CHAPTER 1

Introduction to Financial Statements

ANSWERS TO QUESTIONS

1. The three basic forms of business organizations are (1) sole proprietorship, (2) partnership, and (3) corporation.

2. Advantages of a corporation are limited liability (stockholders not being personally liable for corporate debts), easy transferability of ownership, and easier to raise funds. Disadvantages of a corporation are increased taxation and government regulations.

3. Proprietorships and partnerships receive favorable tax treatment compared to corporations and are easier to form than corporations. They are also owner controlled. Disadvantages of proprietorships and partnerships are unlimited liability (proprietors/partners are personally liable for all debts) and difficulty in obtaining financing compared to corporations.

4. Yes. A person cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Accounting provides financial information to interested users through the preparation and distribution of financial statements.

5. Internal users are managers who plan, organize, and run a business. To assist management, accounting provides timely internal reports. Examples include financial comparisons of operating alternatives, projections of income from new sales campaigns, forecasts of cash needs for the next year and financial statements.

6. External users are those outside the business who have either a present or potential direct financial interest (investors and creditors) or an indirect financial interest (taxing authorities, regulatory agencies, labor unions, customers, and economic planners).

7. The three types of business activity are financing activities, investing activities, and operating activities. Financing activities include borrowing money and selling shares of stock. Investing activities include the purchase and sale of property, plant, and equipment. Operating activities include selling goods, performing services, and purchasing inventory.

8. (a) Income statement.
(b) Balance sheet.
(c) Income statement.
(d) Balance sheet.
(e) Balance sheet.
(f) Balance sheet.

9. When a company pays dividends it reduces the amount of assets available to pay creditors. Therefore banks and other creditors monitor dividend payments to ensure they do not put a company's ability to make debt payments at risk.

10. Yes. Net income does appear on the income statement—it is the result of subtracting expenses from revenues. In addition, net income appears in the retained earnings statement—it is shown as an addition to the beginning-of-period retained earnings. Indirectly, the net income of a company is also included in the balance sheet. It is included in the retained earnings account which appears in the stockholders' equity section of the balance sheet.

Questions Chapter 1 (Continued)

11. The primary purpose of the statement of cash flows is to provide financial information about the cash receipts and cash payments of a business for a specific period of time.

12. The three categories of the statement of cash flows are operating activities, investing activities, and financing activities. The categories were chosen because they represent the three principal types of business activity.

13. Retained earnings is the net income retained in a corporation. Retained earnings is increased by net income and is decreased by dividends and a net loss.

14. The basic accounting equation is Assets = Liabilities + Stockholders' Equity.

15. (a) Assets are resources owned by a business. Liabilities are amounts owed to creditors. Put more simply, liabilities are existing debts and obligations. Stockholders' equity is the ownership claim on total assets.

(b) The items that affect stockholders' equity are common stock, retained earnings, dividends, revenues, and expenses.

16. The liabilities are (b) Accounts payable and (g) Salaries payable.

17. (a) Net income from the income statement is reported as an increase to retained earnings on the retained earnings statement.

(b) The ending amount on the retained earnings statement is reported as the retained earnings amount on the balance sheet.

(c) The ending amount on the statement of cash flows is reported as the cash amount on the balance sheet.

18. The purpose of the management discussion and analysis section is to provide management's views on its ability to pay short-term obligations, its ability to fund operations and expansion, and its results of operations. The MD&A section is a required part of the annual report.

19. An unqualified opinion shows that, in the opinion of an independent auditor, the financial statements have been presented fairly, in conformity with generally accepted accounting principles. This gives investors more confidence that they can rely on the figures reported in the financial statements.

20. Information included in the notes to the financial statements clarifies information presented in the financial statements and includes descriptions of accounting policies, explanations of uncertainties and contingencies, and statistics and details too voluminous to be reported in the financial statements.

21. Using dollar amounts, Tootsie Roll's accounting equation is:

Assets		Liabilities		Stockholders' Equity
$812,725,000	=	$174,495,000	+	$638,230,000

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 1-1

(a) P Shared control, tax advantages, increased skills and resources.

(b) SP Simple to set up and maintains control with founder.

(c) C Easier to transfer ownership and raise funds, no personal liability.

BRIEF EXERCISE 1-2

(a) 4 Investors in common stock
(b) 3 Marketing managers
(c) 2 Creditors
(d) 5 Chief Financial Officer
(e) 1 Internal Revenue Service

BRIEF EXERCISE 1-3

O (a) Cash received from customers.
F (b) Cash paid to stockholders (dividends).
F (c) Cash received from issuing new common stock.
O (d) Cash paid to suppliers.
I (e) Cash paid to purchase a new office building.

BRIEF EXERCISE 1-4

E (a) Advertising expense
R (b) Service revenue
E (c) Insurance expense
E (d) Salaries expense
D (e) Dividends
R (f) Rent revenue
E (g) Utilities expense
NSE (h) Cash purchase of equipment
C (i) Issued common stock for cash.

