

Chapter 1

Introducing Financial Accounting

Learning Objectives – coverage by question				
	Mini-Exercises	Exercises	Problems	Cases and Projects
LO1 – Identify the users of accounting information and discuss the costs and benefits of disclosure.	25	28, 34		49, 50
LO2 – Describe a company's business activities and explain how these activities are represented by the accounting equation.	19, 20, 21	27, 29, 32, 33	36, 37, 38, 43	47
LO3 – Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity and statement of cash flows.	22, 23, 24	30, 31	37, 38, 39, 40, 41, 42, 43, 44, 45	46, 47, 49
LO4 – Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles.	26	34		50
LO5 – Compute two key ratios that are commonly used to assess profitability and risk – return on equity and the debt-to-equity ratio.		32, 33	36, 43, 44, 45	46, 47, 48, 49
LO6 – Appendix 1A: Explain the conceptual framework for financial reporting.		35		

QUESTIONS

- Q1-1.** Organizations undertake planning activities that subsequently shape three major activities: financing, investing, and operating. Financing is the means used to pay for resources. Investing refers to the buying and selling of resources necessary to carry out the organization's plans. Operating activities are the actual carrying out of these plans. (Planning is the glue that connects these activities, including the organization's ideas, goals and strategies.)
- Q1-2.** An organization's financing activities (liabilities and equity = sources of funds) pay for investing activities (assets = uses of funds). An organization cannot have more or less assets than its liabilities and equity combined and, similarly, it cannot have more or less liabilities and equity than its total assets. This means: $\text{assets} = \text{liabilities} + \text{equity}$. This relation is called the accounting equation (sometimes called the *balance sheet equation*, or BSE), and it applies to all organizations at all times.
- Q1-3.** The four main financial statements are: income statement, balance sheet, statement of stockholders' equity, and statement of cash flows. The income statement provides information relating to the company's revenues, expenses and profitability over a period of time. The balance sheet lists the company's assets (what it owns), liabilities (what it owes), and stockholders' equity (the residual claims of its owners) as of a point in time. The statement of stockholders' equity reports on the changes to each stockholders' equity account during the year. Some changes to stockholders' equity, such as those resulting from the payment of dividends and unrealized gains (losses) on marketable securities, can only be found in this statement as they are not included in the computation of net income. The statement of cash flows identifies the sources (inflows) and uses (outflows) of cash, that is, from what sources the company has derived its cash and how that cash has been used. All four statements are necessary in order to provide a complete picture of the financial condition of the company.
- Q1-4.** The balance sheet provides information that helps users understand a company's resources (assets) and claims to those resources (liabilities and stockholders' equity) as of a given *point in time*.
- An income statement reports whether the business has earned a net income (also called profit or earnings) or a net loss. Importantly, the income statement lists the types and amounts of revenues and expenses making up net income or net loss. The income statement covers a *period of time*.
- Q1-5.** Your authors would agree with Mr. Buffett. A recent study of top financial officers suggests they find earnings and the year-to-year changes in earnings as the most important items to report. We would add cash flows particularly from operations, and the year-to-year changes.

- Q1-6.** The statement of cash flows reports on the cash inflows and outflows relating to a company's operating, investing, and financing activities over a *period of time*. The sum of these three activities yields the net change in cash for the period. This statement is a useful complement to the income statement which reports on revenues and expenses, but conveys relatively little information about cash flows.
- Q1-7.** Articulation refers to the updating of the balance sheet by information contained in the income statement or the statement of cash flows. For example, retained earnings is increased each period by any profit earned during the period (as reported in the income statement) and decreased each period by the payment of dividends (as reported in the statement of cash flows and the statement of stockholders' equity). It is by the process of articulation that the financial statements are linked.
- Q1-8.** Return refers to income, and risk is the uncertainty about the return we expect to earn. The lower the risk, the lower the expected return. For example, savings accounts pay a low return because of the low risk of a bank not returning the principal with interest. Higher returns are to be expected for common stocks as there is a greater uncertainty about the realized return compared with the expected return. Higher expected return offsets this higher risk.
- Q1-9.** Companies often report more information than is required by GAAP because the benefits of doing so outweigh the costs. These benefits often include lower interest rates and better terms from lenders, higher stock prices and greater access to equity investors, improved relationships with suppliers and customers, and increased ability to attract the best employees. All of these benefits arise because the increased disclosure reduces uncertainty about the company's future prospects.
- Q1-10.** External users and their uses of accounting information include: (a) lenders for measuring the risk and return of loans; (b) shareholders for assessing the return and risk in acquiring shares; and (c) analysts for assessing investment potential. Other users are auditors, consultants, officers, directors for overseeing management, employees for judging employment opportunities, regulators, unions, suppliers, and appraisers.
- Q1-11.** Managers deal with a variety of information about their employers and customers that is not generally available to the public. Ethical issues arise concerning the possibility that managers might personally benefit by using confidential information. There is also the possibility that their employers and/or customers might be harmed if certain information is not kept confidential.

- Q1-12.** Return on equity (ROE) is computed as net income divided by average stockholders' equity (an average of stockholders' equity for the current and previous year is commonly used, but the ratio is sometimes computed only with beginning or ending stockholders' equity). The return on equity is a popular measure for analysis because it compares the level of return earned with the amount of equity invested to generate the return. Furthermore, it combines both the income statement and the balance sheet and, thereby, highlights the fact that companies must manage *both* well to achieve high performance.
- Q1-13.** While businesses acknowledge the increasing need for more complete disclosure of financial and nonfinancial information, they have resisted these demands to protect their competitive position. These companies must weigh the benefits they receive from the market as a result of more transparent and revealing financial reporting against the costs of divulging proprietary information.
- Q1-14.** Generally Accepted Accounting Principles (GAAP) are the various methods, rules, practices, and other procedures that have evolved over time in response to the need to regulate the preparation of financial statements. They are primarily set by the Financial Accounting Standards Board (FASB), an entity of the private sector with representatives from companies that issue financial statements, accounting firms that audit those statements, and users of financial information.
- Q1-15.** International Financial Reporting Standards (IFRS) are the accounting methods, rules and principles established by the International Accounting Standards Board (IASB). The need for IFRS stems from the wide variety of accounting principles adopted in various countries and the lack of comparability that this variety creates. IFRS are intended to create a common set of accounting guidelines that will make the financial statements of companies from different countries more comparable.

The IASB has no enforcement authority. As a consequence, the strict enforcement of IFRS is left to the accounting profession and/or securities market regulators in each country. Many countries have reserved the right to make exceptions to IFRS by applying their own (local) accounting rules in selected areas. Some accountants and investors argue that a little diversity is a good thing – variations in accounting practice reflect differences in cultures and business practices of various countries. However, one concern is that IFRS may create the false impression that everyone is following the same rules, even though some variation will continue to permeate international financial reporting.

Q1-16. The auditor's primary function is to express an opinion on whether the financial statements fairly present the financial condition of the company and are free from material misstatements. Auditors do not prepare the financial statements; they only audit them and issue their opinion on them.

