Chapter 1

The Financial Statements

Check Points

(5 min.) CP 1-1

Store manager decisions:

a. What food items to offer and how to market the goods
b. Where to locate a restaurant
c. How to finance operations

Accounting helps managers measure the revenue from food sales, the cost of the food, and the profit (or loss) on each food item. Accounting also helps measure which Taco Bells are most profitable and which are losing money. Finally, accounting helps managers decide how to finance operations.

Items on YUM! Brands' income statement that help decide whether to invest in the company:

The company earned a net income (rather than a net loss).
This year's net income is more than last year's.
Net sales revenue is increasing from year to year.

Student responses may vary.

(5 min.) CP 1-2

Accounting **is the information system that measures business activities, processes data into reports, and communicates results to people.**

Bookkeeping **is only a part of accounting. Bookkeeping is related to accounting as arithmetic is related to mathematics.**

(5 min.) CP 1-3

Standards of professional conduct are designed to produce *relevant and reliable information for decision making*. People need relevant and reliable information in order to make wise decisions.

If accountants had no ethical guidelines, companies could report inaccurate information. This could cause people to invest in the wrong companies and lose money.

(5 min.) CP 1-4

1. **Novak can be misled into believing that YUM! Brands owns more assets than it actually has.**
2. **The *entity concept* applies.**
3. **Application of the entity concept will separate Novak's personal assets from the assets of YUM! Brands. This will help Novak, investors, and lenders know how much in assets the business controls, and this knowledge will help all parties evaluate the business realistically.**

(5 min.) CP 1-5

1. **Owners' Equity = Assets – Liabilities**

   This way of determining the amount of owners' equity applies to eBay, Coca-Cola, your household, a Pizza Hut restaurant, or any other organization.
2. **Liabilities = Assets – Owners' Equity**
3. **Total Assets = Total Liabilities + Total Owners' Equity**

(5 min.) CP 1-6

1. ***Assets*** **are the** ***economic resources*** **of a business that are expected to produce a benefit in the future.**

   Owners' equity **represents the** ***insider claims*** **of a business, the owners' interest in its assets**

   Assets and owners' equity ***differ*** **in that owners' equity is a claim to assets, whereas assets are resources.**

   Assets must be at least as large as owners' equity, so equity can be smaller than assets.

2. **Both liabilities and owners' equity are claims to assets.**

   Liabilities are the ***outsider*** **claims to the assets of a business; they are obligations to pay creditors. Owners' equity represents the** ***insider*** **claims to the assets of the business, the owners' interest in its assets.**

(5-10 min.) CP 1-7

a. **Accounts receivable _A**

b. **Long-term debt L**

c. **Merchandise inventory _A**

d. **Notes payable _L_**

e. **Expenses payable _L_**

f. **Equipment _A**

g. **Accounts payable _L_**

h. **Common stock _E**

i. **Supplies _A**

j. **Retained earnings _E**

k. **Land _A_**

l. **Prepaid expenses _A**

(5 min.) CP 1-8

1. ***Revenues* and *expenses***
2. **Net income (or net loss)**
3. **Total assets are *not* used to measure net income. Only revenues and gains, expenses and losses enter into the measurement of net income.**

(10 min.) CP 1-9

		2003	2002
Percentage of cost of goods sold to company sales	=	$\frac{\$2,300}{\$7,441}$ = 30.9%	$\frac{\$2,109}{\$6,891}$ = 30.6%

This trend is *unfavorable* for YUM because cost of goods sold (an expense) consumed a higher percentage of sales revenue in 2003. That could cause a decrease in profits.

(5 min.) CP 1-10

IHOP Corp.
Statement of Retained Earnings
Year Ended December 31, 2003

	Millions
Retained earnings:	
Balance, beginning of year…………....	$274
Net income ($405 – $368)…………….	37
Less: Dividends………………………....	(16)
Balance, end of year…………………...	$295

(10-15 min.) CP 1-11

Toby Landscaping Services
Balance Sheet
December 31, 2008

ASSETS	
Current assets:	
Cash…………………………………………………	$ 13,000
Receivables………………………………………..	2,000
Inventory……………………………………………	40,000
Total current assets………………………………	55,000
Equipment…………………………………………	85,000
Other assets………………………………………..	10,000
Total assets………………………………………..	$150,000
LIABILITIES	
Current liabilities:	
Accounts payable…………………………………	$ 8,000
Short-term notes payable……………………….	12,000
Total current liabilities…………………………...	20,000
Long-term liabilities:	
Long-term debt……………………………………	80,000
STOCKHOLDERS' EQUITY	
Common stock………………………………………	15,000
Retained earnings……………………………………	35,000*
Total stockholders' equity………………………	50,000
Total liabilities and stockholders' equity…………..	$150,000

*Computation:
Total assets ($150,000) – current liabilities ($20,000) – long-term debt ($80,000) – common stock ($15,000) = $35,000

(10-15 min.) CP 1-12

Clearsource Cable, Inc.
Statement of Cash Flows
Year Ended December 31, 2006

Cash flows from operating activities:		
Net income………………………………………..		$ 88,000
Adjustments to reconcile net income to net cash provided by operating activities….		(20,000)
Net cash provided by operating activities..		68,000
Cash flows from investing activities:		
Purchases of equipment…………	$(300,000)	
Sale of equipment…………………	90,000	
Net cash used for investing activities……..		(210,000)
Cash flows from financing activities:		
Borrowing…………………………..	$150,000	
Payment of dividends…………….	(10,000)	
Net cash provided by financing activities.		140,000
Net increase (decrease) in cash………………….		(2,000)
Cash balance, December 31, 2005……………….		24,000
Cash balance, December 31, 2006……………….		$ 22,000