BRIEF EXERCISE 1-5

MANTLE COMPANY
Balance Sheet
December 31, 2010

Assets	
Cash	$ 22,000
Accounts receivable	81,000
Total assets	$103,000
Liabilities and Stockholders' Equity	
Liabilities	
Accounts payable	$ 75,000
Stockholders' equity	
Common stock	28,000
Total liabilities and stockholders' equity	$103,000

BRIEF EXERCISE 1-6

IS (a) Income tax expense
BS (b) Inventories
BS (c) Accounts payable
BS (d) Retained earnings
BS (e) Property, plant, and equipment
IS (f) Net sales
IS (g) Cost of goods sold
BS (h) Common stock
BS (i) Receivables
IS (j) Interest expense

BRIEF EXERCISE 1-7

I (a) Revenue during the period.
B (b) Supplies on hand at the end of the year.
C (c) Cash received from issuing new bonds during the period.
B (d) Total debts outstanding at the end of the period.

BRIEF EXERCISE 1-8

(a) $90,000 + $230,000 = $320,000 (Total assets)

(b) $170,000 – $90,000 = $80,000 (Total liabilities)

(c) $800,000 – 0.25($800,000) = $600,000 (Stockholders' equity)

BRIEF EXERCISE 1-9

(a) ($800,000 + $150,000) – ($500,000 – $80,000) = $530,000 (Stockholders' equity)

(b) ($500,000 + $100,000) + ($800,000 – $500,000 – $70,000) = $830,000 (Assets)

(c) ($800,000 – $90,000) – ($800,000 – $500,000 + $110,000) = $300,000 (Liabilities)

BRIEF EXERCISE 1-10

A	(a)	Accounts receivable
L	(b)	Salaries payable
A	(c)	Equipment
A	(d)	Office supplies
SE	(e)	Common stock
L	(f)	Notes payable

BRIEF EXERCISE 1-11

(d) All of these are required.

SOLUTIONS TO DO IT! REVIEW EXERCISES

DO IT! 1-1

(1) Easier to transfer ownership: corporation
(2) Easier to raise funds: corporation
(3) More owner control: sole proprietorship
(4) Tax advantages: sole proprietorship and partnership
(5) No personal legal liability: corporation

DO IT! 1-2

(1) Issuance of ownership shares is classified as common stock.
(2) Land purchased is classified as an asset.
(3) Amounts owed to suppliers are classified as liabilities.
(4) Bonds payable are classified as liabilities.
(5) Amount earned from selling a product is classified as revenue.
(6) Cost of advertising is classified as expense.

DO IT! 1-3

COUGAR CORPORATION
Income Statement
For the Year Ended December 31, 2010

Revenues		
Service revenue		$25,000
Expenses		
Rent expense	$10,000	
Advertising expense	2,000	
Supplies expense	1,700	
Total expenses		13,700
Net income		$11,300

DO IT! 1-3 (Continued)

COUGAR CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1	$ –0–
Add: Net income	11,300
	11,300
Less: Dividends	2,500
Retained earnings, December 31	$ 8,800

COUGAR CORPORATION
Balance Sheet
December 31, 2010

Assets

Cash	$ 3,100
Accounts receivable	3,000
Supplies	1,900
Equipment	27,800
Total assets	$35,800

Liabilities and Stockholders' Equity

Liabilities		
Notes payable	$ 7,000	
Account payable	5,000	
Total liabilities		$12,000
Stockholder's equity		
Common stock	$15,000	
Retained earnings	8,800	
Total stockholders' equity		23,800
Total liabilities and stockholder's equity		$35,800

DO IT! 1-4

(1) Description of ability to pay near-term obligations: MD&A
(2) Unqualified Opinion: auditor's report
(3) Details concerning liabilities, which are too voluminous to be included in the statements: notes
(4) Description of favorable and unfavorable trends: MD&A
(5) Certified Public Accountant (CPA): auditor's report
(6) Descriptions of significant accounting policies: notes

SOLUTIONS TO EXERCISES

EXERCISE 1-1

(a) 8. Auditor's opinion
(b) 1. Corporation
(c) 6. Common stock
(d) 7. Accounts payable
(e) 3. Accounts receivable
(f) 2. Creditor
(g) 5. Stockholder
(h) 4. Partnership

EXERCISE 1-2

	(a)	(b)
Accounts payable and accrued liabilities	L	O
Accounts receivable	A	O
Property, plant, and equipment	A	I
Food and beverage operations revenue	R	O
Golf course operations revenue	R	O
Inventory	A	O
Long-term debt	L	F
Office and general expense	E	O
Professional fees expense	E	O
Wages and benefits expense	E	O

EXERCISE 1-3

(a) **Answers will vary.**

	Financing	Investing	Operating
Abitibi Consolidated Inc.	Sale of stock	Purchase long-term investments	Sale of newsprint
Cal State Northridge—Stdt Union	Borrow money from a bank	Purchase office equipment	Payment of wages and benefits
Oracle Corporation	Sale of bonds	Purchase other companies	Payment of research expenses
Sportsco Investments	Payment of dividends to stockholders	Purchase hockey equipment	Payment for rink rentals
Grant Thornton LLP	Distribute earnings to partners	Purchase computers	Bill clients for professional services
Southwest Airlines	Sale of stock	Purchase airplanes	Payment for jet fuel

(b)

Financing

Sale of stock is common to all corporations. Borrowing from a bank is common to all businesses. Payment of dividends is common to all corporations. Sale of bonds is common to large corporations.

