Chapter 1
A Framework for Financial Accounting

REVIEW QUESTIONS

Question 1-1 (LO 1-1)
Accounting is the language of business. Whereas a basic math class might involve adding, subtracting, and solving for unknown variables, accounting involves learning to measure business transactions and communicating those measurements in a format that is generally understood by decision makers.

Question 1-2 (LO 1-1)
Those interested in making decisions about a company include investors, creditors, customers, suppliers, managers, employees, competitors, regulators, tax authorities, and local communities.

Question 1-3 (LO 1-1)
Financial accounting seeks to measure business activities of a company and to communicate those measurements to *external* parties for decision-making purposes. The two primary external, or outside the firm, users of financial accounting information are investors and creditors. Managerial accounting deals with the methods accountants use to provide information to an organization's *internal* users, that is, its own managers.

Question 1-4 (LO 1-1)
The two primary functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors for decision-making purposes.

Question 1-5 (LO 1-2)
The three basic business activities are financing, investing, and operating activities. Financing activities are transactions that raise cash needed to operate the business. Investing activities typically include the purchase or disposal of long-term resources such as land, buildings, equipment, and machinery. Operating activities include the primary operations of the company, providing products and services to customers and the associated costs of doing so, like utilities, taxes, advertising, wages, rent, and maintenance.

Question 1-6 (LO 1-2)
Typical financing activities would include selling stock and paying dividends to investors, as well as borrowing and repaying debt to creditors.

Question 1-7 (LO 1-2)
Typical investing activities would include the purchase or disposal of land, casino buildings, hotels, gaming tables, chairs, cleaning equipment, and food preparation machines.

Answers to Review Questions (continued)

Question 1-8 (LO 1-2)

Typical operating activities would include the sale of software and consulting services, as well as costs related to salaries, research, utilities, advertising, rent, and taxes.

Question 1-9 (LO 1-2)

The three major legal forms of business organizations include sole proprietorship, partnership, and corporation? A corporation is chosen by most of the largest companies in the United States.

Question 1-10 (LO 1-2)

Assets: Resources owned.
Liabilities: Amounts owed.
Stockholders' equity: Owners' claims to resources.
Dividends: Distributions to stockholders.
Revenues: Sales of products or services to customers.
Expenses: Costs of selling products or services.

Question 1-11 (LO 1-2)

The major advantage of a corporation is limited liability. Stockholders of a corporation are not held personally responsible for the financial obligations of the corporation. Owners of sole proprietorships or partnerships remain personally liable for activities of the business. Corporations have the disadvantages of double taxation compared to sole proprietorships and partnerships. Sole proprietorship and partnership forms of business is that income is taxed only once. However, there could be other tax advantages for certain types of corporations, such as a lower overall tax rate.

Question 1-12 (LO 1-3)

1. **Income statement**: Reports the company's revenues and expenses during an interval of time. If revenues exceed expenses, then the company reports net income. If expenses exceed revenues, then the company reports a net loss.
2. **Statement of stockholders' equity**: Summarizes the changes in stockholders' equity from net income, dividends, and stock issuances during an interval of time.
3. **Balance sheet**: Presents the financial position of the company on a particular date. It shows that assets equal liabilities plus stockholders' equity.
4. **Statement of cash flows**: Cash activities related to operating, investing, and financing activities during an interval of time.

Question 1-13 (LO 1-3)

Balances of accounts reported in the income statement, statement of stockholders' equity, and statement of cash flows reflect activity from the beginning of the period through the end of the period. Balances of accounts reported in the balance sheet reflect the financial position of the company as of a single date, the end of the period.

Answers to Review Questions (continued)

Question 1-14 (LO 1-3)

Basic revenues would include sale of products (such as toys, dolls, and games) and services (such as theme park tickets). Expenses include cost of merchandise sold, employee salaries, utilities, advertising, taxes, interest, and legal fees.

Question 1-15 (LO 1-3)

The accounting equation is: Assets = Liabilities + Stockholders' Equity. The format of the balance sheet follows the accounting equation.

Question 1-16 (LO 1-3)

Assets would include items such as merchandise inventory, office supplies, buildings, land, trucks, and equipment. Liabilities would include items such as amounts owed to employees, suppliers, taxing authorities, and lenders.

Question 1-17 (LO 1-3)

Retained earnings represent the cumulative amount of net income earned over the life of the company that has *not* been distributed to stockholders as dividends. Net income is shown in the income statement and retained earnings are reported in the balance sheet. Thus, retained earnings represent a balance sheet account which reflects the cumulative result of income statements over the life of the company (less any dividends).

Question 1-18 (LO 1-3)

The statement of cash flows reports operating, investing, and financing cash flows. Examples of each include:

Operating – selling merchandise, paying employee salaries, and paying for advertisement.
Investing – purchasing land and buildings to open new factories.
Financing – Borrowing from lenders or issuing stock to owners to obtain funds necessary to expand operations.

Question 1-19 (LO 1-3)

Two other important sources of information are the (1) management discussion and analysis of the company's activities and (2) note disclosures to the financial statements.

