000
Less liabilities at December 31	85,000
Equity at December 31	$160,000
Less capital stock at December 31 ($70,000 + $20,000)	90,000
Retained earnings at December 31	$ 70,000

2.

Beginning retained earnings balance	$60,000	
Add net income for period	X	
Less dividends for period	(9,000)	
Ending retained earnings balance	$70,000	(see item 1)

Therefore:

$$\$60{,}000 + X - \$9{,}000 = \$70{,}000$$
$$X = \$19{,}000 = \text{Net Income}$$

Net Income = Revenues – Expenses

$$\$19{,}000 = X - \$55{,}000$$
$$X = \$74{,}000 = \text{Revenues}$$

E 2–6 (LO1, LO2) Balance Sheet Relationships

Canfield Corporation
Balance Sheet
December 31, 2017

Assets		Liabilities	
Cash	$ 55,000	Accounts payable	$ 65,000
Accounts receivable	75,000	Mortgage payable	150,000
Interest receivable	20,000		
Equipment	85,000	Equity	
Buildings	325,000	Capital stock	200,000
		Retained earnings	145,000
Total assets	$560,000	Total liabilities and equity	$560,000

Note: Sales revenue, rent expense, and utilities expense are not part of the balance sheet, but instead are components of the statement of comprehensive income.

E 2–7 (LO1, LO2) Balance Sheet Preparation

Taylorsville Construction Company
Balance Sheet
December 31, 2017

Assets		
Current assets:		
Cash	$153,600	
Accounts receivable	113,500	
Supplies	4,250	
Total current assets		$271,350
Long-term assets:		
Land	$ 90,000	
Buildings	512,000	
Total long-term assets		602,000
Total assets		$873,350
Liabilities and Equity		
Liabilities:		
Accounts payable	$ 74,300	
Mortgage payable	423,400	
Total liabilities		$497,700
Equity		375,650*
Total liabilities and equity		$873,350

**Computation of Equity:*

Equity, January 1, 2017	$314,300
Add net income for 2017	109,450
	$423,750
Less distributions to owners during 2017	48,100
Equity, December 31, 2017	$375,650

E 2–8(LO1) Correcting an Incorrectly Prepared Balance Sheet

Westhood Company
Balance Sheet
December 31, 2017

Assets	
Cash	$ 14,000
Accounts receivable	8,500
Supplies	8,000
Equipment	48,000

Total assets		$78,500

Equity and Liabilities

Equity		
Share capital—ordinary	$50,000	
Retained earnings (€17,500 – €5,000)	12,500	$62,500
Liabilities		
Accounts payable		16,000
Total equity and liabilities		$78,500

E 2–9 (LO2) **Statement of Comprehensive Income Computations**

1.

Revenues		$335,000
Expenses:		
Supplies expense	$ 95,000	
Salaries expense	120,000	
Rent expense	10,000	
Administrative expense	16,000	241,000
Income before income taxes		$ 94,000

2.

Income before income taxes	$ 94,000
Income tax rate	× 30%
Income taxes	$ 28,200

3.

Income before income taxes	$ 94,000
Income taxes	28,200
Net income	$ 65,800

4.

Earnings per share ($65,800/25,000 shares)	$ 2.63

5. Because this example assumes no other comprehensive income. Hence, net income equals comprehensive income.

E 2–10 (LO2) **Statement of Comprehensive Income Preparation**

1.

Pickard and Associates
Statement of Comprehensive Income
For the Year Ended December 31, 2017

Fees (revenues)		$476,000
Expenses:		
Advertising expense	$14,500	
Supplies expense	31,500	
Rent expense	12,000	
Utilities expense	2,500	
Miscellaneous expense	5,100	
Salaries expense	78,000	143,600
Income before income taxes		$332,400
Income taxes (30%)		99,720
Net income		$ 232,680
Other comprehensive income		0
Comprehensive income		$232,680
Earnings per share ($232,680/11,000 shares)		$ 21.15

2. EPS tells the reader that for every individual share of stock outstanding, Pickard and Associates earned $21.15 during 2017. This helps investors see how profitable their individual investments in Pickard and Associates are.