Investing

Purchase and sale of property, plant, and equipment would be common to all businesses—the types of assets would vary according to the type of business and some types of businesses require a larger investment in long-lived assets. A new business or expanding business would be more apt to acquire property plant and equipment while a mature of declining business would be more apt to sell it.

Operating

The general activities identified would be common to most businesses, although the service or product would differ.

EXERCISE 1-4

DENSON CO.
Income Statement
For the Year Ended December 31, 2010

Revenues		
Service revenue		$53,000
Expenses		
Salaries expense	$30,000	
Rent expense	10,400	
Utilities expense	2,400	
Advertising expense	1,800	
Total expenses		44,600
Net income		$ 8,400

DENSON CO.
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1	$64,000
Add: Net income	8,400
	72,400
Less: Dividends	6,000
Retained earnings, December 31	$66,400

EXERCISE 1-5

(a) Hollis Corporation is distributing nearly all of this year's net income as dividends. This suggests that Hollis is not pursuing rapid growth. Companies that have a lot of opportunities for growth pay low dividends.

(b) Zhiang Corporation is not generating sufficient cash provided by operating activities to fund its investing activities. Instead it generates additional cash through financing activities. This is common for companies in their early years of existence.

EXERCISE 1-6

WILLINGHAM INC.
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1		$130,000
Add: Net income		230,000*
		360,000
Less: Dividends		82,000
Retained earnings, December 31		$278,000

*Revenue from legal services	$400,000
Total expenses	170,000
Net income	$230,000

EXERCISE 1-7

First note that the retained earnings statement shows that (b) equals $25,000.

Accounts payable + Common stock + Retained earnings = Total liabilities and stockholders' equity

$5,000 + a + $25,000 = $60,000
a + $30,000 = $60,000
a = $\underline{\underline{\$30,000}}$

Beginning retained earnings + Net income – Dividends = Ending retained earnings

$10,000 + e – $5,000 = $25,000
$5,000 + e = $25,000
e = $\underline{\underline{\$20,000}}$

From above, we know that net income (d) equals $20,000.

Revenue – Cost of goods sold – Administrative expenses = Net income

$85,000 – c – $10,000 = $20,000
$75,000 – c = $20,000
c = $\underline{\underline{\$55,000}}$

EXERCISE 1-8

(a)

A	Cash and short-term investments
SE	Retained earnings
E	Cost of goods sold
E	Selling, general and administrative expenses
A	Prepaid expenses
A	Inventories
A	Receivables
R	Sales revenue
L	Income taxes payable
L	Accounts payable
R	Franchising revenues
E	Interest expense

(b)

WAYSIDE INC.
Income Statement
For the Year Ended December 31, 2010

Revenues	
Sales revenue	$584,951
Franchising revenues	4,786
Total revenues	589,737
Expenses	
Cost of goods sold	438,458
Selling, general and administrative expenses	115,131
Interest expense	1,994
Total expenses	555,583
Net income	$ 34,154

EXERCISE 1-9

(a)

Camping fee revenue	$132,000
General store revenue	25,000
Total revenue	157,000
Expenses	129,000
Net income	$ 28,000

(b)

FOREST PARK
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained earnings, January 1	$ 5,000
Add: Net income	28,000
	33,000
Less: Dividends	9,000
Retained earnings, December 31	$24,000

FOREST PARK
Balance Sheet
December 31, 2010

Assets

Cash	$ 8,500
Supplies	2,500
Equipment	114,000
Total assets	$125,000

EXERCISE 1-9 (Continued)

Liabilities and Stockholders' Equity

Liabilities		
Notes payable	$50,000	
Accounts payable	11,000	
Total liabilities		$ 61,000
Stockholders' equity		
Common stock	40,000	
Retained earnings	24,000	64,000
Total liabilities and stockholders' equity		$125,000

(c) The income statement indicates that revenues from the general store were only about 16% ($25,000 ÷ $157,000) of total revenue which tends to support Steve's opinion. In order to decide if the store is "more trouble than it is worth," I would need to know the amount of expenses attributable to the general store. The income statement reports all expenses in a single category rather than separating them into camping and general store expenses to correspond with revenues. A break down into two categories would help me decide if the general store is generating a profit or loss.

Even if the general store is operating at a loss, I might recommend retaining it if campers indicated that the convenience of having a general store on site was an important amenity in selecting a camp ground.