(10 min.) CP 1-13

1. **Cash <u>BS, SCF</u>**
2. **Net cash used for financing activities <u>SCF</u>**
3. **Accounts payable <u>BS</u>**
4. **Common stock <u>BS</u>**
5. **Interest revenue <u>IS</u>**
6. **Long-term debt <u>BS</u>**
7. **Increase or decrease in cash <u>SCF</u>**
8. **Dividends <u>SRE, SCF</u>**
9. **Salary expense <u>IS</u>**
10. **Inventory <u>BS</u>**
11. **Sales revenue <u>IS</u>**
12. **Retained earnings <u>SRE, BS</u>**
13. **Net cash provided by operating activities <u>SCF</u>**
14. **Net income (or net loss) <u>IS, SRE, SCF</u>**

Exercises

(10-15 min.) E 1-1

a. *Proprietorship*. There is a single owner of the business, so the owner is answerable to no other owner.

b. *Partnership*. If the partnership fails and cannot pay its liabilities, creditors can force the partners to pay the business's debts from their personal assets. A partnership affords more protection for creditors than a proprietorship because there are two or more owners to share this liability.

c. *Corporation*. If the corporation fails and cannot pay its liabilities, creditors cannot force stockholders to pay the business's debts from their personal assets. Therefore, the most an investor can lose on an investment in a corporation is the amount invested.

d. *Corporation*. Most investors are willing to invest more in a corporation than in a proprietorship or a partnership because of their limited personal liability for a corporation's debts.

What form of business organization would you choose?

The answer depends on your objective. If you want to maintain absolute control of the business, you may prefer to organize as a *proprietorship*. If your objective is to maintain a high degree of control but you need additional money or expertise, a *partnership* may work for you. If you want the business to grow large, or if you wish to avoid personal liability for business debts, you should organize as a *corporation*.

Student responses may vary.

(10 min.) E 1-2

The *income statement* reports the revenues and expenses of a particular entity for a period such as a month or a year. Total *revenues* minus total *expenses* equals *net income*, or profit. A lender would require this information in order to predict whether the borrower can generate enough income to repay the loan.

The *balance sheet* reports the assets, liabilities, and owners' equity of the entity at a particular point in time. The *assets* show the resources that the business has to work with. Because borrowers pay loans with assets, a lender wants to know the business's assets (especially cash). *Liabilities* — debts — represent creditors' claims to the business's *assets*. *Owners' equity* is the portion of the business assets owned outright by the owners.

Student responses may vary.

(5-10 min.) E 1-3

a. Entity concept
b. Going-concern concept
c. Cost principle
d. Entity concept (No, Comer could not determine the success or failure of the business solely from his checkbook.)
e. Reliability (Objectivity) principle (PepsiCo. should wait to record a gain or loss after it sells the land.)

(5-15 min.) E 1-4

(Amounts in billions)

	Assets	=	Liabilities	+	Owners' Equity
Dell	$19		$13		$ 6
Pier 1 Imports	0.9		0.3		0.6
Boeing	53		45		8

Pier 1 appears to have the strongest financial position because its liabilities make up the smallest percentage of company assets ($3 / $9 = .333). Stated differently, Pier 1's equity is the highest percentage of company assets ($6 / $9 = .667).

(10-15 min.) E 1-5

Req. 1

(Amounts in millions)

	Assets	=	Liabilities	+	Stockholders' Equity
	$141		$ 60		
	202		77		
	67				
Total	$410	=	$137	+	$273
	8		8		8
Req. 2	Resources to work with	*Req. 3*	Amount owed to creditors	*Req. 4*	Actually owned by the stockholders

Req. 5

Krispy Kreme appears able to pay current liabilities of $60 million because current assets are over twice as large as current liabilities.

Krispy Kreme also appears able to pay total liabilities because total assets far exceed total liabilities.

(10-20 min.) E 1-6

	Situation 1	Situation 2	Situation 3
		Billions	
Total stockholders' equity			
January 31, 2003 ($30 – $10)…………..	$20	$20	$20
Add: Issuances of stock………………..	1	-0-	5
Net income…………………………	1*	4*	
Less: Dividends…………………………...	-0-	(2)	(1)
Net loss……………………………..			(2)*
Total stockholders' equity,			
January 31, 2004 ($34 – $12)…………..	$22	$22	$22

Situation 2 indicates the *strongest* results because net income is the highest.

Situation 3 is the *weakest* because of the net loss.

*Must solve for these amounts.

(10-15 min.) E 1-7

1. Fossil Inc.

(Amounts in millions)

	Assets	=	Liabilities	+	Stockholders' Equity
Beginning	$ 483	=	$142	+	$341
Multiplier for increase	×1.217				
Ending	$ 588				

2. Bed Bath & Beyond

(Amounts in billions)

	Assets	–	Liabilities	=	Stockholders' Equity
Beginning amount	$2.2	–	$0.7	=	$1.5
Net income					0.4
Ending amount					$1.9

(10-15 min.) E 1-8

a. Balance sheet

b. Income statement

c. Balance sheet

d. Balance sheet

e. Statement of retained earnings, Statement of cash flows

f. Income statement

g. Balance sheet, Statement of retained earnings

h. Income statement

i. Balance sheet

j. Statement of cash flows

k. Income statement

l. Statement of cash flows

m. Balance sheet, Statement of cash flows

n. Balance sheet

o. Income statement, Statement of retained earnings, Statement of cash flows

(10-20 min.) E 1-9

Wells Fargo & Company
Balance Sheet (Adapted; *Amounts in billions*)
December 31, 2003

