LO7 Explain the fundamental concepts and assumptions that underlie financial accounting.

FUNDAMENTAL CONCEPT OR ASSUMPTION	DESCRIPTION
Specific entity concept	Financial statements are prepared for a specific economic entity; the private affairs of the owners are not to be mixed in with the business transactions.
Time-period assumption	A business should report the financial results of its activities over a standard time period.
Arm's-length transaction	A market price accurately reflects underlying value when the transaction occurs between two unrelated parties, each bargaining for his or her own interests.
Cost principle	In general, financial statement items are measured at their cost on the original transaction date.
Fair value	Assets and liabilities are measured at fair value to improve relevance of accounting information.
Monetary measurement concept	In order to be included in the financial statements, the value of an item must be measurable in terms of dollars.
Going concern assumption	When preparing the financial statements, the accountant assumes that the business will survive for the foreseeable future. Without this assumption, balance sheet items would be recorded at emergency liquidation amounts.

Key Terms & Concepts

Review Problem

The Statement of Comprehensive Income and Balance Sheet

Shirley Baum manages The Copy Shop. She has come to you for help in preparing a statement of comprehensive income and a balance sheet for the year ended December 31, 2017. Several amounts, determined as of December 31, 2017, are presented below. No dividends were paid and no other comprehensive income incurred this year.

Capital stock (10,000 shares outstanding)	$40,000
Retained earnings (12/31/16)	12,400
Advertising expense	2,000
Cash	17,000
Rent expense	2,400
Building (net)	100,000
Interest expense	700

Mortgage payable	$72,000
Accounts payable	6,000
Land	24,000
Supplies	2,000
Salary expense	20,000
Revenues	42,000
Other expenses	1,300
Accounts receivable	3,000

Required:

1. Prepare a statement of comprehensive income for the year ended December 31, 2017, including EPS.
2. Determine the amount of retained earnings at December 31, 2017.
3. Prepare a classified balance sheet as of December 31, 2017.

Solution:

1. **Statement of Comprehensive Income**
The first step in solving this problem is to separate the balance sheet items from the statement of comprehensive income items. Asset, liability, and equity items reflect the company's financial position and appear on the balance sheet; revenues and expenses are reported on the statement of comprehensive income.

Balance Sheet Items
Capital stock
Retained earnings
Cash
Building (net)
Mortgage payable
Accounts payable
Land
Supplies
Accounts receivable

Statement of Comprehensive Income Items
Advertising expense
Rent expense
Interest expense
Salary expense
Revenues
Other expenses

After the items have been separated, the statement of comprehensive income and the balance sheet may be prepared using a proper format.

The Copy Shop
Statement of Comprehensive Income
For the Year Ended December 31, 2017

Revenues		$42,000
Expenses:		
Advertising expense	$ 2,000	
Rent expense	2,400	
Interest expense	700	
Salary expense	20,000	
Other expenses	1,300	26,400
Net income		$15,600
Other comprehensive income		0
Comprehensive income		$15,600

EPS = \$15,600 ÷ 10,000 shares = \$1.56
Note: This example assumes no other comprehensive income. Hence, net income equals comprehensive income.

2. **Retained Earnings**
The amount of retained earnings at December 31, 2017, may be calculated as follows:

Retained earnings (12/31/16)	$12,400
Add: Net income for year	15,600
Subtract: Dividends for year	0
Retained earnings (12/31/17)	$28,000

Since no dividends were paid during 2017, the ending balance in Retained Earnings is simply the beginning balance plus net income for the year.

3. Balance Sheet

The Copy Shop
Balance Sheet
December 31, 2017

Assets			**Liabilities and Equity**		
Current assets:			**Current liabilities:**		
Cash	$ 17,000		Accounts payable	$ 6,000	
Accounts receivable	3,000				
Supplies	2,000	$ 22,000	**Non-current (long-term) liabilities:**		
			Mortgage payable	72,000	
Long-term assets:			Total liabilities		$ 78,000
Land	$ 24,000				
Building (net)	100,000	124,000	**Equity:**		
			Capital stock	$40,000	
			Retained earnings	28,000*	68,000
Total assets		$146,000	Total liabilities and equity		$146,000

*See item 2 for calculation.