EXERCISE 1-10

(a)

SE	Retained earnings
E	Cost of goods sold
E	Selling and administrative expenses
A	Cash
L	Notes payable
E	Interest expense
L	Long-term debt
A	Inventories
R	Net sales
L	Accounts payable
SE	Common stock
E	Income tax expense
R	Other revenue

(b)

KELLOGG COMPANY
Income Statement
For the Year Ended December 31, 2006
(in millions)

Revenues		
Net sales		$10,906.7
Other revenue		13.2
Total revenue		10,919.9
Expenses		
Cost of goods sold	6,081.5	
Selling and administrative expenses	3,059.4	
Income tax expense	466.5	
Interest expense	307.4	
Total expenses		9,914.8
Net income		$ 1,005.1

EXERCISE 1-11

(a)

DAMON CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Cash received from customers	$ 60,000	
Cash paid to suppliers	(18,000)	
Net cash provided by operating activities		$ 42,000
Cash flows from investing activities		
Cash paid for new equipment	(35,000)	
Net cash used by investing activities		(35,000)
Cash flows from financing activities		
Cash received from lenders	20,000	
Cash dividends paid	(8,000)	
Net cash provided by financing activities		12,000
Net increase in cash		19,000
Cash at beginning of period		12,000
Cash at end of period		$ 31,000

(b) As a creditor, I would feel reasonably confident that Damon has the ability to repay its lenders. During 2010, Damon generated $42,000 of cash from its operating activities. This amount more than covered its expenditures for new equipment but not dividends.

EXERCISE 1-12

BENELLI COMPANY
Balance Sheet
December 31, 2010

Assets		
Cash		$20,500
Accounts receivable		12,000
Supplies		9,500
Equipment		40,000
Total assets		$82,000
Liabilities and Stockholders' Equity		
Liabilities		
Accounts payable		$16,000
Stockholders' equity		
Common stock	$40,000	
Retained earnings	26,000*	66,000
Total liabilities and stockholders' equity		$82,000

*$34,000 – $8,000

EXERCISE 1-13

All dollars are in millions.

(a) Assets

Cash	$ 828.0
Accounts receivable	2,120.2
Inventories	1,633.6
Property, plant, and equipment	1,586.9
Other assets	1,722.9
Total assets	$7,891.6

Liabilities

Notes payable	$ 146.0
Accounts payable	763.8
Other liabilities	2,081.9
Income taxes payable	118.2
Total liabilities	$3,109.9

Stockholders' Equity

Common stock	$ 890.6
Retained earnings	3,891.1
Total stockholders' equity	$4,781.7

(b)

Assets	=	Liabilities	+	Stockholders' Equity
$7,891.6		$3,109.9		$4,781.7

(c) Nike has relied more heavily on equity than debt to finance its assets. Debt (liabilities) financed 39% of its assets ($3,109.9 ÷ $7,891.6) compared to equity financing of 61% ($4,781.7 ÷ $7,891.6).

EXERCISE 1-14

(a) Financial statements
(b) Auditor's report
(c) Notes to the financial statements
(d) Financial statements
(e) Management discussion and analysis
(f) Not disclosed

SOLUTIONS TO PROBLEMS

PROBLEM 1-1A

(a) The fact that the combined business expects that it will need to raise significant funds in the near future makes the corporate form more desirable in this case.

(b) The concern over legal liability would make the corporate form a better choice over a partnership. Also, the corporate form will allow the business to raise cash more easily, which may be of importance in a rapidly growing business.

(c) It is likely that this business would form as a partnership. Its needs for additional funds would probably be minimal in the foreseeable future. Also, the three know each other well and would appear to be contributing equally to the firm. Service firms, like consulting businesses, are frequently formed as partnerships.

(d) One way to ensure control would be for Ben to form a sole proprietorship. However, in order for this business to thrive it will need a substantial investment of funds early. This would suggest the corporate form of business. In order for Ben to maintain control over the business he would need to own more than 50 percent of the voting shares of common stock. In order for the business to grow, he may have to be willing to give up some control.

(e) Chad should run his business as a sole proprietor. He has no real need to raise funds, and he doesn't need the expertise provided by other partners. The sole proprietorship form would provide the easiest form. One should avoid a more complicated form of business unless the characteristics of that form are needed.

PROBLEM 1-2A

(a) In deciding whether to extend credit for 30 days you would be most interested in the balance sheet because the balance sheet shows the assets on hand that would be available for settlement of the debt in the near-term.

(b) In purchasing an investment that will be held for an extended period, the investor must try to predict the future performance of Home Depot. The income statement provides the most useful information for predicting future performance.

(c) In extending a loan for a relatively long period of time the lender is most interested in the probability that the company will generate sufficient income to meet its interest payments and repay its principal. The lender would therefore be interested in predicting future net income using the income statement. It should be noted, however, that the lender would also be very interested in both the balance sheet and statement of cash flows—the balance sheet because it would show the amount of debt the company had already incurred, as well as assets that could be liquidated to repay the loan. And the company would be interested in the statement of cash flows because it would provide useful information for predicting the company's ability to generate cash to repay its obligations.