ASSETS		LIABILITIES	
Cash	$ 16	Current liabilities	$290
Receivable	253	Long-term liabilities	64
Investment assets	72	Total liabilities	354
Property and equipment, net	4		
Other assets	43	STOCKHOLDERS' EQUITY	
		Common stock	12
		Retained earnings	22*
		Total stockholders' equity	34
Total assets	$388	Total liabilities and stockholders' equity	$388

***Computation of retained earnings:**
Total assets ($388) – Total liabilities ($354) – Common stock ($12) = $22

(15-25 min.) E 1-10

Req. 1

Wells Fargo & Company
Income Statement (Adapted)
Year Ended December 31, 2003

		Billions
Total revenue……………………………………….		**$32**
Expenses:		
Interest expense……………………………..	**$ 3**	
Salary and other employee expenses………	**9**	
Other expenses……………………………….	**14**	
Total expenses……………………………….		**26**
Net income…………………………………………		**$ 6**

Req. 2

The statement of retained earnings helps to compute dividends, as follows:

Statement of Retained Earnings (Adapted)

	Billions
Retained earnings, beginning of year…………………	**$19**
Add: Net income for the year (*Req. 1*)…………………	**6**
	25
Less: Dividends…………………………………………...	**(3)**
Retained earnings, end of year (from Exercise 1-9)……	**$22**

Students are not required to prepare a statement of retained earnings.

(15-20 min.) E 1-11

ADP, Inc.
Statement of Cash Flows
Year Ended December 31, 2004

		Millions
Cash flows from operating activities:		
Net income……………………………………….	**$ 395**	
Adjustments to reconcile net income to net cash provided by operating activities…..	**2,330**	
Net cash provided by operating activities…………		**$2,725**
Cash flows from investing activities:		
Net cash used for investing activities…………..		**(3,140)**
Cash flows from financing activities:		
Net cash provided by financing activities………		**420**
Net increase in cash…………………………………………		**5**
Beginning cash balance……………………………………		**145**
Ending cash balance………………………………………..		**$ 150**

Items given that do not appear on the statement of cash flows:

Total assets – Balance sheet
Total liabilities – Balance sheet

Kinko's INCOME STATEMENT MONTH ENDED JULY 31, 20X6		
Revenue:		
Service revenue………………..		$12,400
Expenses:		
Salary expense…………………	$4,000	
Rent expense…………………...	700	
Utilities expense……………….	200	
Total expenses…………………		4,900
Net income…………………………		$ 7,500

Kinko's STATEMENT OF RETAINED EARNINGS MONTH ENDED JULY 31, 20X6	
Retained earnings, June 30, 20X6……	$ -0-
Add: Net income for the month……….	7,500
	7,500
Less: Dividends…………………………	(2,000)
Retained earnings, July 31, 20X6…….	$5,500

(15-20 min.) E 1-13

Kinko's BALANCE SHEET JULY 31, 20X6			
Assets		**Liabilities**	
Cash……………..	$ 6,500	Accounts payable………….	$ 3,200
Office supplies…	1,200		
Equipment………	36,000	**Stockholders' Equity**	
		Common stock……………..	35,000
		Retained earnings…………	5,500
		Total stockholders' equity.	40,500
Total assets…….	$43,700	Total liabilities and stockholders' equity……	$43,700

(15-20 min.) E 1-14

Kinko's
STATEMENT OF CASH FLOWS
MONTH ENDED JULY 31, 20X6

Cash flows from operating activities:		
Net income………………………………………….		$ 7,500
Adjustments to reconcile net income		
to net cash provided by operations…………….		2,000
Net cash provided by operating activities…		9,500
Cash flows from investing activities:		
Acquisition of equipment…………………………	$(36,000)	
Net cash used for investing activities………		(36,000)
Cash flows from financing activities:		
Issuance (sale) of stock to owners……………..	$ 35,000	
Payment of dividends……………………………..	(2,000)	
Net cash provided by financing activities….		33,000
Net increase in cash…………………………………..		$ 6,500
Cash balance, June 30, 20X6………………………..		0
Cash balance, July 31, 20X6…………………………		$ 6,500

(10-15 min.) E 1-15

TO: Owner of Kinko's store

FROM: Student Name

SUBJECT: Opinion of operating results, dividends, financial position, and cash flows

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Your first month of operations appears to have been successful. Revenues totaled $12,400 and net income was $7,500. These operating results look very strong.

The company was able to pay a $2,000 dividend, and this should make you happy with so quick a return on your investment.

Your financial position looks secure, with assets of $43,700 and liabilities of only $3,200. Your stockholders' equity is $40,500.

Operating activities generated cash of $9,500, which is respectable. You ended the month with cash of $6,500. Based on the above facts, I believe you should stay in business.

Student responses may vary.

(15-20 min.) E 1-16

a. **The single best source of cash for a business is *net income and the related cash receipts.* This source of cash is best because it results from the core operations of the business.**

b. ***Borrowing, issuing stock, and selling* land, buildings, and equipment can bring in cash even when the company has losses.**

c. ***Paying large dividends* will cause retained earnings to be low.**

d. **Heavy *investing activity* and *paying off debts* can result in a cash shortage even if net income has been high.**

e. **You can finance the payment of current liabilities in several ways: *Borrow money, issue (sell) stock to stockholders, or sell long-term assets* such as land, buildings, and equipment.**

Practice Quiz

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

				Stockholders'
Assets	=	Liabilities	+	Equity
+ $20,000	=	– $4,000		$\boxed{+ \$24{,}000}$

5. d
6. a
7. b
8. c
9. d
10. c ($140,000 – $22,000 – $8,000 – $3,000 = $107,000)
11. d ($110,000 + $95,000 – $30,000 = $175,000)
12. d
13. b
14. a

					Stockholders'
	Assets	=	Liabilities	+	Equity
Begin.	$25,000	=	$10,000*	+	$15,000
Changes			– 8,000		
End.	$20,000*	=	$ 2,000*	+	$18,000

*Must solve for these amounts.

