CHAPTER 1
SOLUTIONS TO END OF CHAPTER MATERIAL

QUESTIONS

1. The three general types of business are typically categorized as follows: service, manufacturing and merchandising.

Service example:	airline company, e.g. Southwest
Manufacturing example:	steel manufacturing company, e.g. US Steel
Merchandising example:	wholesaler company, e.g. Costco

2. The three common forms of business organizations are sole proprietorships, partnerships and corporations.

   The major differences between these forms of business organizations are in terms of ownership, liability and taxation. A sole proprietorship is owned by a single individual, who has unlimited liability; profits of the proprietorship flow through to the owner, who individually pays taxes on those profits. A partnership is owned by two or more individuals, who each have unlimited liability. Profits of the business flow through to the partners, who individually pay taxes on their specific share of those profits. A corporation is owned by stockholders; liability for organizational debts is limited to the amount of funds invested by owners, who cannot be held individually responsible for the debts. A corporation files a tax return and pays taxes. (Stockholders receiving dividends from a corporation commonly must pay taxes on those dividends…even though the corporation paid taxes on the profits from which the dividends are paid. Thus, it is said that corporate profits are effectively taxed twice: once upon being earned and once upon being distributed.)

   The most common form of business in the United States is the sole proprietorship.

3. The primary function of a business's accounting function is to provide quantitative information, primarily financial in nature, about economic entities. The information is intended to be useful in making economic decisions for internal and external users of the information.

4. The four major financial statements are the balance sheet, income statement, statement of cash flows and statement of stockholder's equity.

   Balance Sheet: Summarizes the assets (resources an organization owns), liabilities (debts that the organization owes), and stockholders' equity (amounts owners have contributed and the net amount that the entity has earned for them) of an entity at a specific time.

   Income Statement: Summarizes a business's revenues and expenses for a specific time period.

Statement of Cash Flows: Reveals how a business generated and spent cash during a given accounting period.

Businesses issue financial statements because financial statements provide information about an organization's financial performance over a period of time. These statements are useful to third parties such as investors, bankers, CEOs and management during their decision making.

5. This statement is false because a company's fiscal year may begin on any date. For example, the Walt Disney Company has a fiscal year that runs from October 1 to September 30.

6. The three types of activities are operating, investing, and financing.

   Operating activities: Reflect the day-to-day activities of a business that generate revenues by providing products or services and that create the costs of generating those revenues

   Investing activities: Involve the acquisition and sale of (1) long-term assets used in the business and (2) non-operating investment assets

   Financing activities: Involve cash inflows and outflows from transactions with creditors and investors.

   The Statement of Cash Flows uses the above three business activities as section headings.

7. GAAP is a group of accounting rules, concepts and principles that are used as a standard framework of guidelines in the preparation of financial statements. GAAP's primary purpose is use as a guideline in conducting and reviewing accounting transactions. The FASB is the principal accounting board in charge of establishing GAAP.

8. Private accounting involves internal work within a business entity, not-for-profit organization, or government agency. Public accounting involves external work as an independent firm with various firms in business.

   Individuals in private accounting may have job titles such as controller, internal auditor, financial accountant, cost analyst and tax accountant.

9. Public accounting firms offer auditing, tax preparation and advice, certain types of consulting, and bookkeeping services.

   Auditing is the most important service offered by public accounting firms because it involves the determination of the fairness, fullness and compliance with GAAP for financial statements and accounting records of companies. These financial statements provide third parties with vital information in the making of economic decisions.

10. The collapse of the stock market in 1929 led Congress to establish the SEC in the early 1930s with the intent to deter the abusive accounting and financial reporting practices that contributed to the stock market's collapse. The SEC ensures that publicly owned companies provide third parties with sufficient information to make informed economic decisions regarding the securities these firms sell.

EXERCISES

11. (a) T
    (b) T
    (c) F The FASB is the board that issues most of the new accounting rules in the U.S.
    (d) F Corporations account for the most business revenues each year.
    (e) T
    (f) F The Balance Sheet is a statement of position at a specific point in time; the Income Statement and the Statement of Cash Flows cover a fiscal year.
    (g) T
    (h) T
    (i) F Accounting contributes significantly to the success of business organizations by providing useful information on the transactions and results of transactions for those entities.
    (j) T
    (k) F Owners of LLPs, LLCs, and Subchapter S corporations pay taxes for their companies.