Q1-17.^A The objectives of financial accounting are to provide information:

- That is useful to investors, creditors, and other decision makers who possess a reasonable knowledge of business activities and accounting
- To help investors and creditors assess the amount, timing and uncertainty of cash flows. This includes the information presented in the cash flow statement as well as other information that might help investors and creditors assess future dividend and debt payments
- About economic resources and financial claims on those resources. This includes the information in the balance sheet and any supporting information that might help the user assess the value of the company's assets and future obligations
- About a company's financial performance, including net income and its components (i.e., revenues and expenses)
- That allows decision makers to monitor company management to evaluate their effective, efficient, and ethical stewardship of company resources

Q1-18.^A The four enhancing qualitative characteristics of accounting information are comparability, verifiability, timeliness, and understandability.

Comparability refers to the use of similar accounting methods across companies. Comparability improves the users' ability to interpret the information by making comparisons to other companies. *Verifiability* means that consensus among independent observers could be reached that reported information is a faithful representation. Verifiable financial information improves the quality of the information because auditing and interpretation of the reported data will be easier and more trusted.

Timeliness means that the financial reporting information must be available to decision makers in time for the financial statement users to make decisions. *Understandability* means that the financial statements should be presented in such a way that users who have reasonable knowledge of business activities can understand the statements. This is difficult because organizations and transactions have become more complex over time (more global, expanding into new industries, etc.) and thus the reporting of such complexities is difficult. The more understandable the statements can be the better for users of the statements.

MINI EXERCISES

M1-19. (10 minutes)

LO 2

(\$ millions)

Assets	=	Liabilities	+	Equity
\$19,381		<u>\$13,720</u>		\$5,661

Macy's receives more of its financing from creditors (\$13,720 million) versus owners (\$5,661 million). Its owner financing comprises 29.2%% of its total financing (\$5,661 mil / \$19,381 mil.).

M1-20. (10 minutes)

LO 2

(\$ millions)

Assets	=	Liabilities	+	Equity
\$87,896		\$68,919		<u>\$18,977</u>

Coca-Cola receives more of its financing from creditors (\$68,919 million) than from owners (\$18,977 million). Its owner financing comprises 21.6% of its total financing (\$18,977 mil./ \$87,896 mil.).

M1-21. (15 minutes)

LO 2

(\$ millions)

	Assets	=	Liabilities	+	Equity
Hewlett-Packard Enterprises Co	\$ 55,493		\$ 34,219		(a) <u>\$ 21,274</u>
General Mills	\$30,624.0		(b) <u>\$24,482.9</u>		\$6,141.1
Harley-Davidson	(c) <u>\$ 9,972.7</u>		\$ 8,128.4		\$1,844.3

The percent of owner financing for each company follows:

Hewlett-Packard Ent. Co:	38.3% (\$21,274 mil./ \$55,493 mil.);
General Mills:	20.1% (\$6,141.1 mil./ \$30,624 mil.);
Harley-Davidson:	18.5% (\$1,844.3 mil./ \$9,972.7 mil.).

continued next page

The creditor percent of financing is computed as 100% minus the owner percent. Therefore, Hewlett Packard Enterprises Co is more owner-financed (38.3%) than the other two firms, while Harley-Davidson has the highest percentage of creditor (non-owner) financing (81.5% = 100% - 18.5%).

M1-22. (15 minutes)
LO 3

For its annual report dated September 29, 2018, Apple reports the following amounts (in \$ millions):

Assets	=	Liabilities	+	Equity
\$365,725	=	\$258,578	+	\$107,147

As shown, the accounting equation holds for Apple. Also, we can see that Apple's creditor financing is 70.7% of its total financing (\$258,578 mil./\$365,725 mil).

M1-23. (20 minutes)
LO 3

Nike, Inc. Statement of Shareholders' Equity For Year Ended May 31, 2017				
	Contributed Capital	Retained Earnings	Other Stockholders' Equity	Total Stockholders' Equity
Balance, May 31, 2016	\$ 7,789	\$ 4,151	\$ 318	\$ 12,258
Stock Issuance	121			121
Net Income		4,240		4,240
Dividends		(1,159)		(1,159)
Other changes	731	(3,253)	(531)	(3,053)
Balance, May 31, 2017	\$ 8,641	\$ 3,979	\$ (213)	\$ 12,407

Nike was more profitable in the fiscal year ending May 2017 versus in the fiscal year ending May 2018. Net income was \$4,240 million in the fiscal year ending May 2017 compared to \$1,933 in the fiscal year ending May 2018. Note: As reported in the text, ROE was 17.4% in the fiscal year ending May 2018 compared to 34.4% in the fiscal year ending May 2017.

M1-24. (20 minutes)

LO 3

- | | | |
|-------|--------------|---------------|
| a. BS | d. BS and SE | g. SCF and SE |
| b. IS | e. SCF | h. SCF and SE |
| c. BS | f. BS and SE | i. IS and SE |

M1-25. (10 minutes)

LO 1

There are many stakeholders affected by this business decision, including the following (along with a description of how):

- You/Manager—your reputation, self-esteem, and potentially your livelihood can be affected.
- Creditors/Bondholders— credit decisions based on inaccurate information can occur.
- Shareholders—buying or selling shares based on inaccurate information can occur.
- Management/Employees of your company—repercussions of your decision extend to them; also, your decision may suggest an environment condoning dishonesty

Indeed, our decisions can affect many more parties than we might initially realize.

M1-26. (10 minutes)

LO 4

Internal controls are rules and procedures that involve monitoring an organization's activities, transactions, and interactions with customers, employees and other stakeholders to promote efficiency and to prevent wrongful use of its resources. They help prevent fraud, ensure the validity and credibility of accounting reports, and are often crucial to effective and efficient operations.

The absence or failure of internal controls can adversely affect the effectiveness of both domestic and global financial markets. Enron (along with other accounting scandals) provided a case in point. Because the failure of internal controls can have significant economic consequences, Congress is interested in making sure that publicly- traded companies have adequate internal controls and that any concerns about internal controls are properly reported.

EXERCISES

E1-27. (15 minutes)

LO 2

(\$ millions)	Assets	=	Liabilities	+	Equity
Motorola Solutions, Inc	\$ 8,208		<u>\$ 9,950</u>		\$ (1,742)
Kraft Heinz Company	<u>\$ 119,992</u>		\$53,958		\$ 66,034
Merck & Co Inc.	\$87,872		\$53,303		<u>\$34,569</u>

The percent of creditor financing for each company follows:

Motorola Solutions: 121.2% (\$9,950 mil./ \$8,208 mil.);
 Kraft Heinz: 45.0% (\$53,958 mil./ \$119,992 mil.);
 Merck & Co: 60.7% (\$53,303 mil./ \$87,872 mil.).

The owner percent of financing is computed as 100% minus the owner percent. Merck is more creditor-financed than Kraft Heinz. Motorola has negative equity so their liabilities are larger than their recorded assets.

E1-28. (15 minutes)

LO 1

External users and some questions they seek to answer with accounting information from financial statements include:

- Shareholders (investors), who seek answers to questions such as:
 - Are resources owned by a business adequate to carry out plans?
 - Are the debts owed excessive in amount?
 - What is the current level of income (and its components)?
- Creditors, who seek answers for questions such as:
 - Does the business have the ability to repay its debts?
 - Can the business take on additional debt?
 - Are resources sufficient to cover current amounts owed?
- Employees (and potential employees), who seek answers to questions such as:
 - Is the business financially stable?
 - Can the business afford to pay higher salaries?
 - What are growth prospects for the organization?