15. c

	Total stockholders' equity	
Begin.	$520,000 – $200,000 = $320,000	
+ Net income	X	= $160,000
– Dividends	– 30,000	
End.	$750,000 – $300,000 = $450,000	

Problems

Group A

(15-30 min.) P 1-1A

TO: Investment committee

SUBJECT: Genome Science Corporation request for us to buy its stock

I recommend purchasing Genome Science stock because:

1. Operations are the main source of Genome's cash, and the company is increasing cash without a lot of borrowing. Moreover, Genome has been investing lots of money in long-term assets, as shown by its investing cash flows.

2. Net income has increased dramatically during the past two years.

3. Total assets have grown from $590,000 to $990,000 during the past two years, and liabilities have risen more slowly.

   I believe Genome has a bright future and that its stock is likely to increase in value.

Student responses may vary.

(15-20 min.) P 1-2A

Req. 1

General Electric Company
Income Statement
Year Ended December 31, 20X5

	Billions	
Sales revenue………………………..	$ 53	
Other revenue………………………..	73	
Total revenue………………………...		$126
Cost of goods sold………………….	36	
Other expenses……………………...	70	
Total expenses………………………		106
Income before income tax…………		20
Income tax expense ($20 × .30)…...		6
Net income……………………………		$ 14

Req. 2

a. Reliability (objectivity) principle. Report revenues at their actual sale value because that amount is more reliable than what management believes the goods are worth.

b. Cost principle. Account for expenses at their actual cost, not a hypothetical amount that the company might have incurred if the products were purchased outside.

c. Cost principle. Account for expenses at their actual cost.

d. Entity concept. Each division of the company is a separate entity, and the company as a whole constitutes an entity for accounting purposes.

e. Stable-monetary-unit concept. Accounting in the United States ignores the effect of inflation.

f. Going-concern concept. There is no evidence that General Electric is going out of business, so it seems safe to assume that the company is a going concern.

(30-40 min.) P 1-3A

Computed amounts are shown in $\boxed{\text{boxes}}$. Amounts are in *billions*.

	FedEx Corp.	Coca-Cola Company	Ford Corp.
***Beginning*:**			
Assets	$12	$17	$279
– Liabilities	(7)	(10)	(228)
= Owners' equity	$ 5	$ 7	$ 51
***Ending*:**			
Assets	$13	$19	$ $\boxed{269}$[3]
– Liabilities	(7)	(11)	(204)
= Owners' Equity	$ 6	$ 8	$ 65
***Owners' Equity*:**			
Issuance of stock	$ $\boxed{1}$[1]	$ 0	$ 1
– Dividends	(1)	(3)	(9)
***Income Statement*:**			
Revenues	$20	$19	$119
– Expenses	(19)	$\boxed{(15)}$[2]	(97)
= Net income	$ 1	$ 4	$ 22
***Statement of owners' equity*:**			
Beginning owners' equity	$ 5	$ 7	$ 51
+ Issuance of stock	$\boxed{1}$[1]	0	1
+ Net income	1	$\boxed{4}$[2]	22
– Dividends	(1)	(3)	(9)
= Ending owners' equity	$ 6	$ 8	$ 65

[1]$5 + Issuance of stock + $1 – $1 = $6
Issuance of stock = $1

[2]Net income = $4
Revenue – expenses = net income
$19 – expenses = $4
Expenses = $15

[3]Assets = liabilities + OE
Assets = $204 + $65
Assets = $269

		FedEx Corp.	Coca-Cola Company	Ford Corp.
Percentage of liabilities to assets	=	$\frac{\$7}{\$13}$	$\frac{\$11}{\$19}$	$\frac{\$204}{\$269}$
		= 53.8% Lowest	= 57.9% 2nd Lowest	= 75.8%
Percentage of net income to revenues	=	$\frac{\$1}{\$20}$	$\frac{\$4}{\$19}$	$\frac{\$22}{\$119}$
		= 5%	= 21.1% Highest	= 18.5%

On these measures, Coca-Cola looks the strongest. Coca-Cola has the second lowest percentage of liabilities to assets and the highest percentage of net income to revenues.

(20-25 min.) P 1-4A

Req. 1

ICON, Inc.
Balance Sheet
July 31, 20X7

ASSETS		LIABILITIES	
Cash	$15,000	Accounts payable	$ 9,000
Accounts receivable	12,000	Note payable	16,000
Office supplies	1,000	Total liabilities	25,000
Office furniture	10,000	STOCKHOLDERS' EQUITY	
Land	44,000		
		Stockholders' equity	57,000*
		Total liabilities and	
Total assets	$82,000	stockholders' equity	$82,000

______

***Total assets ($82,000) – Total liabilities ($25,000) = Stockholders' equity ($57,000).**

Req. 2

ICON, Inc., is in *better* financial position than the erroneous balance sheet reports. True, assets are lower than reported, but by only $10,500 ($92,500 – $82,000). But liabilities are much lower, and owners' equity is $36,300 higher than reported originally. Overall, ICON has less debt and more equity than first reported.

Req. 3

The following accounts are not reported on the balance sheet because they are revenues or expenses. These accounts are reported on the income statement.