Question 1-20 (LO 1-4)

Successful companies use their resources efficiently to sell products and services for a profit. Unsuccessful companies either offer lower-quality products and services or do not efficiently keep their costs low. When a company is unprofitable, investors will neither invest in nor lend to the firm. Without these sources of financing, eventually the company will fail. When a company is able to make a profit, investors and creditors are willing to transfer their resources to it, and the company will expand its profitable operations even further. Investors and creditors rely heavily on financial accounting information in making investment and lending decisions.

Answers to Review Questions (continued)

Question 1-21 (LO 1-5)

GAAP refers to Generally Accepted Accounting Principles, or the rules of financial accounting. The fact that all companies use the same rules is critical to financial statement users, because it allows them to accurately *compare* financial information among companies when they are making decisions about where to lend or invest their resources.

Question 1-22 (LO 1-5)

The Financial Accounting Standards Board (FASB) is primarily responsible for the establishment of GAAP in the United States. The International Accounting Standards Board (IASB) serves this function on an international basis.

Question 1-23 (LO 1-5)

U.S. GAAP refers to the set of accounting standards being developed in the United States by the Financial Accounting Standards Board (FASB). IFRS (International Financial Reporting Standards) refers to the set of accounting standards being developed by the International Accounting Standards Board (IASB). The IASB promotes the use of IFRS around the world. Today, the IASB and FASB work closely in an effort to converge the two sets of accounting standards.

Question 1-24 (LO 1-5)

The 1933 Securities Act and the 1934 Securities Exchange Act were designed to restore investor confidence in financial accounting following the stock market crash in 1929 and the ensuing Great Depression. The SEC has the power to require companies with publicly traded securities to prepare periodic financial statements for distribution to investors and creditors.

Question 1-25 (LO 1-5)

The role of auditors is to help ensure that management has in fact appropriately applied GAAP in preparing the company's financial statements. They are hired by a company as an independent party to express a professional opinion of the conformity of that company's financial statements with GAAP. Auditors play a major role in investors' and creditors' decisions by adding credibility to the financial statements.

Question 1-26 (LO 1-5)

The three objectives of financial reporting are providing information that:

1. is useful to investors and creditors in making decisions.
2. helps to predict cash flows.
3. tells about economic resources, claims to resources, and changes in resources and claims.

Answers to Review Questions (continued)

Question 1-27 (LO 1-6)

The benefits to obtaining a degree in accounting include a wide variety of job opportunities, high demand, and high salaries. Public accounting firms are professional service firms that traditionally have focused on three areas: auditing, tax preparation/planning, and business consulting. Private accounting means providing accounting services to the company that employs you. Traditional careers include auditor, tax preparer, consultant, and basic accounting services. Accountants are now expanding to work as financial analysts, forensic accountants, tax lawyers, FBI agents, and many others.

Question 1-28 (LO 1-7)

Relevance and *faithful representation* are the two fundamental qualitative characteristics. Relevance implies that information is useful to the decision at hand. Faithful representation indicates that information accurately represents the underlying activity.

Question 1-29 (LO 1-7)

The three components/aspects of relevance include:

1. Predictive value – Information is useful in helping to forecast future outcomes.
2. Confirmatory value – Information provides feedback on past activities.
3. Materiality – The nature or amount of an item has the ability to affect decisions.

The three components/aspects of faithful representation include:

1. Completeness – All information necessary to describe an item is reported.
2. Verifiability – Measurements that independent parties would agree upon.
3. Free from error – Reported amounts reflect the best available information.

Question 1-30 (LO 1-7)

Cost effectiveness refers to practical boundaries (constraints) to achieving desired qualitative characteristics. Cost effectiveness suggests that financial accounting information is provided only when the benefits of doing so exceed the costs.

Question 1-31 (LO 1-7)

The four basic assumptions underlying GAAP include:

1. Economic entity assumption – All economic events can be identified with a particular economic entity.
2. Monetary unit assumption - A common denominator is needed to measure all elements. The dollar in the United States is the most appropriate common denominator to express information about financial statement elements and changes in those elements.
3. Periodicity assumption – The economic life of an enterprise (presumed to be indefinite) can be divided into artificial time periods for financial reporting.
4. Going concern assumption **–** In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.

BRIEF EXERCISES

Brief Exercise 1-1 (LO 1-1)

1. True
2. True
3. False

Brief Exercise 1-2 (LO 1-2)

1. b.
2. c.
3. a.

Brief Exercise 1-3 (LO 1-2)

1. c.
2. a.
3. b.

Brief Exercise 1-4 (LO 1-2)

1. e.
2. f.
3. b.
4. c.
5. a.
6. d.

Brief Exercise 1-5 (LO 1-2)

1. e.
2. d.
3. f.
4. a.
5. b.

Brief Exercise 1-6 (LO 1-2)

1. b.
2. a.
3. e.
4. c.
5. d.

Brief Exercise 1-7 (LO 1-3)

1. b.
2. a.
3. d.
4. c.

Brief Exercise 1-8 (LO 1-3)

1. c.
2. a.
3. d.
4. b.