E1-29. (20 minutes)**LO 2, 3**

(\$ millions)

a. Using the accounting equation:

(\$ millions)	Assets	=	Liabilities	+	Equity
Intel	\$123,249		\$54,230		<u>\$69,019</u>

b. Starting with the accounting equation at the *beginning* of the year:

(\$ millions)	Assets	=	Liabilities	+	Equity
JetBlue Airways.....	\$9,323		<u>\$5,310</u>		\$4,013

Using the accounting equation at the *end* of the year:

(\$ millions)	Assets	=	Liabilities	+	Equity
JetBlue Airways.....	\$9,781		\$4,947		<u>\$4,834</u>
	(\$9,323+\$458)		(\$5,310-\$363)		

Alternative approach to solving part (b):

$$\Delta \text{Assets}(\$458) = \Delta \text{Liabilities}(\$ -363) + \Delta \text{Equity}(?)$$

where “Δ” refers to “change in.”

$$\text{Thus: } \Delta \text{ Ending Equity} = \$458 + \$363 = \$821 \text{ and}$$

$$\text{Ending equity} = \$4,013 + \$821 = \underline{\underline{\$4,834}}$$

c. Starting with the accounting equation at the *end* of the year:

(\$ millions)	Assets	=	Liabilities	+	Equity
Walt Disney	\$98,598		\$44,693		<u>\$53,905</u>
			(\$49,637-\$4,944)		

Using the accounting equation at the *beginning* of the year:

(\$ millions)	Assets	=	Liabilities	+	Equity
Walt Disney	\$95,789		\$49,637		<u>\$46,152</u>
	(\$98,598-\$2,809)				

E1-30. (10 minutes)
LO 3

Computation of dividends

Retained earnings, 2016	\$19,922
+ Net income	2,024
– Cash dividends	<u>(?)</u>
= Retained earnings, 2017	<u>\$20,531</u>

Thus, dividends were \$1,415 million for 2017. This dividends amount comprises 70% (\$1,415/ \$2,024) of its 2017 net income.

E1-31. (20 minutes)
LO 3

COLGATE-PALMOLIVE COMPANY Income Statement For the year ended December 31, 2017 (\$millions)	
Revenues	\$15,454
Cost of goods sold	<u>6,099</u>
Gross profit	9,355
Other expenses, including income taxes	<u>7,331</u>
Net income (or loss)	<u>\$ 2,024</u>

E1-32. (15 minutes)
LO 2, 5

a. Return on equity (ROE) = Net income / Average stockholders' equity
= \$12,662 / [(\$152,502 + \$139,036)/2]
= 8.69%

$$\begin{aligned} \text{b. Debt-to-equity} &= \text{Total liabilities} / \text{Stockholders' equity} \\ &= \$44,793^* / \$152,502 \\ &= 29.4 \end{aligned}$$

$$*\$44,793 = \$197,295 - \$152,502$$

LO 2, 5

b. Debt-to-equity = Total liabilities / Stockholders' equity
= €191,582* / €64,023
= 2.99

LO 1, 4

- ## LO 6

-
- Financial Accounting, 6th Edition*

PROBLEMS

P1-36. (40 minutes)

LO 2, 5

a.

Year	Assets	Liabilities	Equity	Net Income
2016	\$127,136	\$69,153	<u>\$57,983</u>	\$10,508
2017	<u>\$118,806</u>	\$64,628	\$54,178	\$15,326
2018	\$118,310	<u>\$66,984</u>	\$51,326	\$9,750

b. 2017 ROE = $\$15,326 / [(\$57,983 + \$54,178) / 2] = \underline{27.3\%}$

2018 ROE = $\$9,750 / [(\$51,326 + \$54,178) / 2] = \underline{18.5\%}$

P&G's ROE decreased in 2018, however, it was above the median for Fortune 500 companies in both years.

c. 2017 debt-to-equity = $\$64,628 / \$54,178 = \underline{1.19}$

2018 debt-to-equity = $\$66,984 / \$51,326 = \underline{1.31}$

P&G's debt-to-equity ratio increased in 2018 and it is below the median for Fortune 500 companies in both years.

P1-37. (30 minutes)
LO 2, 3

a.

GENERAL MILLS, INC. Income Statement For Year Ended May 27, 2018 (\$ millions)	
Sales.....	\$15,740.4
Cost of goods sold	<u>10,312.9</u>
Gross profit	5,427.5
Other expenses, including income taxes	<u>3,264.5</u>
Net income.....	<u>\$ 2,163</u>

GENERAL MILLS, INC. Balance Sheet May 27, 2018 (\$ millions)			
Cash & cash equivalents	\$ 399	Total liabilities	\$24,131.6
Noncash assets	<u>30,225</u>	Stockholders' equity	<u>6,492.4</u>
Total assets	<u>\$30,624</u>	Total liabilities and equity	<u>\$30,624</u>

GENERAL MILLS, INC. Statement of Cash Flows For Year Ended May 27, 2018 (\$ millions)	
Net cash flows from operations.....	\$ 2,841
Net cash flows from investing	(8,685.4)
Net cash flows from financing	5,445.5
Effect of exchange rates on cash.....	<u>31.8</u>
Net change in cash	(367.1)
Cash, beginning year	<u>766.1</u>
Cash, ending year.....	<u>\$ 399</u>

b. $\$6,492.4 / \$30,624 = 21.2\%$ contributed by owners

P1-38. (30 minutes)
LO 2, 3

a.

ABERCROMBIE & FITCH Income Statement For Year Ended February 3, 2018 (\$ millions)	
---	--

Sales.....	\$ 3,492.7
Cost of goods sold	<u>1,408.8</u>
Gross profit	2,083.9
Other expenses including income taxes	<u>2,073.4</u>
Net income.....	<u>\$ 10.5</u>

ABERCROMBIE & FITCH Balance Sheet February 3, 2018 (\$ millions)			
---	--	--	--

Cash asset	\$ 675.6	Total liabilities	\$ 1,073.2
Noncash assets	<u>1,650.1</u>	Stockholders' equity	<u>1,252.5</u>
Total assets	<u>\$ 2,325.7</u>	Total liabilities and equity	<u>\$ 2,325.7</u>

ABERCROMBIE & FITCH Statement of Cash Flows For Year Ended February 1, 2014 (\$ millions)	
--	--

Net cash flows from operations.....	\$ 285.7
Net cash flows from investing	(106.8)
Net cash flows from financing	(74.8)
Effect of exchange rate changes on cash	<u>24.3</u>
Net change in cash	128.4
Cash, beginning year	<u>547.2</u>
Cash, ending year	<u>\$ 675.6</u>

- b. $\$1,252.5 / \$2,325.7 = 53.9\%$ contributed by owners
 $\$1,073.2 / \$2,325.7 = 46.1\%$ contributed by creditors