Rent expense
Advertising expense
Service revenue
Property tax expense

(20-25 min. P 1-5A

Req. 1

Marjorie Caballero, Realtor, Inc.
Balance Sheet
November 30, 2004

ASSETS		LIABILITIES	
Cash	$ 6,000	Accounts payable	$ 6,000
Office supplies	1,000	Note payable	40,000
Franchise	20,000	Total liabilities	46,000
Furniture	17,000	STOCKHOLDERS' EQUITY	
Land	120,000		
		Common stock	50,000
		Retained earnings	68,000*
		Total stockholders' equity	118,000
Total assets	$164,000	Total liabilities and stockholders' equity	$164,000

*Total assets ($164,000) – Total liabilities ($46,000) – Common stock ($50,000) = $68,000.

Req. 2

It appears that Caballero's realty business can pay its debts. Total assets far exceed total liabilities.

Req. 3

Personal items not reported on the balance sheet of the business:

a. Personal cash ($10,000)
b. Personal account payable ($1,800)
g. Personal residence ($160,000) and mortgage payable ($100,000)

(30-45 min.) P 1-6A

Req. 1

Hercules, Inc.
Income Statement
Year Ended December 31, 20X8

Revenue		
Service revenue…………………		**$220,000**
Expenses		
Salary expense…………………	**$63,000**	
Rent expense……………………	**23,000**	
Advertising expense……………	**13,000**	
Interest expense………………...	**9,000**	
Property tax expense…………..	**4,000**	
Total expenses…………………..		**112,000**
Net income…………………………		**$108,000**

Req. 2

Hercules, Inc.
Statement of Retained Earnings
Year Ended December 31, 20X8

Retained earnings, beginning of year……	**$ 10,000**
Add: Net income for the year……………	**108,000**
	118,000
Less: Dividends…………………………….	**(70,000)**
Retained earnings, end of year……………	**$ 48,000**

Req. 3

Hercules, Inc.
Balance Sheet
December 31, 20X8

ASSETS		LIABILITIES	
Cash	$ 10,000	Accounts payable	$ 19,000
Accounts receivable	12,000	Salary payable	1,000
Supplies	3,000	Note payable	185,000
Furniture	20,000	Total liabilities	205,000
Building	150,000	STOCKHOLDERS' EQUITY	
Land	98,000		
		Common stock	40,000
		Retained earnings	48,000
		Total stockholders' equity	88,000
Total assets	$293,000	Total liabilities and stockholders' equity	$293,000

Req. 4

a. Hercules was profitable; net income was $108,000.

b. Retained earnings increased by $38,000 — from $10,000 to $48,000.

c. Total liabilities ($205,000) exceeds stockholders' equity ($88,000).

The creditors own more of Hercules' assets than do the company's stockholders.

(20 min.) P 1-7A

Req. 1

Nike, Inc.
Statement of Cash Flows
Year Ended May 31, 20X4

		Millions
Cash flows from operating activities:		
Net income……………………………………….		$796
Adjustments to reconcile net income to cash provided by operations………………..		(473)
Net cash provided by operating activities…		323
Cash flows from investing activities:		
Purchases of property, plant, and equipment..	$(510)	
Sales of property, plant, and equipment………	24	
Other investing cash receipts…………………..	33	
Net cash used for investing activities………		(453)
Cash flows from financing activities:		
Borrowing……………………………………….	$ 388	
Issuance of common stock……………………..	26	
Payment of dividends……………………………	(101)	
Net cash provided by financing activities		313
Net increase in cash………………………………		$ 183
Cash, beginning……………………………………		262
Cash, ending………………………………………..		$ 445

Req. 2

Operations and financing provided roughly equal amounts of cash. This signals a little financial weakness. Operations should be the main source of cash.

(40-50 min.) P 1-8A

Req. 1

			20X6	20X5		
			(Thousands)			
STATEMENT OF OPERATIONS						
Revenues	$94,749	=	$ k	$88,412		
Cost of goods sold			(74,564)	(a)	=	65,586
Other expenses			(15,839)	(13,564)		
Income before income taxes			4,346	9,262		
Income taxes (36.95% in 20X6)	1,606	=	(l)	(1,581)		
Net income	2,740	=	$ m	$ b	=	7,681
STATEMENT OF RETAINED EARNINGS						
Beginning balance	17,213	=	$ n	$ 9,987		
Net income	2,740	=	o	c	=	7,681
Dividends			(559)	(455)		
Ending balance	19,394	=	$ p	$ d	=	17,213
BALANCE SHEET						
Assets:						
Cash	83	=	$ q	$ e	=	45
Property, plant and equipment			23,894	20,874		
Other assets	18,564	=	r	16,900		
Total assets	42,541	=	$ s	$37,819		
Liabilities:						
Current liabilities	11,454	=	$ t	$ 9,973		
Long-term debt and other liabilities			11,331	10,120		
Total liabilities			22,785	f	=	20,093
Shareholders' Equity:						
Common stock			$ 229	$ 230		
Retained earnings	19,394	=	u	g	=	17,213
Other shareholders' equity			133	283		
Total shareholders' equity	19,756	=	v	17,726		
Total liabilities and shareholders' equity	42,541	=	$ w	$ h	=	37,819
STATEMENT OF CASH FLOWS						
Net cash provided by operating activities	2,383	=	$ x	$ 2,906		
Net cash used for investing activities			(3,332)	(3,792)		
Net cash provided by financing activities			987	911		
Increase (decrease) in cash			38	i	=	25
Cash at beginning of year	45	=	y	20		
Cash at end of year	83	=	$ z	$ j	=	45

Req. 2

a. Operations deteriorated during 20X6. Revenues increased, but net income fell from $7,681 thousand to $2,740 thousand.

b. The company retains most of its net income for use in the business. Dividends were much less than net income.

c. Total assets at the end of 20X6 were $42,541 thousand. This is the amount of total resources that the company has to work with as it moves into the year 20X7.

d. At the end of 20X5, the company owed total liabilities of $20,093 thousand. At the end of 20X6, the company owed $22,785 thousand.

e. The company's major source of cash is operating activities, and cash is increasing. Based on these two facts, it appears that the company's ability to generate cash is strong despite the dip in 20X6 net income. The company is using most of its cash to expand. This is clear from the large amounts of cash used for investing activities, which indicate that the company is growing.