E 2–11 (LO3) Income and Retained Earnings Relationships

1.	Increase in retained earnings	$750,000
	Plus dividends paid	270,000
	Net income	$1,020,000
2.	Revenues	$1,660,000
	Less net income	1,020,000
	Expenses for the year	$640,000

E 2–12 (LO3) Retained Earnings Computations

Retained earnings, December 31, 2016 = $170,000
Retained earnings, December 31, 2017 = $250,000

Computations:

Revenues in 2017	$ 520,000
Expenses in 2017	(390,000)
Net income in 2017	$ 130,000
Assets: December 31, 2016	$ 700,000
Liabilities: December 31, 2016	(210,000)
Equity: December 31, 2016	$ 490,000
Equity: December 31, 2016	$ 490,000
Capital stock: December 31, 2016	(320,000)
Retained earnings: December 31, 2016	$ 170,000
Retained earnings: December 31, 2016	$ 170,000
Add net income for 2017	130,000
Deduct dividends for 2017	(50,000)
Retained earnings: December 31, 2017	$ 250,000

E 2–13 (LO2, LO3) Preparation of Statement of Comprehensive Income and Statement of Retained Earnings

Big Sky Corporation
Statement of Comprehensive Income
For the Year Ended June 30, 2017

Ski rental revenue		$77,900
Expenses:		
Rent expense	$ 6,000	
Salaries expense	38,600	
Utilities expense	2,400	
Advertising expense	7,500	
Miscellaneous expense	7,700	62,200
Income before income taxes		$15,700
Income taxes		2,100
Net income		$13,600
Other comprehensive income		0
Comprehensive income		$13,600
Earnings per share ($13,600/1,500 shares)		$ 9.07 (rounded)

Big Sky Corporation
Statement of Retained Earnings
For the Year Ended June 30, 2017

Retained earnings, July 1, 2016	$76,800
Add net income for the year	13,600
	$90,400
Less dividends	6,500
Retained earnings, June 30, 2017	$83,900

E 2–14 (LO3) Articulation: Relationships between a Balance Sheet and a Statement of Comprehensive Income

1. Assets (increased $64,000) = Liabilities (increased $16,000) + Equity (increased $48,000). If equity increased by $48,000 and dividends of $12,100 were paid, net income must have been $48,000 + $12,100, or $60,100.

2. Again, If equity increased $48,000 and $18,000 of this was the result of additional issuance of stock, net income must have been $48,000 – $18,000, or $30,000.

3. Again, if equity increased by $48,000 but additional stock was issued for $72,000 and dividends of $12,400 were paid, then the net loss must have been $48,000 – $72,000 + $12,400, or ($11,600).

Chapter 2

E 2–15 (LO4) Cash Flow Computations

1. Cash receipts from:

Customers		$ 410,000
Cash payments for:		
Wages	$164,000	
Utilities	9,000	
Advertising	15,000	
Rent	56,000	
Taxes	83,000	327,000
Net cash provided by operating activities		$ 83,000

2.

Cash receipts from sale of building	$ 225,000
Cash payments for purchase of land	(289,000)
Net cash used by investing activities	$ (64,000)

3. Cash receipts from:

Investments by owners	$ 80,000	
Bank loan	100,000	$ 180,000
Cash payments for:		
Dividends	$ 45,000	
Repayment of principal on loan	60,000	105,000
Net cash provided by financing activities		$ 75,000

Note: IAS7 permits there are alternative classifications in statement of cash flows for the interest/dividends payments/receipts, which is shown below. IAS7 states that companies can choose from the alternative classifications but need to apply consistently across periods for comparativeness. For more details, please refer to Ch.13.

	Operating activities	Investing activities	Financing activities
Interest payment	V		V
Interest receipt	V	V	
Dividends payment	V		V
Dividends receipt	V	V	

4.

Cash flows from operating activities	$ 83,000
Cash flows from investing activities	(64,000)
Cash flows from financing activities	75,000
Net increase in cash	$ 94,000

5.

Cash balance at beginning of year	$417,000
Net increase in cash during the year	94,000
Cash balance at the end of the year	$511,000

E 2–16 (LO4) Cash Flow Classifications

a. OA
b. FA
c. IA
d. OA or FA
e. FA
f. OA
g. OA
h. IA

E 2–17 (LO7) The Cost Principle

The property purchased by Peet Development Company on January 1, 2017, should be recorded at $325,000, the amount of cash paid for the property. This assumes that the land was purchased in an arm's-length transaction. The amount reported at year-end, after the rezoning decision, would still be $325,000—the historical cost or exchange price, at the date of the transaction. The historical cost provides an objective measure of value in accounting measurements. The increased value of the land would be recognized later, when the land is sold in another arm's-length transaction.