P1-39. (30 minutes)
LO 3

TILLY'S, INC. Income Statements For years ended February 3, 2018 and January 28, 2017 (\$ thousands)		
Fiscal year ending	2018	2017
Sales	\$576,899	\$568,952
Cost of goods sold	401,529	400,493
Gross profit	175,370	168,459
Other expenses, including income taxes	160,670	157,049
Net income	<u>\$ 14,700</u>	<u>\$ 11,410</u>

TILLY'S, INC. Balance Sheets February 3, 2018 and January 28, 2017 (\$ thousands)		
	2018	2017
Cash asset	\$ 53,202	\$ 78,994
Noncash assets	236,909	211,512
Total assets	<u>\$290,111</u>	<u>\$290,506</u>
Total liabilities	\$ 129,686	\$ 101,286
Stockholders' equity	160,425	189,220
Total liabilities and stockholders' equity	<u>\$290,111</u>	<u>\$290,506</u>

TILLY'S, INC. Cash Flow Statements For years ended February 3, 2018 and January 28, 2017 (\$ thousands)		
	2018	2017
Cash flow from operating activities	\$32,708	\$48,509
Cash flow from investing activities	(40,878)	(21,658)
Cash flow from financing activities	(17,622)	1,123
Change in cash	(25,792)	27,974
Cash balance, beginning of the year	78,994	51,020
Cash balance, end of the year	<u>\$53,202</u>	<u>\$78,994</u>

P1-40. (30 minutes)**LO 3**

TESLA , INC. Income Statements For years ended December 31, 2017 and 2016 (\$ millions)		
	2017	2016
Sales	\$11,758.8	\$ 7,000.1
Cost of goods sold	9,536.3	5,400.9
Gross profit	2,222.5	1,599.2
Other expenses, including income taxes	4,183.9	2,274.2
Net income (loss)	<u>\$ (1,961.4)</u>	<u>\$ (675.0)</u>

TESLA, INC. Balance Sheets December 31, 2017 and 2016 (\$ millions)		
	2018	2017
Cash asset	\$ 3,367.9	\$ 3,393.2
Noncash assets	25,287.5	19,270.9
Total assets	<u>\$28,655.4</u>	<u>\$22,664.1</u>
Total liabilities	\$23,420.8	\$ 17,126
Stockholders' equity	5,234.6	5,538.1
Total liabilities and stockholders' equity	<u>\$28,655.4</u>	<u>\$22,664.1</u>

TESLA, INC. Cash Flow Statements For years ended December 31, 2017 and 2016 (\$ millions)		
	2017	2016
Cash flow from operating activities	\$(60.7)	\$(123.8)
Cash flow from investing activities	(4,419)	(1,416.4)
Cash flow from financing activities	4,414.9	3,744.0
Effect of exchange rate changes on cash	<u>39.5</u>	<u>(7.4)</u>
Change in cash	(25.3)	2,196.3
Cash balance, beginning of the year	<u>3,393.2</u>	<u>1,196.9</u>
Cash balance, end of the year	<u>\$3,367.9</u>	<u>\$3,393.2</u>

P1-41. (15 minutes)
LO 3

CROCKER CORPORATION Statement of Stockholders' Equity For Year Ended December 31, 2019			
	Contributed Capital	Retained Earnings	Stockholders' Equity
December 31, 2018	\$ 70,000	\$ 30,000	\$100,000
Issuance of common stock	30,000		30,000
Net income		50,000	50,000
Cash dividends	_____	<u>(25,000)</u>	<u>(25,000)</u>
December 31, 2019	<u>\$100,000</u>	<u>\$ 55,000</u>	<u>\$155,000</u>

P1-42. (15 minutes)
LO 3

DP SYSTEMS, INC. Statement of Stockholders' Equity For Year Ended December 31, 2019			
	Common Stock	Retained Earnings	Stockholders' Equity
December 31, 2018	\$ 550	\$2,437	\$2,987
Net income		859	859
Cash dividends	_____	<u>(281)</u>	<u>(281)</u>
December 31, 2019	<u>\$ 550</u>	<u>\$3,015</u>	<u>\$3,565</u>

P1-43. (15 minutes)**LO 2, 3, 5**

- a. Return on equity is net income divided by average stockholders' equity.

Nokia's ROE: $\text{€-1,458} / [(\text{€16,218} + \text{€20,975})/2] = -0.078$ or -7.8%.

- b. Debt-to-equity is total liabilities divided by stockholders' equity.

Nokia's debt-to-equity: $(\text{€41,024} - \text{€16,218}) / \text{€16,218} = \underline{1.53}$.

- c. Revenues less expenses equal net income. Taking the revenues and net income numbers for Nokia, yields:

$\text{€23,147 million} - \text{Expenses} = \text{€-1,458 million}$.

Therefore, expenses must equal €24,605 million.

P1-44. (20 minutes)**LO 3, 5**

- a.

BEST BUY CO., INC. Income Statement For the year ended February 3, 2018 (\$ millions)	
Sales revenue	\$42,151
Cost of goods sold	<u>32,275</u>
Gross profit	9,876
Other expenses, including income taxes	<u>8,876</u>
Net income (or loss)	<u>\$ 1,000</u>

- b. Best Buy's ROE = $\$1,000 \text{ mil.} / [(\$4,709 \text{ mil.} + \$3,612 \text{ mil.})/2] = \underline{24.0\%}$.

- c. Best Buy's debt-to-equity = $(\$13,049 - \$3,612) / \$3,612 = \underline{2.61}$

P1-45. (20 minutes)
LO 3, 5

a.

FACEBOOK, INC. Income Statement For the years ended December 31, 2017 and 2016 (\$ millions)		
	2017	2016
Revenue	\$ 40,653	\$ 27,638
Operating expenses	20,450	15,211
Gross profit from operations	20,203	12,427
Other expenses, including income taxes	4,269	2,210
Net income	<u>\$ 15,934</u>	<u>\$ 10,217</u>

- b. Stockholders' equity: 2017 -- \$84,524 mil. - \$10,177 mil. = \$74,347 mil.
2016 -- \$64,961 mil. - \$5,767 mil. = \$59,194 mil.

2017 ROE = \$15,934 mil. / [(\$74,347 mil. + \$59,194 mil.)/2] = 23.9,0%.

2016 ROE = \$10,217 mil. / [(\$59,194 mil. + \$44,218 mil.)/2] = 19.8%.

- c. 2017 debt-to-equity = \$10,177 / \$74,347 = 0.14.
2016 debt-to-equity = \$5,767 / \$59,194 = 0.10.

CASES and PROJECTS

C1-46. (40 minutes)

LO 3, 5

a.

STARBUCKS CORPORATION Income Statement For the years ended September 30, 2018 and October 1, 2017 (\$ millions)		
	2018	2017
Sales revenue	\$ 24,719.5	\$ 22,386.8
Cost of goods sold	10,174.5	9,034.3
Gross profit on sales	14,545.0	13,352.5
Other expenses, including income taxes	10,027	10,467.6
Net income	<u>\$4,518.0</u>	<u>\$ 2,884.9</u>

- b. 2018 stockholders' equity: \$24,256.4 mil. – \$22,980.6 mil. = \$1,275.8 mil.
 2017 stockholders' equity: \$14,365.6 mil. -- \$8,908.6 mil. = \$5,457 mil.