Problems

Group B

(15-30 min.) P 1-1B

TO: Edward Jones loan committee

SUBJECT: Kaiser Corporation loan request

I recommend *not* lending $50 million to Kaiser because:

1. **Operations are generating less and less of the company's cash, and the cash balance has decreased by $120 million during the past three years.**

2. **Revenues decreased in 2007, and net income has decreased for the past two years.**

3. **Dividends have exceeded net income for the past two years. As a result, stockholders' equity has decreased from $400 million to $330 million.**

4. **Liabilities have increased from $260 million to $390 million, which exceeds stockholders' equity. A $50 million loan to Kaiser would make this situation worse.**

I doubt Kaiser could repay this loan.

Student responses may vary.

(15-20 min.) P 1-2B

Req. 1

Chrysler Division of DaimlerChrysler Corporation
Income Statement
Year Ended December 31, 20X5

	Billions	
Sales revenue……………………………..	$69.4	
Other revenue……………………………..	5.8	
Total revenue……………………………..		$75.2
Cost of goods sold……………………….	$59.0	
Selling and administrative expenses…	3.7	
Other expenses…………………………..	4.5	
Total operating expenses……………….		67.2
Income before income tax………………		8.0
Income tax expense ($8.0 × .35)……….		2.8
Net income………………………………..		$ 5.2

Req. 2

a. **Reliability (objectivity) principle. Report revenues at their actual sale value because that amount is more reliable than what management believes the good are worth.**

b. **Cost principle. Account for expenses at their actual cost, not a hypothetical amount that the company might have incurred if the products were purchased outside.**

c. **Cost principle. Account for expenses at their actual cost.**

d. **Entity concept. Each division of the company is a separate entity, and the company as a whole constitutes an entity for accounting purposes.**

e. **Stable-monetary-unit concept. Accounting in the United States ignores the effect of inflation.**

f. **Going-concern concept. There is no evidence that Chrysler is going out of business, so it seems safe to assume that the division is a going concern.**

(30-40 min.) **P 1-3B**

Computed amounts are shown in boxes.

Amounts in billions

	Best Buy	Pier 1	Wal-Mart
***Beginning*:**			
Assets	$ 3.0	$ 0.7	$ 78
– Liabilities	(1.9)	(0.2)	(47)
= Owners' equity	$ 1.1	$ 0.5	$ 31
***Ending*:**			
Assets	$ 4.8	$ 0.9	$ $\boxed{83}$[3]
– Liabilities	(3.0)	(0.3)	(48)
= Owners' Equity	$ 1.8	$ 0.6	$ 35
***Owners' Equity*:**			
Issuance of stock	$ $\boxed{0.3}$[1]	$ 0	$ 0
– Dividends	(0)	(0)	(3)
***Income Statement*:**			
Revenues	$15.3	$1.5	$218
– Expenses	(14.9)	$\boxed{(1.4)}$[2]	(211)
= Net income	$ 0.4	$ 0.1	$ 7
***Statement of owners' equity*:**			
Beginning owners' equity	$ 1.1	$ 0.5	$ 31
+ Issuance of stock	$\boxed{0.3}$[1]	0	0
+ Net income	0.4	$\boxed{0.1}$[2]	7
– Dividends	(0)	(0)	(3)
= Ending owners' equity	$ 1.8	$ 0.6	$ 35

[1]$1.1 + Issuance of stock (x) + $0.4 – $0 = $1.8
Issuance of stock = $0.3

[2]Net income (y) = $0.1
Revenue – expenses = net income
$1.5 – expenses = $0.1
Expenses = $1.4

[3]Assets – liabilities = OE
Assets – $48 = $35
Assets = $83

		Best Buy	Pier 1	Wal-Mart
Percentage of liabilities to assets	=	$\frac{\$3.0}{\$4.8}$	$\frac{\$0.3}{\$0.9}$	$\frac{\$48}{\$83}$
		= 62.5%	= 33.3% Lowest	= 57.8%
Percentage of net income to revenues	=	$\frac{\$0.4}{\$15.3}$	$\frac{\$0.1}{\$1.5}$	$\frac{\$\ 7}{\$218}$
		= 2.6%	= 6.7% Highest	= 3.2%

On these two measures, Pier 1 looks the strongest. Pier 1's percentage of liabilities to assets is the lowest, and Pier 1's percentage of net income to revenues is the highest.

(20-25 min.) P 1-4B

Req. 1

Shipp Belting, Inc.
Balance Sheet
October 31, 20X8

ASSETS		LIABILITIES	
Cash	$ 15,400	Accounts payable	$ 3,000
Accounts receivable	2,600	Note payable	50,000
Notes receivable	14,000	Total liabilities	53,000
Office supplies	800	STOCKHOLDERS' EQUITY	
Equipment	36,700		
Land	80,500	Stockholders' equity	97,000*
Total assets	$150,000	Total liabilities and stockholders' equity	$150,000

***Total assets ($150,000) – Total liabilities ($53,000) = Stockholders' equity ($97,000).**

Req. 2

Shipp Belting is in *better* financial position than the erroneous balance sheet reports. Liabilities are less, and assets and equity are greater than reported originally.

Req. 3

The following accounts are not reported on the balance sheet because they are expenses. Expenses are reported on the income statement.