E 2–18 (LO7) The Monetary Measurement Concept

Accounting records report only those transactions and events that can be measured in dollars. Some items are not measurable in monetary terms and therefore are not reported on financial statements. There can be little doubt that good employees add great value to a business enterprise. However, measuring that value is very difficult, and it is the main reason why that information is not reported on a balance sheet.

E 2-19 (LO7) Fundamental Concepts and Assumptions

1. Correct. The *fair value principle* requires companies to use fair value to measure a company's holdings of equity securities.

2. Correct. The *monetary unit assumption* requires that companies include in the accounting records only transaction data that can be expressed in terms of money.

3. Incorrect. The *economic entity assumption* requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

E 2–20 (LO7) The Going Concern Assumption

If the auto repair business is regarded as a going concern, the values assigned to the assets will be equal to the original exchange prices of the transactions. If the business is not regarded as a going concern, the values assigned to the assets will likely be much lower (reflecting the lower liquidation values that the entity would obtain if it were forced to sell the assets immediately).

PROBLEMS

P 2–1 (LO1) Balance Sheet Classifications and Relationships

1.

Cash	$106,500*
Accounts receivable	178,500
Total current assets	$285,000

**Computations:*

Total liabilities plus stockholders' equity = Total current liabilities ($298,500) + Long-term liabilities ($379,500) + Total equity ($579,000) = $1,257,000.

Total current assets ($285,000) = Total assets ($1,257,000) – Total long-term assets ($972,000).

Cash ($106,500) = Total current assets ($285,000) – Accounts receivable ($178,500).

2.

Land	$312,000
Building	337,500
Equipment	322,500
Total long-term assets	$972,000

3.

Accounts payable	$151,500
Notes payable (short-term)	147,000
Total current liabilities	$298,500

4.

Mortgage payable (Total long-term liabilities)	$379,500

5.

Capital stock	$300,000
Retained earnings	279,000
Total equity	$579,000

P 2–2 (LO1, LO2) Preparation of a Classified Balance Sheet

1.

Siraco Company
Balance Sheet
December 31, 2017

Assets		
Current assets:		
Cash	$ 1,950	
Accounts receivable	2,500	
Supplies	1,800	
Total current assets		$ 6,250
Long-term assets:		
Equipment	$11,275	
Total long-term assets		11,275
Total assets		$17,525
Liabilities and Equity		
Current liabilities:		
Accounts payable	$ 3,450	
Wages payable	250	
Total current liabilities		$ 3,700
Equity:		
Capital stock	$ 775	
Retained earnings	13,050*	
Total equity		13,825
Total liabilities and equity		$17,525

*Retained Earnings as of December 31, 2017, is equal to the January 1, 2017, Retained Earnings balance plus net income, less dividends paid for 2017.

Beginning retained earnings	$12,000
Net income (see following calculation)	2,550
Dividends paid	(1,500)
Ending retained earnings	$13,050

During 2017, Siraco earned $2,550, as shown below.

Revenues		$10,000
Expenses:		
Wages expense	$2,200	
Supplies expense	3,700	
Miscellaneous expense	1,550	7,450
Net income		$ 2,550

The decision to pay dividends was probably a reasonable one. The earnings were positive, and sufficient cash was available to cover the amount of dividends paid.

P 2–3 (LO1) **Balance Sheet Preparation with a Missing Element**

1.

Schubert Products Inc.
Balance Sheet
December 31, 2017

Assets		
Cash	$ 7,500	
Accounts receivable	20,000	
Supplies	2,000	
Building	49,500	
Land	20,000	
Total assets		$99,000
Liabilities and Equity		
Liabilities:		
Accounts payable		$24,000
Equity:		
Capital stock	$42,000	
Retained earnings	33,000*	75,000
Total liabilities and equity		$99,000

*2. Assets – Liabilities = Equity – Capital stock = Retained earnings
$99,000 – $24,000 = $75,000 – $42,000 = $33,000

3. The balance sheet is a depiction of the accounting equation because it shows total assets being equal to total liabilities and equity. Thus, A = L + E, as shown on each balance sheet.