Put it on Paper — Discussion Questions

1. As an external user of financial statements, perhaps an investor or creditor, what type of accounting information do you need?
2. What is the major purpose of:
   a. A balance sheet?
   b. A statement of comprehensive income?
   c. A statement of cash flows?
3. Assume you want to invest in the stock market and your friends tell you about a company's stock that is "guaranteed" to have an annual growth rate of 150%. Should you trust your friends and invest immediately or should you research the company's financial statements before investing? Explain.
4. Why are classified and comparative financial statements generally presented in annual reports to shareholders?
5. Why are equity and liabilities considered the "sources" of assets?
6. Equity is not cash; it is not a liability; and it generally is not equal to the current worth of a business. What is the nature of equity?
7. What are the limitations of the balance sheet? Why is it important to be aware of them when evaluating a company's growth potential?
8. Some people feel that the statement of comprehensive income is more important than the balance sheet. Do you agree? Why or why not?
9. How might an investor be misled by looking only at the "bottom line" (the net income or EPS number) on a statement of comprehensive income?
10. Why is it important to classify cash flows according to operating, investing, and financing activities?
11. You are thinking of investing in one of two companies. In one annual report, the auditor's opinion states that the financial statements were prepared in accordance with generally accepted accounting principles. The other makes no such claim. How important is that to you? Explain.
12. Some people think that auditors are responsible for ensuring the accuracy of financial statements. Are they correct? Why or why not?
13. What are the four general types of financial statement notes typically included in annual reports to stockholders?
14. Explain why each of the following is important in accounting:
    a. The separate entity concept
    b. The assumption of arm's-length transactions
    c. The cost principle
    d. The monetary measurement concept
    e. The going concern assumption
    f. The time-period assumption

Practice Exercises

Note that in the following practice exercises, exercises, problems, and analytical assignments, the amount of other comprehensive income is assumed to be zero, unless otherwise specified.

PE 2-1 LO 1

Total Assets

Using the following information, compute total assets.

Equipment	$30,000	Wages payable	$ 1,800
Accounts payable	3,600	Accounts receivable	6,000
Capital stock	5,600	Retained earnings	10,800
Cash	2,800	Supplies	9,000
Loan payable	26,000		

PE 2-2 LO 1

Total Liabilities

Refer to the data in PE 2-1. Compute total liabilities.

PE 2-3 LO 1

Total Equity

Refer to the data in PE 2-1. Compute total equity.

PE 2-4 LO 1

The Accounting Equation

For the following four cases, use the accounting equation to compute the missing quantity.

	Assets	Liabilities	Equity
Case A	$10,000	$ 4,000	A
Case B	8,000	B	$3,500
Case C	C	5,500	7,000
Case D	13,000	15,000	D

PE 2-5 LO 1

Balance Sheet

Using the data in PE 2-1, prepare a balance sheet.

PE 2-6 LO 1

Current Assets

Using the following information, compute total current assets.

Land	$8,000	Buildings	$9,500
Machinery	1,700	Accounts receivable	1,400
Accounts payable	1,200	Retained earnings	3,800
Cash	950	Supplies	3,300

PE 2-7 LO 1

Current Liabilities

Using the following information, compute total current liabilities.

Supplies	$9,000	Mortgage payable (due in 30 years)	$10,000
Loan payable (due in 14 months)	1,100	Loan payable (due in 6 months)	250
Capital stock	1,750	Accounts payable	700
Cash	400	Retained earnings	5,000

PE 2-8 LO 1

Book Value and Market Value of Equity

For the following four cases, compute (1) the book value of equity and (2) the market value of equity.

	Assets	Liabilities	Number of Shares of Stock Outstanding	Market Price per Share
Case A	$ 10,000	$ 4,000	1,000	$15
Case B	8,000	7,000	500	10
Case C	13,500	5,500	300	20
Case D	100,000	150,000	1,000	7

PE 2-9
LO 2

Total Revenues

Using the following information, compute total revenues. *Caution: Not all of the items listed should be included in the computation of total revenues.*

Interest revenue	$1,400	Wages payable	$ 650
Advertising expense	5,300	Accounts receivable	2,100
Cash	1,600	Retained earnings	11,600
Wages expense	29,200	Consulting revenue	36,600

PE 2-10
LO 2

Total Expenses

Using the data in PE 2-9, compute total expenses. *Caution: Not all of the items listed should be included in the computation of total expenses.*

PE 2-11
LO 2

Computation of Net Income

For the following four cases, compute net income (or net loss). *Caution: Not all of the items listed should be included in the computation of net income.*

	Case A	Case B	Case C	Case D
Wages expense	$ 60,000	$ 30,000	$60,000	$110,000
Interest expense	18,000	47,000	25,000	31,000
Cash	3,000	4,500	2,100	6,000
Retained earnings	50,000	15,000	31,000	70,000
Service revenue	100,000	150,000	70,000	200,000
Accounts payable	12,000	20,000	5,000	38,000
Rent revenue	5,000	1,000	12,000	10,000
Machinery	175,000	60,000	50,000	185,000

PE 2-12
LO 2

Statement of Comprehensive Income

Using the following information, prepare a statement of comprehensive income.