2018 ROE: $\$4,518 / [(\$1,275.8 + \$5,457)/2] = \underline{134.2\%}$

2017 ROE: $\$2,884.9 / [(\$5,457 + \$5,890.7)/2] = \underline{50.8\%}$

- c. 2018 debt-to-equity: $\$22,980.6 / \$1,275.8 = \underline{18.01}$
 2017 debt-to-equity: $\$8,908.6 / 5,457 = \underline{1.63}$

- d. 2018 ROE restated: $(\$4,518.0 - \$3,700) / [(\$1,275.8 - \$3,700 + 5,457)/2] = \underline{53.9\%}$

The unrecorded potential litigation cost of \$3,700 is subtracted from the net income number and from the 2018 stockholders' equity amount to arrive at this number.

This does not take into account the effect of income taxes.

- e. The primary cost to Starbucks of disclosing information about the pending litigation is that the disclosure may cause potential investors and creditors to hold a less favorable view of the company. A concern about the disclosure is that such disclosure may actually affect the outcome of the litigation.

The primary benefit to disclosure is that by disclosing information about the lawsuit before its completion, the company cannot be accused of withholding relevant information from stakeholders. This prevents potential lawsuits from investors or creditors and contributes to the company's reputation for reliable financial reporting.

C1-47. (40 minutes)
LO 2, 3, 5

- a. The Gap, Inc.: $\text{ROE} = \$848 / [(\$3,144 + \$2,904)/2] = \underline{28.00\%}$
 Nordstrom, Inc.: $\text{ROE} = \$437 / [(\$977 + \$870)/2] = \underline{47.3\%}$

Nordstrom had the higher ROE.

- b. The Gap, Inc.: $\text{Debt-to-equity} = (\$7,989 - \$3,144) / \$3,144 = \underline{1.54}$
 Nordstrom, Inc.: $\text{Debt-to-equity} = (\$8,115 - \$977) / \$977 = \underline{7.31}$

Nordstrom relies more on debt than The Gap.

c.

THE GAP, INC. 2018 Income Statement (\$millions)	
Revenues	\$15,855
Cost of goods sold	<u>9,789</u>
Gross profit	6,066
Other expenses, including income taxes	<u>5,218</u>
Net income (or loss)	<u>\$ 848</u>

NORDSTROM, INC. 2013 Income Statement (\$millions)	
Revenues	\$15,478
Cost of goods sold	<u>9,890</u>
Gross profit	5,588
Other expenses, including income taxes	<u>5,151</u>
Net income (or loss)	<u>\$ 437</u>

The Gap: $\$6,066 / \$15,855 = 38.3\%$

Nordstrom: $\$5,588 / \$15,478 = 36.1\%$

- d. Nordstrom earned a higher ROE than The Gap (47.3% vs. 28%). Nordstrom's debt-to-equity ratio is 7.31 vs. about 1.54 for The Gap. The Gap reported a slightly higher gross profit per dollar of sales revenue (38.3% vs. 36.1% for Nordstrom). These two percentages are very close, reflecting the similarity of their retail operations. One important difference (not provided or apparent in the information supplied) is that Nordstrom has a larger consumer credit business than The Gap.

C1-48. (30 minutes)**LO 5**

- a. JetBlue: $\text{ROE} = \$1,147 / \{[(\$9,781 - \$1,108) + (\$9,323 - \$1,444)] / 2\} = \underline{13.9\%}$
- Southwest: $\text{ROE} = \$3,488 / \{[(\$25,110 - \$13,973) + (\$23,286 - \$14,845)] / 2\} = \underline{35.6\%}$
- b. JetBlue: $\text{Debt-to-equity} = \$1,108 / (\$9,781 - \$1,108) = \underline{0.13}$
- Southwest: $\text{Debt-to-equity} = \$13,973 / (\$25,110 - \$13,973) = \underline{1.25}$
- c. JetBlue: $\$1,147 / \$7,015 = 16.4\%$
- Southwest: $\$3,488 / \$21,171 = 16.5\%$
- d. JetBlue's ROE was 13.9% for the year. In comparison, Southwest earned an ROE of 35.6% in 2017. Both of these ROE numbers are at or above the average for *Fortune* 500 companies. Currently, Southwest uses more creditor financing. This has changed over time, JetBlue carried more debt just 5 years ago. Southwest's debt-to-equity ratio is 1.25 compared to a debt-to-equity ratio of 0.13 for JetBlue. In terms of income per dollar of sales, both companies look very similar. JetBlue's reported net income equaled 16.4% of revenues, while Southwest reported net income equal to 16.5% of revenues. The numbers for both airlines have improved significantly in recent years.

C1-49. (20 minutes)**LO 1, 3, 5**

- a. $\$285,000 \text{ Assets} - \$45,000 \text{ Liabilities} = \$240,000 \text{ Net Assets}$. $\$72,000 \text{ Average Annual Income} / \$240,000 \text{ Investment} = 30\% \text{ return}$. Seale's return would be 24% ($\$72,000 \text{ Average Annual Income} / \$300,000 \text{ Investment}$), assuming no adjustment is made for Meg's salary. (See part b.)
- b. No. Withdrawals do not affect net income, because they are not part of the firm's operating activities. However, in calculating Krey's return in part a, Seale might wish to "impute" an amount for Krey's half-time work in computing Krey's return on investment. Thus, if Seale believes that Krey's services are worth \$18,000 (half of the \$36,000 salary she expects to pay a full-time manager), annual income should be calculated at \$54,000 instead of \$72,000. If Seale hires a full-time manager at \$36,000, her return will be only 12% $[(\$72,000 - \$36,000) / \$300,000]$.
- c. Yes, the difference between net income shown in the financial statements and net income shown on the tax return can be legitimate, because income tax rules for determining revenues and deductions from revenues differ from Generally Accepted Accounting Principles. Seale may obtain additional assurance about the propriety of the financial statements by engaging a licensed professional accountant to audit the financial statements and render a report on them.

C1-50. (15 minutes)

LO 1, 4

- a. It is important for a CPA to be independent when performing audit services because third parties will be relying on the audited financial statements in making decisions. The financial statements are the representations of the corporation's management. The audit by a CPA adds credibility to the financial statements. Only if third parties believe that the CPA is independent will a CPA be able to add credibility to financial statements.
- b. Jackie is not independent for two reasons: (1) her brother is president and chair of the board of directors of the company to be audited and (2) Jackie is on the board of directors of the company to be audited. The auditing profession takes the position that Jackie's other activities for the company—consulting and tax work—do not impair a CPA's independence. This last point may generate some discussion, particularly in this case when the potential auditor is the same person (Jackie) who is doing the consulting work. Usually, when the same CPA firm does both auditing and consulting work, those tasks are assigned to different persons to ensure auditor independence.