P 2–4 (LO2) **Statement of Comprehensive Income Preparation**

1.

Rulon Candies, Inc.
Comparative Statement of Comprehensive Income
For the Years Ended December 31, 2017 and 2016

	2017	2016
Services revenue	$185,000	$265,000
Operating expenses:		
Employee salaries	$115,000	$110,000
Advertising expenses	10,000	20,000
Utilities expenses	15,000	8,500
Total operating expenses	$140,000	$138,500
Operating income	$ 45,000	$126,500
Interest revenue	10,000	10,000
Interest expense	(25,000)	(15,000)
Income before income taxes	$ 30,000	$121,500
Income tax expense	9,000	36,500
Net income	$ 21,000	$ 85,000
Other comprehensive income	0	0
Comprehensive income	$ 21,000	$ 85,000
Earnings per share	$ 5.25	$ 21.25

2. From just the limited information on the statement of comprehensive income, the following recommendations could be made to improve profitability for the year 2018:

- Increase sales of services. Sales of services dropped by 30% from 2016 to 2017.
- Why did employee salaries increase when both revenues and profits significantly decreased? Instead of increasing salaries in 2018, give bonus incentives to employees for reaching sales and cost-saving goals.
- Expenditures for advertising decreased 50% from 2016 to 2017. The decrease in advertising may have caused the lower sales volume. Increase advertising expenditures in the year 2017.
- Interest expense increased from $15,000 in 2016 to $25,000 in 2017, a 67% increase. Did Rulon borrow a large amount in 2017? It may be a good idea to repay some loans and increase owner investment.

P 2–5 (LO2) Statement of Comprehensive Income Preparation

Wadley's Car Wash
Statement of Comprehensive Income
For the Year Ended December 31, 2017

Service revenues		$210,000
Expenses:		
Rent expense	$ 6,000	
Salaries expense	41,000	
Utilities expense	4,300	
Supplies expense	10,300	
Miscellaneous expense	970	62,570
Income before income taxes		$147,430
Income taxes		45,000
Net income		$102,430
Other comprehensive income		0
Comprehensive income		$102,430
Earnings per share ($102,430/3,000 shares).		$ 34.14 (rounded)

P 2–6 (LO1, LO2) Expanded Accounting Equation

1. Compute net increase in assets:

Cash	$ 12,500
Interest receivable	(7,500)
Accounts receivable	(11,750)
Building	157,500
Net increase in assets	$150,750

2. Compute net increase in liabilities:

Accounts payable	$ 22,500
Mortgage payable	87,500
Wages payable	(35,250)
Net increase in liabilities	$ 74,750

3. Figure overall increase in equity from net increases in assets and liabilities:

Net increase in assets	$150,750
Less: Net increase in liabilities	74,750
Net increase in equity	$ 76,000

P 2–6 (LO1, LO2) (Continued)

4. Compute known net increase in equity:

Capital stock	$ 26,250
Retained earnings (dividends paid)	(25,000)
Known net increase in equity	$ 1,250

5. Net increase of $76,000 in equity resulted from changes in (1) the known net increase in equity and (2) net income. Thus, net income can be figured by:

Overall net increase in equity	$ 76,000
Less: Known net increase in equity	(1,250)
Net income for 2017	$ 74,750

P 2–7 (LO2) Statement of Comprehensive Income Preparation

1.

Precision Corporation
Statement of Comprehensive Income
For the Year Ended December 31, 2017

Services revenue		$68,000
Expenses:		
Advertising expense	$ 1,530	
Delivery expense	8,410	
Packaging expense	355	
Salaries expense	18,350	
Supplies expense	480	29,125
Income before income taxes		$38,875
Income taxes		4,360
Net income		$34,515
Other comprehensive income		0
Comprehensive income		$34,515
Earnings per share		$ 3.45

2. 10,000 shares $\left(\frac{\$34,515}{\$3.45} = 10,004 \text{ shares}^*\right)$

*Rounded

P 2–8 (LO2) Net Income

1.