Interest expense	$1,200	Accounts payable	$ 400
Wages expense	900	Accounts receivable	750
Cash	600	Retained earnings	3,300
Service revenue	4,700	Income tax expense	800

PE 2-13
LO 3

Computation of Ending Retained Earnings

For the following four cases, compute the ending amount of retained earnings. *Caution: Not all of the items listed should be included in the computation of ending retained earnings.*

	Case A	Case B	Case C	Case D
Capital stock	$ 60,000	$ 30,000	$60,000	$110,000
Long-term loan payable	18,000	47,000	25,000	31,000
Dividends	3,000	4,500	2,100	6,000
Retained earnings (beginning)	50,000	15,000	31,000	70,000
Inventory	100,000	150,000	70,000	200,000
Cash	12,000	20,000	5,000	38,000
Net income (loss)	5,000	1,000	12,000	(10,000)
Machinery	175,000	60,000	50,000	185,000

PE 2-14
LO 1
LO 3

Missing Amounts in Financial Statements

For the following four cases, compute the missing quantity.

	Assets	Liabilities	Capital Stock	Retained Earnings
Renald Company	$34,000	$16,000	A	$ 9,500
Jim's Retail Shop	14,500	B	$ 5,300	3,100
Shakira Company	C	22,000	13,000	29,000
Oliver Company	80,000	57,000	28,000	D

PE 2-15
LO 4

Computing Cash from Operating Activities

Using the following data, compute cash flow from operating activities.

	Cash Inflow (Outflow)	
a.	Cash received from sale of a building	$ 5,600
b.	Cash paid for interest	(450)
c.	Cash paid to repay a loan	(1,000)
d.	Cash collected from customers	10,000
e.	Cash paid for dividends	(780)
f.	Cash paid for income taxes	(1,320)
g.	Cash received upon the issuance of new shares of stock	3,000
h.	Cash received from tenants renting part of a building	600
i.	Cash paid to purchase land	(12,000)

PE 2-16
LO 4

Computing Cash from Investing Activities

Refer to the information in PE 2-15. Use that information to compute cash flow from investing activities.

PE 2-17
LO 4

Computing Cash from Financing Activities

Refer to the information in PE 2-15. Use that information to compute cash flow from financing activities.

PE 2-18
LO 4

Preparing a Statement of Cash Flows

Refer to the information in PE 2-15. Use that information to prepare a complete statement of cash flows. The beginning cash balance for the year was $2,000.

PE 2-19
LO 4

Financial Statement Articulation

For the following four cases, use the principle of financial statement articulation to compute the missing amounts.

	Case A	Case B	Case C	Case D
Dividends	$ 4,500	$ 9,200	$ 1,300	G
Cash, beginning	9,000	C	6,700	$ 41,000
Retained earnings, ending	A	23,000	12,500	18,000
Net increase (decrease) in cash	5,800	11,000	E	(9,200)
Net income (loss)	21,000	34,000	F	(19,000)
Retained earnings, beginning	37,000	D	17,000	43,000
Cash, ending	B	46,000	2,500	H

EXERCISES

E 2-1
LO 1

Classification of Financial Statement Elements

Indicate for each of the following items whether it would appear on a balance sheet (BS) or a statement of comprehensive income (SCI). If a balance sheet item, is it an asset (A), a liability (L), or an equity item (E)?

1. Accounts Payable
2. Accounts Receivable
3. Advertising Expense
4. Cash
5. Supplies
6. Consulting Revenue
7. Land
8. Capital Stock
9. Rent Expense
10. Equipment
11. Interest Receivable
12. Mortgage Payable
13. Notes Payable
14. Buildings
15. Salaries & Wages Expense
16. Retained Earnings
17. Utilities Expense

E 2-2
LO 1

Accounting Equation

Compute the missing amounts for the following three companies.

	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	?	41,000
Accounts payable	?	3,500	16,000
Mortgage payable	37,500	19,000	32,250
Equity	22,000	14,500	?

E 2-3
LO 1

Analyze the Effect of Transactions on Assets, Liabilities, and Equity

Georgia Corporation entered into the following transactions during May 2017.

1. Purchased computer terminals for $20,000 from TSM company on account.
2. Paid TaiYen Power Company $11,000 cash for energy usage in May.
3. Received $14,000 cash from customers for contracts billed in April.
4. Shareholders invested an additional $32,000 in the business.
5. Paid $3,000 cash for May rent on storage space.
6. Performed computer services to Starwood Recreation Corporation for $2,400 cash.
7. Paid TSM Company for the terminals purchased in (1) above.
8. Incurred advertising expense for May of $1,100 on account.