Brief Exercise 1-9 (LO 1-5)

1. b.
2. d.
3. a.
4. c.

Brief Exercise 1-10 (LO 1-5)

1. Yes.
2. No.
3. Yes.
4. No.
5. Yes.
6. No.

Brief Exercise 1-11 (LO 1-6)

1. **True**
2. **True**
3. **True**
4. **True**
5. **True**
6. **True**
7. **True**
8. **True**
9. **True**
10. **True**
11. **True**
12. **True**

Brief Exercise 1-12 (LO 1-7)

1. b.
2. a.
3. c.

Brief Exercise 1-13 (LO 1-7)

1. c.
2. b.
3. a.

EXERCISES

Exercise 1-1 (LO 1-2)

1. a.
2. c.
3. a.
4. b.
5. c.
6. a.
7. b.

Exercise 1-2 (LO 1-2)

Transaction	Financial Statement	Account	Activity
1. Falcon purchases common stock of Wildcat.	Balance sheet	Asset	Investing
2. Falcon borrows from Wildcat by signing a note.	Balance sheet	Liability	Financing
3. Falcon provides services to Wildcat.	Income statement	Revenue	Operating
4. Falcon pays interest to Wildcat on borrowing.	Income statement	Expense	Operating

Exercise 1-3 (LO 1-2)

Transaction	Financial Statement	Account	Activity
1. Wildcat issues common stock to Falcon.	Balance sheet	Equity	Financing
2. Wildcat lends to Falcon by accepting a note.	Balance sheet	Asset	Investing
3. Wildcat receives services from Falcon.	Income statement	Expense	Operating
4. Wildcat receives interest from Falcon on lending.	Income statement	Revenue	Operating

Exercise 1-4 (LO 1-2)

Requirement 1

Revenues	−	Expenses	=	Net Income
$14,000	−	$9,000	=	**$5,000**

Requirement 2

Assets	=	Liabilities	+	Stockholders' equity
$50,000	=	$27,000	+	$X
$50,000	−	$27,000	=	**$23,000**

Exercise 1-5 (LO 1-2)

Requirement 1

Revenues	−	Expenses	=	Net Loss
$28,000	−	$33,000	=	**($5,000)**

Requirement 2

Assets	=	Liabilities	+	Stockholders' equity
$19,000	=	$15,000	+	$X
$19,000	−	$15,000	=	**$4,000**

Exercise 1-6 (LO 1-3)

Cowboy Law Firm
Income Statement
For the period ended December 31

Service revenue	$9,300
Expenses:	
Salaries	2,200
Utilities	1,200
Total expenses	3,400
Net income	$5,900

Exercise 1-7 (LO 1-3)

Buffalo Drilling
Statement of Stockholders' Equity
For the year ended December 31

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance, Jan. 1	$11,000	$ 8,200	$19,200
Issuance of common stock	8,000		8,000
Add: Net income		8,500	8,500
Less: Dividends		(3,200)	(3,200)
Ending balance, Dec. 31	$19,000	$13,500	$32,500

Exercise 1-8 (LO 1-3)

Wolfpack Construction
Balance Sheet
December 31

Assets		**Liabilities**	
Cash	$ 6,000	Accounts payable	$ 3,000
Land	18,000	Notes payable	20,000
Equipment	26,000	Total liabilities	23,000
		Stockholders' Equity	
		Common stock	11,000
		Retained earnings	16,000 *
		Total stockholders' equity	27,000
Total assets	$50,000	Total liabilities and stockholders' equity	$50,000

*	Assets	=	Liabilities	+	Stockholders' equity
	$50,000	=	$23,000	+	($11,000 + Retained earnings)
	$50,000	−	$23,000	−	$11,000 = Retained earnings
					$16,000 = Retained earnings

Exercise 1-9 (LO 1-3)

Requirement 1

Beginning balance	$ 5,000
Cash received from sale of products to customers	40,000
Cash received from the bank for long-term loan	45,000
Cash paid to purchase factory equipment	(50,000)
Cash paid to merchandise suppliers	(12,000)
Cash received from the sale of an unused warehouse	13,000
Cash paid to workers	(24,000)
Cash paid for advertisement	(4,000)
Cash received for sale of services to customers	30,000
Cash paid for dividends to stockholders	(6,000)
Ending balance	**$37,000**

Requirement 2

Tiger Trade
Statement of Cash Flows

Cash Flows from Operating Activities		
Cash inflows:		
From sale of products to customers	$40,000	
From sale of services to customers	30,000	
Cash outflows:		
For merchandise suppliers	(12,000)	
For workers	(24,000)	
For advertisement	(4,000)	
Net cash flows from operating activities		$30,000
Cash Flows from Investing Activities		
Purchase factory equipment	(50,000)	
Sale of warehouse	13,000	
Net cash flows from investing activities		(37,000)
Cash Flows from Financing Activities		
Borrow from bank	45,000	
Pay dividends	(6,000)	
Net cash flows from financing activities		39,000
Net increase in cash		32,000
Cash at the beginning of the year		5,000
Cash at the end of the year		$37,000

Exercise 1-10 (LO 1-3)