(d) The individual would probably be most interested in the statement of cash flows since it shows how much cash the company generates and how that cash is used. The statement of cash flows can be used to predict the company's future cash-generating ability.

PROBLEM 1-3A

(a)

COPICAT INC.
Income Statement
For the Month Ended August 31, 2007

Revenues		
Revenue		$11,000
Expenses		
Wage expense	$3,400	
Supplies expense	3,000	
Rent expense	1,600	
Advertising expense	500	
Utilities expense	200	
Total expenses		8,700
Net income		$2,300

COPICAT INC.
Retained Earnings Statement
For the Month Ended August 31, 2007

Retained earnings, August 1	$ 0
Add: Net income	2,300
	2,300
Less: Dividends	600
Retained earnings, August 31	$1,700

PROBLEM 1-3A (Continued)

COPICAT INC.
Balance Sheet
August 31, 2007

Assets

Cash		$ 3,800
Accounts receivable		1,000
Supplies		1,800
Equipment		12,000
Total assets		$18,600

Liabilities and Stockholders' Equity

Liabilities		
Notes payable	$6,000	
Accounts payable	900	
Total liabilities		$ 6,900
Stockholders' equity		
Common stock	10,000	
Retained earnings	1,700	11,700
Total liabilities and stockholders' equity		$18,600

(b) Copicat had a very successful first month, earning $2,300 or a 21% return on revenues of $11,000. Its net income represents a 23% return on the initial investment ($2,300 ÷ $10,000).

(c) Distributing a dividend after only one month of operations is probably unusual. Most new businesses choose to build up a cash balance to provide for future operating and investing activities or pay down debt. Copicat distributed 26% ($600 ÷ $2,300) of its first month's income but it had adequate cash to do so and still showed a significant increase in retained earnings.

PROBLEM 1-4A

(a) Showalter Corporation should include the following items in its statement of cash flows:

Cash paid to suppliers
Cash dividends paid
Cash paid to purchase equipment
Cash received from customers
Cash received from issuing common stock

SHOWALTER CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities		
Cash received from customers	$93,000	
Cash paid to suppliers	(76,000)	
Net cash provided by operating activities		$17,000
Cash flows from investing activities		
Cash paid to purchase equipment	(8,000)	
Net cash used by investing activities		(8,000)
Cash flows from financing activities		
Cash received from issuing common stock	18,000	
Cash dividends paid	(4,000)	
Net cash provided by financing activities		14,000
Net increase in cash		$23,000

(b) Showalter Corporation's operating activities provided $17,000 cash which was adequate to fund its investing activities ($8,000) and make $4,000 of dividend payments.

PROBLEM 1-5A

(a) 1. Since the motorcycle actually belongs to Dan Jasper—not to Julius Corporation—it should not be reported on the corporation's balance sheet. Likewise, the motorcycle loan is a personal loan of Dan's—not a liability of Julius Corporation.

2. The truck should be reported at $18,000, the amount paid when it was purchased.

3. The $8,000 is not a receivable of Julius Corporation because the sale has not occurred yet.

(b)

JULIUS CORPORATION
Balance Sheet
December 31, 2007

Assets		
Cash		$20,000
Accounts receivable		31,000*
Truck		18,000
Total assets		$69,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$15,000	
Accounts payable	40,000	
Total liabilities		$55,000
Stockholders' equity		14,000**
Total liabilities and stockholders' equity		$69,000

*$39,000 – $8,000
**$69,000 – $55,000 (Total assets minus total liabilities)

PROBLEM 1-1B

(a) The concern over legal liability would make the corporate form a better choice over a partnership. Also, the corporate form will allow the business to raise cash more easily, which may be of importance in a rapidly growing industry.

(b) Daniel should run his business as a sole proprietor. He has no real need to raise funds, and he doesn't need the expertise provided by other partners. The sole proprietorship form would provide the easiest form. One should avoid a more complicated form of business unless the characteristics of that form are needed.

(c) The fact that the combined business expects that it will need to raise significant funds in the near future makes the corporate form more desirable in this case.

(d) It is likely that this business would form as a partnership. Its needs for additional funds would probably be minimal in the foreseeable future. Also, the three know each other well and would appear to be contributing equally to the firm. Service firms, like consulting businesses, are frequently formed as partnerships.

(e) One way to ensure control would be for Stan to form a sole proprietorship. However, in order for this business to thrive it will need a substantial investment of funds early. This would suggest the corporate form of business. In order for Stan to maintain control over the business he would need to own more than 50 percent of the voting shares of common stock. In order for the business to grow, he may have to be willing to give up some control.

PROBLEM 1-2B

(a) In purchasing an investment that will be held for an extended period, the investor must try to predict the future performance of Bally Total Fitness. The income statement provides the most useful information for predicting future performance.