Indicate with the appropriate letter whether each of the transactions above results in:

(a) An increase in assets and a decrease in assets.
(b) An increase in assets and an increase in equity.
(c) An increase in assets and an increase in liabilities.
(d) A decrease in assets and a decrease in equity.
(e) A decrease in assets and a decrease in liabilities.
(f) An increase in liabilities and a decrease in equity.
(g) An increase in equity and a decrease in liabilities.

E 2-4
LO 1
LO 2

Comprehensive Accounting Equation

Assuming no additional investments by or distributions to owners, compute the missing amounts for the three companies below.

	Davis Company	Conaton Company	Seipke Company
Assets: January 1, 2017	$360	$?	$230
Liabilities: January 1, 2017	280	460	?
Equity: January 1, 2017	?	620	150
Assets: December 31, 2017	380	?	310
Liabilities: December 31, 2017	?	520	90
Equity: December 31, 2017	?	720	?
Revenues in 2017	80	?	400
Expenses in 2017	100	116	?

E 2-5
LO 1
LO 2

Computing Elements of Equity

From the information provided, determine:

1. The amount of retained earnings at December 31.
2. The amount of revenues for the period.

Totals	January 1	December 31
Current assets	$ 15,000	$ 25,000
All other assets	240,000	220,000
Liabilities	125,000	85,000
Capital stock	70,000	?
Retained earnings	60,000	?

Additional data:

Expenses for the period were $55,000.
Dividends paid were $9,000.
Capital stock increased by $20,000 during the period.

E 2-6
LO 1
LO 2

Balance Sheet Relationships

Correct the following balance sheet.

Canfield Corporation
Balance Sheet
December 31, 2017

Assets		Liabilities and Equity	
Cash	$ 55,000	Buildings	$325,000
Accounts payable	65,000	Accounts receivable	75,000
Interest receivable	20,000	Mortgage payable	150,000
Capital stock	200,000	Service revenue	350,000
Rent expense	60,000	Equipment	85,000
Retained earnings	145,000	Utilities expense	5,000
Total assets	$545,000	Total liabilities and equity	$990,000

E 2-7
LO 1
LO 2

Balance Sheet Preparation

From the following data, prepare a classified balance sheet for Taylorsville Construction Company on December 31, 2017.

Accounts payable	$ 74,300
Accounts receivable	113,500
Buildings	512,000
Equity, 1/1/17	314,300
Cash	153,600
Distributions to owners during 2017	48,100

Supplies	$ 4,250
Land	90,000
Mortgage payable	423,400
Net income for 2017	109,450
Equity, 12/31/17	?

E 2-8
LO 1
LO 2

Correcting an Incorrectly Prepared Balance Sheet

Rachel Celie is the bookkeeper for Westhood Company. Rachel has been trying to get the balance sheet of Westhood Company to balance. Westhood's balance sheet is shown as follows.

Westhood Company
Balance Sheet
December 31, 2017

Assets		**Liabilities and Equity**	
Equipment	$48,000	Capital stock	$50,000
Supplies	8,000	Retained earnings	17,500
Cash	14,000	Accounts payable	16,000
Dividends	5,000	Accounts receivable	(8,500)
Total assets	$75,000	Total liabilities and equity	$75,000

Prepare a correct balance sheet.

E 2-9
LO 2

Statement of Comprehensive Income Computations

Following are the operating data for a marketing firm for the year ended December 31, 2017.

Revenues	$335,000
Supplies expense	95,000
Salaries expense	120,000
Rent expense	10,000

Administrative expense	$16,000
Income taxes (30% of income before income tax)	?

For 2017, determine:

1. Income before income tax.
2. Income tax expense.
3. Net income.
4. Earnings per share (EPS), assuming there are 25,000 shares of stock outstanding.
5. Comprehensive income. (Other comprehensive income is zero.)

E 2-10
LO 2

Statement of Comprehensive Income Preparation

The following selected information is taken from the records of Pickard and Associates for 2017.

Accounts payable	$ 143,000
Accounts receivable	95,000
Advertising expense	14,500
Cash	63,000
Supplies expense	31,500
Rent expense	12,000
Utilities expense	2,500

Income taxes (30% of income before income tax)	$?
Miscellaneous expense	5,100
Equity	215,000
Salaries expense	78,000
Fees (revenues)	476,000

1. Prepare a statement of comprehensive income for the year ended December 31, 2017. (Assume that 11,000 shares of stock are outstanding and other comprehensive income is zero.)
2. Explain what the EPS number tells the reader about Pickard and Associates.

E 2-11
LO 3

Income and Retained Earnings Relationships

Assume that retained earnings increased by $750,000 from December 31, 2016, to December 31, 2017, for Jarvie Distribution Corporation. During the year, a cash dividend of $270,000 was paid.