Requirement 1

Fighting Okra Cooking Services
Income Statement
For the year ended December 31, 2021

Service revenue		$75,000
Expenses:		
Salaries	$24,000	
Supplies	14,500	
Rent	10,600	
Legal fees	2,400	
Postage	1,500	
Total expenses		53,000
Net income		**$22,000**

Requirement 2

Fighting Okra Cooking Services
Statement of Stockholders' Equity
For the year ended December 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	$200,000	$32,000	$232,000
Issuance of common stock	25,000		25,000
Add: Net income		**22,000**	22,000
Less: Dividends		(10,000)	(10,000)
Ending balance	$225,000	$44,000	$269,000

Exercise 1-11 (LO 1-3)

Requirement 1

Artichoke Academy
Statement of Stockholders' Equity
For the year ended December 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	$150,000	$50,000	$200,000
Issuance of common stock	40,000		40,000
Add: Net income		30,000	30,000
Less: Dividends		(10,000)	(10,000)
Ending balance	**$190,000**	**$70,000**	$260,000

Requirement 2

Artichoke Academy
Balance Sheet
December 31, 2021

Assets		**Liabilities**	
Cash	$52,600	Accounts payable	$ 9,100
Supplies	13,400	Utilities payable	2,400
Prepaid rent	24,000	Salaries payable	3,500
Land	200,000	Notes payable	15,000
		Total liabilities	30,000
		Stockholders' Equity	
		Common stock	**190,000**
		Retained earnings	**70,000**
		Total stockholders' equity	260,000
Total assets	$290,000	Total liabilities and stockholders' equity	$290,000

Exercise 1-12 (LO 1-3)

Requirement 1

Squirrel Tree Services
Balance Sheet
December 31, 2021

Assets		Liabilities	
Cash	$ 7,700	Accounts payable	$ 9,700
Supplies	1,800	Salaries payable	3,500
Prepaid insurance	3,500	Notes payable	20,000
Building	72,000	Total liabilities	33,200
		Stockholders' Equity	
		Common stock	40,000
		Retained earnings	11,800
		Total stockholders' equity	51,800
Total assets	$85,000	Total liabilities and stockholders' equity	$85,000

Requirement 2

Squirrel Tree Services
Statement of Cash Flows
For the year ended December 31, 2021

Cash Flows from Operating Activities		
Cash inflows from customers	$ 60,000	
Cash outflows for salaries	(22,000)	
Cash outflows for supplies	(4,000)	
Net cash flows from operating activities		$34,000
Cash Flows from Investing Activities		
Sale investments	10,000	
Purchase building	(62,000)	
Net cash flows from investing activities		(52,000)
Cash Flows from Financing Activities		
Borrow from bank	20,000	
Pay dividends	(6,500)	
Net cash flows from financing activities		13,500
Net decrease in cash		(4,500)
Cash at the beginning of the year*		12,200
Cash at the end of the year		$ **7,700**

* Plug number in order to calculate correct ending balance

Exercise 1-13 (LO 1-3)

1.	Revenues	−	Expenses	=	Net Income
	$27,000	−	$18,000	=	**$9,000**

2.	Change in stockholders' equity	=	Issue common stock	+	Net Income	−	Dividends
	$17,000	=	$11,000	+	$12,000	−	$X
	$17,000	−	$11,000	−	$12,000	=	**$6,000**

3.	Assets	=	Liabilities	+	Stockholders' equity
	$24,000	=	$X	+	$15,000
	$24,000	=	**$9,000**	+	$15,000

4.	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
	$26,000	=	$34,000	+	($17,000)	+	$X
	$26,000	−	$34,000	−	($17,000)	=	**$9,000**

Exercise 1-14 (LO 1-3)

Year	Net Income	Dividends	Retained Earnings*
1	$1,700	$ 600	**$ 1,100**
2	2,200	600	**2,700**
3	3,100	1,500	**4,300**
4	4,200	1,500	**7,000**
5	5,400	1,500	**10,900**

* Retained earnings = Beginning retained earnings + Net income − Dividends

Exercise 1-15 (LO 1-3)

($ in billions)

	Change in retained earnings	=	Net income	−	Dividends
1.	Change in retained earnings	=	Net income	−	Dividends
	\$3.2	=	\$6.9	−	**\$X**
	\$3.2	=	\$6.9	−	**\$3.7**
2.	Change in retained earnings	=	Net income	−	Dividends
	\$3.4	=	**\$X**	−	\$2.6
	\$3.4	=	**\$6.0**	−	\$2.6
3.	Change in retained earnings	=	Net income	−	Dividends
	\$1.6	=	\$1.6	−	**\$X**
	\$1.6	=	\$1.6	−	**\$0**
4.	Change in retained earnings	=	Net income	−	Dividends
	[\$X − (−\$1.6)]	=	(\$1.0)	−	\$0
	\$X = **(\$2.6)**				
5.	Change in retained earnings	=	Net income	−	Dividends
	[\$1.56 − \$X]	=	\$0.43	−	\$0.06
	\$X = **\$1.19**				

Exercise 1-16 (LO 1-3)