12. (a) (1) M
        (2) S
        (3) S
        (4) R
        (5) M
    (b) (1) Determine the estimated amount of goods needed to be produced to meet the market demand of products. Accountants can provide the inventory accounts balances.
        (2) Determine the amount of cash from operations. Accountants can provide the Cash Flow from operating activities statement.
        (3) Determine the ability of a customer to repay loans. Accountants can analyze the customer's financial statements.
        (4) Determine the growth in revenues during the last fiscal period. Accountants can compare the income statement of the current fiscal period and the preceding fiscal period.
        (5) Determine the cost of manufacturing a product. Accountants can calculate the total costs incurred in the manufacturing of a product.

13. (a) Proprietorship vs. Corporation
    Advantages
    - no double taxation
    - easy to start up

- cheap to establish
- no particular record keeping requirements
- no one to share profits with

Disadvantages

- self-employment tax rate
- unlimited liability
- lack of financing strength

(b) Partnership vs. Corporation

Advantages

- no double taxation
- easy to set up
- can establish with friends or relatives

Disadvantages

- unlimited liability
- joint and several liability

(c) LLP (limited liability partnership); LLC (limited liability company); and Subchapter S (Sub S) corporation

The distinguishing characteristics of these forms of business organizations are that they possess key features of other forms of business. Each of these business types is a hybrid between a corporation and a partnership. Owners are provided with limited liability (as in a corporation) and are only taxed as individuals (as in a partnership).

14. (a) Net Income – Management
Inventory cost per unit – Retailer
Total liability – Loan Officer
Total sales by geographical area of business operations – Marketing department
Five-year trend in total sales – Investor
Employee salaries by department – Management

(b) To measure profitability of company
To determine selling price per unit
To measure risk of business
To understand the market of product
To determine stability of company
To allocate payroll by department

15. TO: JIM HARDY
FROM: ACCOUNTANTS
DATE: JULY 1, 20X1
SUBJECT: FINANCIAL STATEMENTS

It has come to our attention that your business, Jim's Bike Shop, has not been keeping any accounting records of its financial activity since operations commenced.

Financial statements are an integral part of any business organization. These statements reflect the company's revenues and expenses and, thus, profitability, for a specific period. The financial statements also show the company's financial position through detailing the assets owned, liabilities owed, and the capital balances of the owner. The company's cash flow is also reflected in the financial statements, so that it is apparent where money is being generated and used. The statements provide readers with useful information necessary to make vital economic decisions. The information needs to be provided in a timely manner for it to be useful. Thus, there is an urgent need for you to prepare monthly financial statements for your business. With reasonably accurate and timely financial statements users can easily determine the profitability and risk of your business. You can also keep track of your income, expenses, cash flows, assets, and debts.

16. Transactions:

Transactions	Assets	=	Liabilities	+	Equity
(a) Purchased equipment for $12,500 cash	+$12,500 – $12,500	=	$0	+	$0
(b) Fuente & Demond bought additional $17,000 of stock in firm	$17,000	=	$0	+	$17,000
(c) Paid $1,500 owed to an office supply store for a purchase made the previous month	-$1,500	=	-$1,500	+	$0
(d) Purchased supplies for $4,000 on credit	$4,000	=	$4,000	+	$0

PROBLEMS

17. (a) (1) Stockholders: Determine return on investment; estimate future returns and profitability
    (2) Executives: Determine the next year's budget; whether the company met its current financial objectives
    (3) Bankers: Determine ability to repay loans and pay for purchases.
    (b) (1) Stockholders: Why the rate of return on revenues is so low
    (2) Executives: The interest rate and tax rate the company is paying; the proportion of operating expenses that is cost of goods sold; what comprises "other revenue"
    (3) Bankers: Why the rate of return on revenues is so low; how the company intends to decrease costs in future years