1. Compute the net income for the year.
2. Assume that the revenues for the year were $1,660,000. Compute the expenses incurred for the year.

E 2-12
LO 3

Retained Earnings Computations

During 2017, Shadow Price Corporation had revenues of $520,000 and expenses, including income taxes, of $390,000. On December 31, 2016, Shadow Price had assets of $700,000, liabilities of $210,000, and capital stock of $320,000. Shadow Price paid a cash dividend of $50,000 in 2017. No additional stock was issued. Compute the retained earnings on December 31, 2016, and 2017.

E 2-13
LO 2
LO 3

Preparation of Statement of Comprehensive Income and Statement of Retained Earnings

Prepare a statement of comprehensive income and a statement of retained earnings for Big Sky Corporation for the year ended June 30, 2017, based on the following information. Assume that other comprehensive income is zero.

Capital stock (1,500 shares @ $100)		$150,000
Retained earnings, July 1, 2016		76,800
Dividends		6,500
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	
Income tax expense	2,100	64,300

E 2-14
LO 3

Articulation: Relationships between a Balance Sheet and a Statement of Comprehensive Income

The total assets and liabilities of Omni Company at January 1 and December 31, 2017, are presented below.

	January 1	December 31
Assets	$103,000	$167,000
Liabilities	72,000	88,000

Determine the amount of net income or loss for 2017, applying each of the following assumptions concerning the additional issuance of stock and dividends paid by the firm. Each case is independent of the others.

1. Dividends of $12,100 were paid and no additional stock was issued during the year.
2. Additional stock of $18,000 was issued and no dividends were paid during the year.
3. Additional stock of $72,000 was issued and dividends of $12,400 were paid during the year.

E 2-15
LO 4

Cash Flow Computations

From the following selected data, compute:

1. Net cash flow provided (used) by operating activities.
2. Net cash flow provided (used) by investing activities.
3. Net cash flow provided (used) by financing activities.
4. Net increase (decrease) in cash during the year.
5. The cash balance at the end of the year.

Cash receipts from:	
Customers	410,000
Investments by owners	80,000
Sale of building	225,000
Proceeds from bank loan	100,000
Cash payments for:	
Wages	$164,000
Utilities	9,000
Advertising	15,000
Rent	56,000
Taxes	83,000
Dividends	45,000
Repayment of principal on loan	60,000
Purchase of land	289,000
Cash balance at beginning of year	417,000

E 2-16
LO 4

Cash Flow Classifications

For each of the following items, indicate whether it would be classified and reported under the operating activities (OA), investing activities (IA), or financing activities (FA) section of a statement of cash flows:

a. Cash payments for wages and salaries
b. Cash proceeds from sale of stock
c. Cash purchase of equipment
d. Cash dividends paid
e. Cash received from bank loan
f. Cash receipts from services rendered
g. Cash payments for taxes
h. Cash proceeds from sale of property no longer needed as expansion site

E 2-17
LO 7

The Cost Principle

On January 1, 2017, Peet Development Company paid $325,000 in cash for a parcel of land to be used as the new office building site. During March, the company petitioned the city council to rezone the area for professional office buildings. The city council refused, preferring to maintain the area as a residential zone. After nine months of negotiation, Peet Development convinced the council to rezone the property for commercial use, thus raising its value to $475,000.

For accounting purposes, what value should be used to record the transaction on January 1, 2017? At what value would the property be reported at year-end, after the city council rezoning? Explain why accountants use historical costs to record transactions.

E 2-18
LO 7

The Monetary Measurement Concept

Many successful companies, like Ford Motor Company, ExxonMobil, and Marriott Corporation, readily acknowledge the importance and value of their employees. In fact, the employees of a company are often viewed as the most valued asset of the company. Yet in the asset section of the balance sheets of these companies there is no mention of the asset Employees. What is the reason for this oversight and apparent inconsistency?

E 2-19
LO 7

Fundamental Concepts and Assumptions

The following situations involve accounting principles and assumptions.

1. Belin Company holds equity securities that are worth substantially more than they originally cost. In an effort to provide more relevant information, Belin reports the equity securities at fair value in its accounting reports.
2. Jacob Company AG includes in its accounting records only transaction data that can be expressed in terms of money.
3. Ohlson Stocchi, president of Akira Recreation Company, records his personal living costs as expenses of the Akira.

For each of the three situations, state if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

E 2-20
LO 7

The Going Concern Assumption

Assume that you open an auto repair business. You purchase a building and buy new equipment. What difference does the going concern assumption make with regard to how you would account for these assets?

PROBLEMS

P 2-1
LO 1

Balance Sheet Classifications and Relationships

Stoker and Co. has the following balance sheet elements as of December 31, 2017.