($ in billions)

	Assets	=	Liabilities	+	Stockholders' equity
1.	Assets	=	Liabilities	+	Stockholders' equity
	$228	=	$107	+	**$X**
	$228	=	$107	+	**$121**
2.	Assets	=	Liabilities	+	Stockholders' equity
	$X	=	$1,500	+	$110
	$1,610	=	$1,500	+	$110
3.	Assets	=	Liabilities	+	Stockholders' equity
	$4.7	=	$X	+	$0.3
	$4.7	=	**$4.4**	+	$0.3
4.	Change in assets	=	Change in liabilities	+	Change in stockholders' equity
	$1.2	=	$0.3	+	**$X**
	$1.2	=	$0.3	+	**$0.9**
5.	Change in assets	=	Change in liabilities	+	Change in stockholders' equity
	$X	=	($0.34)	+	$0.02
	($0.32)	=	($0.34)	+	$0.02

Exercise 1-17 (LO 1-3)

($ in billions)

	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
1.	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
	$0	=	$3.6	+	$0.6	+	($4.2)
2.	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
	($X − $0.7)	=	$1.4	+	($0.3)	+	($1.4)
	$X = $0.4						
3.	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
	$0.04	=	$0.07	+	$0.63	+	**($0.66)**
4.	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
	$0.02	=	$0.60	+	**($1.00)**	+	$0.42
5.	Total change in cash	=	Operating cash flows	+	Investing cash flows	+	Financing cash flows
	$0.02	=	**$0.41**	+	($1.42)	+	$1.03

Exercise 1-18 (LO 1-5)

1. d.
2. e.
3. a.
4. c.
5. f.
6. b.
7. g.

Exercise 1-19 (LO 1-7)

1. **g.** Comparability
2. **f.** Free from error
3. **b.** Predictive value
4. **i.** Timeliness
5. **a.** Confirmatory value
6. **e.** Neutrality
7. **d.** Completeness
8. **h.** Verifiability
9. **j.** Understandability
10. **c.** Materiality

Exercise 1-20 (LO 1-7)

1. b.
2. c.
3. d.
4. a.

PROBLEMS: SET A

Problem 1-1A (LO 1-2)

	Type of business activity	Transactions
1.	**Financing**	Pay amount owed to the bank for previous borrowing
2.	**Operating**	Pay utility costs
3.	**Investing**	Purchase equipment to be used in operations
4.	**Operating**	Provide services to customers
5.	**Operating**	Purchase office supplies
6.	**Investing**	Purchase a building
7.	**Operating**	Pay workers' salaries
8.	**Operating**	Pay for research and development costs
9.	**Operating**	Pay taxes to the IRS
10.	**Financing**	Sell common stock to investors

Problem 1-2A (LO 1-2)

	Account classifications	Account Names
1.	**Stockholders' equity**	Common stock
2.	**Asset**	Equipment
3.	**Liability**	Salaries payable
4.	**Revenue**	Service revenue
5.	**Expense**	Utilities expense
6.	**Asset**	Supplies
7.	**Expense**	Research and development expense
8.	**Asset**	Land
9.	**Liability**	Income tax payable
10.	**Liability**	Interest payable

Problem 1-3A (LO 1-3)

Longhorn Corporation
Income Statement
For the year ended Dec. 31, 2021

Service revenue	$67,700
Expenses:	
Cost of goods sold	53,400
Salaries	5,500
Delivery	2,600
Total expenses	61,500
Net income	$ 6,200

Longhorn Corporation
Statement of Stockholders' Equity
For the year ended Dec. 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	$40,000	$18,200	$58,200
Issuance of common stock	4,000		4,000
Add: Net income		6,200	6,200
Less: Dividends		(0)	(0)
Ending balance	$44,000	$24,400	$68,400

Problem 1-3A (concluded)

Longhorn Corporation
Balance Sheet
Dec. 31, 2021

Assets		**Liabilities**	
Cash	$ 1,200	Accounts payable	$ 4,400
Supplies	3,400	Salaries payable	800
Equipment	29,000	Total liabilities	5,200
Buildings	40,000		
		Stockholders' Equity	
		Common stock	44,000
		Retained earnings	24,400
		Total stockholders' equity	68,400
Total assets	$73,600	Total liabilities and stockholders' equity	$73,600

Problem 1-4A (LO 1-3)

(Suggested order of calculation)

On the statement of stockholders' equity,
\$7,000 + (c) − \$3,000 = \$10,000
(c) = **\$6,000**

From (c),
(b) = **\$6,000**

From (b),
\$39,000 − (a) − \$6,000 − \$4,000 = \$6,000 (b)
(a) = **\$23,000**

From the statement of stockholders' equity,
(e) = **\$11,100**
(f) = **\$10,000**

From total assets,
(g) = **\$26,000**

From (e), (f), and (g),
(d) + \$11,100 (e) + \$10,000 (f) = \$26,000 (g)
(d) = **\$4,900**

Problem 1-5A (LO 1-3)