18. (a) Lifestyle Magazines Total Net Income = ($207,300,000 + $246,300,000 + $264,000,000) = <u>$717,600,000</u>
    Big Win = $45,360,000
    Quick & Yummy Foods = $288,019,000
    (b) BigWin Hotel & Casino = [(2009 NI – 2007 NI) ÷ 2007 NI] = [$18,745,000 – $10,649,000) ÷ $10,649,000] = $8,096,000 ÷ $10,649,000 = <u>76.03</u>%
    Lifestyle Magazines = $56,700,000 ÷ $207,300,000 = 27.35%
    Quick & Yummy Foods = $29,553,000 ÷ $80,517,000 = 36.70%

(c) Lifestyle Magazine
- Customer demand affected by other competitors
- Customer demand affected by presence of alternative sources like the internet

BigWin Hotel & Casino
- Barriers of entry to industry create a monopoly situation
- State rules and regulations affect profitability of business

Quick & Yummy Foods, Inc.
- Easy entry into industry creates competition
- Location of restaurants vital to profitability
- Food is generally perishable, thus small profit margins are realized by food industry

19. (a)	Assets	=	Liabilities	+	Equity
	$510,000	=	a	+	$318,000
	a	=	$510,000	-	$318,000
	a	=	$200,000		
(b)					
	Net Income	=	Revenues	-	Expenses
	b	=	$510,000	-	$320,000
	b	=	$190,000		
(c)					
	Assets	=	Liabilities	+	Equity
	c	=	$430,000	+	$320,000
	c	=	$770,000		
(d)					
	Net Income	=	Revenues	-	Expenses
	$210,000	=	$870,000	-	d
	d	=	$660,000		
(e)					
	Assets	=	Liabilities	+	Equity
	$950,000	=	$367,000	+	e
	e	=	$950,000	-	$367,000
	e	=	$583,000		
(f)					
	Net Income	=	Revenues	-	Expenses
	$331,000	=	f	-	$678,000
	f	=	$331,000	+	$678,000
	f	=	$1,009,000		

20. (a) Selling Price – Cost = $3,000,000 = $1,000,000 = $2,000,000 loss
(b) $2,000,000 ÷ 5 years = $400,000 per year
(c) The special accounting treatment for losses on sale of certain securities is misleading to financial statement users because net income is overstated during the year of loss on sale and understated in succeeding years when the loss is offset by income.

CASES

21. (a) Year begins on December 1st
    Year ends on November 30th
    (b) Balance sheet information = 2 years
    (c) Income statement information = 3 years
    (d) Cash flow information = 3 years
    (e) Shareholders' equity information = 3 years
    (f) (1) Balance Sheet 2007, Statement of Cash Flows 2007
        (2) Statement of Cash Flows 2007, Balance Sheet 2006
        (3) Balance Sheet 2007, Statement of Shareholders' Equity 2007
        (4) Income Statement 2007, Statement of Shareholders' Equity 2007
        (5) Balance Sheet 2007, Statement of Shareholders' Equity 2007
    (g) PricewaterhouseCoopers LLP

22. (a) The Securities Exchange Commission has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934.
    (b) Since 1973
    (c) The mission of 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.
    (d) As of November 2009, it was Robert H. Herz. Current board personnel can be checked at http://www.fasb.org.
    (e) Ways topics are added to the FASB agenda
    - Pervasiveness of the issue
    - Alternative solutions
    - Technical feasibility
    - Convergence possibilities
    - Cooperative opportunities
    - Resources

    (f) Upon reaching conclusions on researched issues, the FASB prepares a proposed Exposure Draft for consideration by the Board. After further discussion and revisions, Board members vote whether to issue the Exposure Draft. A majority vote of the Board is required to approve a document for issuance as an Exposure Draft. Alternative views, if any, are explained in the document and posted on the FASB website. The Exposure Draft sets forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information, and an explanation of the basis for the Board's conclusions. At the end of the exposure period, comment letters and position papers are analyzed to search for new information and persuasive arguments regarding the issues (rather than being simply a "nose count" of how many support or oppose a given point of view). In addition to studying this analysis, Board members review the comment letters to help them in reaching conclusions. When the Board is satisfied that all reasonable alternatives have been considered adequately, the staff is directed to prepare a draft of a final document for consideration by the Board.

(g) This answer depends on the point in time that the web site is searched.