Land	$312,000	Mortgage payable	$379,500
Cash	?	Capital stock	300,000
Building	337,500	Retained earnings	279,000
Accounts payable	151,500	Accounts receivable	178,500
Notes payable (short-term)	147,000		
Equipment	322,500		

Required:

Compute the total amount of:

1. Current assets.
2. Long-term assets.
3. Current liabilities.
4. Long-term liabilities.
5. Equity.

P 2-2
LO 1
LO 2

Preparation of a Classified Balance Sheet

Following are the December 31, 2017, account balances for Siraco Company.

Cash	$ 1,950	Capital stock	$ 775
Accounts receivable	2,500	Retained earnings, January 1, 2017	12,000
Supplies	1,800	Revenues	10,000
Equipment	11,275	Miscellaneous expense	1,550
Accounts payable	3,450	Supplies expense	3,700
Wages payable	250	Wages expense	2,200
Dividends paid	1,500		

Required:

1. Prepare a classified balance sheet as of December 31, 2017.
2. **Interpretive Question:** On the basis of its 2017 earnings, was this company's decision to pay dividends of $1,500 a sound one?

P 2-3
LO 1

Balance Sheet Preparation with a Missing Element

The following data are available for Schubert Products Inc. as of December 31, 2017.

Cash	$ 7,500
Accounts payable	24,000
Capital stock	42,000
Accounts receivable	20,000
Building	49,500
Supplies	2,000
Retained earnings	?
Land	20,000

Required:

1. Prepare a balance sheet for Schubert Products Inc.
2. Determine the amount of retained earnings at December 31, 2017.
3. **Interpretive Question:** In what way is a balance sheet a depiction of the basic accounting equation?

P 2-4
LO 2

Statement of Comprehensive Income Preparation

Listed below are the results of Rulon Candies' operations for 2016 and 2017. (Assume 4,000 shares of outstanding stock for both years.)

	2017	2016
Service revenue	$185,000	$265,000
Utilities expenses	15,000	8,500
Employee salaries	115,000	110,000
Advertising expenses	10,000	20,000
Income tax expense	9,000	36,500
Interest expense	25,000	15,000
Interest revenue	10,000	10,000

Required:

1. Prepare a comparative statement of comprehensive income for Rulon Candies, Inc., for the years ended December 31, 2017, and 2016. Be sure to include figures for operating income, income before taxes, net income, and earnings per share. Ignore other comprehensive income.
2. **Interpretive Question:** What advice would you give Rulon Candies, Inc., to improve its profitability for the year 2018?

P 2-5
LO 2

Statement of Comprehensive Income Preparation

The following information is taken from the records of Wadley's Car Wash for the year ended December 31, 2017.

Income taxes	$ 45,000
Service revenues	210,000
Rent expense	6,000
Salaries expense	41,000

Miscellaneous expense	$ 970
Utilities expense	4,300
Supplies expense	10,300

Required:

Prepare a statement of comprehensive income for Wadley's Car Wash for the year ended December 31, 2017. (Assume that 3,000 shares of stock are outstanding.) Ignore other comprehensive income.

P 2-6

LO 1
LO 2

Expanded Accounting Equation

At the end of 2017, Spencer Systems, Inc., had a fire that destroyed the majority of its accounting records. Spencer Systems, Inc., was able to gather the following financial information for 2017.

a. Retained earnings was changed only as a result of net income and a $25,000 dividend payment to Spencer's investors.

b. All other account changes for the year are listed below. The amount of change for each account is shown as a net increase or decrease.

	Increase or (Decrease)
Cash	$ 12,500
Interest receivable	(7,500)
Accounts receivable	(11,750)
Building	157,500
Accounts payable	22,500
Mortgage payable	87,500
Wages payable	(35,250)
Capital stock	26,250

Required:

Using the accounting equation, compute Spencer's net income for 2017.

P 2-7

LO 2

Statement of Comprehensive Income Preparation

Precision Corporation is a delivery services company. Following are the results of Precision's operations for 2017.

Service revenue	$68,000	Packaging expense	$ 355
Advertising expense	1,530	Salaries expense	18,350
Income taxes	4,360	Supplies expense	480
Delivery expense	8,410	EPS	3.45

Required:

1. Prepare a statement of comprehensive income for the year ended December 31, 2017. Ignore other comprehensive income.
2. How many shares of stock were outstanding?

P 2-8

LO 2

Net Income

A summary of the operations of Streuling Company for the year ended May 31, 2017, is shown below.