Cornhusker Company
Income Statement
For the year ended December 31, 2021

Service revenues		$37,000
Expenses:		
Rent		7,000
Utilities		4,900
Salaries		13,300
Insurance		3,500
Total expenses		28,700
Net income		$ 8,300

Cornhusker Company
Statement of Stockholders' Equity
For the year ended December 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Jan. 1)	$16,000	$7,300	$23,300
Issuance of common stock	0		0
Add: Net income		8,300	8,300
Less: Dividends		(3,200)	(3,200)
Ending balance (Dec. 31)	$16,000	$12,400	$28,400

Problem 1-5A (concluded)

Cornhusker Company
Balance Sheet
December 31, 2021

Assets		**Liabilities**	
Cash	$ 4,800	Accounts payable	$ 2,200
Accounts receivable	7,200	Salaries payable	2,400
Land	21,000	Total liabilities	4,600
		Stockholders' Equity	
		Common stock	16,000
		Retained earnings	12,400
		Total stockholders' equity	28,400
Total assets	$33,000	Total liabilities and stockholders' equity	$33,000

Problem 1-6A (LO 1-7)

	Assumption violated
1.	**Going concern**
2.	**Economic entity**
3.	**Monetary unit**
4.	**Periodicity**

Problem 1-7A (LO 1-7)

1. d.
2. b.
3. i.
4. c.
5. a.
6. g.
7. h.
8. f.
9. e.

PROBLEMS: SET B

Problem 1-1B (LO 1-2)

	Type of business activity	Transactions
1.	**Operating**	Pay for advertising
2.	**Financing**	Pay dividends to stockholders
3.	**Operating**	Collect cash from customer for previous sale
4.	**Investing**	Purchase a building to be used for operations
5.	**Investing**	Purchase equipment
6.	**Investing**	Sell land
7.	**Financing**	Receive a loan from the bank by signing a note
8.	**Operating**	Pay suppliers for purchase of supplies
9.	**Operating**	Provide services to customers
10.	**Investing**	Invest in securities of another company

Problem 1-2B (LO 1-2)

	Account classifications	Account Names
1.	**Asset**	Cash
2.	**Revenue**	Service Revenue
3.	**Asset**	Supplies
4.	**Asset**	Buildings
5.	**Expense**	Advertising Expense
6.	**Asset**	Equipment
7.	**Expense**	Interest Expense
8.	**Liability**	Accounts Payable
9.	**Dividends**	Dividends
10.	**Liability**	Notes Payable

Problem 1-3B (LO 1-3)

Gator Investments
Income Statement
For the year ended Dec. 31, 2021

Service revenue	$127,600
Expenses:	
Advertising	33,500
Salaries	65,100
Utilities	15,500
Interest	3,500
Total expenses	117,600
Net income	$ 10,000

Gator Investments
Statement of Stockholders' Equity
For the year ended Dec. 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	$100,000	$30,300	$130,300
Issuance of common stock	11,000		11,000
Add: Net income		10,000	10,000
Less: Dividends		(5,200)	(5,200)
Ending balance	$111,000	$35,100	$146,100

Problem 1-3B (concluded)

Gator Investments
Balance Sheet
Dec. 31, 2021

Assets		Liabilities	
Cash	$ 5,500	Accounts payable	$ 6,400
Equipment	27,000	Notes payable	30,000
Buildings	150,000	Total liabilities	36,400
		Stockholders' Equity	
		Common stock	111,000
		Retained earnings	35,100
		Total stockholders' equity	146,100
Total assets	$182,500	Total liabilities and stockholders' equity	$182,500

Problem 1-4B (LO 1-3)

(Suggested order of calculation)

On the statement of stockholders' equity,
\$14,000 + (c) = \$17,000
(c) = **\$3,000**

\$7,000 + \$5,000 − (d) = \$8,000
(d) = **\$4,000**

(b) = **\$5,000**

From (b),
(a) − \$13,000 − \$7,000 − \$5,000 = \$5,000 (b)
(a) = **\$30,000**

From the statement of stockholders' equity,
(g) = **\$17,000**
(h) = **\$8,000**

From (g) and (h),
\$4,000 + \$17,000 (g) + \$8,000 (h) = (i)
(i) = **\$29,000**

From total liabilities and stockholders' equity,
(f) = **\$29,000**

From (f),
\$1,100 + (e) + \$6,000 + \$16,000 = \$29,000 (f)
(e) = **\$5,900**

Problem 1-5B (LO 1-3)

Tar Heel Corporation
Income Statement
For the year ended December 31, 2021

Service revenues	$69,400
Expenses:	
Advertising	10,400
Utilities	6,000
Salaries	26,700
Interest	2,100
Total expenses	45,200
Net income	$24,200

Tar Heel Corporation
Statement of Stockholders' Equity
For the year ended December 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	$21,000	$26,800	$47,800
Issuance of common stock	6,000		6,000
Add: Net income		24,200	24,200
Less: Dividends		**(11,000)** *	(11,000)
Ending balance	$27,000	$40,000	$67,000

* Beginning retained earnings	$26,800
+ Net income	24,200
− Dividends	?
= Ending retained earnings	$40,000

Problem 1-5B (concluded)