(b) In deciding whether to extend credit for 60 days Boeing would be most interested in the balance sheet because the balance sheet shows the assets on hand that would be available for settlement of the debt in the near-term.

(c) The president would probably be most interested in the statement of cash flows since it shows how much cash the company generates and how that cash is used. The statement of cash flows can be used to predict the company's future cash-generating ability.

(d) In extending a loan for a relatively long period of time the lender is most interested in the probability that the company will generate sufficient income to meet its interest payments and repay its principal. The lender would therefore be interested in predicting future income using the income statement. It should be noted, however, that the lender would also be very interested in both the balance sheet and the statement of cash flows—the balance sheet because it would show the amount of debt the company had already incurred, as well as assets that could be liquidated to repay the loan. And the company would be interested in the statement of cash flows because it would provide useful information for predicting the company's ability to generate cash to repay its obligations.

PROBLEM 1-3B

(a)

ECKERSLEY SERVICE CO.
Income Statement
For the Month Ended June 30, 2010

Revenues		
Revenue		$7,000
Expenses		
Wage expense	$1,400	
Supplies expense	1,000	
Gas and oil expense	600	
Advertising expense	400	
Utilities expense	300	
Total expenses		3,700
Net income		$3,300

ECKERSLEY SERVICE CO.
Retained Earnings Statement
For the Month Ended June 30, 2010

Retained earnings, June 1	$ 0
Add: Net income	3,300
	3,300
Less: Dividends	2,000
Retained earnings, June 30	$1,300

PROBLEM 1-3B (Continued)

ECKERSLEY SERVICE CO.
Balance Sheet
June 30, 2010

Assets		
Cash		$ 4,600
Accounts receivable		4,000
Supplies		2,400
Equipment		29,000
Total assets		$40,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$12,000	
Accounts payable	500	
Total liabilities		$12,500
Stockholders' equity		
Common stock	26,200	
Retained earnings	1,300	27,500
Total liabilities and stockholders' equity	$40,000	

(b) Eckersley had a very successful first month, earning $3,300 or a 47% return on revenues of $7,000. Its net income represents a 13% return on the initial investment ($3,300 ÷ $26,200).

(c) Distributing a dividend after only one month of operations is probably unusual. Most new businesses choose to build up a cash balance to provide for future operating and investing activities or pay down debt. Eckersley distributed 61% ($2,000 ÷ $3,300) of its first month's income but it had adequate cash to do so and still showed a significant increase in retained earnings.

PROBLEM 1-4B

(a) Eaton Corporation should include the following items in its statement of cash flows:

Cash paid to suppliers
Cash dividends paid
Cash paid to purchase equipment
Cash received from customers
Cash received from issuing bonds payable

EATON CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Cash received from customers	$178,000	
Cash paid to suppliers	(154,000)	
Net cash provided by operating activities		$24,000
Cash flows from investing activities		
Cash paid to purchase equipment	(34,000)	
Net cash used by investing activities		(34,000)
Cash flows from financing activities		
Cash received from issuing bonds payable	35,000	
Cash dividends paid	(9,000)	
Net cash provided by financing activities		26,000
Net increase in cash		$16,000

(b) Operating activities provided $24,000 cash which was not adequate to cover $34,000 needed for investing activities and $9,000 of dividend payments. Eaton issued $35,000 of bonds payable to fund these cash payments and increase its year-end cash balance.

PROBLEM 1-5B

(a) 1. Since the boat actually belongs to Trent Radinsky—not to Penington Corporation—it should not be reported on the corporation's balance sheet. Likewise, the boat loan is a personal loan of Trent's—not a liability of Penington Corporation.

2. The inventory should be reported at $21,000, the amount paid when it was purchased. Penington Corporation will record $33,000 as revenues when the inventory is sold.

3. The $12,000 receivable is not an asset of Penington Corporation—it is a personal asset of Trent Radinsky.

(b)

PENINGTON CORPORATION
Balance Sheet
December 31, 2010

Assets		
Cash		$20,000
Accounts receivable		38,000*
Inventory		21,000
Total assets		$79,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$15,000	
Accounts payable	30,000	
Total liabilities		$45,000
Stockholders' equity		34,000**
Total liabilities and stockholders' equity		$79,000

*$50,000 – $12,000
**$79,000 – $45,000 (Total assets minus total liabilities)

BYP 1-1 FINANCIAL REPORTING PROBLEM

(a) Tootsie Roll's total assets at December 31, 2007 were $812,725,000 and at December 31, 2006 were $791,639,000.

(b) Tootsie Roll had $57,606,000 of cash at December 31, 2007.

(c) Tootsie Roll had accounts payable totaling $11,572,000 on December 31, 2007 and $13,102,000 on December 31, 2006.

(d) Tootsie Roll reported sales revenue in 2007 of $492,742,000 and in 2006 of $495,990,000.

(e) Tootsie Roll's net income decreased by $14,294,000 from 2006 to 2007, from $65,919,000 to $51,625,000.