Chapter 2

Constructing Financial Statements

Learning Objectives – coverage by question				
	Mini-Exercises	Exercises	Problems	Cases and Projects
LO1 – Describe and construct the balance sheet and understand how it can be used for analysis.	14, 17, 19, 21 - 27, 29 - 31	34-44, 46, 47	49 - 57, 59, 60, 62, 66, 67, 69	71
LO2 – Use the financial statement effects template (FSET) to analyze transactions.	18, 29 - 31	44 - 47	57, 62, 67, 69	
LO3 – Describe and construct the income statement and discuss how it can be used to evaluate management performance.	19 - 23, 28, 31	35, 37, 39 - 44, 47	49 - 51, 54, 57, 61, 62, 64 - 67, 69	71, 72
LO4 – Explain revenue recognition, accrual accounting, and their effects on retained earnings.	18 - 20, 22, 23, 25, 26, 28, 29, 31	39, 44, 47	57, 62, 67, 69	71
LO5 – Illustrate equity transactions and the statement of stockholders' equity.	18, 21 - 24, 27, 31	35 - 37	53, 66, 67, 69	71
LO6 – Use journal entries and T-accounts to analyze and record transactions.	32, 33	45, 48	58, 63, 68, 70	
LO7 – Compute net working capital, the current ratio, and the quick ratio, and explain how they reflect liquidity.		34, 36, 38, 41, 42, 46	52, 55, 56, 59, 60	

QUESTIONS

Q2-1. An asset is something that we own that is expected to provide future benefits. A liability is a current obligation that will require a future sacrifice. Equity is the difference between assets and liabilities. It represents the claims of the company's owners to its income and assets. The following are some examples of each:

Assets	• Cash • Receivables • Inventories • Plant, property and equipment
Liabilities	• Accounts payable • Accrued liabilities • Notes payable • Long-term debt
Equity	• Contributed capital (common and preferred stock) • Additional paid-in capital • Earned capital (retained earnings) • Treasury stock

Q2-2. The revenue recognition principle requires that revenues be recognized when earned. Revenues are earned when the product has been delivered to the buyer and is usually signified by a formal transfer of title. A good test of whether revenue has been earned is whether the rights, risks and obligations of ownership have been transferred to the buyer. If a service is involved, revenues are not earned until the service has been provided. The expense recognition principle prescribes that expenses be recognized when assets are diminished (or liabilities increased) as a result of earning revenue or carrying out the company's operations. When these two principles are followed, income can be properly measured in a given accounting reporting period.

Q2-3. Accrual accounting entails the recognition of revenue under the revenue recognition principle (record revenues when goods or services are transferred to the customer), and the recognition of expenses when net assets decrease from the process of earning revenue or supporting the company's operations. The recognition of revenues or the expenses does not require that cash be received or disbursed. For example, the recognition of revenues on sale can lead to an account receivable, and wage expense can be accrued using a wages payable (accrued) liability account.

- Q2-4.** The statement of stockholders' equity provides information relating to all events that impact stockholders' equity during the period. It contains information relating to stock sales and repurchases, net income, dividends, and the use of stock for other purposes including occasional acquisition of assets. This statement, also referred to as the statement of owners' equity, also includes the effects of some transactions that are not captured in the determination of net income. These items are included in what is called "other comprehensive income." One example of such an item is the loss or gain on the translation of the assets and liabilities of foreign owned subsidiaries into United States currency.
- Q2-5.** An asset must be "owned" and it must provide "future benefits." Owning means we have title to the asset (some leased assets are also recorded on the balance sheet as we will discuss in Chapter 10). Future benefits can mean the future inflows of cash. Or, it could relate to some other benefit, such as the reduction of expenditures, an increase in another asset, or the reduction of a liability.
- Q2-6.** Liquidity generally refers to cash. That is, how much cash do we have, how much cash is being generated, and how much cash can we raise quickly. Liquidity is essential to the survival of the business. After all, we can only pay our loans with cash, and our employees will only accept cash for their wages. Some assets are more liquid than others in the sense that they can be converted more easily to cash. Money market accounts and accounts receivable, which can be sold, provide examples. Inventories are considered more liquid than plant assets. We will address liquidity issues more formally in Chapters 4 and 9.
- Q2-7.** Current means that the asset will be liquidated (converted to cash) within the next year (or the operating cycle if longer than 1 year).
- Q2-8.** Historical costs are used by accountants because they are less subjective and, therefore, more reliable than using market values. Market values can be biased for two reasons: first, we may not be able to measure them accurately (consider our inability to accurately measure the market value of a production facility, for example), and second, managers may intervene in the reporting process to intentionally bias the results in order to achieve a particular objective (i.e. enhancing the stock price). The use of historical costs in accounting records does not negate the importance of market values. For example, a firm offering to pledge land as collateral for a loan will be expected to use the market value of that land rather than its historic cost. The same would be true if a corporation were considering the sale of the land. Finally, we shall see that certain assets are reported at market value in the balance sheet; securities that are available to be sold provide an example.

- Q2-9.** An intangible asset is an asset that we cannot touch. To be included on the balance sheet, it has to meet the tests of an asset (e.g., we own it, and it will provide future benefits). In addition, recognized intangible assets are always acquired in a transaction with an independent party. Internally generated intangible assets, however, are not recorded on the balance sheet. Some examples are goodwill, patents and trademarks, contractual agreements like royalties, leases, and franchise agreements. All of the intangible assets, though not recorded if internally generated, are recorded if purchased, as in an acquisition of another company, for example.
- Q2-10.** Both the current ratio and quick ratio are measures of a firm's ability to pay its obligations as they come due; measures of a firm's liquidity. The current ratio is computed by dividing the firm's current assets by its current liabilities. Current ratios that exceed 1.0 are deemed to represent a strong current liquidity position. The quick ratio is an even more conservative measure of a firm's liquidity as it excludes inventory from the calculation. The quick ratio is computed by dividing the firm's sum of cash and cash equivalents, marketable securities and accounts receivable by its current liabilities.
- Q2-11.** The three conditions necessary to recognize a liability are:
1. The liability reflects a probable future sacrifice on the part of the organization.
 2. The amount of the obligation is known or can be reasonably estimated.
 3. The transaction that caused the obligation has occurred.
- Q2-12.** Net working capital = Current assets – Current liabilities. Increasing the amount of trade credit (e.g., accounts payable to suppliers) increases current liabilities and reduces net working capital. As trade credit increases, we are using someone else's cash rather than our own. As a business grows, its net working capital grows, as the growth of inventories and receivables are generally greater than that of accounts payable and accrued liabilities. Net working capital is an asset category that must be financed just like fixed assets.
- Q2-13.** $\$700,000 \text{ Assets} - \$220,000 \text{ Liabilities} = \$480,000 \text{ Stockholders' equity}$
 $\$480,000 \text{ Stockholders' equity} - \$300,000 \text{ Common stock}$
 $= \$180,000 \text{ Retained earnings}$

MINI EXERCISES

M2-14. (10 minutes)

LO 1

Use the accounting equation.

a. Cash		\$ 8,000
Accounts receivable		23,000
Supplies		9,000
Equipment		<u>138,000</u>
		178,000
Accounts payable	\$ 11,000	
Common stock	<u>110,000</u>	<u>121,000</u>
Retained earnings		<u>\$ 57,000</u>
b. Retained Earnings:		
December 31, 2018	\$ 57,000	
January 1, 2018	<u>30,000</u>	
Increase	27,000	
Add: Dividends	<u>12,000</u>	
Net Income	<u>\$ 39,000</u>	

M2-15. (5 minutes)