Streuling Company
Statement of Comprehensive Income
For the Year Ended May 31, 2017

Consulting fees		$115,100
Expenses:		
Advertising expense	$ 2,760	
Supplies expense	37,820	
Rent expense	1,500	
Salaries expense	18,150	
Miscellaneous expense	4,170	
Administrative expense	7,250	71,650
Income before income taxes		$ 43,450
Income taxes		21,180
Net income		$ 22,270
Other comprehensive income		0
Comprehensive income		$ 22,270
Earnings per share ($22,270/3,000 shares)		$ 7.42 (rounded)

2. If Streuling Company had a loss, it may or may not be a good idea to pay dividends. It would depend on the amount of cash available, whether the loss is considered only a temporary situation, and the expectations of the shareholders. Many large companies do continue to pay dividends, even though they have a loss, in order to satisfy both perceived and real shareholder expectations.

P 2–9 (LO1,2,3) Preparing Statement of Comprehensive Income, Statement of Retained Earnings, and Balance Sheet

1.

Muchon Flying Experience Ltd.
Statement of Comprehensive Income (in thousands)
For the Month Ended May 31, 2017

Revenues		
Service revenue		$13,600
Expenses		
Gasoline expense	$5,000	
Rent expense	2,000	
Advertising expense	1,000	
Utilities expense	800	
Maintenance and repairs expense	800	
Total expenses		9,600
Net income		$ 4,000

MUCHON FLYING EXPERIENCE LTD.
Statement of Retained Earnings (in thousands)
For the Month Ended May 31, 2017

Retained Earnings, January 1		$ 0
Add:	Net income	4,000
		4,000
Less:	Dividends	960
Retained earnings, May 31		$ 3,040

MUCHON FLYING EXPERIENCE LTD.
Balance Sheet (in thousands)
January 31, 2017

Assets

Cash	$ 9,000	
Accounts receivable		14,840
Equipment		128,000
Total assets		$ 151,840

P 2-9 (LO1,2,3) (Continued)

MUCHON FLYING EXPERIENCE LTD.
Balance Sheet (Continued)
January 31, 2017

Equity and Liabilities

Equity		
Share capital—ordinary	$90,000*	
Retained earnings	3,040	
Total equity		$93,040
Liabilities		
Notes payable	$56,000	
Accounts payable	2,800	
Total liabilities		58,800
Total equity and liabilities		$151,840

*					
Assets	– Liabilities	= Equity	– Retained earnings	= Capital stock
$151,840	– $58,800	= $93,040	– $3,040	=$90,000

2.

MUCHON FLYING EXPERIENCE LTD.
Statement of Comprehensive Income (in thousands)
For the Month Ended May 31, 2017

Revenues		
Service revenue ($13,600 + $1,800)		$15,400
Expenses		
Gasoline expense ($5,000 + $3,000)	$8,000	
Rent expense	2,000	
Advertising expense	1,000	
Utilities expense	800	
Maintenance and repairs expense	800	
Total expenses		12,600
Net income		$2,800

MUCHON FLYING EXPERIENCE LTD.
Statement of Retained Earnings (in thousands)
For the Month Ended May 31, 2017

Retained Earnings, January 1	$ 0

Add: Net income	2,800
	2,800
Less: Dividends	960
Retained Earnings, May 31	$ 1,840

P 2–10 (LO2, LO3) Net Income and Statement of Retained Earnings

1.

Quincy Company
Statement of Comprehensive Income
For the Year Ended May 31, 2017

Consulting fees		$176,400
Expenses:		
Advertising expense	$ 4,650	
Supplies expense	38,410	
Rent expense	2,400	
Salaries expense	25,340	
Miscellaneous expense	10,200	
Administrative expense	13,900	94,900
Income before income taxes		$ 81,500
Income taxes		20,760
Net income		$ 60,740
Other comprehensive income		0
Comprehensive income		$60,740
Earnings per share ($60,740/8,000 shares)		$ 7.59 (rounded)

2.

Quincy Company
Statement of Retained Earnings
For the Year Ended May 31, 2017

Retained earnings, June 1, 2016	$175,670
Add net income for the year	60,740
	$236,410
Less dividends	19,500
Retained earnings, May 31, 2017	$216,910

3.