Utilities expense
Advertising expense
Salary expense
Interest expense

(20-25 min.) P 1-5B

Req. 1

Mike Cassell, Realtor, Inc.
Balance Sheet
March 31, 2008

ASSETS		LIABILITIES	
Cash	$ 16,000	Accounts payable	$ 6,000
Office supplies	1,000	Note payable	33,000
Franchise	35,000	Total liabilities	39,000
Furniture	12,000	STOCKHOLDERS' EQUITY	
Land	100,000		
		Common stock	75,000
		Retained earnings	50,000*
		Total stockholders' equity	125,000
Total assets	$164,000	Total liabilities and stockholders' equity	$164,000

*Total assets ($164,000) – Total liabilities ($39,000) – Common stock ($75,000) = Retained earnings ($50,000).

Req. 2

It appears that Cassell's realty business can pay its debts. Total assets far exced total liabilities.

Req. 3

Personal items not reported on the balance sheet of the business:
- a. Personal cash ($9,000)
- e. Personal residence ($190,000) and mortgage payable ($65,000)
- f. Personal account payable ($300)

(30-45 min.) P 1-6B

Req. 1

Kellogg Services, Inc.
Income Statement
Year Ended December 31, 20X7

Revenue		
Service revenue……………….		**$115,000**
Expenses		
Salary expense………………...	**$34,000**	
Rent expense…………………..	**14,000**	
Interest expense……………….	**4,000**	
Utilities expense……………….	**3,000**	
Property tax expense…………	**2,000**	
Total expenses…………………		**57,000**
Net income………………………...		**$ 58,000**

Req. 2

Kellogg Services, Inc.
Statement of Retained Earnings
Year Ended December 31, 20X7

Retained earnings, beginning of year	**$111,000**
Add: Net income for the year………..	**58,000**
	169,000
Less: Dividends………………………...	**(42,000)**
Retained earnings, end of year………..	**$127,000**

Req. 3

Kellogg Services, Inc.
Balance Sheet
December 31, 20X7

ASSETS		LIABILITIES	
Cash	$ 4,000	Accounts payable	$ 12,000
Accounts receivable	10,000	Interest payable	1,000
Supplies	2,000	Note payable	31,000
Equipment	31,000	Total liabilities	44,000
Building	126,000	STOCKHOLDERS' EQUITY	
Land	8,000		
		Common stock	10,000
		Retained earnings	127,000
		Total stockholders' equity	137,000
Total assets	$181,000	Total liabilities and stockholders' equity	$181,000

Req. 4

a. Kellogg was profitable; net income was $58,000.

b. Retained earnings increased by $16,000 — from $111,000 to $127,000.

c. Total equity ($137,000) exceeds total liabilities ($44,000).

Therefore, the stockholders own more of the company's assets than do the creditors.

(20 min.) P 1-7B

Req. 1

The Home Depot, Inc.
Statement of Cash Flows
Year Ended January 31, 20X3

		Millions
Cash flows from operating activities:		
Net income………………………………………		$ 3,044
Adjustments to reconcile net income to cash provided by operations…………….		2,919
Net cash provided by operating activities..		5,963
Cash flows from investing activities:		
Purchases of property, plant, and equipment.	$(3,393)	
Sales of property, plant, and equipment……..	176	
Other investing cash payments………………..	(263)	
Net cash used for investing activities……..		(3,480)
Cash flows from financing activities:		
Borrowing…………………………………….	$ 532	
Payment of long-term debt………………………	(754)	
Issuance of common stock……………………..	445	
Payment of dividends……………………………	(396)	
Net cash used for financing activities……..		(173)
Net increase in cash……………………………….		2,310
Cash, beginning……………………………………..		167
Cash, ending………………………………………..		$ 2,477

Req. 2

Operations provided the bulk of Home Depot's cash. This is a sign of strength.

(40-50 min.) P 1-8B

Req. 1

			20X5	20X4		
			(Thousands)			
STATEMENT OF OPERATIONS						
Revenues	13,176	=	$ k	$15,487		
Cost of goods sold			(11,026)	(a)	=	12,822
Other expenses			(1,230)	(1,169)		
Income before income taxes			920	1,496		
Income taxes (35% in 20X5)	322	=	(l)	(100)		
Net income	598	=	$ m	$ b	=	1,396
STATEMENT OF RETAINED EARNINGS						
Beginning balance	4,043	=	$ n	$ 2,702		
Net income	598	=	o	c	=	1,396
Dividends			(65)	(55)		
Ending balance	4,576	=	$ p	$ d	=	4,043
BALANCE SHEET						
Assets:						
Cash	1,421	=	$ q	$ e	=	1,086
Property, plant and equipment			1,597	1,750		
Other assets	10,198	=	r	10,190		
Total assets	13,216	=	$ s	$13,026		
Liabilities:						
Current liabilities	5,706	=	$ t	$ 5,403		
Notes payable and long-term debt			2,569	3,138		
Other liabilities			69	72		
Total liabilities			8,344	f	=	8,613
Shareholders' Equity:						
Common stock			$ 117	$ 118		
Retained earnings	4,576	=	u	g	=	4,043
Other shareholders' equity			179	252		
Total shareholders' equity	4,872	=	v	4,413		
Total liabilities and shareholders' equity	13,216	=	$ w	$ h	=	13,026
STATEMENT OF CASH FLOWS						
Net cash provided by operating activities	986	=	$ x	$ 575		
Net cash provided by investing activities			58	474		
Net cash used for financing activities			(709)	(1,045)		
Increase (decrease) in cash			335	i	=	4
Cash at beginning of year	1,086	=	y	1,082		
Cash at end of year	1,421	=	$ z	$ j	=	1,086

Req. 2

a. Operations deteriorated during 20X5. Revenues decreased, and net income fell from $1,396 thousand to $598 thousand.

b. The company retained most of its net earnings for use in the business. Dividends were much less than net earnings.

c. Total assets at the end of 20X5 were $13,216 thousand. This is the amount of total resources that the company has to work with as it moves into the year 20X6.

d. At the end of 20X4 the company owed total liabilities of $8,613 thousand. At the end of 20X5 the company owed $8,344 thousand. A decrease in total liabilities is a good trend in relation to an increase in total assets because this means that stockholders' equity is increasing.

e. The company's major source of cash is operating activities, and cash is increasing. Based on these two facts, it appears that the company's ability to generate cash is strong despite the drop in 20X5 net income.