Tar Heel Corporation
Balance Sheet
December 31, 2021

Assets		**Liabilities**	
Cash	$ 5,200	Accounts payable	$ 7,700
Accounts receivable	13,200	Salaries payable	3,300
Supplies	4,600	Note payable	25,000
Building	80,000	Total liabilities	36,000
		Stockholders' Equity	
		Common stock	27,000
		Retained earnings	40,000
		Total stockholders' equity	67,000
Total assets	$103,000	Total liabilities and stockholders' equity	$103,000

Problem 1-6B (LO 1-7)

	Assumption violated
1.	**Periodicity**
2.	**Monetary unit**
3.	**Going concern**
4.	**Economic entity**

Problem 1-7B (LO 1-7)

1. h.
2. g.
3. f.
4. a.
5. d.
6. e.
7. i.
8. b.
9. c.

ADDITIONAL PERSPECTIVES

Additional Perspective 1-1

Requirement 1

The three primary forms of business organizations include sole proprietorship, partnership, and corporation. The major advantage of a corporation is limited liability. Stockholders of a corporation are not held personally responsible for the financial obligations of the corporation. Owners of sole proprietorships or partnerships remain personally liable for activities of the business. Corporations have the disadvantages of double taxation compared to sole proprietorships and partnerships. Because of the higher risk of personal injury due to outdoor adventure activities, it is recommended that Great Adventures be organized as a corporation.

Requirement 2

Typical financing activities include issuing common stock, borrowing, and repayment of borrowing. Typical investing activities include the purchase of long-term assets such as land, buildings, equipment, vehicles, and machinery. Typical operating activities include providing services and products to customers and the associated costs of running the business such as advertising, rent, insurance, wages, and taxes.

Requirement 3

Assets – cash, accounts receivable, supplies, and equipment.
Liabilities – accounts payable, salaries payable, and notes payable.
Stockholders' equity – common stock and retained earnings.
Revenues – service revenue.
Expenses – advertising, salaries, insurance, and supplies.

Requirement 4

Income statement – revenues less expenses equal net income during an interval of time.
Statement of stockholders' equity – changes in common stock and retained earnings during an interval of time.
Balance sheet – assets equal liabilities plus stockholders' equity at a point in time.
Statement of cash flows – cash inflows and outflows related to operating, investing, and financing activities during an interval of time.

Additional Perspective 1-2

AMERICAN EAGLE OUTFITTERS

($ in thousands)

Requirement 1

Total assets	= $1,816,313
Total liabilities	= $569,522
Stockholders' equity	= $1,246,791

Assets	=	Liabilities	+	Stockholders' Equity
$1,816,313	=	$569,522	+	$1,246,791

Requirement 2

Consolidated Statements of Operations

Requirement 3

Net sales	= $3,795,549
Net income	= $204,163

Requirement 4

	Inflows	Outflows
Investing activities	There are none	Capital expenditures for property and equipment
Financing activities	Net proceeds from stock options exercised	Cash dividends paid

Requirement 5

The company's auditor is Ernst & Young LLP.

The auditor states, "We have audited the accompanying consolidated balance sheets of American Eagle Outfitters, Inc. (the Company) as of February 3, 2018 and January 28, 2017, and the related consolidated statements of operations, comprehensive income, stockholders' equity and cash flows for each of the three years in the period ended February 3, 2018, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at February 3, 2018 and January 28, 2017, and the results of its operations and its cash flows for each of the three years in the period ended February 3, 2018, in conformity with U.S. generally accepted accounting principles."

Additional Perspective 1-3

BUCKLE

($ in thousands)

Requirement 1

Total assets	= $538,116
Total liabilities	= $146,868
Stockholders' equity	= $391,248

Assets	=	Liabilities	+	Stockholders' Equity
$538,116	=	$146,868	+	$391,248

Requirement 2

Consolidated Statements of Income

Requirement 3

Net sales	= $913,380
Net income	= $89,707

Requirement 4

	Inflows	Outflows
Investing activities	Proceeds from sales/maturities of investments	Purchases of investments
Financing activities	There are none	Payment of dividends

Requirement 5

The company's auditor is Deloitte & Touche LLP.
The auditor states, "We have audited the accompanying consolidated balance sheets of The Buckle, Inc. and subsidiary (the "Company") as of February 3, 2018 and January 28, 2017, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three fiscal years in the period ended February 3, 2018, and the related notes and the schedule listed in the Index at Item 15 (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of February 3, 2018 and January 28, 2017, and the results of its operations and its cash flows for each of the three fiscal years in the period ended February 3, 2018, in conformity with accounting principles generally accepted in the United States of America."

Additional Perspective 1-4

Requirement 1
The total assets of **American Eagle** are higher than the total assets of Buckle.

Requirement 2
The total liabilities of **American Eagle** are higher than the total liabilities of Buckle.
A higher amount of liabilities **does not** necessarily mean a higher chance of bankruptcy. The probability of bankruptcy relates to the ability of a company to repay its liabilities as they become due. If sufficient resources are available, then high levels of debt can be paid.