LO 1

- a. $\$200,000 - \$85,000 = \$115,000$ equity
- b. $\$32,000 + \$28,000 = \$60,000$ assets
- c. $\$93,000 - \$52,000 = \$41,000$ liabilities

M2-16. (5 minutes)

LO 1

- a. $\$375,000 - \$105,000 = \$270,000$ equity
- b. $\$43,000 + \$11,000 = \$54,000$ assets
- c. $\$878,000 - \$422,000 = \$456,000$ liabilities

M2-17. (5 minutes)**LO 1**

- a. $\$450,000 - \$326,000 = \$124,000$ equity
- b. $\$618,000 - \$165,000 = \$453,000$ liabilities
- c. $\$400,000 + \$200,000 + \$185,000 = \$785,000$ assets

M2-18. (10 minutes)**LO 2, 4, 5**

- a. no effect
- b. decrease
- c. decrease
- d. no effect
- e. increase
- f. increase
- g. increase

M2-19. (15 minutes)**LO 1, 3, 4**

- a. Balance sheet
- b. Income statement
- c. Balance sheet
- d. Income statement
- e. Balance sheet
- f. Balance sheet
- g. Balance sheet
- h. Balance sheet
- i. Income statement
- j. Income statement
- k. Balance sheet
- l. Balance sheet

M2-20. (20 minutes)**LO 3, 4**

- a. Net income computation

Service revenue (record when earned)	\$100,000
Wage expense	<u>(60,000)</u>
Net income	<u>\$ 40,000</u>
- b. Yes, recognizing the wage liability would cause wage expense to increase by \$10,000 and net income would decrease by the same amount (before taxes).

M2-21. (10 minutes)

LO 1, 3, 5

- a. Balance sheet
- b. Income statement, Statement of stockholders' equity
- c. Balance sheet
- d. Income statement
- e. Statement of stockholders' equity
- f. Statement of stockholders' equity
- g. Balance sheet
- h. Income statement
- i. Statement of stockholders' equity, Balance sheet

M2-22. (10 minutes)

LO 1, 3, 4, 5

- a. Balance sheet
- b. Balance sheet
- c. Income statement, Statement of stockholders' equity
- d. Statement of stockholders' equity, Balance sheet
- e. Balance sheet
- f. Income statement
- g. Balance sheet
- h. Balance sheet

M2-23. (10 minutes)

LO 1, 3, 4, 5

- a. Balance sheet
- b. Income statement
- c. Statement of stockholders' equity, Balance sheet
- d. Income statement
- e. Statement of stockholders' equity
- f. Balance sheet
- g. Balance sheet
- h. Balance sheet

M2-24. (15 minutes)
LO 1, 5

Ending retained earnings = Beginning retained earnings + Net income – Dividends + the effects of other adjustments. And, the ending retained earnings for one period is the beginning retained earnings for the following period.

Fiscal year ending:	Jan. 28, 2017	Feb. 3, 2018
Beginning retained earnings (deficit)	\$ (258)	\$ (727)
Net income (loss)	1,158	983
Dividends paid	(1,268)	(686)
Other net changes in retained earnings	(359)	(321)
Ending retained earnings (deficit)	<u>\$ (727)</u>	<u>\$ (751)</u>

M2-25. (10 minutes)
LO 1, 4

- a. Increase assets (Cash);
Increase equity (Service Revenues)
- b. Increase assets (Office Supplies)
Increase liabilities (Accounts Payable)
- c. Increase assets (Cash)
Increase equity (Contributed Capital or Common Stock)
- d. Decrease liabilities (Accounts Payable)
Decrease assets (Cash)
- e. Increase assets (Cash)
Increase liabilities (Notes Payable)
- f. Increase assets (Accounts Receivable)
Increase equity (Service Revenues)
- g. Increase assets (Office Equipment)
Decrease assets (Cash)
- h. Decrease equity (Interest Expense)
Decrease assets (Cash)
- i. Decrease equity (Utilities Expense)
Increase liabilities (Accounts Payable)

M2-26. (10 minutes)**LO 1, 4**

- a. Increase assets (Office Equipment)
Decrease assets (Cash)
- b. Increase assets (Accounts Receivable)
Increase equity (Service Revenue)
- c. Decrease equity (Rent Expense)
Decrease assets (Cash)
- d. Increase assets (Cash)
Increase equity (Service Revenue)
- e. Increase assets (Cash)
Decrease assets (Accounts Receivable)
- f. Increase assets (Office Equipment)
Increase liabilities (Accounts Payable)
- g. Decrease equity (Salaries Expense)
Decrease assets (Cash)
- h. Decrease liabilities (Accounts Payable)
Decrease assets (Cash)
- i. Decrease equity (Retained Earnings)
Decrease assets (Cash)

M2-27. (10 minutes)**LO 1, 5**

JOHNSON & JOHNSON Statement of Retained Earnings For Year Ended December 31, 2017	
Retained earnings, January 1, 2017	\$70,418
Add: Net income	1,300
Less: Dividends	(8,943)
Other retained earnings changes	<u>(2,615)</u>
Retained earnings, December 28, 2014	<u>\$60,160</u>

M2-28. (10 minutes)
LO 3, 4

	2018	2019
Revenues	\$350,000	\$ 0
Expenses	<u>200,000</u>	<u>0</u>
Net income	<u>\$150,000</u>	<u>\$ 0</u>

Explanation: All of the revenue is reported in 2018 when services are provided—per the revenue recognition principle. Likewise, the expense is reported in 2018 when it is incurred—because a liability was incurred to generate the revenue. The timing of receipts or payments of cash does not affect the recording of revenues, expenses, and net income.

M2-29. (15 minutes)
LO 1, 2, 4

Transaction	Balance Sheet						Income Statement		
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital
							Revenues	-	Expenses
									Net Income
a. Issue stock for \$20,000 cash.	+20,000 Cash			=		+20,000 Common Stock		-	=
b. Pay \$2,000 rent in advance.	-2,000 Cash		+2,000 Prepaid rent	=				-	=
c. Purchase computer equipment for \$7,000 cash.	-7,000 Cash		+7,000 Computer Equipment	=				-	=
d. Purchase inventory for \$13,000 on account			+13,000 Inventory	=	+13,000 Accts Payable			-	=
e. Pay supplier of inventory in part d.	-13,000 Cash			=	-13,000 Accts Payable			-	=
Totals	-2,000	+	22,000	=	0	+	20,000	+	
								-	=

M2-30 (15 minutes)
LO 1, 2

Transaction	Balance Sheet								Income Statement					
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
a. Borrow €19,000 from local bank.	+19,000 Cash				+19,000 = Note Payable							-		=
b. Pay €3,000 insurance premium for covered for following year.	-3,000 Cash		+3,000 Prepaid insurance	=								-		=
c. Purchase vehicle for €32,000 cash.	-32,000 Cash		+32,000 Vehicle	=								-		=
d. Purchase and receive €2,500 of office supplies on account (pay supplier later).			+2,500 Supplies Inventory	=	+2,500 Accts Payable							-		=
e. Place order for €1,000 of additional supplies to be delivered next month.			NO ENTRY	=								-		=
Totals	-16,000	+	37,500	=	21,500	+	0	+	0			-		=