BYP 1-2 COMPARATIVE ANALYSIS PROBLEM

(a)

(amounts in thousands)	Tootsie Roll Industries, Inc.	Hershey Foods Corporation
1. Total assets	$812,725	$4,247,113
2. Net property, plant and equipment	$201,401	$1,539,715
3. Sales revenue	$492,742	$4,946,716
4. Net income	$ 51,625	$ 214,154

(b) Both companies are profitable. Hershey's total assets and sales revenue suggest that it is a substantially bigger company than Tootsie Roll. Hershey's total assets are more than five times as big as those of Tootsie Roll and its total sales are more than 10 times as big as those of Tootsie Roll.

BYP 1-3 RESEARCH CASE

(a) The rankings of each of the "Big Four" accounting firms were:
Deloitte and Touche (1)
PricewaterhouseCoopers (2)
Ernst and Young (3)
KPMG (11)

(b) The article suggest that, because the accounting firms are facing an "epic talent shortage" they had to rethink how they hire and retain new employees. As a consequence, the accounting firms were among the most innovative employers in terms of the types of techniques used to attract students, and in terms of the types of benefits provided to employees.

(c) Deloitte and Touche named communication skills as its most desirable trait for a new employee.

(d) The starting salary for a new employee at Deloitte and Touche was $50,000 to $55,000.

(e) At the time the article was written in 2007, the number of students graduating with accounting degrees had increased by 29% relative to 2002.

BYP 1-4 INTERPRETING FINANCIAL STATEMENTS

(a) Creditors lend money to companies with the expectation that they will be repaid at a specified point in time in the future. If a company is generating cash from operations in excess of its investing needs, it is more likely that it will be able to repay its creditors. Not only did Xerox actually have negative cash from operations, but most of the cash it received in order to meet its cash deficiency was from issuing new debt. Both of these facts would be of concern to the company's creditors, since it would suggest it will be less likely to be able to repay its debts.

(b) As a stockholder you are interested in the long-term performance of a company and how that translates into its stock price. Often during the early years of a company's life its cash provided by operations is not sufficient to meet its investment needs, so the company will have to get cash from outside sources. However, in the case of Xerox, the company has operated for many years and has a well established name brand. The negative cash from operations might suggest operating deficiencies.

(c) The statement of cash flows reports information on a cash basis. An investor cannot get the complete story on the company's performance and financial position without looking at the income statement and balance sheet. Also, investors would want to look at more than one year's worth of data. The current year might not be representative of past or future years.

(d) Xerox is a well known company. It has a past record of paying dividends. Its management probably decided to continue to pay a dividend to demonstrate confidence in the company's future. They may have felt that by not paying the dividend for the year they would send a negative message to investors. However, by choosing to pay a cash dividend the company obviously weakened its cash position, and decreased its ability to repay its debts.

BYP 1-5 FINANCIAL ANALYSIS ON THE WEB

Answers to this question will differ depending on the companies chosen by the student, and the year. We provide the following solution for Tootsie Roll for the year ended December 31, 2007.

(a) **You must read the description of "ttm" to see the period that net income and sales were measured over. During the year ended December 31, 2007, Tootsie Roll reported net income of $51.6 million.**

(b) **During the year ended December 31, 2007, Tootsie Roll reported sales of $493 million.**

(c) **The "Industry" label on the left side of the Profile site tells us that Tootsie Roll is in the Confectioners industry.**

(d) **Companies also in this industry would include Hershey Foods Corp., WM Wrigley Jr Co., M and F Worldwide Corp., Imperial Sugar Co., and Rocky Mountain Chocolate Factory Inc.**

(e) **We chose WM Wrigley Jr Co. During the year ended December 31, 2007, Wrigley reported sales of $5.4 billion and net income of $632.0 million.**

BYP 1-6 DECISION-MAKING ACROSS THE ORGANIZATION

(a) The Report of Independent Accountants indicates that PriceWaterhouse Coopers LLP performed the audit of Tootsie Roll's financial statements.

(b) The Consolidated Statement of Earnings, Comprehensive Earnings and Retained Earnings states that its earnings per share were $0.94 in 2007.

(c) Note 9 indicates that net sales in foreign countries were $46,922,000 in 2007.

(d) Management's Discussion and Analysis of Financial Condition and Results of Operations states that the decrease "reflects the conclusion of a contract to manufacture product under a private-level for a third party, which accounted for approximately $2,200 in net product sales in 2006, and a non-recurring sale of certain inventory in the amount of approximately $1,000 to a new foreign distributive in the first question of 2006.

(e) Per the Five Year Summary of Earnings and Financial Highlights, Net Sales in 2003 were $392,656,000.

(f) The Shareholders' Equity section of the Consolidated Statement of Financial Position states that 40,000,000 shares were authorized.

(g) Per the Consolidated Statement of Cash Flows, $14,767,000 was spent on capital expenditures.