Requirement 3
Ability to repay debt.
The ratio of total liabilities to total assets can be used as one measure of a company's ability to repay its liabilities. The higher the ratio, the more difficult it will be for a company to pay its liabilities.

Requirement 4
The net income of **American Eagle** is higher than the net income of Buckle. When one company has a higher net income than another company does, this **does not** always mean the company's operations are more successful. One company may be larger than another company so it has higher net income in absolute dollar amounts because operations are larger, but it may be making less profit per dollar of invested assets.

Requirement 5
Ability to generate profits.
Net income provides a measure of a company's ability to generate profit for its owners. In the case of American Eagle and Buckle, the owners are the stockholders of the company. An increase in net income is a desirable characteristic of a company that, along with other factors, increases the value (or stock price) of the company to its owners.

Additional Perspective 1-5

1. **Yes.**
The role of an auditor is to express an independent, professional opinion of the extent to which financial statements are prepared in compliance with Generally Accepted Accounting Principles. An auditor's ethics might be challenged because of the need to retain the client as a source of revenue. In this case, the auditor might fear losing the audit fee if it upsets its largest client by requiring a correction to the financial statements because of questionable accounting practices. The company may fire the auditor and retain the services of someone else. This problem is further worsened by the company offering an additional $200,000 in audit fees this year and the promise of continued services for the next five years. Management may be using these monetary incentives as a way to entice the auditor to allow certain reporting practices. If the auditor upsets the client, the auditor faces the possibility of losing revenue each year from audit services.

2. **No.**
Auditors are not employees of the company. They are hired by a company as an independent party. To the extent they feel management's reporting practices violate Generally Accepted Accounting Principles, they can issue an opinion stating so.

3. **Yes.**
Although ultimate responsibility for fair presentation of financial statements lies with management, the auditor's opinion lends additional credibility to those financial statements. These statements are useful to investors, creditors and others for making decisions. In addition, if the auditor detects that financial statements are misstated and does not disclose this opinion, then the auditor likely faces monetary penalties and other sanctions that could limit its ability to perform any audits in the future.

4. **No.**
Even though the auditor faces this ethical dilemma, they serve an important role in the reporting of financial information to help investors and creditors make decisions. Auditors follow a strict set of guidelines in providing auditing services. In addition, they typically face severe legal and monetary penalties in the case of negligence or willful allowance of materially misstated financial statements by management. The auditor should issue an opinion stating its belief that financial statements are materially misstated.

Additional Perspective 1-6

Requirement 1

The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

The SEC was created to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing.

The Securities Act of 1933 has two basic objectives:

- require that investors receive financial and other significant information concerning securities being offered for public sale; and
- prohibit deceit, misrepresentations, and other fraud in the sale of securities.

The Securities Exchange Act of 1934 created the Securities and Exchange Commission. The Act empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

Additional Perspective 1-6 (continued)

Requirement 2

The four main financial statements discussed by the SEC are: (1) balance sheets; (2) income statements; (3) cash flow statements; and (4) statements of shareholders' equity.

A balance sheet provides detailed information about a company's assets, liabilities and shareholders' equity.

An income statement is a report that shows how much revenue a company earned over a specific time period (usually for a year or some portion of a year). An income statement also shows the costs and expenses associated with earning that revenue. The literal "bottom line" of the statement usually shows the company's net earnings or losses. This tells you how much the company earned or lost over the period.

Cash flow statements report a company's inflows and outflows of cash from three types of activities: (1) operating activities; (2) investing activities; and (3) financing activities.

The statement of shareholders' equity shows changes in the interests of the company's shareholders over time.

The disclosure notes provide additional information beyond that reported in the financial statements. This information includes items such as significant accounting policies and practices, income taxes, pension and other retirement plans, stock options, and much more.

MD&A is management's opportunity to provide investors with its view of the financial performance and condition of the company. It's management's opportunity to tell investors what the financial statements show and do not show, as well as important trends and risks that have shaped the past or are reasonably likely to shape the company's future.

Additional Perspective 1-6 (concluded)

Requirement 3

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector (like the FASB) for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

Requirement 4

(a) Yes; Nike properly prepared the four financial statements.

(b) NIKE designs, develops, markets, and sells athletic footwear, apparel, equipment, accessories, and services worldwide.

(c) In the segment disclosure note, the company reports amounts for items such as revenue, depreciation, net income, accounts receivable, inventories and capital expenditures for each segment.

Additional Perspective 1-7

The functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

The four financial statements include:
1. Income statement, which shows revenues and expenses during the reporting period.
2. Statement of stockholders' equity, which shows the change in stockholders' equity during the reporting period.
3. Balance sheet, which shows a company's resources (assets), creditors' claims to those assets (liabilities), and the remaining claims of stockholders' to those assets (stockholders' equity) at the end of the period.
4. Statement of cash flows, which shows a company's inflows and outflows of cash arising from operating, investing, and financing activities during the reporting period.

The role of auditors is to help ensure that management has in fact appropriately applied Generally Accepted Accounting Principles in preparing the company's financial statements. Auditors are trained individuals hired by a company as an independent party to express a professional opinion of that company's financial statements.