LO 1, 2, 3, 4, 5

Transaction	Balance Sheet								Income Statement					
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
a. Receive merchandise inventory costing \$9,000, purchased with cash	-9,000 Cash		+9,000 Inventory	=								-		=
b. Sell half of inventory in (a) for \$7,500 on credit.			-4,500 Inventory						-4,500			+4,500 Cost of Goods Sold		-4,500
			+7,500 Accounts Receivable	=					+7,500	+7,500 Revenue	-		=	+7,500
c. Place order for \$5,000 of additional merchandise inventory to be delivered next month.			NO ENTRY	=								-		=
d. Pay employee \$4,000 for compensation earned during the month.	-4,000 Cash			=					-4,000			+4,000 Wage Expense		-4,000
												-		=
e. Pay \$7,000 rent for use of premises during the month.	-7,000 Cash			=					-7,000			+7,000 Rent Expense		-7,000
												-		=
f. Receive full payment from customer in part b.	+7,500 Cash		-7,500 Accounts Receivable											
Totals	-12,500	+	4,500	=		+		+	-8,000	7,500	-	15,500	=	-8,000

M2-32. (10 minutes)**LO 6**

a. Inventory (+A)	9,000	
Cash (-A)		9,000
b. Cost of goods sold expense (+E, -SE)	4,500	
Inventory (-A)		4,500
Accounts receivable (+A)	7,500	
Sales revenue (+R, +SE)		7,500
c. NO ENTRY		
d. Wage expense (+E, -SE)	4,000	
Cash (-A)		4,000
e. Rent expense (+E, -SE)	7,000	
Cash (-A)		7,000
f. Cash (+A)	7,500	
Accounts receivable (-A)		7,500

M2-33. (10 minutes)**LO 6**

+ Cash (A) -		+ Accounts Receivable (A) -	
(f) 7,500	(a) 9,000	(b) 7,500	(f) 7,500
	(d) 4,000		
	(e) 7,000		
+ Inventory (A) -		+ Cost of Goods Sold (E) -	
(a) 9,000	(b) 4,500	(b) 4,500	
- Sales (R) +		+ Wage Expense (E) -	
	(b) 7,500	(d) 4,000	
		+ Rent Expense (E) -	
		(e) 7,000	

EXERCISES

E2-34. (25 minutes)

LO 1, 7

Use the accounting equation to determine Retained Earnings as of May 31, 2019.

a. & b.

BEAVER, INC. Balance Sheets		
	<u>May 31, 2019</u>	<u>June 1, 2019</u>
<u>Assets</u>		
Cash	\$ 12,200	\$ 3,200
Accounts receivable	18,300	18,300
Supplies	16,400	16,400
Equipment	<u>55,000</u>	<u>70,000</u>
Total assets	<u>\$101,900</u>	<u>\$107,900</u>
<u>Liabilities</u>		
Accounts payable	\$ 5,200	\$ 5,200
Notes payable	<u>20,000</u>	<u>33,000</u>
Total liabilities	<u>25,200</u>	<u>38,200</u>
<u>Stockholders' Equity</u>		
Common stock	42,500	42,500
Retained earnings	<u>34,200</u>	<u>27,200</u>
Total stockholders' equity	<u>76,700</u>	<u>69,700</u>
Total liabilities and stockholders' equity	<u>\$101,900</u>	<u>\$107,900</u>

- c. Net working capital = Current assets – Current liabilities
 $\$32,700 = (\$3,200 + \$18,300 + \$16,400) - \$5,200$

E2-35. (30 minutes)
LO 1, 3, 5

Use the accounting equation and the information on changes in contributed capital and retained earnings.

Beginning equity (= Beginning assets – Beginning liabilities)

+ Common Stock Issued

+ Net income (= Revenues – Expenses)

– Dividends

Ending equity (= Ending assets – Ending liabilities)

a.	Equity, Beginning (\$28,000 - \$18,600).....	\$ 9,400
	Equity, Ending (\$30,000 - \$17,300).....	<u>12,700</u>
	Increase.....	3,300
	Add: Net Capital Withdrawn (\$5,000 - \$2,000).....	<u>3,000</u>
	Net Income.....	6,300
	Add: Expenses.....	<u>8,500</u>
	Revenues.....	<u>\$14,800</u>
b.	Equity, Beginning (\$12,000 - \$5,000).....	\$ 7,000
	Add: Net Capital Contributed (\$4,500 - \$1,500).....	<u>3,000</u>
		10,000
	Add: Net Income (\$28,000 - \$21,000).....	<u>7,000</u>
	Equity, Ending.....	<u>\$17,000</u>
	Assets, Ending.....	\$26,000
	Equity, Ending.....	<u>17,000</u>
	Liabilities, Ending.....	<u>\$ 9,000</u>
c.	Equity, Beginning (\$28,000 - \$19,000).....	\$ 9,000
	Add: Net Income (\$18,000 - \$11,000).....	<u>7,000</u>
		16,000
	Less: Dividends.....	<u>1,000</u>
		15,000
	Equity, Ending (\$34,000 - \$15,000).....	<u>19,000</u>
	Common Stock Issued.....	<u>\$ 4,000</u>
d.	Common Stock Issued.....	\$ 3,500
	Net Income (\$24,000 - \$17,000).....	<u>7,000</u>
		10,500
	Cash Dividends.....	<u>6,500</u>
	Increase in Equity.....	4,000
	Equity, Ending (\$40,000 - \$19,000).....	<u>21,000</u>
	Equity, Beginning.....	17,000
	Add: Liabilities, Beginning.....	<u>9,000</u>
	Total Assets, Beginning.....	<u>\$26,000</u>

E2-36 (30 minutes)
LO 1, 5, 7

Use the accounting equation to determine stockholders' equity balances.

a.

LANG SERVICES		
Balance Sheets		
	<u>December 31,</u>	
	<u>2018</u>	<u>2017</u>
<u>Assets</u>		
Cash	\$10,000	\$ 8,000
Accounts receivable	22,800	17,500
Supplies	4,700	4,200
Equipment	<u>32,000</u>	<u>27,000</u>
Total assets	<u>\$69,500</u>	<u>\$56,700</u>
<u>Liabilities</u>		
Accounts payable	\$25,000	\$25,000
Notes payable	<u>1,800</u>	<u>1,600</u>
Total liabilities	26,800	26,600
<u>Stockholders' equity</u>		
Equity	<u>42,700</u>	<u>30,100</u>
Total liabilities and stockholders' equity	<u>\$69,500</u>	<u>\$56,700</u>

b. Equity, December 31, 2018.....	\$42,700
Equity, December 31, 2017.....	<u>30,100</u>
Increase.....	12,600
Add: Dividends.....	<u>17,000</u>
	29,600
Less: Common Stock issued.....	<u>5,000</u>
Net Income for 2018.....	<u>\$24,600</u>

- c. Current ratio = $(\$10,000 + \$22,800 + \$4,700) / \$25,000 = 1.50$
 Quick ratio = $(\$10,000 + \$22,800) / \$25,000 = 1.31$

- d. Lang's liquidity position is satisfactory as its current ratio meets the industry norm, and its quick ratio is also above the industry average. The firm appears to have invested about the "right" amount in liquid assets—neither too much, nor too little.