Advertising expense	$ 2,760	Dividends	$ 12,400
Supplies expense	37,820	Retained earnings (6/1/16)	156,540
Rent expense	1,500	Income taxes	21,180
Salaries expense	18,150	Consulting fees (revenues)	115,100
Miscellaneous expense	4,170	Administrative expense	7,250

Required:

1. Determine the net income for the year by preparing a statement of comprehensive income. Ignore other comprehensive income. (Assume that 3,000 shares of stock are outstanding.)
2. **Interpretive Question:** Assuming an operating loss for the year, is it a good idea for Streuling to still pay its shareholders dividends?

P 2-9

LO 1 LO 2 LO 3

Preparing Statement of Comprehensive Income, Statement of Retained Earnings, and Balance Sheet

On January 1, 2017, Muchon Flying Experience Ltd., a company that provides flying lessons, was started with an investment of $45,000 cash in the business. Following are the assets and liabilities of the company on May 31, 2017, and the revenues and expenses for the month of May (all amounts in thousands).

Cash	$ 9,000	Notes Payable	$ 56,000
Accounts Receivable	14,840	Rent Expense	2,000
Equipment	128,000	Maintenance and Repairs Expense	800
Service Revenue	13,600	Gasoline Expense	5,000
Advertising Expense	1,000	Utilities Expense	800
Accounts Payable	2,800		

No additional investments were made in May, but the company paid dividends of $960,000 during the month.

Required:

1. Prepare a statement of comprehensive income and a statement of retained earnings for the month of May and a balance sheet at January 31. (Show numbers in thousands.)
2. Prepare a statement of comprehensive income and a statement of retained earnings for May assuming the following data are not included above: (1) $1,800,000 worth of services were performed and billed but not collected at January 31, and (2) $3,000,000 of gasoline expense was incurred but not paid.

P 2-10

LO 2 LO 3

Net Income and Statement of Retained Earnings

A summary of the operations of Quincy Company for the year ended May 31, 2017, is shown below.

Advertising expense	$ 4,650	Dividends	$ 19,500
Supplies expense	38,410	Retained earnings (6/1/16)	175,670
Rent expense	2,400	Income taxes	20,760
Salaries expense	25,340	Consulting fees (revenues)	176,400
Miscellaneous expense	10,200	Administrative expense	13,900

Required:

1. Determine the net income for the year by preparing a statement of comprehensive income. (There are 8,000 shares of stock outstanding.) Ignore other comprehensive income.
2. Prepare a statement of retained earnings for the year ended May 31, 2017.
3. Prepare a statement of retained earnings assuming that Quincy had a net loss for the year of $38,000.
4. **Interpretive Question:** Assuming a loss as in (3), is it a good idea for Quincy to still pay its shareholders dividends?

P 2-11

LO 1 LO 2

Comprehensive Financial Statement Preparation

The following information was obtained from the records of Wilcox, Inc., as of December 31, 2017.

Land	$ 42,500	Accounts receivable	$ 90,000
Buildings	197,550	Supplies expense	110,600
Salaries expense	125,350	Cash	?
Utilities expense	5,250	Notes payable (long-term)	63,800
Accounts payable	38,050	Rent expense	21,200
Revenues	389,950	Dividends in 2017	95,500
Supplies	72,500	Other expenses	11,250
Retained earnings (1/1/17)	311,000	Income taxes	35,000
Capital stock (2,000 shares outstanding)	65,000		

Required:

1. Prepare a statement of comprehensive income for the year ended December 31, 2017. Ignore other comprehensive income.
2. Prepare a classified balance sheet as of December 31, 2017.
3. **Interpretive Question:** Why is the balance in Retained Earnings so large as compared with the balance in Capital Stock?

P 2-12
LO 4

Statement of Cash Flows

Pratt & Jordan Development, Inc. provides consulting services for customers. The financial information shown below was gathered from its accounting records for 2017. Assume any increase or decrease in the balances from 1/1/17 to 12/31/17 resulted from either receiving or paying cash in the transaction. For example, during 2017 the balance on loans for land holdings increased $75,000 because the company received $75,000 in cash by taking out an additional loan on the land.

Items	Balance as of 1/1/17	Balance as of 12/31/17
Cash	$130,000	$175,000
Cash receipts from customers	—	750,000
Loans on land holdings	225,000	300,000
Cash distributions to owners	—	60,000
Loan on building	130,000	80,000
Investments in securities	600,000	845,000
Cash payments for other expenses	—	32,000
Cash payments for taxes	—	43,000
Cash payments for operating expenses	—	215,000
Cash payments for wages and salaries	—	135,000

Required:

1. Prepare a statement of cash flows for Pratt & Jordan Development, Inc., for the year ended December 31, 2017.
2. **Interpretive Question:** Does Pratt & Jordan Development, Inc., appear to be in good shape from a cash flow standpoint? What other information would help you analyze the situation?