Decision Cases

(20-30 min.) Decision Case 1

Req. 1

The most pressing need is *cash*, which is very low.

Req. 2

Data Services Corp.
Income Statement
Year Ended Dec. 31, 2004

Revenues………..	$90,000[1]
Expenses………..	90,000[2]
Net income………	$ -0-

Data Services Corp.
Balance Sheet
Dec. 31, 2004

Cash……………	$ 3,000	Liabilities………	$35,000[4]
Other assets….	52,000[3]	Equity…………..	20,000[5]
Total assets…...	$55,000	Total liabilities and equity……..	$55,000

[1]$80,000 + $10,000 = $90,000

[2]$60,000 + $25,000 + $5,000 = $90,000

[3]$67,000 – $25,000 + $10,000 = $52,000

[4]$30,000 + $5,000 = $35,000

[5]$40,000 – $25,000 + $10,000 – $5,000 = $20,000

Req. 3

Data Services' *financial position* is much *weaker* than originally reported. Assets and equity are lower and liabilities are higher. Liabilities make up a higher percentage of assets. *Results of operations* are *worse* than reported. The company did not earn a profit as reported. In fact, it broke even for the year.

Req. 4

Based on the actual figures, I would *not* invest in Data Services Corp for reasons given in *Req. 3*.

(30-40 min.) Decision Case 2

Based solely on these balance sheets, MLK, Inc. appears to be the better credit risk because:

1. **JFK has more assets ($431,000) than MLK ($213,500), but JFK owes much more in liabilities ($391,000 versus $30,000 for MKL). MLK's stockholders' equity is far greater than that of JFK ($183,500 compared to $40,000). MLK is not heavily in debt, but JFK is.**

2. **You would be better off granting the loan to MLK. You should consider what will happen if the borrower cannot pay you back as planned. JFK has far more liabilities to pay, and it may be hard for JFK to come up with the money to pay you. On the other hand, MLK has little debt to pay to others before paying you.**

Ethical Issue

Req. 1

The fundamental ethical issue in these situations is telling the truth about the companies' financial positions and operating performance. Both companies needed to improve their financial appearances, and their financial statements should have presented the truth about their finances. They should not have rigged the statements to improve their appearance.

Req. 2

Enron:	**Assets**	**=**	**Liabilities**	**+**	**Owners' Equity**
			↓ ***were understated***		↑ ***was overstated***
World Com:	**Assets**	**=**	**Liabilities**	**+**	**Owners' Equity**
	↑ ***were overstated***				↑ ***was overstated***

Req. 3

When companies report untrue financial data, investors waste their money on undeserving entities and usually suffer losses. Investors then file lawsuits in the hope of recovering their losses, but they are seldom able to recover much.

Focus on Financials: YUM! Brands

(30 min.)

1. ***Net income*, because it shows the net result of all the revenues minus all the expenses for a period. In effect, net income gives the results of operations in a single figure.**

   During 2003, net income rose from $583 million to $617 million. This is good news because the company's profit increased during the year.

2. **YUM's largest expense is for food and paper. This is YUM's cost of the inputs to the food the company sold. Food and paper expense is less than sales revenue because YUM buys food and paper at one price and then sells the food for a higher price.**

   Another title of this expense is *cost of goods sold*.

3. **Total resources (total assets) at the end of 2003…………………………………………….... $5,620 million**
   Amount owed (total liabilities) at the end of the year…………………………………………… $4,500 million
   Portion of the company's assets owned by the company's stockholders (this is shareholders' equity)………………………….... $1,120 million

YUM's accounting equation *(in millions):*

Assets	**=**	**Liabilities**	**+**	**Stockholders' equity**
$5,620	**=**	**$4,500**	**+**	**$1,120**

4. **YUM gets most of its cash from operating activities.**

   At the beginning of 2003, YUM had $130 million of cash. At the end of the year, YUM had $192 million of cash.

Focus on Analysis: Pier 1 Imports

(30 min.)

1. ***(Amounts in millions)***

$$\textbf{Assets} = \textbf{Liabilities} + \textbf{Shareholders' equity}$$

$$\$1{,}052 = \underbrace{(\$280 + \$19 + \$69)}_{\$368} + \$684$$

Pier 1 appears to be in *strong* financial condition. Total assets are almost three times total liabilities. That suggests that the company will have no difficulty paying its debts and will have money to expand.

2. **Accounts payable increased because Pier 1 bought lots of inventory, supplies, and other items during 2004.**

3. ***Retained earnings* had the largest increase among the items of equity. The increase resulted from Pier 1's earning *net income* during 2004.**

4. **The *balance sheet* reports cash as part of financial position. The *statement of cash flows* tells why cash increased or decreased.**

   ***Capital expenditures and purchases of treasury stock* caused Pier 1's cash to decrease the most during 2004.**

5. **The result of operations for 2004 was *net income* of $118 million. Net income de*creased* during 2004, and that is *bad news* because it means that Pier 1's operations were *less successful* in 2004 than during the preceding year.**