Quincy Company
Statement of Retained Earnings
For the Year Ended May 31, 2017

Retained earnings, June 1, 2016		$175,670
Less: Net loss for year	$38,000	
Dividends	19,500	57,500
Retained earnings, May 31, 2017		$118,170

P 2–10 (LO2, LO3) (Continued)

4. If Quincy Company had a loss, as in (3) above, it may or may not be a good idea to pay dividends. It would depend on the amount of cash available, whether the loss is considered only a temporary situation, and the expectations of the shareholders. Many large companies do continue to pay dividends, even though they have a loss, in order to satisfy both perceived and real shareholder expectations.

P 2–11 (LO1, LO2) Comprehensive Financial Statement Preparation

1.

Wilcox, Inc.
Statement of Comprehensive Income
For the Year Ended December 31, 2017

Revenues		$389,950
Expenses:		
Salaries expense	$125,350	
Utilities expense	5,250	
Supplies expense	110,600	
Rent expense	21,200	
Other expenses	11,250	273,650
Income before income taxes		$116,300
Income taxes		35,000
Net income		$ 81,300
Other comprehensive income		0
Comprehensive income		$ 81,300
Earnings per share ($81,300/2,000 shares)		$ 40.65

2.

Wilcox, Inc.
Balance Sheet
December 31, 2017

Assets		
Current assets:		
Cash	$ 61,100*	
Accounts receivable	90,000	
Supplies	72,500	
Total current assets		$223,600
Long-term assets:		
Land	$ 42,500	
Buildings	197,550	
Total long-term assets		240,050
Total assets		$463,650
Liabilities and Equity		
Current liabilities:		
Accounts payable	$ 38,050	
Long-term liabilities:		
Notes payable	63,800	
Total liabilities		$101,850
Equity:		
Capital stock	$ 65,000	
Retained earnings	296,800*	
Total equity		361,800
Total liabilities and equity		$463,650

**Computations:*

Retained earnings, December 31, 2017 ($296,800) = Retained earnings, January 1, 2016 ($311,000) + Net income ($81,300) – Dividends ($95,500)

Total current assets ($223,600) = Total assets ($463,650) – Total long-term assets ($240,050)

Cash ($61,100) = Total current assets ($223,600) – Accounts receivable ($90,000) – Supplies ($72,500)

3. The company has been profitable over the past several years, even though more was paid out in dividends this year than was earned. The company apparently has retained most of the past years' earnings in the business.

P 2–12 (LO4) Statement of Cash Flows

1.

Pratt & Jordan Development, Inc.
Statement of Cash Flows
For the Year Ended December 31, 2017

Cash Flows from Operating Activities		
Cash inflows from:		
Customers		$ 750,000
Cash outflows from:		
Payment of operating expenses	$ 215,000	
Payment of wages and salaries	135,000	
Payment of taxes	43,000	
Other expenses	32,000	425,000
Net cash provided by operating activities		$ 325,000
Cash Flows from Investing Activities		
Investments in securities	$(245,000)	
Net cash used by investing activities		(245,000)
Cash Flows from Financing Activities		
Proceeds from land loans	$ 75,000	
Payment of building loan	(50,000)	
Distributions to owners	(60,000)	
Net cash used by financing activities		(35,000)
Net increase in cash		$ 45,000
Cash at the beginning of the year		130,000
Cash at the end of the year		$ 175,000

Yes, Pratt & Jordan Development, Inc. appears to be in good shape from a cash flow standpoint. It generated $325,000 in cash flows from operating activities, which was used for investing and financing activities. Pratt & Jordan Development, Inc., was able to distribute an amount to its owners and still add $45,000 toward its end-of-year cash balance. It would help to have comparative statements of cash flows, as well as the other financial statements, to see the trends and relationships of the information.

