# 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 Price per Market

Outstanding × Share = 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

### 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 indicating that either the company has reported a cumulative loss over its history 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 $35,000C $ 6,700 $ 41,000

Net increase (decrease) in cash 5,800 11,000 (4,200)E (9,200)

Cash, ending $14,800B $46,000 $ 2,500 $ 31,800H

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 6,000G

Ending retained earnings $53,500A $23,000 $12,500 $ 18,000

## EXERCISES

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

1. L

2. A

3. SCI

4. A

5. A

6. SCI

7. A

8. E

9. SCI

10. A

11. A

12. L

13. L

14. A

15. SCI

16. E

17. SCI

### E 2–2 (LO1) Accounting Equation

Johnson Best Coury

Company Company 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 Conaton Seipke

Company Company 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 = Net Income

Net Income = Revenues – Expenses

$19,000 = X – $55,000

X = $74,000 = Revenues

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

Canfield Corporation

Balance Sheet

December 31, 2017

Assets

Cash $ 55,000

Accounts receivable 75,000

Interest receivable 20,000

Equipment 85,000

Buildings 325,000

Total assets $560,000

Liabilities

Accounts payable $ 65,000

Mortgage payable 150,000

Equity

Capital stock 200,000

Retained earnings 145,000

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).

### 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

2. 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 

\*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 +** $1,8**00)** $**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

P 2–11 (LO1, LO2) (Continued)

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

2. 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.