(h) Note 1 states that depreciation is based on "useful lives of 20 to 35 years for buildings."

(i) Per the Consolidated Statement of Financial Position, raw materials and supplies were $21,811,000 in 2006.

BYP 1-7 COMMUNICATION ACTIVITY

To: Diane Wynne

From: Student

I have received the balance sheet of Bates Company, Inc. as of December 31, 2010. The purpose of a balance sheet is to report a company's financial position at a point in time. It reports what the company owns (assets) and what it owes (liabilities) and the net amount attributed to owners (equity). A number of items in this balance sheet are not properly reported. They are:

(1) The balance sheet should be dated as of a specific date, not for a period of time. Therefore, it should be stated "December 31, 2010."

(2) Equipment should be below Supplies on the balance sheet.

(3) Accounts receivable should be shown as an asset and reported between Cash and Supplies on the balance sheet.

(4) Accounts payable should be shown as a liability, not an asset. The note payable is also a liability and should be reported in the liability section.

(5) Liabilities and stockholders' equity should be shown separately on the balance sheet. Common stock, Retained earnings, and Dividends are not liabilities.

(6) Common stock, Retained earnings, and Dividends are part of stockholders' equity. The Dividends account is not reported on the balance sheet but is subtracted from Retained earnings to arrive at the ending balance.

A correct balance sheet is as follows:

BYP 1-7 (Continued)

BATES COMPANY, INC.
Balance Sheet
December 31, 2010

Assets		
Cash		$ 10,500
Accounts receivable		6,000
Supplies		2,000
Equipment		20,500
Total assets		$39,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$14,000	
Accounts payable	5,000	
Total liabilities		19,000
Stockholders' equity		
Common stock	12,000	
Retained earnings	8,000*	20,000
Total liabilities and stockholders' equity		$39,000

*Retained earnings	$10,000
Less: Dividends	2,000
Ending retained earnings	$ 8,000

BYP 1-8 ETHICS CASE

(a) **Investors rely on auditors to perform an independent assessment of a company. If the auditor owns stock in that company, he or she might not be able to act in an independent and impartial manner.**

(b) **There are pros and cons to this argument. On the positive side, it could be argued that as long as a person has no direct relationship with a client company, that person will not influence the findings of the work. However, a counter argument is that an influential partner within a firm, who had a investment in a client that he or she didn't work on, might be tempted to try to influence the findings of the audit if he or she feared that the findings were going to negatively affect the value of his or her investment.**

(c) **The fact that four firms have become so big means that the current rules prohibit employees (or even relatives of those employees) of those firms from buying stock in roughly 25% of publicly traded firms. Some would argue that this creates an undue hardship, and unfairly restricts the investment options of these people. They also argue that in such a large organization it is increasingly unlikely that an individual who doesn't work on a particular audit will be able to influence the outcome of the audit.**

(d) **Answers to this question will vary. This is a particularly difficult issue since the rule effectively eliminates the individual's control over their investment portfolio. They did nothing wrong when they bought the shares, but now they are being forced to sell when it is not advantageous.**

(e) **The management of PricewaterhouseCoopers noted that auditor independence is vitally important to the audit function. If investors don't think the auditor is independent of the client they will lose faith in auditing, which would have dire consequences for securities markets. Therefore, it was important that the firm make a bold, unambiguous response to address this problem.**

BYP 1-9 ALL ABOUT YOU: THE ETHICS OF FINANCIAL AID

(a) Answers to the following will vary depending on students' opinions.

- (i) This does not represent the hiding of assets, but rather a choice as to the order of use of assets. This would seem to be ethical.
- (ii) This does not represent the hiding of assets, but rather is a change in the nature of assets. Since the expenditure was necessary, although perhaps accelerated, it would seem to be ethical.
- (iii) This represents an intentional attempt to deceive the financial aid office. It would therefore appear to be both unethical and potentially illegal.
- (iv) This is a difficult issue. By taking the leave, actual net income would be reduced. The form asks the applicant to report actual net income. However, it is potentially deceptive since you do not intend on taking unpaid absences in the future, thus future income would be higher than reported income.

(b) Companies might want to overstate net income in order to potentially increase the stock price by improving investors' perceptions of the company. Also, a higher net income would make it easier to receive debt financing. Finally, managers would want a higher net income to increase the size of their bonuses.

(c) Sometimes companies want to report a lower income if they are negotiating with employees. For example, professional sports teams frequently argue that they can not increase salaries because they aren't making enough money. This also occurs in negotiations with unions. For tax accounting (as opposed to the financial accounting in this course) companies frequently try to minimize the amount of reported taxable income.

(d) Unfortunately many times people who are otherwise very ethical will make unethical decisions regarding financial reporting. They might be driven to do this because of greed. Frequently it is because their superiors have put pressure on them to take an unethical action, and they are afraid to not follow directions because they might lose their job. Also, in some instances top managers will tell subordinates that they should be a team player, and do the action because it would help the company, and therefore would help fellow employees.