P 2–13 (LO4) **Statement of Cash Flows**

Esplin Enterprises
Statement of Cash Flows
For the Year Ended December 31, 2017

Cash Flows from Operating Activities		
Cash receipts from:		
Services		$2,214,000
Cash payments for:		
Operating expenses	$1,735,000	
Taxes	207,000	1,942,000
Net cash provided by operating activities		$ 272,000
Cash Flows from Investing Activities		
Cash receipts from sale of land	$ 194,000	
Cash payment to purchase building	(352,000)	
Net cash used by investing activities		(158,000)
Cash Flows from Financing Activities		
Cash receipts from investments by owners	$ 93,000	
Cash payments for distributions to owners	(68,000)	
Net cash provided by financing activities		25,000
Net increase in cash		$ 139,000
Cash at the beginning of the year		676,000*
Cash at the end of the year		$ 815,000

*X + $139,000 = $815,000
X = $676,000

ANALYTICAL ASSIGNMENTS

AA 2–1 Creditor and Investor Information Needs

Discussion

As the bank's loan officer, you would want to see comparative balance sheets, statements of comprehensive income, and statements of cash flows. The profitability of a company is a major factor in determining whether a company will have sufficient future cash flows to repay its loans as well as to pay the interest on those loans. In analyzing the liquidity, solvency, and overall financial position of the company, you also would be interested in the relationships disclosed on the balance sheet and the cash flow statement.

As a potential investor, you would want to determine Ink Spot's cash flow position and its operating profitability during its first two years of existence. These factors will affect the value of the company's stock (and therefore its resale value) as well as the company's ability to pay dividends to its stockholders.

AA 2–2 *You Decide:* Is the cash flow statement necessary?

Judgment Call

Issues to be discussed are:

1. Many companies focus on EBITDA these days and pay much more attention to EBITDA than to cash flows.
2. Most of the information on the statement of cash flows can be derived from looking at successive balance sheets and statements of comprehensive income, although it is much harder to obtain.
3. In the end, it is cash flows—much more than earnings or EBITDA—that really matter. If a company doesn't have sufficient cash, it cannot pay its obligations and will have liquidity problems.
4. It is important to see how much cash flow comes from the three activities of operations, financing, and investments.
5. EBITDA is often used as a surrogate for cash flows. It adjusts earnings for depreciation and amortization, which is also done on the statement of cash flows.

AA 2–3 *You Decide:* Are the notes to the financial statements necessary?

Judgment Call

Issues to be discussed are:

1. It is impossible to completely understand the financial statements without reading and understanding the notes. There are many estimates and assumptions involved in preparing financial statements and those estimates and assumptions must be explained in the notes.
2. The notes also provide additional detail that helps explain many of the changes in the financial statements from year to year.
3. The notes help readers understand the risk posture of the company—is it using aggressive accounting principles or conservative accounting principles?
4. Without notes, it would be difficult to know whether or not GAAP is being followed.

AA 2–4 Infosys

International

1. The first major difference students should notice on Infosys' balance sheet is the listing of categories such as "Sources of Funds" and "Application of Funds." Indian balance sheets are organized according to how money flows to the company and then how it is spent. "Sources of Funds" show where the company gets its money, and "Application of Funds" shows how the company has spent or allocated it. Another thing students will notice is that there is no easy way to conclude that the balance sheet does balance according to the basic accounting equation. As indicated in the next question, there is no total for assets or for liabilities and stockholders' equity.
2. Infosys does not provide a number indicating total assets. The company nets current assets and liabilities and then adds that net figure to its fixed assets, investments, and deferred tax assets. In the United States, a number indicating total assets is always provided.
3. Companies around the world use different terms than we might be accustomed to, but we can unravel the meaning of the words. For example, Provisions are subtracted from Current Assets, Loans, and Advances to arrive at Net Current Assets. Thus, Provisions is most likely a name used for Infosys' current liabilities. We can use the same logic to determine that Sundry Debtors refers to Accounts Receivable; and Reserves and Surplus are most likely related to Retained Earnings.

AA 2–5 Violating a Covenant

Ethics

There are many ways to change the current ratio. Some of them have a legitimate business purpose and some don't. For example, selling a product or service at a profit will cause the current ratio to increase, as will selling equipment. The difference is that selling a product or service is a long-term solution to the current problem, while selling equipment that the company will need is a short-term solution.

Would investors want management deciding on short-term, quick-fix solutions to avoid violating debt covenants? Management might argue that it is in the best interest of shareholders to keep the bank out of the company's business. Thus, manipulating the current ratio is the proper thing to do. The lender would counter that selling equipment to inflate the current ratio violates the spirit of the debt covenant.

What's the right answer? As is often the case in gray areas, it is probably not clear. But one thing is certain: you must always be careful when making business decisions that do not have a clear business purpose.