P 2-13
LO 4

Statement of Cash Flows

The cash account for Esplin Enterprises shows the following for the year ended December 31, 2017.

Beginning cash balance	$?
Cash receipts during year from:	
Services	2,214,000
Investments by owners	93,000
Sale of land	194,000
Cash payments during year for:	
Operating expenses	1,735,000
Taxes	207,000
Purchase of building	352,000
Distributions to owners	68,000
Ending cash balance	815,000

Required:

Prepare a statement of cash flows for Esplin Enterprises for the year ended December 31, 2017.

Analytical Assignments

AA 2-1
Discussion

Creditor and Investor Information Needs

Ink Spot is a small company that has been in business for two years. Wilford Smith, the president of the company, has decided that it is time to expand. He needs $10,000 to purchase additional equipment and to pay for increased operating expenses. Wilford can either apply for a loan at First City Bank, or he can issue more stock (1,000 shares are outstanding) to new investors. Assuming that you are the loan officer at First City Bank, what information would you request from Ink Spot before deciding whether to make the loan? As a potential investor in Ink Spot, what information would you need to make a good investment decision?

AA 2-2
Judgment Call

You Decide: Is the cash flow statement necessary?

You were at dinner with some family and friends when one of them started talking about the long hours he has been putting in at work—a local waste management company. He said that cash flows have been bad and he has been staying up late trying to figure out the problem.

When asked about the condition of his statement of cash flows, he said, "We don't have one of those statements to assess cash flows, we just use EBITDA (earnings before interest, taxes, depreciation, and amortization). Besides, everything I need to know is in either the balance sheet or statement of comprehensive income." Is a statement of cash flows necessary, or is the information it contains redundant when compared with the balance sheet and statement of comprehensive income?

AA 2-3
Judgment Call

You Decide: Are the notes to the financial statements necessary?

Do the notes to the financial statements add value to investors, or have they evolved from tradition? While listening to talk radio on your way home from work, you heard someone say, "Everything you need to know about a company should be either in the balance sheet, statement of comprehensive income, or statement of cash flows. If you can't find it in there, it is not worth knowing! Besides that, the notes are too complex to understand!" Do you agree with this assumption?

AA 2-4
International

Infosys

Infosys is an Indian IT and consulting company with operations around the globe. The company "defines, designs, and delivers technology-enabled business solutions" that help companies around the world. Infosys' balance sheet for 2011, prepared according to Indian GAAP, is shown on the next page.

1. Can you identify any major differences between Philips' and Infosys' balance sheets in terms of the major categories displayed?
2. What is Infosys' total assets? Is it as easy to determine as Philips' total assets?
3. Take a look at the following list of accounts and identify, given your knowledge of assets, liabilities, and equity, what the American equivalent of those accounts might be (you might want to reference Philips' balance sheet for comparison):
   - Provisions
   - Sundry debtors
   - Reserves and surplus

Infosys
Balance Sheet
March 31, 2011
(in Rupees crore)*

Sources of Funds	
Shareholders' Funds	
Share capital	286
Reserves and surplus	25,690
Deferred tax liabilities	176
Minority interest	0
	26,152
Application of Funds	
Fixed Assets	
Original cost	8,501
Less: Depreciation and amortization	3,266
Net book value	5,235
Add: Capital work-in-progress	525
	5,760
Investments	144
Deferred Tax Assets	497
Current Assets, Loans and Advances	
Sundry debtors	4,653
Cash and bank balances	15,095
Loans and advances	5,320
	25,068
Less: Current liabilities	2,677
Provisions	2,640
Net Current Assets	19,751
	26,152

*1 rupee crore = 10 million rupees

AA 2-5

Ethics

Violating a Covenant

Often, banks will require a company that borrows money to agree to certain restrictions on its activities in order to protect the lending institution. These restrictions are called "debt covenants." An example of a common debt covenant is requiring a company to maintain its current ratio (which is current assets ÷ current liabilities) at a certain level, say, 2.0.

Your boss has just come to you and asked, "How can you make our current ratio higher?" You know that the company has a line of credit with a local bank that requires the company to maintain its current ratio at 1.5. You also know that the company was dangerously close to violating this covenant during the previous quarter. The end of the fiscal period is next week, and some action must be taken to increase the current ratio. If the covenant is violated, the lending agreement allows the bank to significantly modify the terms of the debt (in the bank's favor) and also gives the bank a seat on the company's board of directors. Management would prefer not to have the bank involved in the day-to-day affairs of the business, nor do they want to alter the terms of the lending agreement.

Identify ways in which the current ratio can be increased. Would any of the alternatives you identify be good for the business, e.g., selling equipment might raise the current ratio but would that be good for the business? Should a company engage in these types of transactions?